PIABA 28th Annual Meeting

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PIABA 2019 Annual Meeting
And
Securities Law Seminar
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NASAA 2019 Model Rules
And
NASAA 2019 Enforcement Report

Joseph P. Borg, Director
Alabama Securities Commission

PIABA 2019 Annual Meeting and Securities Law Seminar
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NASAA 2019 Enforcement Report

SECTION ONE

NASAA Prohibited Conduct of Investment Advisers, Investment Adviser Representatives and Federal Covered Investment Advisers
Model Rule USA 2002 502(b)
Adopted 9/17/2008, amended 11/06/17, 5/19/2019

Rule USA 2002 502(b) Prohibited Conduct in Providing Investment Advice

A person who is an investment adviser, an investment adviser representative or a federal covered investment adviser is a fiduciary and has a duty to act primarily for the benefit of its clients. The provisions of this subsection apply to federal covered investment advisers to the extent that the conduct alleged is fraudulent, deceptive, or as otherwise permitted by the National Securities Markets Improvement Act of 1996. While the extent and nature of this duty varies according to the nature of the relationship between an investment adviser, an investment adviser representative or a federal covered investment adviser and its clients and the circumstances of each case, an investment adviser, an investment adviser representative or a federal covered investment adviser shall not engage in prohibited fraudulent, deceptive, or manipulative conduct, including but not limited to the following:

(a) Recommending to a client to whom investment advisory services are provided the purchase, sale or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the client on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known by the investment adviser, investment adviser representative or federal covered investment adviser.

(b) Exercising any discretionary authority in placing an order for the purchase or sale of securities for a client without obtaining written discretionary authority from the client within ten (10) business days after the date of the first transaction placed pursuant to oral discretionary authority, unless the discretionary authority relates solely to the price at which, or the time when, an order involving a definite amount of a specified security shall be executed, or both.

(c) Inducing trading in a client's account that is excessive in size or frequency in view of the financial resources, investment objectives and character of the account.[1]

(d) Placing an order to purchase or sell a security for the account of a client without authority to do so.

(e) Placing an order to purchase or sell a security for the account of a client upon instruction of a third party without first having obtained a written third-party trading authorization from the client.

(f) Borrowing money or securities from a client unless the client is a broker-dealer, an affiliate of the investment adviser or a financial institution engaged in the business of loaning funds.

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[1] The rule appropriately forbids an excessive number of transaction orders to be induced by an adviser for a "customer's account" in light of the fact that an investment adviser or an investment adviser representative in such situations can directly benefit from the number of securities transactions effected in a client's account.

(g) Loaning money or securities to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser.

(h) Misrepresenting to any client, or prospective client, the qualifications of the investment adviser, investment adviser representative, federal covered investment adviser, or any employee, or person affiliated with the investment adviser, investment adviser representative or federal covered investment adviser, or misrepresenting the nature of the advisory services being offered or fees to be charged for such service, or to omit to state a material fact necessary to make the statements made regarding qualifications, services or fees, in light of the circumstances under which they are made, not misleading.

(i) Providing a report or recommendation to any client prepared by someone other than the investment adviser, investment adviser representative or federal covered investment adviser without disclosing that fact. This prohibition does not apply to a situation where the investment adviser, investment adviser representative or federal covered investment adviser uses published research reports or statistical analyses to render advice or where an investment adviser, investment adviser representative or federal covered investment adviser orders such a report in the normal course of providing service.

(j) Charging a client an unreasonable fee.

(k) Failing to disclose to clients in writing before any advice is rendered any material conflict of interest relating to the investment adviser, investment adviser representative or federal covered investment adviser, or any of its employees, or affiliated persons which could reasonably be expected to impair the rendering of unbiased and objective advice including but not limited to:

(1) Compensation arrangements connected with investment advisory services to clients which are in addition to compensation from such clients for such services; and

(2) Charging a client an investment advisory fee for rendering investment advice when compensation for effecting securities transactions pursuant to such advice will be received by the investment adviser, investment adviser representative or federal covered investment adviser or its employees, or affiliated persons.

(l) While acting as principal for its own advisory account, to knowingly sell any security to or purchase any security from a client, or while acting as broker-dealer for a person other than the client, to knowingly effect any sale or purchase of any security for the account of the client, without disclosing to the client in writing before the completion of the transaction the capacity in which it is acting and obtaining the consent of the client to the transaction.

(1) The prohibitions of this subsection shall not apply to any transaction with a customer of a broker-dealer if the broker-dealer is not acting as an investment adviser in relation to the transaction.[2]

(2) The prohibitions of this subsection shall not apply to any transaction with a

[2] Note: 1956 Act § 102(a)(3) not included in 2002 Act.

customer of a broker-dealer if the broker-dealer acts as an investment adviser solely:

(A) by means of publicly distributed written materials or publicly made oral statements;

(B) by means of written materials or oral statements not purporting to meet the objectives or needs of specific individuals or accounts;

(C) through the issuance of statistical information containing no expressions of opinion as to the investment merits of a particular security; or

(D) any combination of the foregoing services.[3]

(3) Publicly distributed written materials or publicly made oral statements shall disclose that, if the purchaser of the advisory communication uses the investment adviser's services in connection with the sale or purchase of a security which is a subject of the communication, the investment adviser may act as principal for its own account or as agent for another person. Compliance by the investment adviser with the foregoing disclosure requirement shall not relieve it of any other disclosure obligations under the Act.[4]

(4) Definitions for purposes of this Rule,

(A) "Publicly distributed written materials" means written materials which are distributed to 35 or more persons who pay for those materials.

(B) "Publicly made oral statements" means oral statements made simultaneously to 35 or more persons who pay for access to those statements.

(m) The prohibitions of this Rule shall not apply to an investment adviser effecting an agency cross transaction for an advisory client provided the following conditions are met:[5]

(1) The advisory client executes a written consent prospectively authorizing the investment adviser to effect agency cross transactions for such client;

(2) Before obtaining such written consent from the client, the investment adviser makes full written disclosure to the client that, with respect to agency cross transactions, the investment adviser will act as broker-dealer for, receive commissions from and have a potentially conflicting division of loyalties and responsibilities regarding both parties to the transactions;

(3) At or before the completion of each agency cross transaction, the investment adviser or any other person relying on this rule sends the client a written confirmation. The written confirmation shall include:

(A) A statement of the nature of the transaction;

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[3] Note: 1956 Rule 102(f)-2(b) not included in 2002 Act.

[4] Note: 1956 Rule 102(f)-2(c).

[5] Note: 1956 Rule 102(f)-1.

(B) The date the transaction took place;

(C) An offer to furnish, upon request, the time when the transaction took place; and

(D) The source and amount of any other remuneration the investment adviser received or will receive in connection with the transaction. In the case of a purchase, if the investment adviser was not participating in a distribution, or, in the case of a sale, if the investment adviser was not participating in a tender offer, the written confirmation may state whether the investment adviser has been receiving or will receive any other remuneration and that the investment adviser will furnish the source and amount of such remuneration to the client upon the client's written request;

(4) At least annually, and with or as part of any written statement or summary of the account from the investment adviser, the investment adviser or any other person relying on this rule sends each client a written disclosure statement identifying:

(A) The total number of agency cross transactions during the period for the client since the date of the last such statement or summary; and

(B) The total amount of all commissions or other remuneration the investment adviser received or will receive in connection with agency cross transactions for the client during the period.

(5) Each written disclosure and confirmation required by this rule must include a conspicuous statement that the client may revoke the written consent required under subsection (m)(1) of this rule at any time by providing written notice to the investment adviser.

(6) No agency cross transaction may be effected in which the same investment adviser recommended the transaction to both any seller and any purchaser.

(7) For purposes of this rule, "agency cross transaction for an advisory client" means a transaction in which a person acts as an investment adviser in relation to a transaction in which the investment adviser, or any person controlling, controlled by, or under common control with such investment adviser, including an investment adviser representative, acts as a broker-dealer for both the advisory client and another person on the other side of the transaction. When acting in such capacity such person is required to be registered [licensed] as a broker-dealer in this state unless excluded from the definition.

(8) Nothing in this rule shall be construed to relieve an investment adviser or investment adviser representative from acting in the best interests of the client, including fulfilling his duty with respect to the best price and execution for the particular transaction for the client nor shall it relieve any investment adviser or investment adviser representative of any other disclosure obligations imposed by the Act.

(n) Guaranteeing a client that a specific result will be achieved with advice rendered.

(o) **[Alternative 1]** Publishing, circulating or distributing any advertisement which does not comply with Rule 206(4)-1 under the Investment Advisers Act of 1940.

(o) **[Alternative 2]** Publishing, circulating or distributing any advertisement which directly or indirectly does any one of the following:

(1) Refers to any testimonial of any kind concerning the investment adviser, investment adviser representative or federal covered investment adviser, or concerning any advice, analysis, report, or other service rendered by such investment adviser or investment adviser representative.

(2) Refers to past specific recommendations of the investment adviser, investment adviser representative or federal covered investment adviser that were or would have been profitable to any person; except that an investment adviser or investment adviser representative may furnish or offer to furnish a list of all recommendations made by the investment adviser, investment adviser representative or federal covered investment adviser within the immediately preceding period of not less than one year if the advertisement or list also includes both of the following:

(A) The name of each security recommended, the date and nature of each recommendation, the market price at that time, the price at which the recommendation was to be acted upon, and the most recently available market price of each such security.

(B) A legend on the first page in prominent print or type that states that the reader should not assume that recommendations made in the future will be profitable or will equal the performance of the securities in the list.

(3) Represents that any graph, chart, formula, or other device being offered can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them; or which represents, directly or indirectly, that any graph, chart, formula, or other device being offered will assist any person in making that person's own decisions as to which securities to buy or sell, or when to buy or sell them, without prominently disclosing in such advertisement the limitations thereof and the difficulties with respect to its use.

(4) Represents that any report, analysis, or other service will be furnished for free or without charge, unless such report, analysis, or other service actually is or will be furnished entirely free and without any direct or indirect condition or obligation.

(5) Represents that the [Administrator] has approved any advertisement.

(6) Contains any untrue statement of a material fact, or that is otherwise false or misleading.

(7) For the purposes of this section, the term "advertisement" shall include any notice, circular, letter, or other written communication addressed to more than one person, or any notice or other announcement in any electronic or paper publication, by

radio or television, or by any medium, that offers any one of the following:

(A) Any analysis, report, or publication concerning securities.

(B) Any analysis, report, or publication that is to be used in making any determination as to when to buy or sell any security or which security to buy or sell.

(C) Any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell.

(D) Any other investment advisory service with regard to securities.

(p) Making, in the solicitation of clients, any untrue statement of a material fact, or omitting to state a material fact necessary in order to make the statement made, in light of the circumstances under which they are made, not misleading.[6]

(q) Failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information contrary to the provisions of Section 204A of the Investment Advisers Act of 1940.

(r) Disclosing the identity, investments, or other financial information of any client or former client unless required by law to do so, or unless consented to by the client.

(s) Taking any action, directly or indirectly, with respect to those securities or funds in which any client has any beneficial interest, where the investment adviser has custody or possession of such securities or funds when the action of the investment adviser or investment adviser representative is subject to and does not comply with the requirements of Rule 411(f)-1.

(t) Engaging in any act, practice, or course of business which is fraudulent, deceptive, manipulative or unethical.

(u) Engaging in conduct or any act, indirectly or through or by any other person, which would be unlawful for such person to do directly under the provisions of the Act or any rule or regulation thereunder.

(v) Accessing a client's account by using the client's own unique identifying information (such as username and password).*

(w) Failing to establish, maintain, and enforce a required policy or procedure.

* This rule amendment is not intended to apply to data aggregation software where: (a) the investment

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[6] Note: 1956 Act § 102(b).

adviser does not know, or have access to, the client's password(s); (b) there is an agreement between the data aggregation software company and the custodian(s)/online account platform which permits this
"back-door" access; and (c) the data is read-only (*i.e.*, the investment adviser can only view the information and cannot effectuate any changes to the client's underlying account(s)).

56 Act cross reference 102(a)(4)-1

SECTION TWO

INVESTMENT ADVISER INFORMATION SECURITY AND PRIVACY RULE

Adopted 5/19/2019

(a) **Physical Security and Cybersecurity Policies and Procedures.** Every investment adviser registered or required to be registered shall establish, implement, update, and enforce written physical security and cybersecurity policies and procedures reasonably designed to ensure the confidentiality, integrity, and availability of physical and electronic records and information. The policies and procedures must be tailored to the investment adviser's business model, taking into account the size of the firm, type(s) of services provided, and the number of locations of the investment adviser.

(1) The physical security and cybersecurity policies and procedures must:

(A) Protect against reasonably anticipated threats or hazards to the security or integrity of client records and information;

(B) Ensure that the investment adviser safeguards confidential client records and information; and

(C) Protect any records and information the release of which could result in harm or inconvenience to any client.

(2) The physical security and cybersecurity policies and procedures must cover at least five functions:

(A) Identify. Develop the organizational understanding to manage information security risk to systems, assets, data, and capabilities;

(B) Protect. Develop and implement the appropriate safeguards to ensure delivery of critical infrastructure services;

(C) Detect. Develop and implement the appropriate activities to identify the occurrence of an information security event;

(D) Respond. Develop and implement the appropriate activities to take action regarding a detected information security event; and

(E) Recover. Develop and implement the appropriate activities to maintain plans for resilience and to restore any capabilities or services that were impaired due to an information security event.

(3) **Maintenance.** The investment adviser must review, no less frequently than annually, and modify, as needed, these policies and procedures to ensure the adequacy of the security measures and the effectiveness of their implementation.

(b) **Privacy Policy.** The investment adviser must deliver upon the investment adviser's engagement by a client, and on an annual basis thereafter, a privacy policy to each client that is reasonably designed to aid in the client's understanding of how the investment adviser collects and shares, to the extent permitted by state and federal law, non-public personal information. The investment adviser must promptly update and deliver to each client an amended privacy policy if any of the information in the policy becomes inaccurate.

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Cybersecurity Checklist for Investment Advisers

Identify Protect Detect Respond Recover

Identify: Risk Assessments & Management	YES	NO	N/A
1. Risk assessments are conducted frequently (e.g. annually, quarterly).			
2. Cybersecurity is included in the risk assessment.			
3. The risk assessment includes a review of the data collected or created, where the data is stored, and if the data is encrypted.			
4. Internal "insider" risk (e.g. disgruntled employees) and external risks are included in the risk assessment.			
5. The risk assessment includes relationships with third parties.			
6. Adequate policies and procedures demonstrate expectations of employees regarding cybersecurity practices (e.g. frequent password changes, locking of devices, reporting of lost or stolen devices, etc.).			
7. Primary and secondary person(s) are assigned as the central point of contact in the event of a cybersecurity incident.			
8. Specific roles and responsibilities are tasked to the primary and secondary person(s) regarding a cybersecurity incident.			
9. The firm has an inventory of all hardware and software.			
Protect: Use of Electronic Mail	YES	NO	N/A
1. Identifiable information of a client is transmitted via email.			
2. Authentication practices for access to email on all devices (computer and mobile devices) is required.			
3. Passwords for access to email are changed frequently (e.g. monthly, quarterly).			
4. Policies and procedures detail how to authenticate client instructions received via email.			

The information provided herein is for your convenience only, is illustrative, and is not intended as legal advice.

5. Email communications are secured. (If the response is no, proceed to the next question.)			
6. Employees and clients are aware that email communication is not secured.			
Protect: Devices	YES	NO	N/A
1. Device access (physical and digital) is permitted for authorized users, including personnel and clients.			
2. Device access is routinely audited and updated appropriately.			
3. Devices are routinely backed up and underlying data is stored in a separate location (i.e. on an external drive, in the cloud, etc.)			
4. Backups are routinely tested.			
5. The investment adviser has written policies and procedures regarding destruction of electronic data and physical documents.			
6. Destruction of electronic data and physical documents are destroyed in accordance with written policies and procedures.			
Protect: Use of Cloud Services	YES	NO	N/A
1. Due diligence has been conducted on the cloud service provider prior to signing an agreement or contract.			
2. As part of the due diligence, the investment adviser has evaluated whether the cloud service provider has safeguards against breaches and a documented process in the event of breaches.			
3. The investment adviser has a business relationship with the cloud service provider and has the contact information for that entity.			
4. The investment adviser is aware of the assignability terms of the contract.			
5. The investment adviser understands how the firm's data is segregated from other entities' data within the cloud service.			
6. The investment adviser is familiar with the restoration procedures in the event of a breach or loss of data stored through the cloud service.			
7. The investment adviser has written policies and procedures in the event that the cloud service provider is purchased, closed, or otherwise unable to be accessed.			

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8. The investment adviser solely relies on free cloud storage.			
9. The investment adviser has a back-up of all records off-site.			
10. Data containing sensitive or personally identifiable information is stored through a cloud service.			
11. Data containing sensitive or personally identifiable information, which is stored through a cloud service, is encrypted.			
12. The investment adviser has written policies and procedures related to the use of mobile devices by staff who access data in the cloud.			
13. The cloud service provider (or its staff) may access and/or view the investment adviser's data stored in the cloud.			
14. The investment adviser allows remote access to its network (e.g. through use of VPN).			
15. The VPN access of employees is monitored.			
16. The investment adviser has written policies and procedures related to the termination of VPN access when an employee resigns or is terminated.			
Protect: Use of Firm Websites	YES	NO	N/A
1. The investment adviser relies on a parent or affiliated company for the construction and maintenance of the website.			
2. The investment adviser relies on internal personnel for the construction and maintenance of the website.			
3. The investment adviser relies on a third-party vendor for the construction and maintenance of the website.			
4. If the investment adviser relies on a third party for website maintenance, there is an agreement with the third party regarding the services and the confidentiality of information.			
5. The investment adviser can directly make changes to the website.			
6. The investment adviser can directly access the domain renewal information and the security certificate information.			
7. The firm's website is used to access client information.			

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8. SSL or other encryption is used when accessing client information on the firm's website.			
9. The firm's website includes a client portal.			
10. SSL or other encryption is used when accessing a client portal.			
11. When accessing the client portal, user authentication credentials (i.e., user name and password) are encrypted.			
12. Additional authentication credentials (i.e., challenge questions, etc.) are required when accessing the client portal from an unfamiliar network or computer.			
13. The investment adviser has written policies and procedures related to a denial of service issue.			
Protect: Custodians & Other Third-Party Vendors	YES	NO	N/A
1. The investment adviser's due diligence on third parties includes cybersecurity as a component.			
2. The investment adviser has requested vendors to complete a cybersecurity questionnaire, with a focus on issues of liability sharing and whether vendors have policies and procedures based on industry standards.			
3. The investment adviser understands that the vendor has IT staff or outsources some of its functions.			
4. The investment adviser has obtained a written attestation from the vendor that it uses software to ensure customer data is protected.			
5. The investment adviser has inquired whether a vendor performs a cybersecurity risk assessment or audit on a regular basis.			
6. The cyber-security terms of the agreement with an outside vendor is not voided because of the actions of an employee of the investment adviser.			
7. Confidentiality agreements are signed by the investment adviser and third-party vendors.			
8. The investment adviser has been provided enough information to assess the cybersecurity practices of any third-party vendors.			
9. [Relevant to custodians only] The investment adviser has discussed with the custodian matters regarding impersonation of clients and authentication of client orders.			

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Protect: Encryption	YES	NO	N/A
1. The investment adviser routinely consults with an IT professional knowledgeable in cybersecurity.			
2. The investment adviser has written policies and procedures in place to categorize data as either confidential or non-confidential.			
3. The investment adviser has written policies and procedures in place to address data security and/or encryption requirements.			
4. The investment adviser has written policies and procedures in place to address the physical security of confidential data and systems containing confidential data (i.e., servers, laptops, tablets, removable media, etc.).			
5. The investment adviser utilizes encryption on all data systems that contain (or access) confidential information.			
6. The identities and credentials for authorized users are monitored.			
Detect: Anti-Virus Protection and Firewalls	YES	NO	N/A
1. The investment adviser firm regularly use anti-virus software on all devices accessing the firm's network, including mobile phones.			
2. The investment adviser firm regularly use anti-virus software on all devices accessing the firm's network, including mobile phones.			
3. The investment adviser understands how the anti-virus software deploys and how to handle alerts.			
4. The investment adviser understands how the anti-virus software deploys and how to handle alerts.			
5. Anti-virus updates are run on a regular and continuous basis.			
6. All software is scheduled to update.			
7. Employees are trained and educated on the basic function of anti-virus programs and how to report potential malicious events.			
8. If the alerts are set up by an outside vendor, there is an ongoing relationship between the vendor and the investment adviser to ensure continuity and updates.			

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9. A firewall is employed and configured appropriate to the firm's needs.			
10. The firm has policies and procedures to address flagged network events.			
Respond: Responding to a Cyber Event	YES	NO	N/A
1. The investment adviser has a plan and procedure for immediately notifying authorities in the case of a disaster or security incident.			
2. The plans and procedures identify which authorities should be contacted based on the type of incident and who should be responsible for initiating those contacts.			
3. The investment adviser has a communications plan, which identifies who will speak to the public/press in the case of an incident and how internal communications will be managed.			
4. The communications plan identifies the process for notifying clients.			
Recover: Cyber-insurance	YES	NO	N/A
1. The investment adviser has considered whether cyber-insurance is necessary or appropriate for the firm.			
2. The firm has evaluated the coverage in a cybersecurity insurance policy to determine whether it covers breaches, including; breaches by foreign cyber intruders; insider breaches (e.g. an employee who steals sensitive data); and breaches as a result of third-party relationships.			
3. The cybersecurity insurance policy covers notification (clients and regulators) costs.			
4. The investment adviser has evaluated whether the policy includes first-party coverage (e.g. damages associated with theft, data loss, hacking and denial of service attacks) or third-party coverage (e.g. legal expenses, notification expenses, third-party remediation expenses).			
5. The exclusions of the cybersecurity insurance policy are appropriate for the investment adviser's business model.			
6. The investment adviser has put into place all safeguards necessary to ensure that the cyber-security policy is not voided through investment adviser employee actions, such as negligent computer security where software patches and updates are not installed in a timely manner.			

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Recover: Disaster Recovery	YES	NO	N/A
1. The investment adviser has a business continuity plan to implement in the event of a cybersecurity event.			
2. The investment adviser has a process for retrieving backed up data and archival copies of information.			
3. The investment adviser has written policies and procedures for employees regarding the storage and archival of information.			
4. The investment adviser provides training on the recovery process.			

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SECTION THREE

NASAA Recordkeeping Requirements For Investment Advisers Model Rule 203(a)-2

Adopted 9/3/87, amended 5/3/99, 4/18/04, 9/11/05; Amended 9/11/2011; Amended 5/19/2019

NOTE: Italicized information is explanatory and not intended for inclusion in the rule text. Language based on the Uniform Securities Act of 1956, as amended.

Rule 203(a)-2 Recordkeeping Requirements [ALTERNATIVE 1]:

(a) Every investment adviser registered or required to be registered under the Act shall make and keep true, accurate and current the following books, ledgers and records:

1. A journal or journals, including cash receipts and disbursements records, and any other records of original entry forming the basis of entries in any ledger.

2. General and auxiliary ledgers (or other comparable records) reflecting asset, liability, reserve, capital, income and expense accounts.

3. A memorandum of each order given by the investment adviser for the purchase or sale of any security, of any instruction received by the investment adviser from the client concerning the purchase, sale, receipt or delivery of a particular security, and of any modification or cancellation of any such order or instruction. The memoranda shall show the terms and conditions of the order, instruction, modification or cancellation; shall identify the person connected with the investment adviser who recommended the transaction to the client and the person who placed the order; and shall show the account for which entered, the date of entry, and the bank, broker-dealer by or through whom executed where appropriate. Orders entered pursuant to the exercise of discretionary power shall be so designated.

4. All check books, bank statements, canceled checks and cash reconciliations of the investment adviser.

5. All bills or statements (or copies of), paid or unpaid, relating to the investment adviser's business as an investment adviser.

6. All trial balances, financial statements prepared in accordance with generally accepted accounting principles, and internal audit working papers relating to the investment adviser's business as an investment adviser. For purposes of this subsection, "financial statements" shall mean a balance sheet prepared in accordance with generally accepted accounting principles, an income statement, a cash flow statement and a net worth computation, if applicable, as required by Rule 202(d)-1 of this Act.

7. Originals of all written communications received and copies of all written communications sent by the investment adviser relating to (A) any recommendation made or proposed to be made and any advice given or proposed to be given, (B) any receipt, disbursement or delivery of funds or securities, or (C) the placing or execution of any order to purchase or sell any security, provided, however, (i) that the investment adviser shall not be required to keep any unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser, and (ii) that if the investment adviser sends any notice, circular or other advertisement offering any report, analysis, publication or other investment advisory

service to more than 10 persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if the notice, circular or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of the notice, circular or advertisement a memorandum describing the list and its source.

8. A list or other record of all accounts which list identifies the accounts in which the investment adviser is vested with any discretionary power with respect to the funds, securities or transactions of any client.

9. A copy of all powers of attorney and other evidences of the granting of any discretionary authority by any client to the investment adviser.

10. A copy in writing of each agreement entered into by the investment adviser with any client, and all other written agreements otherwise relating to the investment adviser's business as an investment adviser.

11. A file containing a copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication including by electronic media that the investment adviser circulates or distributes, directly or indirectly, to two or more persons (other than persons connected with the investment adviser), and if the notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication including by electronic media recommends the purchase or sale of a specific security and does not state the reasons for the recommendation, a memorandum of the investment adviser indicating the reasons for the recommendation.

12. (A) A record of every transaction in a security in which the investment adviser or any advisory representative (as hereinafter defined) of the investment adviser has, or by reason of any transaction acquires, any direct or indirect beneficial ownership, except

i. transactions effected in any account over which neither the investment adviser nor any advisory representative of the investment adviser has any direct or indirect influence or control; and

ii. transactions in securities which are direct obligations of the United States. The record shall state the title and amount of the security involved; the date and nature of the transaction (i.e. purchase, sale or other acquisition or disposition); the price at which it was effected; and the name of the broker-dealer or bank with or through whom the transaction was effected. The record may also contain a statement declaring that the reporting or recording of any transaction shall not be construed as an admission that the investment adviser or advisory representative has any direct or indirect beneficial ownership in the security. A transaction shall be recorded not later than 10 days after the end of the calendar quarter in which the transaction was effected.

(B) For purposes of this subdivision (12) the following definitions will apply. The term "advisory representative" shall mean any partner, officer or director of the investment adviser; any employee who participates in any way in the determination of which recommendations shall be made; any employee who, in connection with his duties, obtains any information concerning which securities are being recommended prior to the effective dissemination of the recommendations; and any of the following persons who obtain information concerning securities recommendations being made by the investment adviser

prior to the effective dissemination of the recommendations:

i. any person in a control relationship to the investment adviser,

ii. any affiliated person of a controlling person and

iii. any affiliated person of an affiliated person.

Control" shall mean the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 % of the voting securities of a company shall be presumed to control such company.

(C) An investment adviser shall not be deemed to have violated the provisions of this subdivision (12) because of the failure to record securities transactions of any advisory representative if the investment adviser establishes that it instituted adequate procedures and used reasonable diligence to obtain promptly reports of all transactions required to be recorded.

13. (A) Notwithstanding the provisions of subdivision (12) above, where the investment adviser is primarily engaged in a business or businesses other than advising investment advisory clients, a record must be maintained of every transaction in a security in which the investment adviser or any advisory representative (as hereinafter defined) of the investment adviser has, or by reason of any transaction acquires, any direct or indirect beneficial ownership, except

i. transactions effected in any account over which neither the investment adviser nor any advisory representative of the investment adviser has any direct or indirect influence or control; and

ii. transactions in securities which are direct obligations of the United States.

(B) The record shall state the title and amount of the security involved; the date and nature of the transaction (i.e. purchase, sale, or other acquisition or disposition); the price at which it was effected; and the name of the broker-dealer or bank with or through whom the transaction was effected. The record may also contain a statement declaring that the reporting or recording of any transaction shall not be construed as an admission that the investment adviser or advisory representative has any direct or indirect beneficial ownership in the security. A transaction shall be recorded not later than 10 days after the end of the calendar quarter in which the transaction was effected.

(C) An investment adviser is "primarily engaged in a business or businesses other than advising investment advisory clients" when, for each of its most recent three fiscal years or for the period of time since organization, whichever is lesser, the investment adviser derived, on an unconsolidated basis, more than 50% of

i. its total sales and revenues, and

ii.its income (or loss) before income taxes and extraordinary items, from such

other business or businesses.

(D) For purposes of this subdivision (13) the following definitions will apply. The term "advisory representative", when used in connection with a company primarily engaged in a business or businesses other than advising investment advisory clients, shall mean any partner, officer, director or employee of the investment adviser who participates in any way in the determination of which recommendation shall be made, or whose functions or duties relate to the determination of which securities are being recommended prior to the effective dissemination of the recommendations; and any of the following persons, who obtain information concerning securities recommendations being made by the investment adviser prior to the effective dissemination of such the recommendations or of the information concerning the recommendations:

i. any person in a control relationship to the investment adviser,

ii. any affiliated person of a controlling person and

iii. any affiliated person of an affiliated person.

"Control" shall mean the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 percent of the voting securities of a company shall be presumed to control such company.

(E) An investment adviser shall not be deemed to have violated the provisions of this subdivision (13) because of the failure to record securities transactions of any advisory representative if the investment adviser establishes that it instituted adequate procedures and used reasonable diligence to obtain promptly reports of all transactions required to be recorded.

14. A copy of each written statement and each amendment or revision, given or sent to any client or prospective client of the investment adviser in accordance with the provisions of Rule 203(b)1 of this Act, and a record of the dates that each written statement, and each amendment or revision, was given, or offered to be given, to any client or prospective client who subsequently becomes a client.

15. For each client that was obtained by the adviser by means of a solicitor to whom a cash fee was paid by the adviser

(A) evidence of a written agreement to which the adviser is a party related to the payment of such fee;

(B) a signed and dated acknowledgment of receipt from the client evidencing the client's receipt of the investment adviser's disclosure statement and a written disclosure statement of the solicitor; and,

(C) a copy of the solicitor's written disclosure statement. The written agreement, acknowledgment and solicitor disclosure statement will be considered to be in

compliance if such documents are in compliance with Rule 275.206(4)-3 of the Investment Advisers Act of 1940. For purposes of this rule, the term "solicitor" shall mean any person or entity who, for compensation, acts as an agent of an investment adviser in referring potential clients.

16. All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication including but not limited to electronic media that the investment adviser circulates or distributes, directly or indirectly, to two or more persons (other than persons connected with the investment adviser); provided, however, that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts shall be deemed to satisfy the requirements of this paragraph.

17. A file containing a copy of all written communications received or sent regarding any litigation involving the investment adviser or any investment adviser representative or employee, and regarding any written customer or client complaint.

18. Written information about each investment advisory client that is the basis for making any recommendation or providing any investment advice to such client.

19. Written procedures to supervise the activities of employees and investment adviser representatives that are reasonably designed to achieve compliance with applicable securities laws and regulations.

20. A file containing a copy of each document (other than any notices of general dissemination) that was filed with or received from any state or federal agency or self regulatory organization and that pertains to the registrant or its investment adviser representatives as that term is defined in subdivision (a)(12)(A) of this Rule, which file should contain, but is not limited to, all applications, amendments, renewal filings, and correspondence.

21. Copies, with original signatures of the investment adviser's appropriate signatory and the investment adviser representative, of each initial Form U-4 and each amendment to Disclosure Reporting Pages (DRPs U-4) must be retained by the investment adviser (filing on behalf of the investment adviser representative) and must be made available for inspection upon regulatory request.

22. Where the adviser inadvertently held or obtained a client's securities or funds and returned them to the client within three business days or has forwarded third party checks within 24 hours the adviser will be considered as not having custody but shall keep the following records relating to the inadvertent custody:

A ledger or other listing of all securities or funds held or obtained, including the following information:

(A) Issuer;

(B) Type of security and series; Date of issue;

(C) For debt instruments, the denomination, interest rate and maturity date;

(D) Certificate number, including alphabetical prefix or suffix;

(E) Name in which registered;

(F) Date given to the adviser;

(G) Date sent to client or sender;

(H) Form of delivery to client or sender, or copy of the form of delivery to client or sender; and

(I) Mail confirmation number, if applicable, or confirmation by client or sender of the fund's or security's return.

23. If an investment adviser obtains possession of securities that are acquired from the issuer in a transaction or chain of transactions not involving any public offering that comply with the exception from custody under NASAA Model Rule 102(e)((1)-1(b)(2), the adviser shall keep the following records;

(A) A record showing the issuer or current transfer agent's name address, phone number and other applicable contract information pertaining to the party responsible for recording client interests in the securities; and

(B) A copy of any legend, shareholder agreement or other agreement showing that those securities that are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

24. (A) A copy of the investment adviser's Physical Security and Cybersecurity Policies and Procedures and Privacy Policy pursuant to [INSERT RULE CITATION]. In addition to the investment adviser's recordkeeping requirements pursuant to sections (e) and (g) of this rule, the investment adviser must maintain a current copy of these policies and procedures either in hard copy in a separate location or stored on electronic storage media that is separate from and not dependent upon access to the investment adviser's computers or a network;

(B) All records documenting the investment adviser's compliance with [INSERT RULE CITATION], including, but not limited to, evidence of the annual review of the policies and procedures;

(C) A record of any violation of the [INSERT RULE CITATION], and of any action taken as a result of the violation.

(b) 1. If an investment adviser has custody, as that term is defined in NASAA Model Rule 102(e)(1)-1(d)(2), of the NASAA Custody Rules, the records required to be made and kept under paragraph (a) above shall include:

(A) A copy of any and all documents executed by the client (including a limited power of attorney) under which the adviser is authorized or permitted to withdraw a client's funds or securities maintained with a custodian upon the adviser's instruction to the custodian.

(B) A journal or other record showing all purchases, sales, receipts and deliveries of securities (including certificate numbers) for all accounts and all other debits and credits to the accounts.

(C) A separate ledger account for each client showing all purchases, sales, receipts and deliveries of securities, the date and price of each purchase and sale, and all debits and credits.

(D) Copies of confirmations of all transactions effected by or for the account of any client.

(E) A record for each security in which any client has a position, which record shall show the name of each client having any interest in each security, the amount or interest of each client, and the location of each security.

(F) A copy of each of the client's quarterly account statements, as generated and delivered by the qualified custodian. If the adviser also generates a statement that is delivered to the client, the adviser shall also maintain copies of such statements along with the date such statements were sent to the clients. If applicable to the adviser's situation, a copy of the special examination report verifying the completion of the examination by an independent certified public accountant and describing the nature and extent of the examination.

(G) A record of any finding by the independent certified public accountant of any material discrepancies found during the examination.

(H) If applicable, evidence of the client's designation of an independent representative.

2. If an investment adviser has custody because it advises a pooled investment vehicle, as defined in Rule 102(e)(1)-1(d)(2)(A)(iii), the adviser shall also keep the following records:

(A) True, accurate and current account statements;

(B) Where the adviser complies with Rule 102(e)(1)-1(b)(4) the records required to be made and kept shall include:

i. the date(s) of the audit;

ii. a copy of the audited financial statements; and

iii. evidence of the mailing of the audited financial to all limited partners, members or other beneficial owners within 120 days of the end of its fiscal year.

(C) Where the adviser complies with rule 102(e)(1)-1(a)(5) the records required

to be made and kept shall include:

i. A copy of the written agreement with the independent party reviewing all fees and expenses, indicating the responsibilities of the independent third party.

ii. Copies of all invoices and receipts showing approval by the independent party for payment through the qualified custodian.

(c) Every investment adviser subject to subsection (a) of this Rule who renders any investment supervisory or management service to any client shall, with respect to the portfolio being supervised or managed and to the extent that the information is reasonably available to or obtainable by the investment adviser, make and keep true, accurate and current:

1. Records showing separately for each client the securities purchased and sold, and the date, amount and price of each purchase and sale.

2. For each security in which any client has a current position, information from which the investment adviser can promptly furnish the name of each the client, and the current amount or interest of the client.

(d) Any books or records required by this Rule may be maintained by the investment adviser in such manner that the identity of any client to whom the investment adviser renders investment supervisory services is indicated by numerical or alphabetical code or some similar designation.

(e) Every investment adviser subject to subsection (a) of this rule shall preserve the following records in the manner prescribed:

1. All books and records required to be made under the provisions of paragraph (a) to (c)(1), inclusive, of this Rule (except for books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this Rule), shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on record, the first two years in the principal office of the investment adviser.

2. Partnership articles and any amendments, articles of incorporation, charters, minute books, and stock certificate books of the investment adviser and of any predecessor, shall be maintained in the principal office of the investment adviser and preserved until at least three years after termination of the enterprise.

3. Books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this Rule shall be maintained and preserved in an easily accessible place for a period of not less than five years, the first two years in an the principal office of the investment adviser, from the end of the fiscal year during which the investment adviser last published or otherwise disseminated, directly or indirectly, the notice, circular,

advertisement, newspaper article, investment letter, bulletin, or other communication including by electronic media.

4. Books and records required to be made under the provisions of paragraphs (a)(17)-(22), inclusive, of this Rule shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in the principal office of the investment adviser, or for the time period during which the investment adviser was registered or required to be registered in the state, if less.

(f) Notwithstanding other record preservation requirements of this Rule, the following records or copies shall be required to be maintained at the business location of the investment adviser from which the customer or client is being provided or has been provided with investment advisory services: (A) records required to be preserved under paragraphs (a)(3),(a)(7)-(10), (a)(14)-(15), (a)(17)- (19), (b) and (c) inclusive, of this Rule, and (B) the records or copies required under the provision of paragraphs (a)(11) and (a)(16) of this Rule which records or related records identify the name of the investment adviser representative providing investment advice from that business location, or which identify the business locations' physical address, mailing address, electronic mailing address, or telephone number. The records will be maintained for the period described in subdivision (e) of this Rule.

(g) An investment adviser subject to subsection (a) of this Rule, before ceasing to conduct or discontinuing business as an investment adviser shall arrange for and be responsible for the preservation of the books and records required to be maintained and preserved under this Rule for the remainder of the period specified in this Rule, and shall notify the [Administrator] in writing of the exact address where the books and records will be maintained during the period.

(h) 1. Pursuant to Rule 203(a)2 (e) the records required to be maintained and preserved may be immediately produced or reproduced, and maintained and preserved for the required time, by an investment adviser on:

(A) Paper or hard copy form, as those records are kept in their original form; or

(B) Micrographic media, including microfilm, microfiche, or any similar medium; or

(C) Electronic storage media, including any digital storage medium or system that meets the terms of this section.

2. The investment adviser must:

(A) Arrange and index the records in a way that permits easy location, access, and retrieval of any particular record;

(B) Provide promptly any of the following that the [Administrator] (by its examiners or other representatives) may request:

(i) A legible, true, and complete copy of the record in the medium and format in which it is stored;
(ii) A legible, true, and complete printout of the record; and
(iii) Means to access, view, and print the records; and

(C) Separately store, for the time required for preservation of the original record, a duplicate copy of the record on any medium allowed by this section.

3. In the case of records created or maintained on electronic storage media, the investment adviser must establish and maintain procedures:

(A) To maintain and preserve the records, so as to reasonably safeguard them from loss, alteration, or destruction;

(B) To limit access to the records to properly authorized personnel and the [Administrator] (including its examiners and other representatives); and To reasonably ensure that any reproduction of a non-electronic original record on electronic storage media is complete, true, and legible when retrieved.

(i) For purposes of this Rule, "investment supervisory services" means the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client; and "discretionary power" shall not include discretion as to the price at which or the time when a transaction is or is to be effected, if, before the order is given by the investment adviser, the client has directed or approved the purchase or sale of a definite amount of the particular security.

(j) Any book or other record made, kept, maintained and preserved in compliance with Rules 17a-3 [17 C.F.R. 240.17a-3] and 17a-4 [17 C.F.R. 240.17a-4] under the Securities Exchange Act of 1934, which is substantially the same as the book or other record required to be made, kept, maintained and preserved under this Rule, shall be deemed to be made, kept, maintained and preserved in compliance with this Rule.

(k) Every investment adviser registered or required to be registered in this state and that has its principal place of business in a state other than this state shall be exempt from the requirements of this section, provided the investment adviser is licensed in such state and is in compliance with such state's recordkeeping requirements.

Rule USA 2002 411(c)-1 Recordkeeping Requirements [ALTERNATIVE 2]

(Language for states which incorporate by reference Rule 204-2 of the Investment Advisers Act of 1940)

(a) Every investment adviser registered [licensed] or required to be registered [licensed] under this Act shall make and keep true, accurate and current the following books, ledgers and records:

(1) Those books and records required to be maintained and preserved in compliance with Rule 204- 2 of the Investment Advisers Act of 1940 (17 C.F.R. 275.204-2 (1996)),

notwithstanding the fact that the investment adviser is not registered or required to be registered under the Investment Advisers Act of 1940.

(2) All trial balances, financial statements prepared in accordance with generally accepted accounting principles, and internal audit working papers relating to the investment adviser's business as an investment adviser. For purposes of this subsection, "financial statements" means balance sheets, income statements, cash flow statements and net worth computations as required by Rule 202(d)-1.

(3) A list or other record of all accounts with respect to the funds, securities, or transactions of any client.

(4) A copy in writing of each agreement entered into by the investment adviser with any client.

(5) A file containing a copy of each record required by Rule 204-2(11) of the Investment Advisers Act of 1940 including any communication by electronic media that the investment adviser circulates or distributes, directly or indirectly, to two or more persons (other than persons connected with the investment adviser)

(6) A copy of each written statement and each amendment or revision given or sent to any client or prospective client of the investment adviser in accordance with the provisions of Rule 411(g) of the Act and a record of the dates that each written statement, and each amendment or revision was given or offered to be given to any client or prospective client who subsequently becomes a client.

(7) For each client that was obtained by the adviser by means of a solicitor to whom a cash fee was paid by the adviser, records required by Rule 206(4)-3 of the Investment Advisers Act of 1940, notwithstanding the fact that the investment adviser is not registered or required to be registered under the Investment Advisers Act of 1940.

(8) All records required by Rule 204-2(16) of the Investment Advisers Act of 1940 including but not limited to electronic media that the investment adviser circulates or distributes, directly or indirectly, to two or more persons (other than persons connected with the investment adviser).

(9) A file containing a copy of all written communications received or sent regarding any litigation involving the investment adviser or any investment adviser representative or employee, and regarding any written customer or client complaint.

(10) Written information about each investment advisory client that is the basis for making any recommendation or providing any investment advice to such client.

(11) Written procedures to supervise the activities of employees and investment adviser representatives that are reasonably designed to achieve compliance with applicable securities laws and regulations.

(12) A file containing a copy of each document (other than any notices of general dissemination) that was filed with or received from any state or federal agency or self regulatory organization and that pertains to the registrant or its investment adviser representatives which file should contain, but is not limited to, all applications, amendments, renewal filings, and correspondence. For investment advisers who have custody, as that term is defined in Rule 411(f)-1(d)(2), of client funds or securities, all records and evidence of compliance required by Rule 206(4)-2 under the Investment Advisers Act of 1940.

(13) (i) A copy of the investment adviser's Physical Security and Cybersecurity Policies and Procedures and Privacy Policy pursuant to [INSERT RULE CITATION]. In addition to the investment adviser's recordkeeping requirements pursuant to sections (b) of this rule, the investment adviser must maintain a current copy of these policies and procedures either in hard copy in a separate location or stored on electronic storage media that is separate from and not dependent upon access to the investment adviser's computers or a network;

(ii) All records documenting the investment adviser's compliance with [INSERT RULE CITATION], including, but not limited to, evidence of the annual review of the policies and procedures;

(iii) A record of any violation of the [INSERT RULE CITATION], and of any action taken as a result of the violation.

(b) Every investment adviser subject to subsection (a) of this rule shall preserve for the period described in subsection (e) of this Rule the following records in the manner prescribed:

(1) Books and records required to be made under the provisions of paragraph (a)(1) of this Rule shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in the principal office of the investment adviser.

(2) Books and records required to be made under the provisions of paragraphs (a)(2)-(a)(13), inclusive, of this Rule shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in the principal office of the investment adviser, or for the time period during which the investment adviser was registered or required to be registered in the state, if less.

(3) Notwithstanding other record preservation requirements of this Rule, the following records or copies shall be required to be maintained at the business location of the investment adviser from which the customer or client is being provided or has been provided with investment advisory services:

(A) records required to be preserved under

i. paragraphs (a)(3), (a)(7)-(10), (a)(14)-(15), (b) and (c) inclusive, of SEC Rule 204-2 of the Investment Advisers Act of 1940.

ii. paragraphs (a)(9)-(11) of this Rule; and

(B) the records or copies required under the provision of paragraphs (a)(11) and (a)(16) of this Rule which records or related records identify the name of the investment adviser representative providing investment advice from that business location, or which identify the business locations' physical address, mailing address, electronic mailing address, or telephone number.

(c) To the extent that the U.S. Securities and Exchange Commission promulgates changes to the above- referenced rules of the Investment Advisers Act of 1940, investment advisers in compliance with such rules as amended shall not be subject to enforcement action by the [Administrator] for violation of this Rule to the extent that the violation results solely from the investment adviser's compliance with the amended rule.

(d) Every investment adviser that has its principal place of business in a state other than this state shall be exempt from the requirements of this section, provided the investment adviser is registered or licensed in such state and is in compliance with the state's recordkeeping requirements.

(e) Every investment adviser subject to subsection (a) of this rule shall preserve the following records in the manner prescribed:

(1) All books and records required to be made under the provisions of paragraph (a) to (c)(1), inclusive, of this Rule (except for books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this Rule), shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on record, the first two years in the principal office of the investment adviser.

(2) Partnership articles and any amendments, articles of incorporation, charters, minute books, and stock certificate books of the investment adviser and of any predecessor, shall be maintained in the principal office of the investment adviser and preserved until at least three years after termination of the enterprise.

(3) Books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this Rule shall be maintained and preserved in an easily accessible place for a period of not less than five years, the first two years in the principal office of the investment adviser, from the end of the fiscal year during which the investment adviser last published or otherwise disseminated, directly or indirectly, the notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication including by electronic media.

(4) Books and records required to be made under the provisions of paragraphs (a)(17)-(22), inclusive, of this Rule shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in the principal office of the investment adviser, or for the time period during which the investment adviser was registered or required to be registered in the state, if less.

(5) Notwithstanding other record preservation requirements of this Rule, the following records or copies shall be required to be maintained at the business location of the investment adviser from which the customer or client is being provided or has been provided with investment advisory services:

(A) records required to be preserved under paragraphs (a)(3),(a)(7)-(10), (a)(14)-(15), (a)(17)- (19), (b) and (c) inclusive, of this Rule, and

(B) the records or copies required under the provision of paragraphs (a)(11) and (a)(16) of this Rule which records or related records identify the name of the investment adviser representative providing investment advice from that business location, or which identify the business locations' physical address, mailing address, electronic mailing address, or telephone number. The records will be maintained for the period described in subsection (e) of this Rule.

SECTION FOUR

NASAA Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers
Model Rule 102(a)(4)-1

Adopted 4/27/97, amended 4/18/04, 9/11/05, 11/06/17, 5/19/2019

Rule 102(a)(4)-1 Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers

[Introduction] A person who is an investment adviser, an investment adviser representative or a federal covered adviser is a fiduciary and has a duty to act primarily for the benefit of its clients. The provisions of this subsection apply to federal covered advisers to the extent that the conduct alleged is fraudulent, deceptive, or as otherwise permitted by the National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290). While the extent and nature of this duty varies according to the nature of the relationship between an investment adviser or an investment adviser representative and its clients and the circumstances of each case, an investment adviser, an investment adviser representative or a federal covered adviser shall not engage in unethical business practices, including the following:

(a) Recommending to a client to whom investment supervisory, management or consulting services are provided the purchase, sale or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the client on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known by the investment adviser.

(b) Exercising any discretionary power in placing an order for the purchase or sale of securities for a client without obtaining written discretionary authority from the client within ten (10) business days after the date of the first transaction placed pursuant to oral discretionary authority, unless the discretionary power relates solely to the price at which, or the time when, an order involving a definite amount of a specified security shall be executed, or both.

(c) Inducing trading in a client's account that is excessive in size or frequency in view of the financial resources, investment objectives and character of the account in light of the fact that an investment adviser or an investment adviser representative in such situations can directly benefit from the number of securities transactions effected in a client's account. The rule appropriately forbids an excessive number of transaction orders to be induced by an adviser for a "customer's account."

(d) Placing an order to purchase or sell a security for the account of a client without authority to do so.

(e) Placing an order to purchase or sell a security for the account of a client upon instruction of a third party without first having obtained a written third-party trading authorization from the client. Borrowing money or securities from a client unless the client is a broker-dealer, an affiliate of the investment adviser, or a financial institution engaged in the business of loaning funds.

(f) Loaning money to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser.

(g) Misrepresenting to any advisory client, or prospective advisory client, the qualifications of the

investment adviser or any employee of the investment adviser, or misrepresenting the nature of the advisory services being offered or fees to be charged for such service, or to omit to state a material fact necessary to make the statements made regarding qualifications, services or fees, in light of the circumstances under which they are made, not misleading.

(h) Providing a report or recommendation to any advisory client prepared by someone other than the adviser without disclosing that fact. (This prohibition does not apply to a situation where the adviser uses published research reports or statistical analyses to render advice or where an adviser orders such a report in the normal course of providing service.)

(i) Charging a client an unreasonable advisory fee.

(j) Failing to disclose to clients 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 clients which are in addition to compensation from such clients for such services; and

(2.) Charging a client 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.

(k) Guaranteeing a client that a specific result will be achieved (gain or no loss) with advice which will be rendered.

(l) **[Alternative 1]** Publishing, circulating or distributing any advertisement which does not comply with Rule 206(4)-1 under the Investment Advisers Act of 1940.

(m) [Alternative 2]

(1.) Except as otherwise provided in subsection (2.), it shall constitute a dishonest or unethical practice within the meaning of [Uniform Act Sec. 102(a)(4)] for any investment adviser or investment adviser representative, directly or indirectly, to use any advertisement that does any one of the following:

(i.) Refers to any testimonial of any kind concerning the investment adviser or investment adviser representative or concerning any advice, analysis, report, or other service rendered by such investment adviser or investment adviser representative.

(ii.) Refers to past specific recommendations of the investment adviser or investment adviser representative that were or would have been profitable to any person; except that an investment adviser or investment adviser representative may furnish or offer to furnish a list of all recommendations made by the investment adviser or investment adviser representative within the immediately preceding period of not less than one year if the advertisement or list also includes both of the following:

(A) The name of each security recommended, the date and nature of each recommendation, the market price at that time, the price at which the recommendation was to be acted upon, and the most

recently available market price of each such security.

(B) A legend on the first page in prominent print or type that states that the reader should not assume that recommendations made in the future will be profitable or will equal the performance of the securities in the list.

(iii.) Represents that any graph, chart, formula, or other device being offered can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them; or which represents, directly or indirectly, that any graph, chart, formula, or other device being offered will assist any person in making that person's own decisions as to which securities to buy or sell, or when to buy or sell them, without prominently disclosing in such advertisement the limitations thereof and the difficulties with respect to its use.

(iv.) Represents that any report, analysis, or other service will be furnished for free or without charge, unless such report, analysis, or other service actually is or will be furnished entirely free and without any direct or indirect condition or obligation.

(v.) Represents that the [Administrator] has approved any advertisement.

(vi.) Contains any untrue statement of a material fact, or that is otherwise false or misleading.

(2.) With respect to federal covered advisers, the provisions of this section only apply to the extent permitted by Section 203A of the Investment Advisers Act of 1940.

(3.) For the purposes of this section, the term "advertisement" shall include any notice, circular, letter, or other written communication addressed to more than one person, or any notice or other announcement in any electronic or paper publication, by radio or television, or by any medium, that offers any one of the following:

(i.) Any analysis, report, or publication concerning securities.

(ii.) Any analysis, report, or publication that is to be used in making any determination as to when to buy or sell any security or which security to buy or sell.

(iii.) Any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell.

(iv.) Any other investment advisory service with regard to securities.

(n) Disclosing the identity, affairs, or investments of any client unless required by law to do so, or unless consented to by the client.

(o) Taking any action, directly or indirectly, with respect to those securities or funds in which any client has any beneficial interest, where the investment adviser has custody or possession of such securities or funds when the advisor's action is subject to and does not comply with the requirements of Rule 102e(1)-1. and any subsequent amendments.

(p) Entering into, extending or renewing any investment advisory contract, unless such contract is in writing and discloses, in substance, the services to be provided, the term of the contract, the advisory fee, the formula for computing the fee, the amount of prepaid fee to be returned in the event of contract termination or non-performance, whether the contract grants discretionary power to the adviser and that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract.

(q) Failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information contrary to the provisions of Section 204A of the Investment Advisers Act of 1940.

(r) Entering into, extending, or renewing any advisory contract contrary to the provisions of Section 205 of the Investment Advisers Act of 1940. This provision shall apply to all advisers and investment adviser representatives registered or required to be registered under this Act, notwithstanding whether such adviser or representative would be exempt from federal registration pursuant to Section 203(b) of the Investment Advisers Act of 1940.

(s) To indicate, in an advisory contract, any condition, stipulation, or provisions binding any person to waive compliance with any provision of this act or of the Investment Advisers Act of 1940, or any other practice contrary to the provisions of Section 215 of the Investment Advisers Act of 1940.

(t) Engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative in contrary to the provisions of Section 206(4) of the Investment Advisers Act of 1940, notwithstanding the fact that such investment adviser or investment adviser representative is not registered or required to be registered under Section 203 of the Investment Advisers Act of 1940.

(u) Engaging in conduct or any act, indirectly or through or by any other person, which would be unlawful for such person to do directly under the provisions of this act or any rule or regulation thereunder.

(v) Accessing a client's account by using the client's own unique identifying information (such as username and password).*

(w) Failing to establish, maintain, and enforce a required policy or procedure.

The conduct set forth above is not inclusive. Engaging in other conduct such as non-disclosure, incomplete disclosure, or deceptive practices shall be deemed an unethical business practice. The federal statutory and regulatory provisions referenced herein shall apply to investment advisers, investment adviser representatives and federal covered advisers to the extent permitted by the National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290).

* This rule amendment is not intended to apply to data aggregation software where: (a) the investment adviser does not know, or have access to, the client's password(s); (b) there is an agreement between the data aggregation software company and the custodian(s)/online account platform which permits this "back-door" access; and (c) the data is read-only (*i.e.*, the investment

adviser can only view the information and cannot effectuate any changes to the client's underlying account(s)).

SECTION FIVE

NASAA 2019

Enforcement Report

Based on 2018 Data

NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Introduction

NASAA at 100: What's Old is New Again

"Another Gusher will soon be flowing."

"The company owns clear unencumbered title to eighty acres of the best proved oil lands in the world, and is as sure to get oil as the stars shine."

"Should only one of these properties produce a gusher . . . the returns will be many times the capital stock of the Company. So that we claim this Company presents one of the best propositions to investors in this field."[1]

These are all statements that you would expect to hear describing an oil and gas offering. It may surprise you to know that these statements are not from current offerings in the oil and gas area but are from offerings a hundred years ago.

In 1917, the U.S. Supreme Court recognized that states had the right to pass reasonable state securities regulations, even if they affected interstate markets. Justice McKenna wrote for the Court, "the purpose being to protect the public against the imposition of unsubstantial schemes and the securities based upon them. Whatever prohibition there is is a means to the same purpose, made necessary, it may be supposed, by the persistence of evil and its insidious forms and the experience of the inadequacy of penalties or other repressive measures. The name that is given to the law indicates the evil at which it is aimed – that is, to use the language of a cited case, 'speculative schemes which have no more basis than so many feet of blue sky; ' or, as stated by counsel in another case, ' to stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines, and other like fraudulent exploitations."[2]

The More Things Change The More They Stay The Same

What's so different about scams that occurred over 100 years ago and those that we deal with on a daily basis?

Fictious Businesses

Whitaker Wright (1900) – Putting prestigious names on the boards of directors of his companies resulted in investments in his companies by the public. On paper, his companies were solvent. In reality the companies were lending money to one another to balance the books. When discovered, the shares collapsed leaving investors penniless.

Barry Minkow (1986) – Minkow took his company, ZZZZ Best, an industrial rug cleaning firm, public with a stock valuation of $200 million. ZZZZ Best did not exist and was funded through credit card thefts.

[1] *Dallas Morning News, April 18, 1901.*

[2] *Hall v. Geiger Jones Co., 242 U.S. 539 (1917); Caldwell v. Sioux Falls Stockyards Co., 242 U.S. 559 (1917); Merrick v. N.W. Halsey & Co.,242 U.S. 568 (1917).*

Ponzi Schemes

Charles Ponzi (1920) – Ponzi purchased postal coupons at a discount and sold them abroad for full price. He promised investors 50% returns in 45 days. Ponzi paid early investors with later investors' funds. Overall, investors lost nearly $10 million.

Bernie Madoff (2008) – Madoff ran an $18 billion Ponzi scheme.

Robert H. Shapiro (Woodbridge Group of Companies LLC)(2015)– Shapiro ran various Woodbridge Funds that made hard-money loans secured by commercial property. Shapiro and his Woodbridge entities raised $1.8 billion. Woodbridge was a Ponzi scheme that resulted in actions brought by multiple state securities regulators and the SEC, along with ongoing criminal prosecutions.

Juan Miguel Lopez (2018) – Lopez raised about $4.9 million involving the sale of business contracts to fund small business loans. Lopez promised investors, most of whom are Hispanic, various companies that would pay between 3% and 8% return when in fact he was operating a Ponzi scheme.

Others

Ivan Boesky (1986) – Boesky amassed a fortune of more than $200 million by betting on corporate takeovers. He was convicted of insider trading.

Bitconnect (2018) – This cryptocurrency lending program had market capitalization of more than $2.6 billion when the Texas State Securities Board and the North Carolina Secretary of State, Securities Division issued cease and desist orders. Bitconnect shuttered, citing the two orders.

Timothy Lloyd Booth (2018) – A pastor, Booth raised $23 million from mostly elderly individuals who invested in Stamedia, Inc. Booth promised a guaranteed 9% annualized return. Instead, the money was used to fund a lavish lifestyle.

Metals.com (2019) – Metals.com cold-called potential investors, mostly between 65 and 90, and advised them that their money was not safe in the hands of registered brokers or investment advisers. Seniors were urged to liquidate their funds to purchase precious metals investments. To date, more than $12.9 million of rescissions have been ordered by the Texas State Securities Board and Colorado Securities Division.

As these examples show, unscrupulous promoters continue to salt the mines to impress investors. Promoters are still paying early investors with new investor money. People are still buying real estate investments based upon artificially inflated prices.

As you look at the history of securities fraud, and peel the transactions down to the basics, the frauds all operate the same. Promoters claim to have the next new project – get in at the start, a secret process, inside information, no risk, promise high returns, or tout special skills all of which will make huge profits for those investors willing to take a chance.

In the last 100 years, scams may not have changed much— tell investors what they want to hear to convince them to part with their money—but the communications with investors has. In the past, communication about potential investments was in person, through newspaper advertisements, or through the mail. Investors had time to think through their investment decisions. Today, everything is electronic allowing for instantaneous responses, and funds are transferred with a push of the button. There is no "cooling off" period now. If it sounds too good to be true, it probably is.

Regulators must keep up with the times, and as this report demonstrates, NASAA members stand ready to aggressively protect investors from fraud and police the integrity of our capital markets well into the 21st century.

Enforcement Overview

The results from this year's enforcement survey once again demonstrate the critical role that NASAA members continue to play in protecting investors and holding securities law violators accountable for the damage that they cause to individual investors and to the integrity of our capital markets.

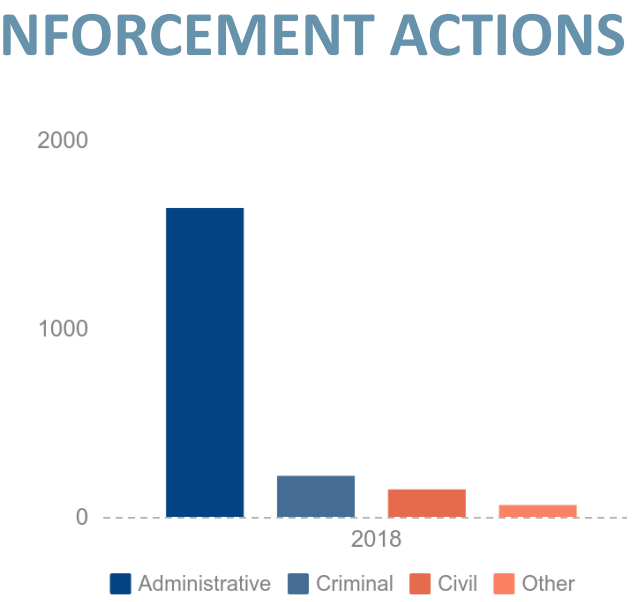
Complaints, Investigations and Enforcement Actions

COMPLAINTS & INVESTIGATIONS

8,814 Complaints Recieved
5,320 Investigations Initiated

The statistics above reflect the number of complaints received and investigations initiated. These formal investigations are supplemented by extensive efforts to informally resolve complaints and referrals. As such, investigations differ widely in their complexity and in the number of respondents and victims involved. The amount of time required to conduct an investigation can range from a few weeks to multiple years.

ENFORCEMENT ACTIONS

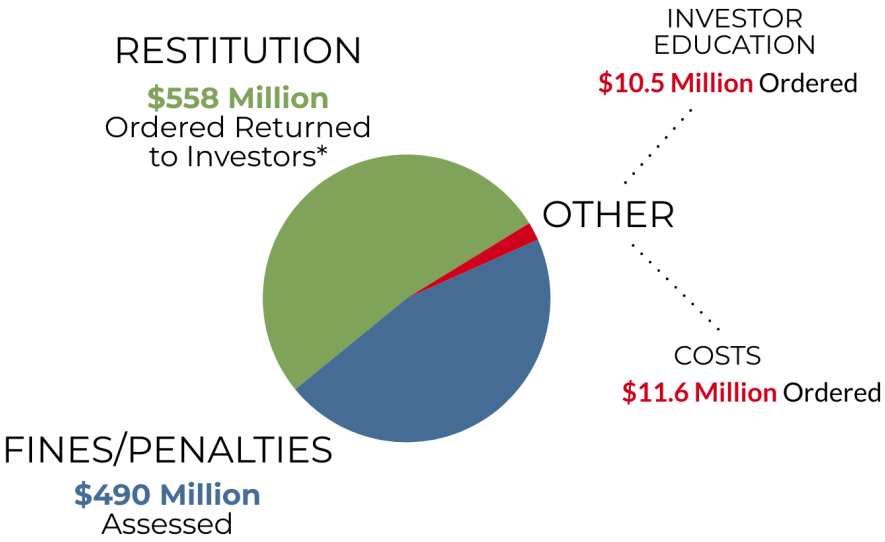


ENFORCEMENT ACTIONS

1,640 Administrative
218 Criminal
146 Civil
63 Other

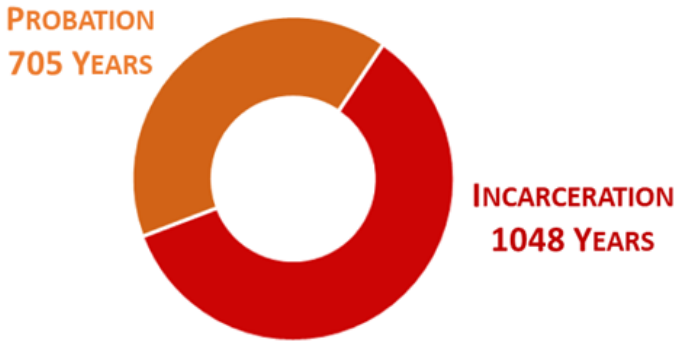
TOTAL: 2,067 Enforcement Actions

MORE THAN $1 BILLION IN MONETARY RELIEF ORDERED



** This figure represents restitution reported by NASAA U.S. member jurisdictions. Not all jurisdictions provided a restitution amount. This figure does not account for unilateral and unreported returns to investors, or rescission offers by firms or investigation targets.*

CRIMINAL RELIEF



RELIEF ORDERED

The sanctions imposed by state securities regulators can vary considerably from year to year, depending on the nature of the cases pursued. In addition to monetary restitution to investors, common types of sanctions include fines and penalties, criminal sentences, and restrictions or prohibitions on participation in the securities industry.

MONETARY RELIEF

$558 million ordered returned to investors.*

$490 million assessed in fines/penalties

$11.6 million ordered for costs

$10.5 million ordered for investor education

CRIMINAL RELIEF

1,753 total years of criminal relief

1,048 years of incarceration

705 years of probation

Licensing Activity

For the 2018 survey year, NASAA's U.S. members reported that their enforcement actions involved registered and unregistered actors in equal numbers. States reported taking action against 639 registered individuals and firms in the securities industry (broker-dealers and investment advisers), and 639 unregistered individuals and firms.

This even breakdown is consistent with a long-term trend: During the five-year period from 2014 to 2018, NASAA's U.S. members reported actions against 3,318 registered individuals and 3,287 unregistered individuals. The numbers of other types of respondents were also broadly consistent with long-term averages. For 2018, states reported taking action against 33 insurance agents and firms, 11 finders and solicitors and 6 financial planners.

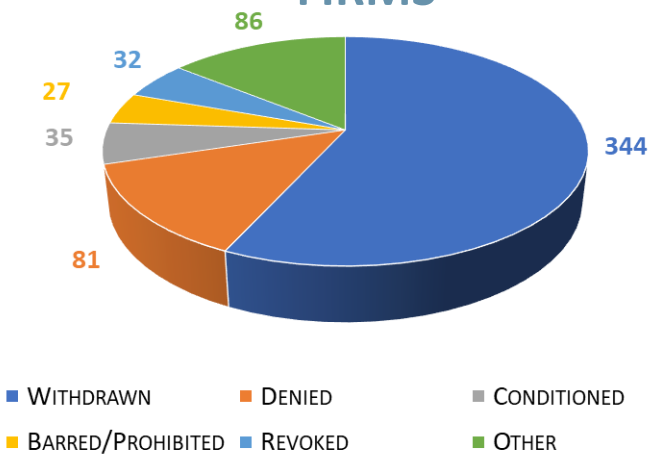
Within the licensed securities industry, NASAA's U.S. members reported a five-year high in the proportion of enforcement actions involving investment adviser (IA) firms. For the 2018 survey year, states reported that 17% of their actions involved IA firms, more than any other category of registered individuals. That share has nearly doubled since 2014, when IA firms represented only 9% of respondents.

Overall, state securities regulators continued to take strong steps to prevent bad actors from operating within the licensed securities industry, and to limit the activity of licensees and registrants. In 2018, as the result of formal enforcement actions NASAA's U.S. members imposed licensing sanctions on nearly 1,000 respondents: they revoked, barred or suspended the licenses/registrations of more than 230 individuals and firms, and denied or conditioned the licenses/registrations of more than 760 others.

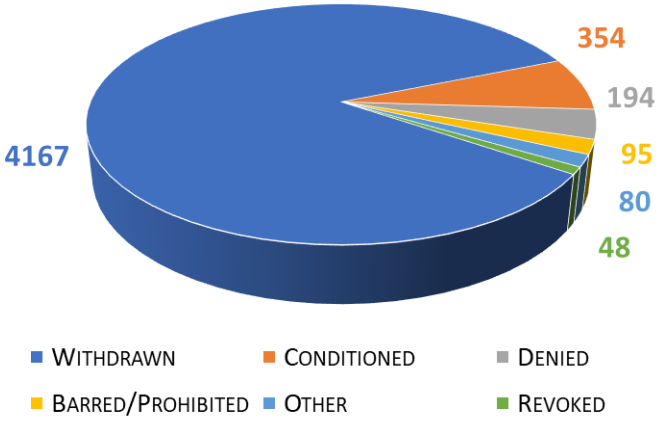
In addition, more than 4,500 license/registration requests were withdrawn as a result of state action or attention. While not always the case, many license/registration requests are withdrawn as a state is preparing to take action to deny, suspend or revoke a license/registration.

Looking ahead, NASAA's U.S. members again reported an increase in investigations of unregistered individuals, to no fewer than 700 in the 2018 survey year. This number has risen for three consecutive years, more than doubling from 335 in 2015. Given the ongoing state enforcement efforts against fraudulent activity involving cryptocurrencies, it would not be surprising to see a sustained high level of investigations and actions against unregistered individuals and firms in the coming years.

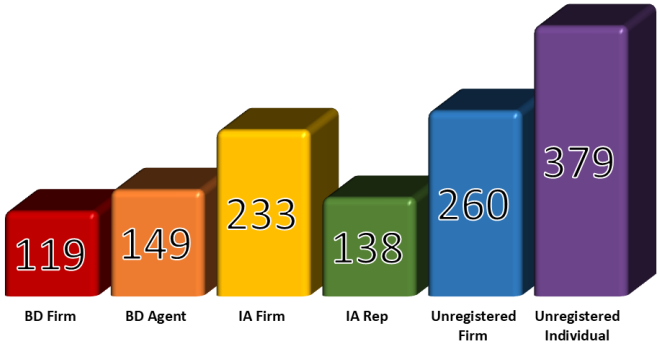
LICENSING SANCTIONS FIRMS



LICENSING SANCTIONS INDIVIDUALS



PARTIES NAMED IN ENFORCEMENT ACTIONS



Enforcement Coordination

State and provincial securities regulators coordinate their enforcement efforts to maximize their collective ability to protect the investing public. This cooperative approach to enforcement ensures that NASAA members can leverage their resources for enhanced efficiency and investor protection by working together.

From the Files . . .

OPERATION CRYPTOSWEEP

Bad actors continue their attempts to capitalize on widespread interest in cryptocurrencies and blockchain technology. In April 2018, NASAA recognized the need to protect investors by organizing an international task force consisting of more than 40 state and provincial securities regulators. The task force initiated Operation Cryptosweep, a coordinated series of investigations and enforcement actions brought against promoters of illegal and fraudulent cryptocurrency investment schemes. The results are compelling, as task force members have opened more than 330 inquiries and investigations and brought more than 85 enforcement actions relating to ICOs and cryptocurrencies.

MULTISTATE INVESTIGATION & SETTLEMENT

The Woodbridge Group of Companies, controlled by Robert Shapiro, sold securities throughout the United States and raised approximately $1.2 billion. Woodbridge purported to be a hard-money lender that made loans to third parties secured by real estate. Woodbridge's main securities product were notes with a term of approximately one year that were purportedly secured by an assignment of a security interest in real estate. Woodbridge was, instead, a Ponzi scheme that lent little money to third parties and instead lent money to companies controlled by Shapiro that purchased property but never paid interest to Woodbridge. With little loan interest income, Woodbridge made principal and interest payments to its investors using other investors' funds.

In May 2015, Massachusetts was the first jurisdiction to take action regarding Woodbridge when the company agreed to a pre-complaint consent order that found Woodbridge's main investment product was an unregistered security. In July 2015, Texas issued an emergency cease and desist order against Woodbridge and Shapiro, alleging registration violations and also alleging that they fraudulently omitted to tell investors about the Massachusetts action. Woodbridge and Shapiro agreed to a consent order in Texas in March 2016.

Arizona issued a temporary order to cease and desist in October 2016 alleging registration violations and alleging that Woodbridge and Shapiro were liable for fraudulently omitting to tell investors about the Massachusetts and Texas actions. Woodbridge and Shapiro eventually agreed to consent orders in Arizona in November 2018 that found them liable for fraud, including the fraudulent omission of the Massachusetts and Texas actions.

Since Arizona's action in October 2016, several other states have taken action against Woodbridge, including California, Colorado, Florida, Idaho, Michigan, and Pennsylvania. Wisconsin and FINRA also took action against several Woodbridge securities sales agents.

Woodbridge petitioned for Chapter 11 bankruptcy protection in December 2017 in the District of Delaware. The company reported in a declaration filed with its bankruptcy petition that it had received information requests from approximately 25 state securities regulators. The bankruptcy court confirmed a plan of liquidation for Woodbridge in October 2018.

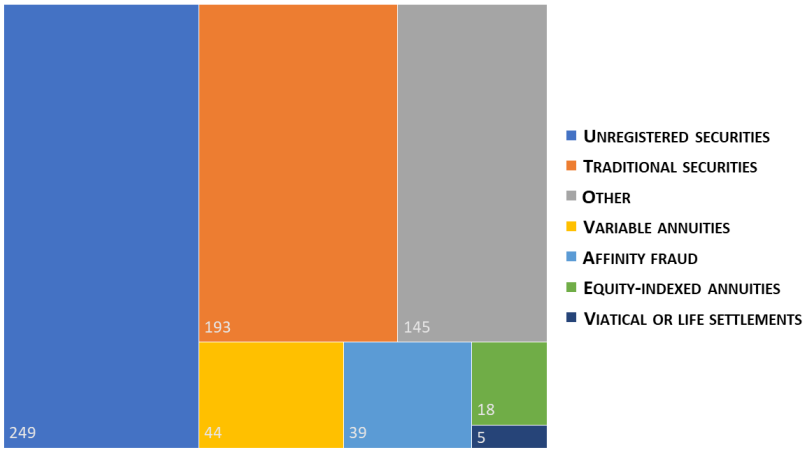
The SEC also brought a securities enforcement action against Woodbridge and Shapiro in December 2017. Woodbridge and Shapiro consented to judgments in the SEC action in December 2018. Shapiro was indicted for federal mail and wire fraud in April 2019. Shapiro plead guilty in August 2019. Sentencing is scheduled for October 2019.

Senior Investor Protection

Senior investors remain a major target of fraudsters, and NASAA member jurisdictions remain focused on this threat.

In 2018, NASAA member jurisdictions brought enforcement actions involving 758 senior victims. Regarding the chart below, "Other" schemes include, but are not limited to, internet romance scams, lottery or sweepstakes scams, Nigerian schemes, and identity theft.

Schemes and Products Used to Target Seniors



This focus has also manifested itself in model legislation. In 2016, NASAA members voted to to approve the NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation, which offers broker-dealer and investment adviser firms qualified immunity for delaying disbursements when the firm reasonably believed financial exploitation would result. The model act also requires financial advisors and others at broker-dealer and investment adviser firms to report any reasonable suspicion of an attempt of financial exploitation.

NASAA Model Act Statistics

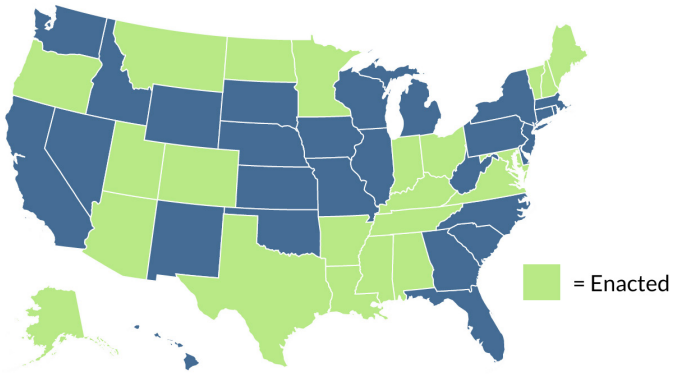
To date, 23 jurisdictions have enacted rules or legislation based on the NASAA model act, including four in 2019 (Arizona, Maine, New Hampshire and Virginia). FINRA also has implemented a rule allowing broker-dealers to delay disbursements to avoid financial exploitation.

In 2018, states received more than 400 reports from broker-dealers and investment advisers. These 400-plus reports shed light on victims of securities fraud, elder exploitation, and other seniors who need some form of assistance.

States have taken action to prevent or stop senior financial exploitation, to punish those responsible, and have also referred reports to more appropriate agencies and sometimes even sought to refer seniors to non-investigative services.

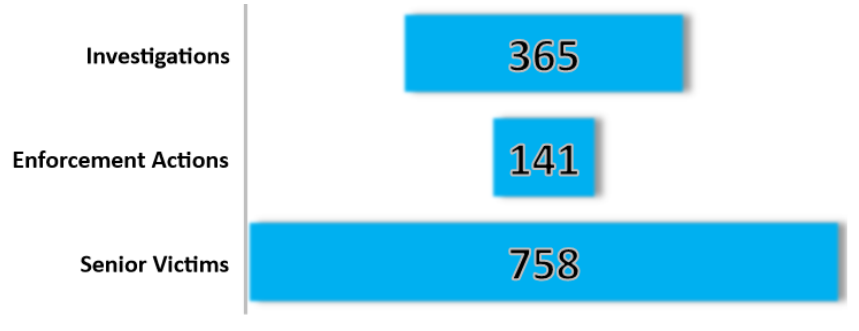
Many of the first states to enact the Model Act have seen a drastic increase in use of these statutes and the number of reports of potential financial exploitation from firms. For example, in 2018, the number of reports received in Alabama increased 225% over fiscal year 2017. Alabama's reports are on track to exceed fiscal 2018's numbers.

States That Have Enacted Legislation Based on NASAA's Model Act to Protect Vulnerable Adults From Financial Exploitation



Senior Investor Protection

2018 Overall Senior-Related Enforcement Activity



From the Files . . .

Shortly after Texas enacted legislation to protect seniors from financial exploitation, a registered firm contacted the Texas State Securities Board to report that metals.com, a nationwide distributor of precious metals, may have financially exploited an 80-year-old-client.

The firm explained that metals.com advised the client to liquidate her retirement accounts and transfer almost $850,000 to invest in precious metals through metals.com. The agency immediately began investigating metals.com and concluded the firm was engaging in a broad, illegal investment advisory scheme.

Texas securities regulators brought an ex parte enforcement action against metals.com to stop it from continuing to illegally render investment advice in Texas and resolved the case through an administrative order that requires metals.com to offer full rescission to more than 80 Texas investors. The Texas State Securities Board coordinated with other state regulators and other agencies, such as the Colorado Division of Securities and the Alabama Securities Commission (or other agencies that file prior to printing). Those states have since conducted their own investigations and brought enforcement actions against metals.com.

A report to the Alabama Securities Commission from an investment adviser regarding a 77-year-old Birmingham, Alabama, resident prevented $200,000 from leaving the investor's accounts.

The investor received a cold call solicitation from a representative of an oil and gas company who convinced him to invest $100,000. The elderly investor contacted his investment advisor to arrange the wire transfer. A few days later, the investor requested a second wire transfer, but this time the adviser asked a series of questions and determined there were enough red flags to warrant a report to the Alabama Securities Commission and Adult Protective Services. A hold was placed on the account, preventing another $200,000 from being lost. The Alabama Securities Commission has also filed enforcement actions against the company and its principals.

2018/19 Canadian NASAA Member Enforcement Activity

Enforcement demands a highly collaborative approach to protect Canadian investors. In addition to local enforcement actions, the CSA Enforcement Committee ("the Committee") members coordinate multijurisdictional investigations and share tools and techniques that help their staff investigate and prosecute securities law violations that cross domestic and international borders.

The Committee provides a forum for jurisdictions to share enforcement intelligence, helping to identify trends and threats as well as transfer ideas and processes among Committee members. The Committee undertakes initiatives that improve enforcement across the country through the work of the following specialized taskforces and working groups:

Enforcement Technology and Analytics Working Group
Facilitates regular, cooperative information sharing focused on the use of technology by enforcement staff, including electronic management, e-discovery, advanced analytics, surveillance and product management issues.

Investment Fraud Taskforce (Emerging Issues)
Responds to emerging investment frauds and threats with holistic and highly targeted initiatives, deploying them in a timely fashion to safeguard Canadian investors. Specific areas include binary options fraud, crypto-asset fraud, and Initial Coin Offering fraud.

Collection Practices and Strategies Working Group
Builds strategies for improving collection of monetary orders through information-sharing and facilitating increased awareness of collections actions and/or results.

Cross-Border Market Fraud Initiative ("Pump-and-Dump")
Encourages proactive approaches and solutions aimed at eradicating pump-and-dump schemes and enabling the initiative members to take action against those engaged in them – across national and international borders.

Enforcement Highlights: At a Glance

U.S. NASAA Member Enforcement Activity 2014-2018

Category	2014	2015	2016	2017	2018	5-Year Total
Investigations	4,853	4,112	4,341	4,790	5,320	23,416
Overall Enforcement Actions	2,042	2,060	2,017	2,150	2,067	12,403
Administrative	1,634	1,593	1,606	1,682	1,640	8,155
Civil	137	151	138	116	146	688
Criminal	271	261	241	255	218	1,246
Other	*not collected*	55	32	52	63	202
Overall Criminal Relief [2]	2,122 years	1,246 years	1,346 years	1,985 years	1,753 years	8,452 years
Incarceration	1,624 years	838 years	824 years	1,551 years	1,048 years	5,885 years
Probation	498 years	408 years	522 years	434 years	705 years	2,567 years
Restitution [3]	$405 million	$536 million	$231 million	$486 million	$558 million	$2.2 billion
Fines/Penalties [4]	$174 million	$230 million	$682 million	$79 million	$490 million	$1.6 billion
Overall License Sanctions [5]	3,585	4,265	3,500	4,456	5,543	21,349
Withdrawn	2,857	3,380	2,843	3,578	4,511	17,169
Denied/Revoked/ Suspended/ Conditioned/Barred	728	885	657	878	1,032	4,180

Notes: 1) Includes administrative, civil, criminal and other actions. 2) Includes prison time sentenced and probation. 3) Money ordered returned to investors by state securities regulators. 4) The method for reporting fines/penalties data was modified beginning with the data collected in 2016. 5.) Includes individual and firm licenses withdrawn, conditioned, barred, denied, revoked or suspended as a result of state action or attention.

2018-2019 NASAA Enforcement Section and Project Groups

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Jesse Devine (NY)
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A. Valerie Mirko, NASAA Liaison

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Zone 2 (Southeast) Ricky Locklar (AL)
Zone 3 (Mid-Atlantic) Marion Quirk (DE)
Zone 4 (Central) Roger Patrick (OH)
Zone 5 (South/Central) Tina Lawrence (TX)
Zone 6 (Mountain) Jonathan Block (CO)
Zone 7 (Western) Alex Calero (CA)
Zone 8 (Canadian) Jason Roy (MB)

NASAA

Organized in 1919, the North American Securities Administrators Association (NASAA) is the oldest international organization devoted to investor protection. NASAA is a voluntary association whose membership consists of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico.

In the United States, NASAA is the voice of state securities agencies responsible for efficient capital formation and grass-roots investor protection. Their fundamental mission is protecting investors who purchase securities or investment advice, and their jurisdiction extends to a wide variety of issuers and intermediaries who offer and sell securities to the public. NASAA members license firms and their agents, investigate violations of state and provincial law, file enforcement actions when appropriate, and educate the public about investment fraud. Through the association, NASAA members also participate in multi-state enforcement actions and information sharing.

For more information, visit: www.nasaa.org

THE FINANCIAL INDUSTRY REGULATORY AUTHORITY'S
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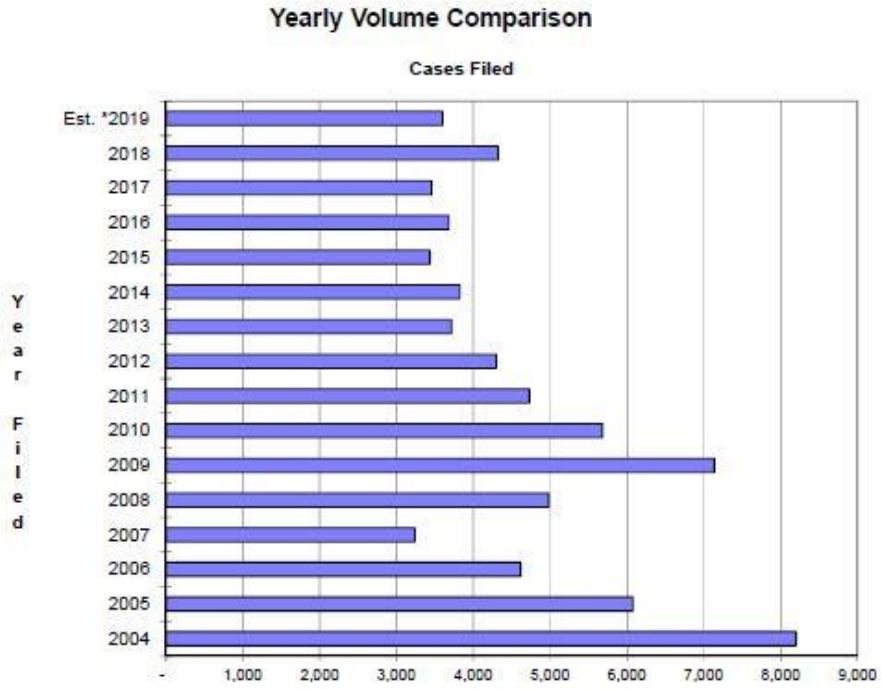

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FINRA Office of Dispute Resolution
Top 15 Controversy Types in Customer Arbitrations Through June

Type of Controversy*		2019 Cases Served	2018	2017	2016	2015
Breach of Fiduciary Duty	Through June	981	1,183	920	1,004	763
	Year-End	--	2,290	1,899	2,002	1,807
Negligence	Through June	884	973	816	936	739
	Year-End	--	1,974	1,662	1,862	1,677
Failure to Supervise	Through June	818	959	794	917	665
	Year-End	--	1,935	1,621	1,802	1,554
Misrepresentation	Through June	742	984	771	814	623
	Year-End	--	1,775	1,663	1,670	1,499
Breach of Contract	Through June	722	830	641	771	601
	Year-End	--	1,711	1,318	1,495	1,444
Suitability	Through June	708	1,021	774	788	535
	Year-End	--	1,779	1,606	1,606	1,364
Fraud	Through June	695	864	639	646	417
	Year-End	--	1,707	1,389	1,301	1,089
Omission of Facts	Through June	664	852	684	675	511
	Year-End	--	1,547	1,493	1,394	1,216
Violation of Blue Sky Laws	Through June	291	397	228	166	104
	Year-End	--	810	547	344	236
Manipulation	Through June	166	128	138	137	83
	Year-End	--	302	299	236	208
Unauthorized Trading	Through June	106	128	146	173	123
	Year-End	--	245	263	362	264
Elder Abuse**	Through June	101	117	--	--	--
	Year-End	--	216	61	--	--
Churning	Through June	91	102	127	144	120
	Year-End	--	205	219	254	247
Margin Calls	Through June	50	38	30	39	46
	Year-End	--	85	62	84	97
Errors-charges	Through June	33	45	23	23	30
	Year-End	--	81	66	56	64

* 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.

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

Type of Security *		2019 Cases Served	2018	2017	2016	2015
Municipal Bond Funds	Through June	338	446	205	263	172
	Year-End	--	959	558	480	607
Municipal Bonds	Through June	331	462	209	214	168
	Year-End	--	971	565	433	559
Mutual Funds	Through June	265	341	193	133	105
	Year-End	--	731	447	352	373
Common Stock	Through June	243	324	297	335	251
	Year-End	--	579	604	646	610
Government Securities	Through June	188	222	69	16	19
	Year-End	--	519	229	96	169
Options	Through June	118	103	63	61	65
	Year-End	--	150	127	124	128
Real Estate Investment Trust	Through June	112	91	103	93	93
	Year-End	--	205	177	184	191
Private Equities	Through June	63	54	69	60	46
	Year-End	--	111	111	114	92
Exchange-Traded Funds	Through June	60	104	74	72	66
	Year-End	--	167	131	133	127
Limited Partnerships	Through June	53	77	98	75	41
	Year-End	--	144	183	199	79
Variable Annuities	Through June	53	51	73	51	57
	Year-End	--	105	129	115	104
Annuities	Through June	49	51	58	64	39
	Year-End	--	101	115	127	81
Corporate Bonds	Through June	44	70	57	66	34
	Year-End	--	135	119	154	194
401(k)**	Through June	26	45	38	2	--
	Year-End	--	94	69	27	--
Structured Products	Through June	24	41	21	27	18
	Year-End	--	78	45	57	25

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

FINRA Office of Dispute Resolution
Top 15 Controversy Types in Intra-Industry Arbitrations Through June

Type of Controversy*		2019 Cases Served	2018	2017	2016	2015
Breach of Contract	Through June	175	177	203	195	200
	Year-End	--	413	403	389	373
Promissory Notes	Through June	120	135	138	204	192
	Year-End	--	261	296	401	401
Libel, Slander, or Defamation	Through June	74	90	51	62	57
	Year-End	--	166	117	124	115
Compensation	Through June	71	79	77	73	74
	Year-End	--	168	161	163	140
Libel or Slander on Form U-5	Through June	60	77	64	59	61
	Year-End	--	135	136	124	119
Wrongful Termination	Through June	55	65	59	57	61
	Year-End	--	122	116	127	123
Commissions	Through June	40	42	56	29	39
	Year-End	--	95	103	60	73
Misrepresentation	Through June	26	42	12	5	11
	Year-End	--	68	54	21	17
Discrimination or Harassment**	Through June	26	24	16	32	29
	Year-End	--	38	37	58	54
Breach of Fiduciary Duty	Through June	22	25	17	9	13
	Year-End	--	39	52	18	28
Suitability	Through June	15	53	12	1	1
	Year-End	--	63	59	15	1
Negligence	Through June	14	21	8	5	10
	Year-End	--	32	25	17	21
Omission of Facts	Through June	12	8	8	3	4
	Year-End	--	18	16	7	8
Raiding Disputes	Through June	11	18	14	16	24
	Year-End	--	37	33	42	40
Fraud	Through June	9	13	7	3	7
	Year-End	--	24	26	11	13

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

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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
2014	135	59	44%	104	39	38%
2015	163	77	47%	84	38	45%
2016	145	63	43%	72	26	36%
2017	137	66	48%	71	26	37%
2018	158	67	42%	58	27	47%
YTD 2019	74	41	55%	31	9	29%

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In [illegible] FINRA Board of Governors approved filing with the proposed amendments to the Code of Arbitration and Mediation Procedure to provide associated persons with a non-attorney representative from participating in FINRA arbitration and mediation forums that would also provide associated persons with a clear process for participating in a FINRA arbitration or mediation and clarify the application of the attorney representative bar in arbitration and mediation. The proposal also included guidance for forum parties regarding the qualifications of FINRA or its staff in the forums.

[illegible]

On June 6, 2018, FINRA submitted Regulatory Notice 18-[illegible] requesting comment on proposed amendments to the Discovery Guide's Firm/Associated Persons Document Production List that would require firms and associated persons to produce documents concerning third-party insurance agreements in customer arbitrations. The proposed amendments would require firms to produce insurance agreements or information about insurance agreements that may be relevant to the matter at issue, including applications for insurance coverage, reservation of rights letters, and declaration pages.

One commenter objected to the proposed amendments, stating that the proposal would discourage settlements, encourage frivolous claims, and increase costs.

The comment period ended on September 4, 2018.

[illegible]

On October 8, 2017, FINRA submitted Regulatory Notice 17-33 proposing rule changes to amend the Code of Arbitration Procedure for Customer Disputes to expand a customer's option to withdraw an arbitration claim and file in court in certain circumstances a mandatory arbitration agreement applies to the claim or in situations where a member firm or associated person fails or refuses to pay a claim in full or during a pending arbitration or after an associated person ceases association with a member firm, including changes to the fee schedule and related rules.

The comment period ended on December 8, 2017.

[illegible] [illegible]

On June 6, 2016, FINRA submitted [illegible] to remind member firms that a customer's agreement to arbitrate a FINRA arbitration and FINRA arbitration forum and time and do

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VII. SIGNIFICANT INITIATIVES

List of **M**embe**r** F□rms an**d** Associate**d** Pe**r**sons with Unpa**□d** Custome**r** A**r**bi**r**ation Awa**rd**s

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and attorneys' fees). FINRA Office of Dispute Resolution promptly mails a notice to the parties requesting the amount in dispute, if any, and requiring payment of the initial filing fee. Parties agree on an acceptable arbitrator from the roster produced in the arbitrator selection process, or parties may request that FINRA provide a more formal process to select arbitrators.

Upon receiving written agreement to use the Regional Director and an arbitrator panel, a trained case administrator will conduct an arbitrator conference call. The case administrator will discuss the administration of the case, arbitrator disclosures, qualifications, and the process for appointing arbitrators, including challenges and interrogatories. Some of the hearing records and discovery hearing issues will be discussed. Parties can use arbitrators from outside of FINRA's roster or provide FINRA with criteria/qualifications to screen arbitrators on FINRA's roster. Parties may also request additional information about arbitrators. The standard FINRA honorarium for arbitrators is a non-refundable administration fee of $1,000 for cases that are heard by non-public arbitrators. Parties agree to use the Regional Program Case Management Plan, which is available on our Regional Offices page.

The Program is designed to address investment disputes involving damage claims of $50,000 or more. Cases can be filed in the Program by agreement of the parties and are not subject to mandatory arbitration.

For information about submitting documents and other requirements for the Code Arbitration Program, see the Code Arbitration Program – Quick Guide on our website at www.finra.org.

Arbitrator Disclosure Reports

Arbitrator Disclosure Reports

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

- Prior to including a party's initial pleading in the case documents sent to the parties, FINRA staff reviews the pleading for any potentially disclosable information.
- If such information is found, FINRA staff requests clarification from the arbitrator and adds the information to the arbitrator's disclosure report.

Internet Searches

- Prior to including a party's initial pleading in the case documents sent to the parties, FINRA staff conducts Internet searches of arbitrators.

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To learn more about FINRA's efforts to diversify our arbitrator and mediator rosters visit □□r
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- Filing Case Documents
- Submitting documents
- Scheduling Hearing Dates and
- Filing Post-Award Arbitrator Ranking Lists to Select Arbitrators and Post-Award Arbitrator Ranked Lists

Regional Offices

The Regional Offices are digitized their arbitration and mediation filings, including forms and non-forms, case documents received filed in electronic format and case documents filed in electronic arbitration and mediation cases, assigned and corresponded and archived and disposed using electronic mail to the extent FINRA is continuing its progress of digitizing new filings.

FINRA Website Dispute Resolution Section

FINRA Office of Dispute Resolution's website, www.finra.org/arbitration-and-mediation, provides various resources for parties and neutrals regarding FINRA's arbitration and mediation programs. On the website, users can find among other things: an overview of arbitration and mediation information on how to file a claim, forms, case and arbitrator rules and arbitrator training, the arbitration process, arbitrator and mediator qualifications, Code of Arbitration Procedure and rule filing information. The website contains a "What's New" section, where users can access case statistics and information on recent FINRA initiatives and announcements.

Awards Online Database

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

In addition to the awards available in Awards Online, parties to FINRA arbitration cases may also access awards via the FINRA arbitration program, which includes the American Arbitration Association, the Chicago Board Options Exchange, the International Securities Exchange, the Philadelphia Stock Exchange and the NASDAQ Stock Market, the New York Stock Exchange and NYSE Arca, Inc.

The database provides users with the ability to search for awards by using multiple criteria, such as a party name, arbitrator name, case number, hearing location, hearing date, forum in which the case was filed, and any combination of these criteria. FINRA does not include in the Awards Online database information about settlement agreements, mediation and pre-dispute arbitration clauses.

Videoconferencing Capabilities

All four of FINRA's regional office locations have videoconferencing capabilities. In addition, parties may request that arbitrators or mediators in Dispute Resolution's main case management offices conduct hearings or meetings in one of the regional offices. There is no additional charge to use videoconferencing capabilities. Parties are encouraged to notify their case administrator at least 30 days prior to the hearing

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In order to solicit parties' use of mediation and raise awareness of its mediation program, FINRA provides an annual "Settlement Month" program every October, which offers reduced m□dia□ion □□□□ □or □ma□□r □a□□□□

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WHERE FINRA ENFORCEMENT AND PIABA LAWYERS INTERSECT - TO COOPERATE OR NOT[1]

Joseph R. Wojciechowski[2]

I. Introduction

Attorneys representing investors will at some point be asked by FINRA if his client is willing to speak with or otherwise cooperate in an investigation relevant to their FINRA arbitration claim. Because investor-claimants are not subject to the jurisdiction of FINRA Enforcement proceedings, they can freely ignore any requests for information or cooperation from FINRA. In many instances, claimants and their attorneys alike question the value to their arbitration claims of cooperating with FINRA, or worse, whether cooperating could actually hurt either the merits of their claim in some way or hinder collection efforts.

FINRA Enforcement has broad discretion to pick and choose whatever cases it investigates and/or prosecutes and there is no set formula which identifies which cases to pursue or investigate. There are many cases PIABA members file for investor-claimants which they surely believe should be the subject of FINRA Enforcement, and they never hear from FINRA. Similarly, FINRA Enforcement may choose to investigate a case that on its face does not appear to include severe misconduct.

Most investor-claimants do not understand the difference between FINRA Dispute Resolution and FINRA Enforcement. Many arbitration-claimants mistakenly believe FINRA Enforcement is charged with obtaining restitution for them through the regulatory process. It is up to arbitration-claimant attorneys to understand these differences and ensure that their clients realize that FINRA Enforcement will not get their money back if they choose to cooperate with an enforcement investigation. Sometimes arbitration-claimants want to assist in the regulatory investigation to either do what they can to prevent the advisor at issue from victimizing others or to extract the proverbial pound of flesh. Further yet, once educated on this issue, some Claimants nonetheless remain desirous of exacting whatever pound of flesh they can from those who have victimized them, without fully appreciating the simple fact that FINRA Enforcement has a wholly different agenda, acts in its own realm and pursues whatever remedies it does, without any substantive decision-making input from claimants.

[1]This article is incorporated into the 2019 PIABA Annual Meeting materials to accompany the breakout session to be held on Wednesday, October 23, 2019 at 1:30 p.m. which will be moderated by Mr. Wojciechowski, at which time Christopher J. Kelly, Esq., Senior Vice-President, FINRA Enforcement Department, will also be presenting a detailed presentation including the various particulars of FINRA Enforcement proceedings, addressing the interface with FINRA Enforcement proceedings and Arbitration Proceedings. The author acknowledges the assistance of Tim O'Connor, who moderated this presentation last year, and whose assistance in preparing both this paper and presentation materials, was invaluable.

[2]Mr. Wojciechowski currently serves as the Editor-in-Chief of the PIABA Bar Journal and has been a PIABA member since 2009. He holds a BA Degree in Political Science from Western Michigan University and a Law Degree from the John Marshall Law School. He is licensed to practice in Illinois and has represented investors throughout the United States, Canada, and worldwide. He has been representing investors in arbitration, litigation, and class actions since 2009.

II. Overview of the FINRA Enforcement

a. FINRA Enforcement Structure

In July 2018, FINRA announced the Department of Enforcement's new structure, which was intended to consolidate the department after the FINRA360 overview.[3] Prior to this reorganization, FINRA's enforcement department was split into two distinct parts: one that handled disciplinary actions related to trading-based matters found through Market Regulation's surveillance and examination programs, and the other, which handled cases referred from other regulatory oversight divisions, including Member Regulation, Corporate Financing, Office of Fraud Detection and Market Intelligence, and Advertising Regulation.

The new structure creates a more unified and centralized enforcement structure split into the Office of the Counsel to the Head of Enforcement, which utilizes experienced enforcement attorneys and staff to review matters referred for enforcement action, and Investigations, which is group of non-attorney investigators that conduct investigations of potential misconduct. Furthermore, Enforcement's legal team of more than 150 attorneys are divided into the Main Enforcement unit, Sales Practice Enforcement, and Market Regulation Enforcement. Each of these units has a specific investigatory concentration. The Main Enforcement unit focuses on investigating and prosecuting all types of disciplinary matters. The Sales Practice enforcement group focuses on bringing disciplinary actions specific to sales practice violations. Last, the Market Regulation group focuses on counseling examiners and analysts in connection with trading examinations and investigations, and prosecuting those investigations that result in disciplinary action.

This consolidation may look on its face to be a reshuffling of the deck more than anything. However, FINRA insists the structural changes, including appointing a singular head of Enforcement that reports to the CEO, will result in a better-organized enforcement department. Susan Schroeder, Executive Vice President, Enforcement said the following at the SIFMA Anti-Money Laundering & Financial Crimes Conference, on February 12, 2018:

> We built our integrated department with a focus on resolving cases with consistent, foreseeable outcomes designed to effect change – to incentivize compliance, to fix things that are broken, to make harmed investors whole and to prevent future harm from recurring.[4]

This statement "to make harmed investors whole" may seem a little troubling to some PIABA attorneys who regularly represent investors in arbitration. Rarely, if ever, do FINRA Enforcement actions result in fines that make investors whole. In fact, FINRA specifically states that by accepting a restitution payment, investors do not release and are not otherwise foreclosed from pursuing other recovery options, including arbitration.[5]

[3]FINRA Announces Enforcement Structure, Senior Leadership Team, FINRA News Release, Thursday, July 26, 2018. https://www.finra.org/newsroom/2018/finra-announces-enforcement-structure-senior-leadership-team.

[4]http://www.finra.org/newsroom/speeches/021218-remarks-sifma-aml.

[5]https://www.finra.org/investors/metlife-securities-inc-variable-annuity-replacements.

Even if FINRA considers making investors whole as part of its lofty enforcement-related goals, the consolidation and reorganization was primarily instituted because the securities industry believe FINRA's previous system was inconsistent, unpredictable, and at times, duplicative. This reorganization's purpose was to remedy those issues and facilitate more streamlined and consistent enforcement procedures.

III. FINRA Enforcement Process and Procedure

FINRA identifies its top priorities as "advance[ing] investor confidence in the securities markets through vigorous, fair and effective enforcement of FINRA and MSRB Rules, and federal securities laws and rules."[6] FINRA Enforcement investigates and prosecutes potential or suspected securities rules violations and brings disciplinary actions when warranted. FINRA Enforcement utilizes two different disciplinary procedures: 1) settlement; or 2) a formal complaint. A settlement results in the issues of an Acceptance, Waiver, and Consent (AWC).

Through the AWC, FINRA levies its penalties, censures, or fines against a respondent broker or firm in the form of a "settlement", meaning the respondent "neither admits nor denies" the allegations by FINRA. The AWC is governed by FINRA Rule 9216(a) which states:

> (1) Notwithstanding Rule 9211, if the Department of Enforcement has reason to believe a violation has occurred and the member or associated person does not dispute the violation, the Department of Enforcement may prepare and request that the member or associated person execute a letter accepting a finding of violation, consenting to the imposition of sanctions, and agreeing to waive such member's or associated person's right to a hearing before a Hearing Panel or, if applicable, an Extended Hearing Panel, and any right of appeal to the National Adjudicatory Council, the SEC, and the courts, or to otherwise challenge the validity of the letter, if the letter is accepted. The letter shall describe the act or practice engaged in or omitted, the rule, regulation, or statutory provision violated, and the sanction or sanctions to be imposed. Unless the letter states otherwise, the effective date of any sanction(s) imposed will be a date to be determined by FINRA staff.

Once submitted, an AWC must be approved by either the Review Subcommittee, the Office of Disciplinary Affairs, or the National Adjudicatory Counsel (NAC). Any of these can reject or accept the AWC.[7] In the event the AWC is accepted, pursuant to FINRA Rule 9216(a)(4), the AWC is "deemed final and shall constitute the complaint, answer, and decision in the matter." If, on the other hand, the AWC is rejected by one of these review bodies, "FINRA may take any other appropriate disciplinary action with respect to the alleged violation or violations." *Id.*

Once submitted by FINRA and accepted by the NAC, or one of the other two facsimiles identified above, the AWC constitutes a waiver of several rights granted under the FINRA code, including

A. The right to have a complaint issued specifying the allegations

[6] https://www.finra.org/industry/enforcement.

[7] *See* FINRA Rule 9216(a)(3).

B. The right to be notified of the complaint and have an opportunity to answer

C. The right to defend against the allegations in a hearing before a hearing panel; and

D. The right to appeal the decision to the NAC, the SEC, and the United States Court of Appeals.

The respondent entering an AWC does so acknowledging the waiver of these rights. The respondent all explicitly affirms, upon acceptance, the following:

> 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: (i) testimonial obligations; or (ii) right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

Although the AWC binds a broker or firm to the findings of fact of the FINRA in the AWC insofar as public statements and other regulatory matters, the AWC also gives the respondent flexibility to challenge and likely deny the facts in proceedings in which FINRA is not a party. Surely, investor-advocates see this phenomenon in investor-arbitration proceeding where brokers or brokerage firms dismiss an AWC as a mere settlement of challenged allegations.

If FINRA and an investigatory target do not settle through the AWC process, FINRA Enforcement will file a formal complaint with the Office of Hearing Officers (OHO), which is the first level of adjudication of a formal regulatory complaint brought by FINRA Enforcement. FINRA OHO hearing panels consist of one full time employee of the FINRA OHO, and two FINRA licensed associated persons of a FINRA member firm. It is essentially an in-house regulatory review board. FINRA has a dedicated team of staff attorneys and paralegals who assist in the hearing process and all procedures related thereto. Just because a formal complaint is filed with the OHO does not mean the matter cannot settle. When it does, it is referred to as an Order Accepting Offer of Settlement which is entered into pursuant to FINRA Rule 9270(e) between the Respondent and FINRA, and approved by the National Adjudicatory Counsel, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs.

The OHO process is governed by the Rule 9100 and Rule 9200 Series of FINRA's Code of Procedure. These procedures establish the process for servicing papers, form and timing of pleadings, discovery, prehearing scheduling, and motion practice. Unlike the Customer Code, the OHO provides for motions for summary disposition in FINRA Rule 9264. Similar to the Customer Code, the hearing officers are not bound by formal rules of evidence, but may look to the Federal Rules of Evidence as a guide in making evidentiary rulings.[8]\

If the Complaint proceeds to a formal hearing before the OHO and is not settled, the hearing and process is not public. Further, the transcripts, audio, and exhibits of the hearing are generally not available to the public. Investor-claimant attorneys can try to access these materials through subpoena pursuant to FINRA Rule 12512. FINRA is not subject to the Freedom of Information

[8]*See* Guide to the Disciplinary Hearing Process, FINRA. http://www.finra.org/industry/guide-disciplinary-hearing-process

Act and FINRA Enforcement does not seem to have any clear written procedures for responding to subpoenas. Some practitioners direct these requests for information or subpoena to FINRA's Office of General Counsel, but recently, those requests are met with an objection to properly serve the subpoena upon FINRA's registered agent.

After a formal hearing with the OHO concludes and a decision is rendered, the decision is final unless a party timely appeals the decision to the National Adjudicatory Counsel ("NAC"), pursuant to FINRA Rule 9268(e). The Respondent or the Department of Enforcement may appeal to the NAC. Further, the NAC does have authority to call an OHO decision for review on its own motion pursuant to FINRA Rule 9312.

Procedures before the NAC are subject to the FINRA Rule 9300 Series. The FINRA NAC is a fourteen member committee drawn from the securities industry, academia, institutional investment, and retired securities industry professionals.[9] In contrast to the OHO hearing officers who are full time adjudicators, the NAC committee members are volunteers. Although they are not involved in the investigatory process, the impartial review of the OHO record, including findings of fact, is *de novo.*

The NAC has its own in-house resources including staff attorneys and administrative personnel who assist in the appeal process, as well as drafting and finalizing decisions on appeal from the OHO. Although the NAC review is usually limited to what was submitted in the underlying case before the OHO, the NAC does have the authority to accept additional document and information from parties, upon request.

Once the NAC decides to confirm, deny, or amend a decision by the OHO, that is not the end of the FINRA Enforcement appeals process. The FINRA Board of Governors, which is comprised of twenty-three industry and public members[10], with ten seats for industry members and thirteen for

[9]Current NAC Committee members are: Norman Ashkenas, Fidelity Brokerage Services, LLC; Belinda Anne Blaine, Morgan Stanley & Co., LLC; Evan Jeremy Charkes, Bank of America; Jill E. Fisch, University of Pennsylvania Law School; Honorable Doris Ling-Cohan, NYC Unifed Court System, Appellate Term, Supreme Court; Ilene Marquardt, Wells Fargo Clearing Services, LLC; Sara McCafferty, Retired; John P. Meegan, Hefren-Tillotson, Inc.; John Parmigiani, Allied Millennial Partners, LLC; Lori Ann Richards, Retired; Robert P. Scales, Retired; Heidi Stam, Retired; John H. Sturc, Retired; Michelle Denise Thomas, WBB Securities, LLC; Andrew F. Tuch, Washington University School of Law.

[10]Current Members of the FINRA Board of Governors are: Chairman and Public Governor, William H. Heyman, The Travelers Companies, Inc.; FINRA CEO Robert W. Cook; Public Governors – Lance Drummond, Retired; Jack Ehnes, CalSTRS; Shelly Lazarus, Ogilvy & Mather; Joshua S. Levine, Retired; Brigitte C. Madrian, BYU Marriott School of Business; Eileen Murray, Bridgewater Associates; Charles I. Plosser, Former President and CEO, Federal Reserve Bank of Philadelphia; Hillary Sale, Georgetown University Law Center; Leslie Seidman, Former Chairman, Financial Accounting Standards Board; Luis M. Viceira, Harvard Business School; Elisse B. Walter, Former Commissioner and Chairman, U.S. Securities and Exchange Commission; Susan Wolburgh Jenah, Former President and CEO Investment Industry Regulatory Organization of Canada; Industry Governors: Andrew S. Duff, Piper Jaffray & Co.; Stephen A. Kohn, Stephen A. Kohn & Associates, Ltd.; Brian Kovack, Kovack Securities, Inc.; Joseph M. Mecane, Citadel Securities; Robert A. Muh, Sutter Securities, Inc.; Kathleen A. Murphy, Fidelity Personal Investing; Paige W. Pierce, Larimer Capital Corporation; Jim Nagengast, Securities America, Inc.; Timothy C. Scheve, Janney Montgomery Scott, LLC; Amy L. Webber, Cambridge Investment Research, Inc.

public members[11], has authority to review NAC decisions, including findings of fact and conclusions of law, on a *de novo* basis. An NAC decision cannot be appealed to the Board of Governors by any party. Rather, this review is at the discretion of the Board of Governors on an *ad hoc* basis. Pursuant to FINRA Rule 9349(c) "The FINRA Board may call the disciplinary proceeding for review pursuant to FINRA Rule 9351. If the FINRA Board does not call the disciplinary proceeding for review, the proposed written Decision of the NAC shall become final…"

The appeal of FINRA Enforcement proceedings does not stop with FINRA however. After a party has completed the OHO process, appealed to the NAC, and possibly subjected to discretionary review by the Board of Governors, there is a right to appeal further to the Securities and Exchange Commission. Pursuant to FINRA Rule 9370:

> [a] Respondent aggrieved by final disciplinary actions pursuant to the Rule 9200 Series [OHO] or the Rule 9300 Series [NAC] may apply for review by the SEC pursuant to Section 19(d)(2) of the Exchange Act. The filing with the SEC of an application for review by the SEC shall stay the effectiveness of any sanction, other than a bar or an expulsion, imposed in a decision constituting final disciplinary action of FINRA for purposes of SEA Rule 19d-1(c)(1).

Once the matter gets to the SEC, that opens up the appeals process to the United States Court of Appeals and then the United States Supreme Court. A FINRA Enforcement proceeding, therefore, potentially has six levels of adjudication: the OHO hearing, the NAC review, potential review by the Board of Governors, review by the SEC, review of the SEC's decision by the U.S. Court of Appeals, and then review of that decision by the United States Supreme Court. FINRA Enforcement proceedings have in certain circumstances dragged on for over ten years from their investigative stage through the exhaustion of appeals.

IV. Procedural Tools Used by FINRA Enforcement: FINRA Rule 8210 and a FINRA Enforcement Rule 8210 Letter

FINRA Enforcement has a very powerful procedural tool to compel the production of documents and testimony from its members and associated persons. FINRA Rule 8210, Provision of Information and Testimony and Inspection and Copying of Books, states:

> **(a) Authority of Adjudicator and FINRA Staff**
>
> For the purpose of an investigation, complaint, examination, or proceeding authorized by the FINRA By-Laws or rules, an Adjudicator or FINRA staff shall have the right to:
>
> > (1) require a member, person associated with a member, or any other person subject to FINRA's jurisdiction to provide information orally, in writing, or electronically (if the requested information is, or is required to be, maintained in electronic form) and to testify at a location specified by FINRA staff, under oath or affirmation administered by a court reporter or

[11] PIABA has raised concerns over how "public" these members truly are. *See* Andrew Stoltmann and Benjamin Edwards, *FINRA Governance Review: Public Governors Should Protect the Public Interest*, PIABA (November 15, 2017).

a notary public if requested, with respect to any matter involved in the investigation, complaint, examination, or proceeding; and

(2) inspect and copy the books, records, and accounts of such member or person with respect to any matter involved in the investigation, complaint, examination, or proceeding that is in such member's or person's possession, custody or control.

FINRA member firms and brokers who fail to comply with this Rule are subject to all categories of vigorous penalties including monetary fines and lifetime bans from the industry. Targets of FINRA Enforcement requests pursuant to Rule 8210 have little choice but to comply with these demands, however arbitrary, capricious, or abusive they may seem.

This rule gives FINRA Enforcement attorneys one of the most powerful regulatory investigative tools of any industry. How powerful is it? FINRA member firms and associated persons are not even permitted to raise the Fifth Amendment objection to the production of responsive documents and information. If they fail to produce documents for this reason, they will surely be summarily suspended or have their licensure summarily taken away. One of the agreements to remaining in the business is that member firms and associated persons will abide by FINRA Rules, including FINRA Rule 8210. Thusly, the failure to abide by the rule is the surest ticket to an industry ban.

(b) On the Record Proceedings

On The Record Proceedings can proceed with in depth questioning as long as FINRA Enforcement attorneys deem it necessary to pursue them. In certain cases, FINRA Enforcement has been known to keep Enforcement cases open in the investigative stage for many years prior to filing a formal complaint against an investigation target. Some have argued that FINRA Enforcement proceedings have failed to afford any modicum of due process and challenges have been made to FINRA Enforcement on this basis. Separate and apart from On The Record testimony and exhibits and documents and other information produced by targets and third-parties in the context of the pre-complaint phase of FINRA Enforcement proceedings, FINRA Enforcement may also prepare its own investigation reports and other internal memoranda and findings even in matters not going to full hearing, but rather, those resolved by way of AWC Agreements.

(c) FINRA Enforcement Trends

From November 1, 2018 to July 29, 2019, there were thirty-one total complaints filed by FINRA enforcement with the OHO. Those complaints allege a plethora of causes of action and violations broken down as follows:

1. Rule 8210 Violations – 11
2. Conversion – 7
3. Suitability – 6
T4. Unauthorized Trading - 4
T4. Failure to Supervise - 4
T4. Books/Records Violations - 4
T4. Falsifying Documents (Firm) – 4
T4. Misleading U-4 Filing - 4
T5. Private Securities Transactions – 3
T5. Fraud/10(b)(5) Violation – 3

T6. Inadequate AML Procedures – 2
T6. Undisclosed Outside Business Activity – 2
T6. Employed Barred Person – 2
T7. Unfair Prices/Commissions – 1
T7. Stock Market Manipulation – 1
T7. Cheating on Series 7 – 1
T7. Falsifying documents/Forgery – 1
T7. Loan From Customer – 1
T7. Sharing in Proceeds – 1
T7. Churning – 1
T7. Breach of Loyalty/Misuse of Information – 1
T7. False Statements to Firm – 1
T7. Unethical Business Conduct – 1
T7. Negligent Misrepresentation – 1
T7. Misrepresentation – 1
T7. Distributing Misleading Sales Information – 1
T7. Sale of Unregistered Securities – 1
T7. False Expense Reports – 1

As one can see, the cases brought by Enforcement to the OHO vary widely from fraud cases to cheating on the Series 7 examination. Notably, of the 31 OHO complaints filed during this time period, eleven of them included violations of FINRA Rule 8210 for either failing to provide information, refusing to provide information, or for providing false information. FINRA maintains a database of these filed complaints on its website.[12] Various filters can be applied to the search criteria, including date range, type of record (AWC, OHO Complaint, etc.).

In terms of volume, AWCs are far and away the most filed Enforcement document. During the same time period above, November 1, 2018 through July 29, 2019, FINRA Enforcement entered into 303 AWCs. The chart below is illustrative of Enforcement's activity:

AWCs	303	
OHO Complaints	31	
OHO Decisions	23	
NAC Decisions	13	
SEC Decisions	5	

Reviews and decisions by the Board of Governors do not seem to be available. According to FINRA, none of the SEC decisions levied during this time period resulted in an appeal.

[12]http://www.finra.org//industry/disciplinary-actions/finra-disciplinary-actions - online?field_fda_document_type_tax_tid=4611.

V. How Can Lawyers for Investor Claimants Obtain Records from FINRA Enforcement Proceedings for Use in Arbitration Proceedings

Understanding the FINRA Enforcement process allows a smart investor-claimant attorney to understand the plethora of discoverable material that could lie in that investigatory file. It is a pretty common scenario to have a FINRA customer case where the broker or the firm have settled a FINRA Enforcement matter through either an AWC or Offer of Settlement. The records, testimony, and evidence that led to that settlement can be game-changing. If there was a formal complaint filed, then transcripts of testimony taken of the broker and possibly supervisory personnel almost certainly exist. In a venue where there are no depositions, obtaining a transcript of testimony given by the broker to enforcement under oath on matters relevant to your FINRA case could be invaluable.

Likewise, brokerage firms seem to always be more reluctant to hide documents or levy absurd objections to production with regulators. Those PIABA members who represented investors during the Morgan Keegan cases will never forget the day the state regulators released their complaints with exhibits attached publicly. There were documents most practitioners did not even know existed and there they were for the world to see. Sadly, Morgan Keegan had probably tried close to 100 customer cases by the time the regulatory complaints were made public and those crucial documents came to light.

The most direct way to obtain records from FINRA in connection with a closed investigation is to file a motion for subpoena pursuant to FINRA Rule 12512. FINRA will not budge on an investigatory file for a pending investigation, so of course, attorneys for investor-claimants should seek these same records from the respondents. If the financial advisor is no longer with the firm being sued and is not a party, practitioners should also consider subpoenaing the records from the broker directly. It is possible he has a transcript of his testimony. If he does not, he can be compelled to request it from FINRA Enforcement and then produce it.

Up until early 2017, FINRA Enforcement would respond to subpoenas for investigative files regularly by turning over virtually all file contents in closed investigations that have resulted in an AWC, except attorney work product, without redaction. Something changed in the last few years however. FINRA has been fighting these subpoenas, even seeking to limit the responses to merely producing FINRA Rule 8210 requests and responses. In a case a few years back, the author was told by FINRA that they could not produce records in response to a subpoena because it was too much work to redact them. Beyond useless excuses like this, FINRA now claims various privileges and other rationales to avoid producing clearly discoverable documents that have been ordered produced by a FINRA panel. In a written response from FINRA Enforcement, through the Office of the General Counsel will suggest that counsel seek the items sought directly from Respondent's counsel. A savvy practitioner will always use that language to their advantage with the Panel and seek to compel the records from the Respondent.

It is important to draw the subpoenas up in accordance with the precise language of the Federal Arbitration Act, so that if you need to enforce the subpoena in court, its form is in strict compliance with the FAA. The easiest place to slip-up is to obtain the signature of the Chairman only. This will not suffice if you seek to enforce the subpoena in court. Pursuant to the FAA, the signatures of all three arbitrators are required on the subpoena in order to properly compel production from FINRA. FINRA rules, however, allow for a single arbitrator, usually the chairperson or designated discovery arbitrator, to issue subpoenas or orders in accordance with the FINRA Code of Arbitration Procedure in routine discovery related matters. Err on the side of caution and specifically request the Subpoena be signed by all three arbitrators.

The production of transcripts of prior testimony of a FINRA member firms and their licensed professionals can be essential in FINRA arbitration proceedings, particularly in the context of preparing both direct and cross-examination of FINRA member firms and professionals. Without access to transcripts and exhibits, claimants in FINRA arbitration proceedings can clearly be deprived of due process and fairness, particularly in circumstances where member firms, their personnel and/or their FINRA licensed professionals decide not to appear, testify or otherwise not be available to participate in FINRA arbitration proceedings. While FINRA Enforcement might fight the production of transcripts, exhibits and relevant documents and information, it is clear that a full and fair adjudication cannot be had in many circumstances without access to them.

Grounds upon which FINRA Enforcement might rely upon in refusing to produce On The Record and hearing transcripts, exhibits and other documents and information would include personal confidential identifying information such as account numbers, dates of birth, Social Security numbers, as well as lack of jurisdiction, prosecutorial confidentiality, investigative privilege, prosecutorial privilege, work product privilege, attorney client privilege and certainly other creative claims to prevent production. Look to the definition used by FINRA when arguing what is PCI and what is not.

Names and mailing addresses are not PCI and therefore, should not be redacted from any documents.

FINRA defines PCI as including:

> Social security numbers;
> Brokerage, bank, or other financial account numbers
> Taxpayer identification numbers; and
> Medical records.[13]

FINRA also identifies situations where it will disclose customer information. Much like the disclaimer in brokerage firm customer privacy policies, FINRA identifies several scenarios where it may disclose customer information:

> FINRA may, however, disclose personal confidential information under the following circumstances: to comply with a state or federal law or regulation; to respond to a subpoena, court order, government request, or other legal process; or as otherwise permitted by law.[14]

Investor-attorneys should resist any demand by Respondent or suggestion by FINRA that it has to redact everything referencing a third-party. To do so would be patently unfair, rob claimant of relevant information, and in many instances, render documents or information provided useless.

[13]Protecting Personal Confidential Information, FINRA, https://www.finra.org/arbitration-and-mediation/protecting-personal-confidential-information (August 2, 2019).

[14]*Id.*

VII. If there has been an AWC or other Offer of Settlement Involving Respondent or its Broker, Respondent Likely has Reams of Discoverable Documents and to Compel Them, The Learned Practitioner Must Know the Case Law That Support Your Motion

Respondents always object to producing documents provided to FINRA or the SEC. They invoke various federal privacy statutes anchored in the Graham Leach Bliley Act arguing that somehow the records are covered by some amorphic privilege. Respondents are wrong and the case law is overwhelmingly against this position. The seminal case on the discoverability of documents and information in the possession of a party involved in a SEC investigation is LaMorte v. Mansfield, 438 F.2d 448 (2nd Cir. 1971). In an opinion authored by Circuit Judge Henry Friendly, considered by many to be the most influential securities law judge in the history of American jurisprudence, the Second Circuit refused to use 17 C.F.R. § 203.6 or § 203.2 as grounds to protect a litigant from producing documents in its possession. Directly at issue in LaMorte was the production of a transcript of testimony given under subpoena by the president of the Shattuck Denn Mining Corp. in an unrelated SEC investigation into the company. In a derivative action, the shareholders of Shattuck Denn sought the transcripts of this testimony through a discovery request. LaMorte refused to produce the transcripts, invoking 5. U.S.C. § 555(c) and 17 C.F.R. § 203.6, arguing that these statutes and regulations protect the confidentiality of the testimony given and the transcripts created. Id. at 450. The District Court ordered LaMorte to produce the transcript. LaMorte promptly filed a Mandamus action requesting that the Circuit Court overrule the District Court, and Circuit Judge Friendly denied the petition. Id.

In denying the Petition, the Second Circuit reasoned that 17 C.F.R. § 203.2 "…was an articulation of the discretion possessed by the *agency* in determining whether to disclose information acquired in the course of certain investigatory proceedings." Id. (emphasis in original). Circuit Judge Friendly concluded, "[t]o the extent that a privilege exists, it is the agency's, not the witness'. The agency is free to withdraw the veil of secrecy, and once the witness has been allowed to obtain the transcript of his testimony, it is no more privileged or confidential in his hands—absent any restriction placed by the agency on disclosure of its contents—than any other record of a previous statement would be." Id. at 451. Thus, the privilege belongs to the SEC, not to the party in possession of the documents or information from whom the production is sought.

Although the LaMorte case is specifically about transcripts of testimony, which are documents, the interpretation of 17 C.F.R. § 203.2, which is frequently relied on by Respondents as their justification for stonewalling, is clearly applicable to documents. These regulations are intended to protect the SEC's enforcement and investigatory capabilities and prevent it from having to produce documents and information to a party in litigation. If the claimant in a case served a subpoena directly on the SEC seeking all documents relating to its investigation of a respondent, the SEC would invoke 17 C.F.R. § 203.6 or § 203.2 as its reasons to refuse production, with possible success. These regulations were drafted to provide protection to the SEC and to preserve the integrity of the agency's investigative and law enforcement abilities. These regulations cannot be used by litigants to avoid producing documents **that are relevant and in the party's possession.**

Other federal courts have ruled similarly. In In the Matter of Four Seasons Securities Laws Litigation, the Court ruled upon a party's Motion to Compel which sought the production of copies of transcripts of testimony, the exhibits referenced to during the testimony, and other documents given to the SEC or any of its investigators or hearing officers. 54 F.R.D. 527, 528 (W.D. Okla. 1972). In that case, the Court relied exclusively on a memorandum submitted to the court on behalf of the SEC as *amicus curiae.* The SEC Memorandum states, "Similarly, **the Commission**

does not object to the disclosure by defendants of documents furnished by them during the course of the Commission's investigation, irrespective of whether such documents are exhibits to testimony." Id. 530-531 (emphasis added). The District court relied exclusively on the SEC Memorandum in overruling the Defendants' objections based on claims of privilege and ordered the defendants to produce the requested transcripts and documents submitted to the Commission. Id.

More recently, the Fourth Circuit in Addario v. Geller, 129 Fed. Appx. 1 (4th Cir. 2005) stated clearly, in overruling a district order refusing Plaintiff's request for documents submitted by defendants in the course of a separate SEC investigation, "[t]he district court erred because there is no such thing as an SEC privilege." 129 Fed. Appx. at 7. In that case, the defendants used 17 C.F.R. § 203.2, just like respondents frequently do in FINRA proceedings, as their shield from producing documents submitted to the SEC. The 4th Circuit stated "…17 C.F.R. § 203.2 provides only that information and documents obtained by the SEC in the course of an investigation are deemed non-public. The regulation does not provide that documents and materials submitted to the SEC are not discoverable in a later civil proceeding." Id.

State courts have also construed these regulations similarly. In Kirkland v. The Superior Court of Los Angeles, Kirkland (like respondents in a FINRA arbitration) refused to produce documents in connection with an SEC investigation invoking privilege and public policy. The court denied the Kirkland's argument stating,

> …there is no law to support Kirkland's claim that the SEC testimony and documents should as a matter of policy be treated as private or confidential, and the law that does exist supports the opposite conclusion. Witnesses who testify or produce documents to the SEC usually have the right to obtain copies of the transcripts of their testimony and documents and where they have done so, as has Kirkland, there is no cognizable claim of confidentiality or privacy in those documents or transcripts.

95 Cal. App. 4th at 98-99 (Cal. App. 2nd Dist. 2002), citing LaMorte v. Mansfield.

Thus, although practitioners should certainly seek to use subpoenas under FINRA Rule 12512 to obtain records directly from FINRA, many of these same records, including transcripts of testimony, are in the possession of Respondent. They will not provide them willingly and will attempt to bully arbitrators by citing all sorts of scary federal laws that allegedly provide some privilege to producing these records. They are wrong and the case law is in claimants' counsel's favor.

VIII. Should Attorneys for Claimants Cooperate with FINRA Enforcement?

This is the question and the answer is not a simple one. On the one hand, regulatory pressure and findings against your respondent or broker could pay dividends for your clients' case. On the other hand, there could be no findings, or no decisions, until years after your case has closed. Worse yet, and although introducing them in a hearing runs counter to NASD Notice to Member 02-53, the prospect of a "no-action letter" finding its way to a Panel and then having to un-ring that bell can be problematic.

This can be a time-consuming process to claimant's counsel and there is no assurance that any benefit from such cooperation will inure to the client. Additionally, there is a risk that counsel for

respondent firms and licensed professionals will surely do their best to make inquiry into any such exchanges and cooperation. Although, anecdotally, these requests are extremely rare and are never granted during a pending investigation, one can see where requesting records from Enforcement could break both ways.

FINRA Enforcement attorneys are subject to their own code of conduct and professional constraints which clearly limit and prohibit their ability to disclose any meaningful and substantive aspects of their pending enforcement cases. Essentially, as with prosecutions in most contexts, it's a one-way street and Claimant's counsel hoping for any information, voluntary cooperation or insights into the scope and focus of FINRA Enforcement proceedings are almost uniformly are unlikely to learn anything. In many circumstances, in exchange for information, FINRA Enforcement can agree to hold any determinations, especially a no-action determination, in abeyance until the conclusion of your client's arbitration case.

Arbitrators are now empowered to take matters into their own hands and make disciplinary referrals to FINRA Enforcement at any point of a proceeding. FINRA Rule 12104 provides in relevant part:

> (b) During the pendency of an arbitration, any arbitrator may refer to the Director any matter or conduct that has come to the arbitrator's attention during a hearing, which the arbitrator has reason to believe poses a serious threat, whether ongoing or imminent, that is likely to harm investors unless immediate action is taken. Arbitrators should not make referrals during the pendency of an arbitration based solely on allegations in the statement of claim, counterclaim, cross claim, or third party claim. If a case is nearing completion, the arbitrator should wait until the case concludes to make the referral if, in the arbitrator's judgment, investor protection will not be materially compromised by this delay.
>
> (c) If any arbitrator refers a matter or conduct for investigation under paragraph (b) of this rule, the Director will disclose the act of making the referral to the parties. A party may request that the referring arbitrator(s) recuse themselves, as provided in the Code, no later than three days after the Director notifies the parties of the referral. If a party does not make the recusal request within the prescribed timeframe, the party forfeits the right to request recusal of the referring arbitrator(s).
>
> (d) The Director will evaluate the arbitrator referral to determine whether to transmit it to other divisions of FINRA. Only the Director shall have the authority to act under this paragraph (d).
>
> (e) At the conclusion of an arbitration, any arbitrator may refer to FINRA for investigation any matter or conduct that has come to the arbitrator's attention during and in connection with the arbitration, either from the record of the proceeding or from material or communications related to the arbitration, which the arbitrator has reason to believe may constitute a violation of the rules of FINRA, the federal securities laws, or other applicable rules or laws.

This rule was amended in 2014 to allow for mid-case referrals.[15] As such, the cross-over between Enforcement and Arbitration has increased in the last few years with the implementation of these referral rules.

IX. What Level of Cooperation Does FINRA Seek – What do they Want?

In most instances, if the Enforcement case has to do with misconduct involving customer accounts, FINRA more than likely has all of the documents it needs by virtue of Rule 8210 requests to the brokerage firm. FINRA wants to hear from your client. Initially, they will seek an informal interview, usually conducted telephonically, on which claimant's counsel must be on the line to interject and listen in. These informal calls are not formal OTRs and there is no transcription or oaths taken.

Participating in these calls should be a no-brainer for claimant. From a practitioner's perspective, the investor-attorney gets to listen-in to her client answer questions from another attorney in a non-adversarial environment. This can be invaluable to any attorney. Use this as an opportunity to listen to how your client answers questions, their demeanor, and their credibility. Use it as a practice session, something most investor-clients sorely need because they are not used to testifying.

If your case involves some outside business activities or selling away, FINRA may seek documents and information from your client. First, it is important to remember that FINRA Enforcement has no jurisdiction over your client and that Rule 8210 does not apply. This is purely voluntary. Take heed and make sure that sharing information about the selling away scheme with FINRA Enforcement will inure to your client's best interests.

X. Conclusion

The FINRA Enforcement process is complicated and can take a decade from start to finish. PIABA members are well served to understand these processes, especially the levels of appeal. There could be valuable discovery in those files and every investor-attorney must be armed to procure those records one way or another. The issue of cooperation is another important aspect that must be weighed based on what is in your client's best interests. Although FINRA Enforcement and claimant-attorneys are not on the same team, there is some common ground that can prove mutually beneficial.

[15]See FINRA, Regulatory Notice 14-42: Mid-case Referral in Arbitration

Key Considerations When Dealing with Respondent's Counsel in FINRA Arbitration

Adam J. Gana

I. Introduction

Claimant's counsel faces unique challenges in the Financial Industry Regulatory Authority ("FINRA") forum due to a decline in customer arbitration claims in recent years. With the stock market indices rising to their highest levels ever, and a 10-year bull market run with no immediate end in sight, customer FINRA arbitration cases are down 22% in 2019 versus 2018 so far this year, according to FINRA's Dispute Resolution Statistics. With filings dramatically down, it is a good time to examine cases more carefully and to take the time to better understand and appreciate Respondent counsel's strategy, tactics, and perspective to zealously and effectively represent investors in this environment. This article examines some of the aspects of the interplay between Claimant and Respondent's counsel in FINRA customer arbitrations.

II. Pre-Filing Settlement Demands

The determination of whether to submit a pre-filing settlement demand to Respondent is a conundrum that confronts Claimant's counsel in many cases. From the outset, it would seem prudent to submit a settlement demand before filing the Statement of Claim in order to accomplish the client's goals sooner and preserve resources for both parties. However, the reality is settlement demands submitted before the initiation of a matter are rarely received seriously, usually lead to reduced settlement amounts or are not successful in resolving claims. Pre-filing settlement demands should only be submitted under limited circumstances.

Pre-filing settlement demands are usually unsuccessful or lead to a less than desirable outcome because a basic letter outlining your client's case may be seen as a demonstration of weakness (either lacking confidence or an attempt to hide a flaw in the case) and fails to communicate the seriousness of the matter. For example, Respondent's counsel could receive the settlement demand and wonder why Claimant lacked confidence to test the claim before the panel. Moreover, settlement demands – especially ones without definitive parameters and deadlines – can lead to Respondent stringing along an investor for months without a resolution. Accordingly, if Claimant wishes to submit a settlement demand before filing, it is advisable to send a draft Statement of Claim along with a letter or email with a specific deadline for Respondent to respond. This approach will communicate to Respondent's counsel that Claimant is serious about the case and ready to file a claim if necessary.

III. Drafting and Filing the Statement of Claim

The Statement of Claim is Claimant's introduction to the panel and Respondent's counsel, and careful consideration must be given to how brief or specifically articulated the facts and legal sections should be drafted. Pursuant to FINRA Rule 12302(a), Claimant is required to provide a statement of facts and remedies in the Statement of Claim. However, unlike federal or state court,

Claimant is not required to plead facts with specificity. Thus, Claimant's counsel has discretion in terms of the detail included in the Statement of Claim.

There are various reasons and considerations why Claimant may wish to draft a brief versus a specific Statement of Claim depending upon the facts, surrounding circumstances, and relationship between the parties and counsels, respectively. On the one hand, Claimant's counsel may desire to send a strong message to Respondent's counsel from the beginning that Claimant's claims are based upon a sound factual narrative and thoroughly researched legal theories. In other words, there may be some correlation between the specificity of the Statement of Claim and the strength of the case, with a more detailed Statement of Claim indicating a stronger case and vice versa. On the other hand, Claimant's counsel may be confronted with a fast-approaching eligibility period expiration, and may need to file the Statement of Claim with only a basic understanding of the facts at the commencement of the matter. Or, Claimant's counsel could refrain from including all of the relevant facts and legal theories at the beginning of the case to allow room for the matter to evolve and develop during discovery or other developments (like a pending regulatory matter).

In any of the above scenarios, whether brief or specific, Claimant's counsel should expect Respondent's counsel will attempt to glean information and tactic from the level of detail included in the Statement of Claim. For example, a brief and undefined Statement of Claim could convey to Respondent's counsel that Claimant's case is not sound. Alternatively, a detailed Statement of Claim that nonetheless contains inaccurate information (or only partial information) will convey to Respondent's counsel that Claimant's counsel is not as familiar with the facts as the Statement of Claim would lead one to believe. Ultimately, Claimant's counsel must weigh a range of considerations when formulating the Statement of Claim to initiate the claim.

IV. Strategies for Dealing with Respondent During Discovery

Many cases are won or lost during discovery, especially in light of the limited discovery procedures (no depositions, interrogatories, etc.) permitted in FINRA customer arbitration. Notwithstanding, many attorneys waste this opportunity to obtain valuable documents and information by allowing Respondent's counsel to stonewall their discovery demands through their own lack of attention to detail. Indeed, a common tactic many Respondents employ is to assert boilerplate objections to document and information requests pursuant to FINRA Rule 12507 and even presumptively discoverable Discovery Guide materials. Claimant's counsel must call out these rote objections in a meet and confer letter to Respondent's counsel, and if necessary, in a motion to compel to the Panel.

Claimant's counsel can stave off Respondent's obstructionist efforts in several ways. First, Claimant must propound discovery early in the case to allow sufficient time for follow-up well in advance of the motion to compel deadline. Second, Claimant's document and information requests must be sufficiently broad to capture all of the documents necessary to prosecute the case, but specific enough so that Respondent (and the panel) can determine the responsiveness of documents. For example, it is advisable to request all electronic communications sent or received by the financial advisor at issue, while also providing a list of search terms in the request. This approach will demonstrate that you possess a command of the case, investments, and facts in dispute early in the case, while increasing the likelihood you will receive the documents necessary

to negotiate settlement or present evidence at hearing. Finally, Claimant's counsel must be prepared to articulate to the panel via a motion to compel why certain documents are responsive and are necessary to the prosecution of the case.

V. Settlement Considerations

Parties in all forms of litigation agree to resolve cases through settlement based upon a myriad of considerations, including but not limited to, financial, reputational, preservation of resources (time, energy, etc.). However, FINRA customer arbitration presents a few unique circumstances that can change the calculus for Respondent's counsel. For example, if your client was the victim of a pervasive fraud or financial misconduct, and there exists a pending regulatory inquiry or investigation related to your client's complaint, then this could have an important impact upon the evaluation of the case by Respondent's counsel. On the one hand, Respondent may determine that settling the case with your client could negatively impact the regulatory investigation. On the other hand, and depending upon the stage of the inquiry, Respondent may determine it is in its best interest to settle with your client early to avoid extensive discovery. Specifically, Respondent may try to avoid turning over sensitive documents it produced to regulators during an examination or investigation that it otherwise would seek to hide during the normal course of discovery absent a regulatory inquiry.

In addition, the financial advisor's status as a potential party to the case or either a current or former employee could have an important impact upon the evaluation of the case by Respondent's counsel. This is particularly true depending on the stature of the financial advisor (i.e. position within the company) and the firm's financial resources. For example, where the individual financial advisor has not been named as a Respondent, and the financial advisor remains employed by the Respondent firm, the advisor may still be forced to contribute to a settlement by the firm. Conversely, if the individual financial advisor has not been named as a Respondent and is no longer employed by the firm, then the firm may have little leverage or ability to seek contribution from the financial advisor towards settlement. These considerations are obviously heightened where the firm has limited financial resources.

Moreover, another factor Respondent's counsel routinely references during negotiations where the financial advisor is still employed by the firm, in particular, involves FINRA registration reporting requirements. Typically, a firm is obligated to report settlements above $14,999. Thus, due to the adverse effect a settlement disclosure may have to a financial advisor's CRD and reputation, the financial advisor may resist agreeing to a specific settlement amount above $14,999. As a result, Claimant's counsel has to take into account Respondent's counsel's position in dealing with both the firm and the financial advisor at the same time especially for small settlement value cases.

In the end, FINRA customer arbitration settlements often take into account a myriad of factors beyond the traditional considerations found in civil litigation such as the existence of a regulatory investigation, the financial advisor's interests, and reporting requirements. Accordingly, Claimant's counsel must carefully strategize and anticipate Respondent's counsel's perspective when it comes to settlement negotiations.

VI. Respondent's Common Defenses

Respondent's counsel utilizes a common set of defenses that often attempt to blame the aggrieved investor for Respondent's negligent or fraudulent misconduct. The most common defenses, include: 1) the sophisticated-investor defense or wealthy investor defense; 2) the blame-the-market defense, 3) the prospectus-defense; 4) the net-out-of-pocket-defense; 5) the failure-to-mitigate-damages defense; and 6) the blame-the-victim defense. Some of these common defenses are based upon an actual legal theory like the "blame-the-market" defense, which is predicated upon breaking the causation link, while other defenses are completely devoid of any legal theory.

With respect to all of these defenses, the common litigation tactic is to seek broad discovery concerning Claimant's personal and financial background to find any possible hook to hang its defense. FINRA's Discovery Guide provides a list of presumptively discoverable materials each customer must produce, including sensitive financial records, which plays directly into Respondent's blame-the-victim defense. For example, List 2, Item 1 requires Claimant to produce: "[a]ll customer party and customer party owned business (including partnership, corporate) federal income tax returns the customer parties filed, limited to pages 1 and 2 of Form 1040, Schedules A, B, D, and E, and the IRS worksheets related to these schedules…for the three years prior to the first transactions at issue in the Statement of Claim through the date the Statement of Claim was filed." Customers also have to provide a resume or information about their education and professional history. These documents provide Respondent's counsel with a roadmap to attack Claimant's financial health and background, and assert the investor was a risk-taker, wealthy, sophisticated, or a combination of all of the above.

Moreover, the breadth of the customer's financial information sought is usually grossly disproportionate to the size of the case or the issues in dispute. For example, some Respondents request business records, loan applications, banking statements, credit card statements, and any other loosely related financial document going back many years. These documents are often times irrelevant and not representative of the investor during the relevant time period, but nonetheless, permit Respondent to paint a picture that the investor was a risk-taker and/or sophisticated with respect to the investments or investment strategy at issue. Claimant's counsel must be on guard to prevent disclosure of sensitive financial information, where possible, which will be taken out of context by Respondent's counsel during settlement negotiations or at hearing.

The risk that Respondent's counsel will use documents and information provided by Claimant to support its own defenses underscores the importance of discovery, both offensively and defensively, in FINRA customer arbitrations. As mentioned, many cases are won or lost during discovery. As a result, it's critical to evaluate the documents exchanged during discovery to anticipate Respondent's common defenses, while at the same time using discovery effectively to advocate on behalf of the investor.

ETHICS IN ARBITRATION, RECENT RULINGS

Jeff Sonn and Adolfo Anzola[1]

The past few years have brought a plethora of new disciplinary proceedings against lawyers across the country for violating ethics rules. This article will explore some of these more recent disciplinary decisions by utilizing their basic fact patterns to test, inform and update the securities arbitration practitioner's knowledge of the ethics rules. Through a series of multiple choice questions, generally modeled on actual ethics cases and an answer key, ethics rules will be reviewed, explored and analyzed.[2]

Ethics Questions

1. Rose Morales hired an attorney in California to represent her in a securities arbitration matter alleging excessive trading of her account. Rose gave a $5,000 deposit to her attorney to be used for expenses in her case. Eighteen months later, the case settled, and Rose was promptly paid her share of the recovery, except that the cost deposit was inadvertently left out of the closing statement, so the expenses were deducted from the recovery, and Rose had forgotten about her expense deposit. Three months later, Rose was looking at her bank statements, and notice the $5,000 check, so she emailed the attorneys' office requesting a refund. Over the next two months, Rose emailed and spoke to the attorney's assistant to request her refund. Rose finally filed suit in small claims court, obtained a judgment, and the attorney thereafter promptly paid the judgment and her court costs. Upon review by the state's disciplinary panel:

   a. The attorney was not disciplined because he promptly paid the judgment.
   b. The attorney was not disciplined because he promptly paid her share of the recovery, and he inadvertently left the cost deposit off the closing statement.
   c. The attorney was disciplined for not putting the cost deposit on the closing statement.
   d. The attorney was disciplined for not timely returning calls and emails.
   e. The attorney was disciplined for not promptly returning the deposit.
   f. The attorney was disciplined for reasons c, d and e, above.

2. A client hired Don to sue his broker dealer to defend him for suit over a margin debit. The attorney charged a flat $20,000, to be paid in four installments. The fee agreement contained no milestones indicating when portions of the fee would be earned. Don was paid the four installments, but he did not keep bookkeeping records indicating when the installments were paid. Don completed his representation one year later, fulling earning the flat fee.

   a. Don violated an ethics rule for not setting milestones indicating when portions of the fee would be earned.
   b. Don did not violate any ethics rules because he completed the representation in full, earning the flat fee.

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[2]Names of the accused were changed to prevent the reader from researching the disciplinary case before answering the question.

c. Don violated an ethics rule for not keeping records when the installments were paid.
d. Answers a and c above.

3. Ann was fired from her job as an associate general counsel at a brokerage firm after telling the President that she saw evidence that certain branch managers were illegally soliciting business in Brazil through unregistered foreign advisors. As a condition of her employment, she signed an agreement requiring her to keep the brokerage's information strictly confidential and to return all secret or confidential materials when her employment terminated. Upon leaving the brokerage firm, Ann took company documents that evidenced the illegal activity. After her firing, Ann hired an attorney to file a whistleblower claim and an arbitration for wrongful termination. Ann's attorney then contacted the brokerage firm and threatened to go to the press if the brokerage firm did not immediately agree to go to mediation. The brokerage firm declined. Ann, through her attorney, filed a whistleblower complaint under Section 806 of the Sarbanes Oxley Act of 2002 ("SOX"), with the Department of Labor, and also sent letters to OSHA, the SEC, the Department of Justice, and the Brazilian Justice Department, supplying the documents Ann had taken from her employer. As part of their litigation plan, Ann and her attorney met with a reporter and provided documents to support Ann's story. The article was then published in the news. The brokerage firm figured out that key details in story could only have come from Ann and filed ethics complaints against Ann and her attorney. During the disciplinary proceeding, Ann did not answer the charges, did not testify on her own behalf, and did not supply any exhibits. She opposed the disciplinary report to the court after findings were made.

a. Ann was found not to violate any ethics rules because the conduct she reported was illegal and thereafter acted on advice of counsel.
b. Ann was found guilty of ethics rules for speaking to the press.
c. Ann was found not to violate any ethics rules by making the whistleblower complaint to the Department of Labor, OSHA, the SEC, and the Department of Justice.
d. Ann violated ethics rules by filing the complaint letters with the US Attorney, Brazilian authorities and the SEC, but not the whistleblower complaint to the Department of Labor under SOX.
e. Ann violated ethics rules in connection with the letters to the US Attorney, Brazilian authorities and the SEC, and because she failed to testify at her ethics hearing to justify her use of the crime fraud exception to the attorney client privilege.
f. All of the above except a.

4. Andrew Fox, a prominent attorney known for his bravado and courtroom theatrics, wrote letters during pending securities arbitrations that offended opposing counsel and FINRA staff, who reported his remarks to a disciplinary committee. Mr. Fox reportedly wrote things like "one female had no brain wave activity" and opined "crudely" about her Valentine's Day plans. Mr. Fox referred to others as "Kurvacious" and "Kooky" and "another beautiful but arrogant female". Fox wrote about another, "beyond [yoga], I cannot fathom anything where she would have sufficient expertise to teach." In another letter to a male administrator at FINRA, Fox called him a "young Jewish man" and suggested that he should be a "goat herder in Lebanon." Despite promising thereafter to FINRA that he would be more professional, Fox later sent a FINRA staff member with whom he was friendly, an email in which he claimed that "he used to expose himself to girls using a popcorn box in a movie theater and while holding it in my lap and having my thing surrounded by popcorn." Needless to say, many complained to the bar about his behavior.

a. Andrew Fox was found not in violate of any ethics rules because he was protected by the judicial proceedings privilege, a doctrine that protects any statement made in the course of a legal proceeding.
b. Andrew Fox was found not to violate any ethics rules because his statements were protected by the First Amendment.
c. Andrew Fox was found liable for violating that part of ethics rule 8.4 that prohibits conduct "prejudicial to the administration of justice."
d. Andrew Fox was found liable for violating the ethics rule 4.4(a) "because the offensive portions of Andrew [Hurley's] unprofessional correspondence had "no substantial purpose other than to embarrass, delay or burden" opposing counsel.
e. Answers c and d.

5. Kevin represented a client in a securities arbitration, and won a big verdict for the client, much higher than both he and the client had discussed as a range of possible outcomes. The client was so happy, he asked Kevin if there was anything he could do for him, in addition to his negotiated fee, to show the client's gratitude. Kevin remembered that his client had accumulated a gun collection and had and the client had discussed the gun collecting because Kevin also collected guns. Kevin also knew that the client had no children to leave his collection. Kevin told the client that if the client desired, he could leave the gun collection to Kevin in his will. The client readily agreed and had his estate attorney draft a codicil to the will. After the client died, a nephew of the client saw the will and the codicil and complained to the bar that Kevin had taken advantage of his uncle.

a. Kevin did not violate any ethics rule because he did not prepare the codicil.
b. Kevin did not violate any ethics rule because the client initially offered to do something extra for Kevin for winning the case.
c. Kevin violated an ethics rule because he accepted a gift from a client.
d. Kevin violated an ethics rule because it was his idea for the client to gift him the gun collection in his will.
e. Answers c and d.

6. Dennis was hired to sue NBS Securities for churning her client's account along with 4 other clients. Dennis had his clients sign a standard contingency fee agreement, part which stated that the client would pay for the actual costs of things like photocopies, faxes, exhibits, witness fees, mileage, and other expenses. At the end of the case, Dennis rendered separate closing statements to each of her five clients, but in doing so, she billed each one the same amount of her actual mileage expense for traveling to and from the final hearing. The clients spoke to each other and discovered the error and complained to Dennis. He immediately reimbursed all of his clients for the mileage, but one of the clients filed a bar complaint.

a. Dennis did not commit any ethics violation because she did disclose that she charged mileage costs in her retainer.
b. Dennis was found to not commit any ethics violation because she immediately reimbursed her clients, and thus no client was harmed.
c. Dennis violated the rule that prohibits making a false statement of material fact by an attorney during the course of representation.
d. Dennis violated the ethics rule that prohibits the rule that prohibits an attorney from charging or collecting an unreasonable fee.
e. Answers c and d.

7. Martin attended an ethics seminar at the annual Public Investors Arbitration Bar Association convention, but walked in almost a half hour late into the presentation. Martin submitted his verification form, stating in part that he had attended the entirety of ethics seminar and claimed 1 credit hour. One of the other attendees turned Martin into the bar for claiming full credit for a CLE course he did not fully attend.

a. Martin did not violate any ethics rule because he read all the course materials and discussed them with his colleagues.
b. Martin did not violate any ethics rules because it is not per se improper to arrive at a CLE class late.
c. Martin can still claim a 1/2 CLE credit for the seminar.
d. Martin violated an ethics rule by making a false statement on his CLE form.

8. Denise agreed to represent a customer who had a suitability claim for $1 million dollars and to defend the customer against a $1 million margin debit. Denise and the client agreed to a 40% fee on the suitability claim and a 30% fee on any savings on the margin debt. following a hearing, the panel awarded $1 million in compensatory damages and wiped out the $1million margin debit. Denise presented her closing agreement for signature to the client showing a $400,000 fee on the suitability claim, and a $300,000 fee on the margin debt cancellation, for a total fee of $700,000. After a $50,000 charge for expenses, the client was left with $250,000. The client refused to sign the closing statement, sued Denise claiming an excessive fee, and filed a bar complaint.

a. Denise violate the ethics rules by charging an excessive fee.
b. Denise violated the ethics rules that prohibit reverse contingency fees.
c. Denise violated Rule 1.8(i) that prohibits an attorney from obtaining a proprietary interest in a client's cause of action.
d. Denise did not violate any ethics rules.

10. While representing a group of claimants against a mid-sized brokerage firm, Arthur and Daniel were approached by two former employees of the brokerage firm, who also had claims for wrongful termination. Arthur and Daniel accepted the wrongful termination cases, and informed their group of other clients. After filing the wrongful termination cases, the brokerage firm sought to disqualify Arthur and Daniel, alleging that the two former employees had discussed the other group claimants' cases with brokerage firm counsel and senior management in furtherance of their defense cases. It came to light Arthur and Daniel were given documents by the former employees.

e. Arthur and Daniel were disqualified under Rule 1.7(a) that prohibits a conflict of interest where the representation of one or more clients by materially limit the lawyer's responsibilities to another existing client.
f. Arthur and Daniel were disqualified under Rule 4.4(a) that states in part that in representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person, or use methods of obtaining evidence that violate the legal rights of such a person.
g. Arthur and Daniel were not disqualified for any ethics violation because under Rule 1.7, the representation did not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.
h. answers a and c.

11. Michael represented Larry and his wife in a claim for fraud and misrepresentation of the sale of securities. During cross examination of Larry, it appeared he became confused with the questions and made statements that contradicted what he had earlier told his attorney. Michael obtained a recess because his wife convinced him Larry was not feeling well. Michael learned during the recess from Larry's wife that he had suffered a minor stroke six months earlier, and she thought he had fully recovered, and Larry was too embarrassed to mention it to Michael. Nonetheless, Michael felt that Larry's testimony had hurt their case and that his continuing to testify could make things work, so he convinced Larry and his wife to settle for $50,000, far less than they had discussed pretrial. After the settlement, Michael convinced Larry's wife to seek and be appointed as his guardian, and upon appointment, asked her to sign the settlement as Larry's guardian. Later, Larry and his wife decided the settlement was too low, so they sued Michael for malpractice, and filed an ethics complaint.

i. Michael did not violate any ethics rules because his clients had hid Larry's minor stroke from him.
j. Michael's advice did not violate any ethics rules because Larry's wife told him that Larry had recovered.
k. Michael violated an ethics rule because he failed to advise the panel of Larry's minor stroke, once he learned of it.
l. Michael properly counseled Larry's wife to be appointed his guardian, so she could sign the settlement on his behalf, as it was in his best interests.

Answer Key:

1. D. The attorney was disciplined for not returning the cost deposit upon termination of employment. See California former Rules of Professional Conduct 3-700(D)(2); ABA Model Code Rule 1.16, Declining or Terminating Representation: ***(d) Upon termination of representation, a lawyer shall take steps to the extent reasonably practicable to protect a client's interests,*** such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled ***and refunding any advance payment of fee or expense that has not been earned or incurred***. The lawyer may retain papers relating to the client to the extent permitted by other law. See State Bar of California, Case No. 16-O-14144 (Complainant, Jake Weber, Jan. 28, 2019).

2. C. The attorney's conduct violated Colorado Rule RPC1.15(j) and ABA Model Rule 1.15 Client-Lawyer Relationship -Safekeeping Property. (a) A lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from the lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. Other property shall be identified as such and appropriately safeguarded. ***Complete records of such account funds and other property shall be kept by the lawyer*** and shall be preserved for a period of [five years] after termination of the representation. See Case No. 16PDJ020 People vs. Flores (Colorado, 3/3/16).

3. E, all of the above. The attorney and former inhouse counsel were found to have violated the ethics rules by speaking to the press, but not found to have violated any ethics rules by filing the whistleblower complaint with the Department of Labor under SOX. See In the Matter of Koeck and Bernabei, DC Court of Appeals, Board on Professional Responsibility, Board Docket No 14-BD-061 (Aug. 30, 2017). Importantly, the former in house counsel failed to testify at her disciplinary hearing, so the Board found she failed to carry her burden of proof of the "crime fraud exception" to the attorney client privilege. Id. At 18-19. Yet, the Board found that SOX protected her when it came to the Department of Labor complaint, as that was a formally filed action. Id at 21.

Rule 1.6(a) states that a lawyer "shall not knowingly reveal" a confidence or secret of her client unless excused by one of the limited exceptions to the Rule." Id at 15. "The ABA Model Rule of Professional Conduct, on the other hand, more generously permits offensive use of client confidences or secrets." Id. Model Rule 1.6 provides in part: (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary . . .(5) to establish a claim or defense on behalf of a lawyer in a controversy between the lawyer and the client . . . .Id. "The Rule 1.6 prohibition encompasses client "confidences" (that is, information protected by the attorney-client privilege) as well as client "secrets" (which comprehensively include "other information gained in the professional relationship that the client has requested be held inviolate, or the disclosure of which would be embarrassing, or would be likely to be detrimental, to the client")." Id; See Rule 1.6(b). The board then determined that there was "no dispute that the in house counsel disclosed he former employer's confidences and secrets (1) to a reporter; (2) to Department of Justice; (3) to Brazilian authorities; (4) to the SEC; and (5) to the Department of Labor." Id at 16. The Committee found that disclosures to the U.S. Attorney and Brazilian authorities were appropriate under the "crime-fraud" exception in Rule 1.6(d), and that disclosures to the SEC were appropriate under federal securities laws," but the Board, reviewing the Committee's recommendation, found that that the former in house counsel failed to testify at all, provided no exhibits, and no evidence to sustain her burden of proof. Thus she was found to have violated Rule 1.6.

The Board made some distinctions between offensive and defensive use of the crime-fraud exception to the attorney client privilege for in house counsel as follows:

> Under D.C. Rule 1.6, an in-house counsel: may not reveal or use employer/client secrets or confidences offensively in making a claim for employment discrimination or retaliatory discharge—unless, of course, such disclosures are authorized by another exception to D.C. Rule 1.6 (e.g., the crime/fraud exceptions in subsection (d)). D.C. Bar Ethics Op. 363 (Oct. 2012). This is so because D.C. Rule 1.6 principally contemplates defensive disclosure of client confidences or secrets. See Rule 1.6(e)(3) (disclosure of information defensively permitted "to the extent reasonably necessary" to respond to allegations by the client or in defending a civil claim). Offensive disclosure is permitted only in a fee collection action, and then only "to the minimum extent necessary." Rule 1.6(e)(5). The ABA Model Rule of Professional Conduct, on the other hand, more generously permits offensive use of client confidences or secrets. In relevant part, Model Rule 1.6 provides: (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary . . . (5) to establish a claim or defense on behalf of a lawyer in a controversy between the lawyer and the client . . . . (emphasis added). Thus, under the Model Rules, an in-house lawyer may reveal client information in a wrongful discharge case against her former employer. Model Rule 1.6(b)(5); see 21 ABA Formal Op. 01-424, at 4 (Sept. 22, 2001) ("We conclude that a retaliatory discharge or similar claim by an in-house lawyer against her employer is a 'claim'" on behalf of a lawyer that can be asserted under this exception). Ms. Koeck's SOX complaint was filed with the DOL, a "tribunal" within the meaning of the disciplinary rules.11 The D.C. Rules have a specific choice of law provision relating to "tribunals." Rule 8.5(b)(1) provides: For conduct in connection with a matter pending before a tribunal, the rules to be applied shall be the rules of the jurisdiction in which the tribunal sits, unless the rules of the tribunal provide otherwise . . . .
>
> See In the Matter of Koeck and Bernabei, DC Court of Appeals, Board on Professional Responsibility, Board Docket No 14-BD-061, at pp. 20-21 (Aug. 30, 2017).

4. D. The attorney was found to have violated Rule 4.4, which states in part "(a) (a) In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person, or use methods of obtaining evidence that violate the legal rights of such a person." The attorney, Joseph Hurley, was found to clearly violate Delaware's version of this Rule. See In re Hurley, 2018 WL 1319010 (Delaware 2018) (email comments that opposing counsel lacked brain activity); See also, In re White, 707 SE2d 411 (South Carolina 2011) (letter stating that other party in zoning dispute "has no brains and it is questionable if he has a soul"); In re Moore, 2016 WL 5886126 (Illinois 2016) (lawyer suspended for racist and demeaning comments toward client and client's parent); In re Teague, 131 AD3d 268 (New York 2015) (lawyer suspended for repeated offensive racial, ethnic, homophobic, sexist and other derogatory remarks while practicing before administrative agency); In re Schiff, 599 190AD2d 293 (New York 2015) (lawyer censured for directing vulgar, obscene and sexist epithets toward opposing counsel during a deposition); Mullaney v Aude, 126 Md App 639 (Maryland 1999) (lawyer sanctioned for racist and sexist comments directed at opposing counsel and witnesses); In re Klahn, 31 DB Rptr ___ (2018) (lawyer disciplined for interactions with court staff that were degrading and served no substantial purpose other than to embarrass, delay, harass or burden).

There is precedent from outside of Delaware for finding Rule 4.4(a) violations based on a lawyer's sexually demeaning and racist comments. See, e.g., Cruz–Aponte v. Caribbean Petroleum Corp., 123 F. Supp. 3d 276 (D.P.R. 2015) (attorney's sexist remark to female opposing counsel during deposition that “You're not getting menopause, I hope” violated Rule 4.4(a)); see also Matter of Schiffi 190 A.D.2d. 293 (N.Y. App. Div. 1993) (attorney's vulgar, obscene and sexist epithets toward female opposing counsel's anatomy and gender were inexcusable, intolerable and violated DR 1–102(A)(7) because they reflected adversely on attorney's fitness to practice law); Mullaney v. Aude, 730 A.2d 759 (Md. Ct. Spec. App. 1999) (male attorney sanctioned for sexist remark to female deponent and addressing female attorney as “babe,” during deposition); Principe v. Assay Partners, 586 N.Y.S.2d 182, 184–88, 191 (N.Y. 1992) (male attorney sanctioned for calling female attorney “little lady,” “little mouse,” and “little girl” repeatedly during deposition).

The disciplinary board in Hurley, however, did not find any violation of Georgia's ethics Rule 8.4, which prohibits "conduct that is prejudicial to the administration of justice." In doing so, the court noted that "as to Rule 8.4(d), however...the evidence did not clearly show that the letters, as offensive and inappropriate as they were, had an actual impact on the administration of justice. Our acceptance of the Board's conclusion on this point in this case should not be read as the adoption of a rule that such conduct, which is entirely unacceptable, could never support a Rule 8.4 violation upon a showing that the conduct affected the performance of opposing counsel or had some other distinct impact on the judicial process." In re Hurley, 2018 WL 1319010 (Delaware 2018); See generally ABA Model Code Rule 8.4(d)(a lawyer shall not engage in conduct that is prejudicial to the administration of justice).

5. D. The attorney violated ABA Model Code Rule 1.8(c) which states: "(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." See In the matter of Kunda, 829 S.E.2d 65 (Ga. 2019). In Kunda, not only did the attorney solicit the gift, but he also prepared the codicil to the will, in violation of Georgia ethics Rule 1.7 "prohibiting lawyer from undertaking representation involving a conflict of interest, absent client’s informed consent." Id.; See generally ABA Model Code 1.8(c)(an attorney shall not solicit gifts); ABA Model Code Rule 1.8(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 (with some exceptions)).

6. D. Dennis violated the rule prohibiting the charging unreasonable fees or expenses. See Iowa Supreme Ct. Att’y Disciplinary Bd. v. Mathahs, 918 N.W.2d 487, 489 (Iowa 2018). Iowa's ethics rule 32:1.5(a) provides in part: " “A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses, or violate any restrictions imposed by law.” Iowa R. Prof’l Conduct 32:1.5(a); Mathahs, 918 NW2d at 489; See also ABA Model Code rule 1.5(a)(" (a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses.")

Some securities arbitration practitioners may be in the habit of charging clients for photocopies, and some courts believe that, for example, .50 cents per page is excessive. See, e.g., Norwest Fin. Inc., v. Fernandez, 121 F. Supp. 2d 258, 263 (S.D.N.Y. 2000)(.50 cents per page excessive); see Corcoran v. City of Chicago, No. 10–cv–06825, 2015 WL 5445694, at *7 (N.D. Ill. Sept. 15, 2015) ($0.50 per page “is far higher that than generally approved in this District,” a district which

included Chicago—a large and expensive legal market); See also, Jones v. Siegelman, 2002 WL 1162406, at *2 (N.D. Ala. May 24, 2002)(.50 cents per page disallowed); A.T.O. Golden Construction Corp. v. Allied World Insurance Company, 2019 WL 2245507, (SDFL 2019)("rates for black and white copies generally range between $ 0.10 and $ 0.25 per page. See Procaps v. Patheon Inc., 2016 WL 411017, at *6 (SDFL 2016) (“Rates between $ 0.10 and $ 0.25 per page are recoverable,” citing Fla. Pawnbrokers & Secondhand Dealers Ass'n v. City of Fort Lauderdale, 711 F. Supp. 1084, 1086 (SDFL 1989) ($ 0.25 per page); Exime v. E.W. Ventures, Inc., 2009 WL 1759351, at *2 (SDFL 2009) ($ 0.19 per page); Ferguson v. Bombadier Servs. Corp., 2007 WL 601921, at *7 (M.D.FL 2007) ($ 0.10 to $ 0.15 per page)). And rates for color copies range as high as $ 1.25 per page. See Curry v. Montgomery, 2010 WL 883798, at *5-6 (S.D.FL 2010)"); Pinilla v. Northwings Accessories Corporation Eyeglasses, 2008 WL 11331788 (SDFL 2008)($25 per compact disc to store data was excessive); Benach v. County of Los Angeles 149 Cal.App.4th 836 (2007)("Given the law firm's equipment, overhead and personnel expenses, the trial court could certainly conclude the 15 cent fee was reasonable."); Rodriguez v. Miami-Dade County, 2019 WL 1901594 (M.D.FL 2019)(" In the Middle District [of Florida], and in other courts in the Eleventh Circuit, the reasonable market rate for copies is $0.10 to $0.15 cents per page. Perkins v. Tolen, No. 3:10-CV-851-J-37TEM, 2012 WL 3244512, at *3 (MDFL 2012)"); See George v. Fla. Dep't of Corr., 2008 WL 2571348 (SDFL 2008) (noting that rates from $ .10 to $ .14 have been deemed reasonable, but that rates from $ .15 to $ .19 cents per page have been found unnecessarily high without factual support for the increased rate."); Yoo v. District of Columbia 2019 WL 117606 (DC 2019)(.15 cents per page is reasonable); Williams v. Schwarz PA 2018 WL 4705559 (NDIL 2018)(Defendants' objection to .20 cents was sustained, and .10 cents per page allowed for in-house copies); Hardwick v. Cty. of Orange, 2017 WL 5664992, at *5 (CDCA. 2017)(Seventeen cents per page is consistent with reasonable printing costs awarded in this District). Wise v. Kelly, 620 F. Supp. 2d 435, 457 (S.D.N.Y. 2008)(10 cents per page, rather than 18 cents, “appears to be the going rate for in-house copying.”); see also Cabrera v. Schafer, 2017 WL 9512409, at *16 (E.D.N.Y. 2017) (collecting cases); Bender vs. Fenimore 2017 WL 10186320 (EDTX 2017)("[T]he Court agrees that the rate of thirteen (13) cents per page seems excessive. The Court's survey of copying costs in the local area shows that eight (8) cents per page is more typical of copying costs in the local area."); Peacock vs. Carpedia Int'l, 2012 WL 4829381 (SDTX 2012)("Houston market rate of twenty cents per page to be fair and reasonable."); See also Canion v. United States, 2005 WL 2216881, at *4 (WDTX 2005) (deeming a copy rate of $0.25 per page to be reasonable in the El Paso market).

There appears to be a split in authority on recovering charges for online legal research. Some Courts have commented that Westlaw charges are merely overhead and thus could not be charged. See In re: Meltzer 535 BR 803 (NDIL 2015)(" Charges for computerized legal research are considered office overhead, and in the absence of evidence to the contrary they are assumed to have been recovered through attorney's fees. In re Rio Hair Naturalizer Prods. Liab. Litig., No. MDL 1055, 1996 WL 780512, at *19 (E.D.MI 1996); E.E.O.C. v. Sears, Roebuck & Co., 111 F.R.D. 385, 394 (N.D.Ill.1986); Cole Taylor Bank v. Kirk Corp. (In re Kirk Corp.), Nos. 09 B 17236, 09 A 788, 2010 WL 2293471, at *7 (N.D. Ill 2010); Migis v. Pearle Vision, Inc., 944 F.Supp. 508, 518 (N.D.TX.1996)(court disallowed expenses for Westlaw charges, finding that such charges are similar to overhead charges; the Fifth Circuit found no abuse of discretion in the district court's decision), See Migis v. Pearle Vision, Inc., 135 F.3d 1041, 1048-49 (5th Cir.1998).

The Second Circuit, citing to the Eighth, Seventh and Tenth Circuits, found Westlaw charges was merely part of the attorneys’ overhead. See U.S. for Use & Benefit of Evergreen Pipeline Const. Co. v. Merritt Meridian Const. Corp., 95 F.3d 153 (2d Cir. 1996), citing Standley v. Chilhowee R–IV School Dist., 5 F.3d 319, 325 & n. 7 (8th Cir.1993) (citing Leftwich v. Harris–Stowe State College, 702 F.2d 686, 695 (8th Cir.1983))(the Eighth Circuit held that computer costs are part of

the attorneys' fees and not to be taxed separately), Haroco, Inc. v. American Nat'l Bank & Trust Co. of Chicago, 38 F.3d 1429, 1440–41 (7th Cir.1994), Jones v. Unisys Corp., 54 F.3d 624, 633 (10th Cir.1995) (computer research costs not statutorily authorized under 28 U.S.C. § 1920).

But more recently however, in Cleanup North Brooklyn by Chantratanapichate v. Brooklyn Transfer LLC, 373 F. Supp. 3d 398, 405 (E.D.N.Y. 2019), the court permitted Westlaw charges, noting "where such expenses are usually billed to clients in addition to the attorney's hourly rate, “in the context of a fee-shifting provision, the charges for such online research may properly be included in a fee award,.” Id., citing Arbor Hill Concerned Citizens Neighborhood Ass'n v. Cty. of Albany, 369 F.3d 91, 98 (2d Cir. 2004).

The Sixth Circuit suggested that the attorneys should distinguish between an online research done on a blanket access fee, and a distinct charge incurred for specific research relating to that case, noting that "we see no reason why such properly documented charges should not be included in the recoverable expenses." Smith v. Serv. Master Corp., 592 Fed.Appx. 363, 366 (6th Cir. 2014); See also, Project Vote v. Blackwell, No. 1:06–CV–1628, 2009 WL 917737, at *19 (N.D.OH Mar.31, 2009) (holding that although the Sixth Circuit has not addressed the issue, “the weight of recent authority favors treating computerized legal research as a recoverable expense”); In re: Catholic Bishop of Northern Alaska, 2008 WL 8652365 (DAL 2008)("The Westlaw charges will be disallowed at this time, but the court will reconsider these costs if an appropriate itemization is provided."); he key question is whether computer-research expenses are “of a type billed separately to the client, i.e., not absorbed in the attorney's hourly rate as overhead.” Gradisher v. Check Enforcement Unit, Inc., No. 1:00–CV–40, 2003 WL 187416, at *8 (W.D.MI 2003); Moore v. Menasha Corp., 2013 WL 308960, at *5–*6 (W.D.MI 2013) ("The key question is whether computer-research expenses are “of a type billed separately to the client, i.e., not absorbed in the attorney's hourly rate as overhead...While it is a close question, the Court concludes that the modern practice is to charge clients separately for computer-research costs.").

7. D. In the Matter of Yee 5 Cal. State Bar Ct. Rptr. 330, 333–334 (Review Dept.2014), the Court applied a totality-of-the-circumstances analysis to find moral turpitude because the attorney falsely verified that she had complied with her CLE requirements. Id. She was found to violate California's Business and Professions Code Section 6106, that states in part that "The commission of any act involving moral turpitude, dishonesty or corruption ... constitutes a cause for disbarment or suspension." See also ABA Model Code Rule 8.4((c)(it is misconduct to engage in conduct involving dishonesty).

In Yee, the Court noted that some of the additional facts that support a finding of an ethics violation is the "the State Bar's dependence on accurate self-reporting with the MCLE program necessarily relying on an “honor system,” and that Yee signed an "affirmation" which "notifies others that the statements are true and complete." In the Matter of Yee 5 Cal. State Bar Ct. Rptr. 330, 333–334 (Review Dept.2014). Yee was publicly reproved, in part because she had eleven (11) witnesses testify to her honesty and had proof her hard drive had crashed. Id. These witnesses included six chief executives from private institutions, a reverend, a former member of the State Bar Board of Trustees, a pro tem judge, and two attorneys. Id.

8. D. In Gibson vs. Epting, the Court did not find that a reverse fee agreement was per se illegal. Gibson v. Epting, 426 S.C. 346, 827 S.E.2d 178 (Ct. App. 2019). In that case, Gibson had agreed to pay Epting 1/3 of any savings of the debt she allegedly owed that was the subject of a loan foreclosure action. Id. Epting successfully negotiated a deed-in-lieu of foreclosure and Gibson was released from an almost $1.7 million debt. Id Further, Epting successfully sued Gibson's bank under a lender liability theory and recovered $2.9 million. Id. Gibson's defense that

the reverse contingency fee agreement for the foreclosure action was rejected as not ambiguous as alleged. Id.; See also In re Market Center East Retail Property, Inc. 448 B.R. 43 (Bankr.D.N.M.2011), affirmed, 469 B.R. 44 (10th Cir. BAP2012) (agreement for hourly fees plus 15% of amount saved in real estate sale). ABA Model Code Rule 1.5(c) is silent regarding reverse contingency fees, but there exists a Formal Opinion 93–373 of the ABA Committee of Ethics and Professional Responsibility, which states in part "that in a reverse contingent fee agreement, there must be a reasonable benchmark figure from which the savings are to be calculated." Formal Opinion 93–373 explains that the amount demanded by the plaintiff cannot automatically be selected as a benchmark figure, for the plaintiff's original claim may be unrealistic. Id. It states in part: "

> A plaintiff may sue defendant for $1,000,000, but the fact that sum is named in the complaint **does not necessarily mean that plaintiff's claim can fairly be said to be for that amount.** Plaintiff's counsel often overstate the amount to which their client is entitled, and indeed have little incentive for restraint. Thus, the amount demanded cannot automatically be the number from which the savings resulting from a judgment or settlement can reasonably be calculated.... Whether or not a specific ad damnum figure is mentioned, for an unliquidated claim, it is incumbent on the defendant's lawyer fairly to evaluate the plaintiff's claim and set a reasonable number as the amount from which the plaintiff's recovery will be subtracted to determine defendant's savings. The sensitivity of this exercise becomes apparent when it is recognized that to the extent defendant's lawyer exaggerates the value of plaintiff's claim, defendant's lawyer enhances his or her prospect of recovering on the contingent arrangement.
>
> ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 93–373 at 1001:181–82 (1993) (emphasis added).

For example, in Brown & Sturm v. Frederick Road Ltd. P'ship, 137 Md.App. 150, 768 A.2d 62, 79 (2001), the Court found the reverse contingency fee agreement to be unreasonable, because the attorneys were in a far better position to know that the IRS's tax valuation of their clients' property at $60 million was completely unrealistic and thus should not have been used as a benchmark to calculate their contingency fee on any savings obtained on IRS taxation of the clients' property. Id. The ultimate settlement valued the property for tax purposes at just $20 million. Id. When the clients could not pay, the attorneys deferred their fee so long as the clients paid them 10% simple interest per year, which was paid for several years. Id. The court found this fee arrangement to be excessive, noting "[t]he undisputed evidence here shows that the reverse contingency fee was based on a reduction in the tax liability claimed by the IRS, which in turn, was premised upon the farm having a fair market value of $60 million, an inflated sum of more than double any other contemporaneous appraisal of the property. The court below found, based on the evidence presented at the trial, that Brown & Sturm failed to disclose to the family at the time of the agreement a more realistic worst-case market *177 value of the farm for the purposes of federal taxation—and that information would have significantly reduced the amount agreed upon as a benchmark for tax liability in the retainer agreement." Id at 177.

9. D. In Calise vs. Brady Sullivan Harris Mills LLC, the attorneys for the plaintiffs were disqualified for violating Rule 1.7(a) and 4.4(a). Calise vs. Brady Sullivan Harris Mills LLC, 2019 WL 1397245 (DRI 2019). The court noted that attorneys are permitted to communicate with former employees of a represented party opponent, but they may not willfully disregard the rights of a third party, such as "unwarranted intrusions into privileged relationships, such as the client-lawyer relationship." Id at 5. In Calise, the former employees shared documents and communications

that the court deemed privileged. Id. See also, Aiken v. Bus. & Indus. Health Grp., Inc., 885 F. Supp. 1474, 1480 (D. Kan. 1995); Chamberlain Grp., Inc. v. Lear Corp., 270 F.R.D. 392, 398 (N.D. Ill. 2010) (it is improper to "use a disgruntled employee to secretly obtain non-public internal business documents from an opposing party."); Arnold v. Cargill Inc 2004 WL 2203410, at *7-9 (DMN 2004) (under Rule 4.4 attorneys have affirmative duty to advise former employee that they should not disclose privileged communications); In re Grievance Proceeding, 2002 WL 31106389, at *3 (DCN 2002) (in ex parte contact, counsel not seek or induce or listen to disclosures from former employees of any privileged attorney-client communications); Dubois v. Gradco Sys., 136 F.R.D. 341, 347 (DCN 1991).

10. D. Under ABA Model Code Rule 1.14, which addresses representation of a person with diminished capacity, it states:

> a) When a client's capacity to make adequately considered decisions in connection with a representation is diminished, whether because of minority, mental impairment or for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client.
>
> b) When the lawyer reasonably believes that the client has diminished capacity, is at risk of substantial physical, financial or other harm unless action is taken and cannot adequately act in the client's own interest, the lawyer may take reasonably necessary protective action, including consulting with individuals or entities that have the ability to take action to protect the client and, in appropriate cases, seeking the appointment of a guardian ad litem, conservator or guardian.
>
> c) Information relating to the representation of a client with diminished capacity is protected by Rule 1.6. When taking protective action pursuant to paragraph (b), the lawyer is impliedly authorized under Rule 1.6(a) to reveal information about the client, but only to the extent reasonably necessary to protect the client's interests. See, In re: Michael Sabatino, 2016 WL 6995384 (Pa. 2016)(the court was asked to decide whether a court appointed lawyer for an alleged incapacitated person could inform the court that the client did not want a guardian and, yet, counsel could also seek the appointment of a guardian based on counsel's belief that the client "needed some form of guardianship."), cited in Frolik, The Role of Counsel for an Alleged Incapacitated person In Pennsylvania Guardianship Proceedings, 89 PABAQ 1 (2018); See also, Larry Bize vs. Larvadain, 263 So.3d 584 (La. 3rd Cir. 2018)(Client alleged malpractice for recommending an inadequate settlement when the attorney should have known of client's diminished capacity, but action dismissed under statute of limitations where trial court had determined that clients were actively involved and extensively informed during all events in question).

DEALING WITH DEFENSE COUNSEL IN FINRA ARBITRATION CLAIMS

Andrew Stoltmann

I. Introduction

A near vertical climb by the major stock market indexes since March 9, 2009 has led to a precipitous decline in the number of customer arbitration claims filed at the Financial Industry Regulatory Authority ("FINRA"). The attorneys who represent brokerage firms and brokers face uniquely different challenges compared to Claimant lawyers. We will examine and discuss some of those dynamics in this article.

II. Considerations In Pre-Filing A Settlement Demand.

In our experience, pre-filing demands are rarely successful and shouldn't be made absent extraordinary circumstances. Most in-house attorneys are extremely busy handling both FINRA and non-FINRA related work for the firm and it is difficult for them to review a case in detail within a reasonable period of time. In addition, most pre-filing demands result in de minimis, low-ball offers. If a claimant is nonetheless inclined to make a pre-filing demand, we recommend preparing a detailed draft Statement of Claim rather than a generalized demand letter. This demonstrates claimant's seriousness and readiness to file. A well-crafted statement of claim is more likely to command the firm's attention than a routine letter to in-house counsel. It is also helpful to have some core documents ready to produce to the other side. The downside is that these documents, or at least the information in them, are almost certain to be used in the Answer if the case does not settle early.

III. Regulatory Inquiries/Investigations.

If there exists a pending regulatory inquiry or investigation related to your client's complaint, or to the broker about whom your client is complaining, this can have an important impact upon the evaluation of the case by the defense lawyer. A brokerage firm may believe that settling a case may have a negative impact upon a regulatory matter. If that is the case, the brokerage firm may believe it is necessary to fight the claim. On the other hand, a regulator may be exerting pressure on a firm to settle a particular case or group of cases, and yours may be included in that discussion. The reality is that regulatory inquiries and investigations usually move at a pace slower than federal practice. While a regulator profess a desire to take statements from brokers, supervisors and clients, soon after learning of the claim, the regulator may end up sitting on statements for years before deciding whether to pursue the matter. Brokerage firm lawyers often believe that a regulatory investigation has ended when in fact it has only been dormant for two or three years. The average FINRA investigator has a caseload even larger than the average brokerage firm in-house attorney. They are also paid substantially less. Things simply tend to move at a glacial-like pace.

IV. Will The Broker Have To Pay Part Of The Settlement?

Will the broker be forced to contribute to the settlement or award? This may become an issue where a firm will only pay a certain amount, and more is needed to reach a final settlement acceptable to the client(s). Where the individual broker has not been named as a Respondent, and

the broker remains employed by the Respondent firm, the broker may still be forced to contribute to a settlement by the firm. This argues for preparing the draft Statement of Claim naming the broker individually. Moreover, when suing a small firm where collection may ultimately be an issue, naming brokers, supervisors and others as parties becomes more relevant and possibly important.

V. Claimant May Place The Respondent's Counsel In A Conflicted Position, Further Enhancing Settlement Pressure.

If the same defense counsel represents the firm and the broker there always exists the possibility that a conflict exists or will develop for the defense attorney. Whether the conflict can be waived depends upon the facts of the individual case. Claimant lawyers can attempt to create conflicts in a number of ways. For example, Claimant's lawyer may request an on-the-record interview of the broker in exchange for the broker's dismissal. This may be in the broker's best interest, but not in the firm's interest. If the defense lawyer believes that a conflict has been created it may become necessary to obtain separate counsel for the broker. Whether this strategy can be productive is questionable. Once a second lawyer is involved, other issues come into play, such as the Respondents getting greater weight on the ranking of the arbitrators.

VI. Defenses To Keep In Mind.

Counsel for brokerage firms have a basic lawyer "playbook" of defenses utilized in virtually every case. The most common defenses in this playbook include (1) the sophisticated-investor defense; (2) the blame-the-market defense, (3) the prospectus-defense; (4) the net-out-of-pocket-defense; (5) the failure-to-mitigate-damages defense; and, most frequently seen, (6) the blame-the-victim defense. To facilitate these defenses, the brokerage firm seeks broad "discovery" from the aggrieved investor, requesting all kinds of financial records. Well-known Claimant's attorney Seth Lipner (and many others) have described this process as a "financial colonoscopy."

The financial documents the brokerage firms seek from the Claimant typically include all customer and customer party owned business (including partnership, corporate) federal income tax returns the customer parties filed, including Schedules A, B, D, and E, and the IRS worksheets related to these schedules, or the equivalent for any other type of return for the three years prior to the first transactions at issue in the Statement of Claim through the date the Statement of Claim was filed. Defense lawyers also typically demand financial statements, including statements made in connection with a loan application, or similar statements of the customer parties' assets, liabilities, and/or net worth. Most enterprising defense lawyers will attempt to reach far beyond this list and ask for banking statements, credit card statements, and any other tangentially related financial document going back ten years.

The goal of this fishing expedition is an attempt to characterize the investor as a gambler or speculator who was seeking to secure outsized returns from his brokerage account and therefore was willing to accept outsized risks. In other words, Claimant is a sophisticated investor who knew and accepted the risk of loss. Many times, the breadth of the information sought is grossly disproportionate to the size of the case. This is often an attempt to burden an investor with a long list of discovery demands.

Another common defense is related to the market's performance. This "blame-the-market" defense is more commonly used in a bear market like in 2000 and 2008 but it is still utilized even with cases filed in 2016 and 2017. The defense lawyer claims the decline in the investor's account was caused by the decline

in the overall market and was completely unanticipated (unforeseeable). This defense can often be overcome with an analysis of how the client's portfolio performed to the actual market during the same exact period. Most expert witnesses can provide this market adjusted information after completing a profit and loss analysis.

The prospectus defense has long been a brokerage firm favorite. It comes out primarily in mutual fund, structured product and other product related cases. The basic premise is that the brokerage firm provided the investor with a prospectus which the investor was required to read. The defense will assert that the investor can't now complain about the investment because they didn't read the prospectus.

The net-out-of-pocket defense is common where the account was open for a long time, or where the investments paid interest or dividends. It is a way to attack the damage issue in a case. The firm using the defense wants credit for any and all interest or dividends received from the investment. They use these positive cash flows to set-off capital losses. The other variation of the net-out-of-pocket defense is the "you-have-to-look-at-the-whole-account" defense. That defense is used to try to convince the arbitrators to ignore an egregious loss on an unsuitable security by setting off that loss against gains made on other (suitable) securities.

A final common defense is the failure-to-mitigate defense. The argument is that some of the loss could have been avoided if the investor had discovered the scheme sooner and acted quicker to liquidate the losing investment. That "you should have caught me sooner" or "you shouldn't have trusted me" defense can be turned around against the firm and the broker many times.

Over the years, these defenses have proved useful to brokerage firms, and they have been the cause of hundreds of middle-ground, compromise awards. For example, if the arbitrators in a case think that something probably went wrong in the sale process, but they aren't certain, these defenses have been used by arbitrators to rationalize lowering the award (even though many state securities acts don't allow these common law related defenses to be used against statutory claims). Arbitrators looking for a middle-ground result have adopted the blame-the-market defense, the netting defense, or the mitigation defense. Be mindful that arbitrators in the past have compromised the award, do not explain their reasoning, and are not usually subject to a motion to vacate absent some limited circumstances.

The lesson to be learned is that we must be aware of these defenses and attempt to include in your case facts you will need to argue that these defenses do not support findings against your client or the reduction of damages.

MED-ARB WORKED IN U.S. FOR REAL ESTATE PARTNERSHIP CLAIMS

By Philip S. Cottone

Abuses in syndicated real estate limited partnerships, very popular in the U.S. in the late nineteen seventies and early eighties prior to the Tax Reform Act of 1986, caused Prudential Securities to be sanctioned by the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD, predecessor to FINRA) in the early nineteen nineties. Prudential was the sponsor of these partnerships and an affiliate usually served as a general partner. In a global settlement with both regulatory bodies, Prudential was required to establish a $500 million settlement fund, and Irv Pollack, a former SEC commissioner, who was at the time Chair of the NASD National Arbitration Committee, was designated Claims Administrator and empowered to design and implement a procedure whereby aggrieved investors could apply for payment from the Fund.

A med-arb process was developed and neutrals around the country were selected to hear the cases, initially as mediator. If the parties did not reach agreement, the same neutral was empowered to act as an arbitrator to decide the matter. Consent of the parties to this procedure was required to obtain a payment from the Fund. The author of this article was a neutral who presided over more than sixty cases in Pennsylvania and New Jersey, both by phone and in person. The claimants had to establish that they were affected by one of the violations cited by the regulatory bodies (causality), and had to prove damages as a result of those abuses.

The Claims Administrator reported that 300,000 claim forms were distributed and about 160,000 claims paid, of which a little more than 2000 were referred for mediation-arbitration. The Fund grew to over $1 billion because Prudential had to post additional deposits, but total payout was just under $1 billion, and the process was completed in two years. The experience of the author was that about 95% of the cases settled in mediation. In those few cases where a decision had to be made as an arbitrator, an abbreviated hearing was conducted and an award was rendered. By and large the parties and their counsel felt the process was fair, that their arguments were heard and considered, and that the result was acceptable, and few, if any, complaints were received.

Med-arb worked effectively in these cases where liability was clear-cut if causality could be established based on the violations found by the regulators, and if resulting damages could be proved. The neutrals selected were experienced arbitrators and mediators who were required to hear the matter in an expeditious fashion and to report the results promptly to the Office of the Claims Administrator so checks could be drawn and sent out without delay. The process worked exceedingly well.

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Thoughts on Managing a Multiparty Mediation By Philip S. Cottone

The Controversy

The NASD Mediation Session Advance Sheet listed two claimants followed by the ubiquitous "et al." I didn't think much of it until I called the lawyers for the claimants and respondents individually, as is my custom. There were numerous claimants, each with a separate claim against the same broker-dealer and its registered representatives. All of the claimants had attended a seminar given by the broker-dealer, after which they cashed in all or a portion of their company retirement funds. The claimants had been receiving a fixed return of more than nine percent, but the year was 1999, and the allure of higher returns was difficult to resist with NASDAQ going through the roof. So they pulled their money out and invested with respondents.

The Statement of Claim asserted various claims against the registered representatives and the broker-dealer alleging guaranteed returns, forgery, unsuitability of investments (most claimants were at or near retirement age and have since retired), breach of fiduciary duty, breach of contract and misrepresentation. The Statement of Claim outlined demands exceeding $2,000,000 in the aggregate, and much more if you included punitive damages. And, I was advised that almost all of the claimants were expected to come in person to the mediation!

Pre-Mediation Suggestions

I made two suggestions when I talked with the lawyers on the phone. I suggested an additional mediator, so we could divide the claimants. I also suggested a second day, so we didn't have to handle all claims in a single session. Neither suggestion was acceptable, primarily because of scheduling difficulties and an early arbitration date. I got the impression that although both lawyers had agreed to mediation neither really believed it would be successful. I gave each a pep talk and asked that they send me the documents together with mediation briefs covering the strengths and weaknesses of their cases. The information I subsequently received from counsel showed a disparity in actual losses. The claimants calculated out of pocket losses of over $700,000. The respondent showed total losses of under $500,000, and, of course, pointed to the market drop in early 2000 and thereafter, and the choices made by the claimants, to explain the decline in value in the accounts.

The Challenge

It was incumbent upon me to figure out how to conduct the mediation in a way that would permit me to handle the large crowd effectively and build confidence on both sides. I wanted all attendees to understand fully what was going to take place, and to trust the process and me. I also thought we had to establish a rationale and methodology for eventual settlement because I felt it was unlikely it could be completed in a single mediation session. I concluded that the most important thing for me to do at the mediation was to try to develop a working dialogue and some trust and respect between the lawyers. I knew that was a tall order because both had been somewhat skeptical on the phone. They did not know each other, and I did not know them from prior cases. A history of working with party representatives has often proved helpful in orchestrating a successful mediation. Nonetheless, here I was shooting in the dark, and I crossed my fingers that counsel on both sides would cooperate and work with me to try to arrange a settlement that would be in their clients' best interests.

I decided in advance to divide the claims into three categories, claims under $10,000, claims from $10,000 to $50,000, and claims over $50,000. Before the mediation I prepared a schedule listing the actual loss differences by account between the claimant and respondent numbers. My thinking was to start with the claims under $10,000 initially, and work to obtain stipulations on the monies in and out. I hoped to get agreement account by account in the lowest claim category. If successful, I thought it might build some rapport that would help us on the tougher issues and in the larger cases later.

The Mediation Session

Sure enough on the day of the mediation almost all of the claimants showed up with their lawyers and an expert witness. When the mediation began I crowded everyone into a large hearing room (over 30 people, including the claimants, some family, four lawyers, one expert, two brokers, one senior officer of the respondent, and one observer). I began by slowly and carefully going over my usual opening statement so that everyone understood what we were about, and that it was totally voluntary and confidential. I explained my role as a neutral, their role and expected good conduct, and the process we were going to follow—with joint sessions and individual caucus meetings. When I was through there were some questions, followed by general agreement with the outlined procedure. I tried my best to relax the claimants, many of whom appeared very apprehensive when they arrived. I assured them that absolutely nothing could happen that they didn't want to happen, and, unlike court or arbitration, it was up to them to agree to any settlement. I think they had a reasonably good understanding of what was planned when the opening statement was finished, and were somewhat less apprehensive.

I then asked counsel for the claimants to describe what had happened from his perspective, and followed that by letting the individual claimants who wanted to speak do so. Some took full advantage and most spoke in measured tones and under control, as I requested in the opening statement. Then the respondents had their turn, as well as the registered representatives. After everyone had their say at an opening session that lasted much longer than usual, I escorted the individual claimants to another room. I concluded that the only way we were going to make progress was without the individual claimants present (only their representatives), a departure from usual mediation procedure where the claimants are ordinarily participants for most of the session.

After the individual claimants left, I kept the others together in the joint session to go over my suggestions that we divide the claims into three categories by amount, and start by reconciling differences in out of pocket losses. Both sides agreed with the approach. I also suggested that any understandings reached in the first category of smaller claims would not necessarily establish precedents for dealing with the second and third categories. I felt it was important that we dispose of as many of the smaller claims as possible to reduce the number of people involved, and to make some real progress that we could build upon without holding these smaller claims hostage to larger issues. I also wanted to use the small dollars to try to get settlements that, on a percentage basis, might not be possible with the larger claims.

Building Momentum

The first discussion related to appropriate cut-off dates for each account. We went back and forth (some had closed accounts earlier than others; some still had money on deposit with the respondent; and some had made unsolicited purchases in their accounts), and before too long we were able to reach agreement on the principles that would establish the cut-off dates. We also agreed that these same principles could be applied to the larger accounts because they had nothing to do with money, but to fairness and equity in terms of what the firm should be charged as a beginning point by way of actual losses...temporarily setting aside the question of liability itself. In other words, I suggested that we agree on the actual account loss amounts if we could, and then argue about liability separately. As I had hoped, the lawyers and the business people developed a working dialogue in discussing the dollars invested and withdrawn, in part because it was relatively easy with the small amounts with which we started. The first couple of accounts took a while, but once we established a procedure and hammered out some principles it became easier. We realized that the legal associates for each firm, with the help of the registered representatives who had good records with them, could do the rest essentially by themselves.

Liability questions, of course, were more difficult, and here I separated the parties into two caucus rooms and started the usual work of reviewing the strengths and weaknesses of their respective legal positions. Claimants' counsel eventually came to understand that under the facts of his cases it was unlikely an arbitration panel would award one hundred percent of the losses, no less losses plus costs, and punitive damages, as claimed. I felt it was important that we talk to his clients and provide the reasons why he had reached that conclusion. As agreed, I spoke with all of the claimants as a group, and I answered some questions as well. Claimants' counsel then met privately with his clients, and secured their permission to talk about a settlement at something less than one hundred percent of losses. He and I had earlier discussed the pros and cons of meeting with the claimants individually or as a group, and he felt he could secure their permission to do it primarily as a group to save time, leaving open the possibility that any individual who wanted a personal discussion could have one.

At the same time I was meeting with the respondents to get a feel for where they were going to be able to go, and to help them review their case and their risk if they went to trial on all of these claims. Shuttling back and forth among the three rooms (claimants, claimants' counsel and respondents), and occasionally getting the lawyers for both sides together, we kept trying to come up with a percentage of the out of pocket loss everyone would find agreeable.

The Settlement

It was mid-afternoon and the clock was ticking loudly, but we had made a lot of progress. The registered representatives and the legal associates had continued work on stipulating to out of pocket dollars, and that was coming along well...and we had established that any settlement would be based on something less than one hundred percent of out of pocket losses. Still I had to push things along a little faster now. It seemed to me that we might have a shot at getting agreement on all claims except those that were larger in dollars and involved a greater number of other issues needing resolution. I probed both sides as to whether a settlement of all, or all but the largest, would be possible today. The respondent said, "yes" but the settling claimants who were present wanted to reserve the right to testify for any claimants who did not settle. The respondent would only settle if that testimony was barred, for obvious reasons. Putting that aside for the moment, we were closing in on a number that would do the job for most of the claimants (a fixed percentage settlement amount in excess of 50% of the losses). I suggested we try to resolve the claims at the agreed percentage of loss, except for the larger claims, subject to the lawyers (with my help if necessary on the phone) finishing the review and stipulating to the amount of out of pocket losses in those accounts. Then we could work separately on the large dollar disparity in the bigger cases and negotiate a settlement. The registered representatives believed that the claimants in the larger cases were misinformed

about the number of accounts, and the amounts initially deposited, but they needed office records for verification. If we were able to resolve the larger cases in a few days, the testimony issue would go away, and we would have a settlement of all claims.

By evening, we shook hands on a settlement percentage for all the claims save the largest, but we still needed to do more work on actual loss stipulations for perhaps half of the claims. However, I was confident that the legal associates who had developed a good working relationship at the mediation, would be able to agree on the out of pocket numbers. Within the week it was done. I was kept informed by telephone, and didn't need to resolve any disputes between them. Similarly, both sides were hard at work trying to resolve the issues regarding the last claim. They agreed to the same settlement percentage if the secondary issues could be worked out, and within a week these issues were resolved to everyone's satisfaction. Here I did have to talk with each side by phone to help them get together at the end.

Closing Observations

As is often the case, less on the part of the mediator was more. That is, I don't think we would have made much progress if I had used the traditional mediation model and not seen the critical importance of getting the lawyers to work together cooperatively to build a settlement. What was needed, of course, was counsel who knew what they were doing, and who were interested in getting a result to serve their clients' best interests, not in posturing or positioning themselves for the arbitration. The two senior lawyers and their hard working associates, who took the cue from their bosses, deserve all the credit for getting this done. I was pleased, and very satisfied, to have helped a little bit in their settlement process.

Philip S. Cottone

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Additionally, Mr. Cottone serves as an arbitrator for the NASD, NYSE, and has served for JAMS. He was a mediator/arbitrator for the Claims Administrator in *SEC v. Prudential Securities*, handling cases in eastern Pennsylvania and New Jersey. He received an A.B. from Columbia College (1961) and an LL.B. from New York University School of Law (1966). He is a retired member of the New York Bar, and has extensive experience in real estate and securities. He also is a member of the faculty of the Real Estate Institute at the NYU School of Professional and Continuing Education.

Anatomy of a Securities Mediation: What to Expect, How to Prepare, & How to Win

by Jeff Abrams, JD

Mediation is a tool designed to be used at strategic times to facilitate a negotiated solution to a dispute. Mediation allows the parties to retain control of the outcome rather than relinquishing the power of decision to a panel of arbitrators. The FINRA mediation program encourages settlement of securities disputes with a panel of highly skilled and well-trained mediators. The following is a summary of a caucus-based model of mediation, the one commonly favored by FINRA mediators.

FINRA rules allow any matter eligible for arbitration to be submitted to mediation. Some cases are relatively simple two party matters. Others are multi-party disputes encompassing a myriad of complex issues. Most issues involve money, some involve pride, and all involve a wide range of human emotions. Your mediator needs to be skilled in handling whatever comes up.

The role of the mediator is defined by FINRA Mediation Rule 14109(c): "The mediator shall act as a neutral, impartial, facilitator of the mediation process and shall not have the authority to determine issues, make decisions or otherwise resolve the matter." Despite the negations of power, the mediator wields a great deal of influence. The mediator "facilitate(s), through joint sessions, caucuses and/or other means, discussions between the parties, with the goal of assisting the parties in reaching their own resolution of the matter." (Italics added, FINRA Mediation Rule 14109(d). How can you be sure that the mediator is right for you? How can you best represent yourself or your client in this unique forum?

PRE-MEDIATION

Selecting a mediator with the right process skills is an important step. There are as many different "styles" of mediation as there are mediators. Some mediators are more facilitative, viewing their role as a facilitator of negotiations. Other mediators are more evaluative, preferring to direct the negotiations with a view toward evaluating the claim for the parties. Most operate along a continuum, blending facilitative and evaluative approaches as need be.

Find out about your mediator and his or her style. What kind of experience does he/she have? What kind of training have they received? How will the mediation be conducted? Will the mediator use joint meetings, private caucuses, or a combination of both? Think about what you want in a mediator. Does the mediator have experience in resolving similar matters? Learn as much as you can about the environment and the mediator in advance of the mediation.

Have a private conversation with your mediator where you start explaining the case from your client's perspective. Unlike arbitration where ex parte contact is

prohibited, the essence of mediation (and what helps a mediator work his magic) is the ability to speak with one party outside the presence of the other. The mediator, as a shuttle diplomat, can help the parties barter both information and settlement offers. A conversation with the mediator before the formal session can be very valuable in setting the stage for a successful negotiating session. Always be sure to confirm confidentiality of your communications at the beginning of the first conversation.

PREPARATION IS KEY

Spend time analyzing the case from different perspectives using the following suggested outline. A seasoned mediator will be exploring these areas during the mediation.

- Prepare a ten minute summary of your case:
    - Facts—Undisputed and disputed
    - Law—Undisputed and disputed
    - Key witnesses and other proof
    - Damages

- Summarize your opponent's case as noted above. A good advocate can argue both sides!

- Describe the strengths and weaknesses of your case. Do not pull any punches.

- Describe the strengths and weaknesses of your opponent's case.

- Identify your client's interests (expressed or, as more often the case, unexpressed); i.e., what does the client need; what are motivating factors that underlie the dispute; why settle the case at all?

- Identify the interests, expressed and unexpressed, of the other party.

- Review the alternatives to reaching an agreement (i.e., assuming there is no settlement and the matter must go to arbitration). Ask yourself:

    What is the likely outcome expressed as a range (assess some numerical probability)?

    What are the expected fees and costs (and the value of lost opportunity time)?

    How long must the parties wait until final disposition?
    Is the client being realistic or do you need help in moderating expectations ("reality testing")?

- Are there any unresolved procedural matters that would be dispositive of the case? If so, how does this impact your desire or willingness to settle?

- What is the relationship between the parties? Has there been any past or current business dealing? Is there a desire for a future relationship? Can anything be done to improve or preserve the relationship?

- What is the relationship between the advocates? Can anything be done to improve that relationship?

- What is the history of settlement negotiations? What obstacles to settlement have you observed?

- Does your client have authority to settle the dispute? Does the opposing party representative have similar authority? Are there other factors affecting the negotiations, such as a spouse or third-party "leaning" on the client, the precedential value of the case, the publicity factor, etc.?

- What are some creative options for settlement? Don't be concerned with whether the other party would find them acceptable. This is brainstorming. Keep in mind that the resolution need not be confined to the sort of "relief" available in arbitration. Be creative and expansive.

- What external standards could be applied to the options to frame them as fair and legitimate in the eyes of all concerned parties? If the settlement is objectively "fair," it is more likely to be acceptable.

- What proposals for settlement do you think <u>your client</u> would be willing to make? What proposals do you think the <u>other side</u> would be willing to make? How do you think the other will react to your negotiating strategy?

At this point, you have organized your thoughts and can now focus on your presentation and strategy.

• Prepare a confidential mediation statement, (5 to 15 pages) similar to a settlement brochure. Make copies for you, your client, and the mediator, tabbed with sections to show:
  - Summary of case
  - Liability analysis
  - Summary of damages
  - Operative live pleading, dispositive pending motions & <u>most pertinent</u> case law, if applicable (highlighted for ease of reference)
  - Representative sample of key documents (highlighted) and other evidence

• You may want to send a separate settlement brochure (without confidential information) to the other party in advance of the mediation. If you do so, you are providing information and analysis, not drawing "lines in the sand" by making intractable and unyielding demands.

• Send materials for mediator to review at least ten (10) days before session.

• Be sure that your party or party representative will be present for the entire mediation (reserve the full day) and that the party has FULL authority to settle the case (not just a "bottom line"). Make certain that others who may influence the decision are available, even if by telephone, on the day of the mediation.

HOW WILL YOU NEGOTIATE?

Plan a negotiating strategy with your client. Think about appropriate parameters for settlement and the kind of information you need to influence your decisions. A mediation session may uncover new information and reveal different perspectives. Therefore, come with an open mind and a willingness to be flexible. At the same time, it is good practice to think about a negotiating strategy for your moves.

The mediator is condensing weeks or months of negotiation into a single day (mediation is sometimes called "Turbo-

charged Negotiation"). Do not set your negotiating plan in concrete. Avoid setting absolute "bottom lines" with your client or "saving face" later can be a real obstacle to settlement. It is helpful to consider an integrative or collaborative approach to the negotiation. Remain flexible with the process. Never let the mediator control your side of the negotiation. You and your client are in charge.

A good part of mediation training curriculum is negotiation theory and practice. Utilizing the paradigm of mediator as a "guest" at a negotiation, mediators must know about the process of negotiation to aid the parties.

We use an acronym, CAIROS, to demonstrate essential principles of interest-based negotiation.

"C" stands for "Communication." Good negotiators ask themselves "what do we want to learn from the other side" and "what messages do we want to send to the other side." Negotiators appreciate the importance of asking questions – both to obtain essential information as well as to persuade the other side to "come about" in their thinking.

"A" stands for "Alternatives." Good negotiators always focus on the alternative to reaching an agreement, or the consequences of a failed negotiation. What are the risks of the arbitration? What might happen? Consider the whole array of possibilities and not just the "best case" scenario. What are the real and imagined costs?

"I" stands for "Interests." Good negotiators look at the interests and needs of all participants in a negotiation. Collaborative negotiators avoid the tendency to focus on positions, which are invariably at opposite ends of the spectrum. There is often a great deal of commonality between the interests of the parties, starting with a common interest to negotiate a settlement and avoid the alternative. Negotiators build on common ground. Interest analysis leads to creative problem-solving solutions.

To some degree, everyone acts out of a sense of self-interest. Ask yourself, how are the needs of the participants going to be satisfied? To the extent that an agreement addresses such interests, it is more likely to be acceptable and honored in the long run.

"R" stands for "Relationship." Good working relationships are the key to productive interactions in negotiations, business, family and personal life. Negotiators ask themselves what can be done to improve the relationship? How can we create a positive working environment?

"O" stands for "Options." Options generation is a creative process. True brainstorming involves a suspension of judgment. It requires abandonment of positional thinking, the "either or" dilemma. We assume the pie is expandable, that we can create value.

"S" stands for "Standards." Good negotiators look for objective external standards as a formula or rationale for their proposals. On what basis shall we decide? A search for standards is attempting to apply objectivity and fairness to a proposal, making it more palatable to the other side.

Of course not all elements of interest-based negotiation are present in every

engagement. Experience has shown that a successful integrative solution is more likely to be achieved when these six factors are present.

AT THE MEDIATION SESSION: JOINT SESSION

The mediator's opening statement is designed to set a specific tone and is likely to include the following:

- Introductions by the persons present
- A summary of the mediator's background and experience
- A discussion of the mediator's role as distinguished from an arbitrator, neutral case evaluator, or fact-finder
- A presentation on the voluntary and confidential nature of the process
- An outline of how the day is likely to proceed and a summary of the ground rules
- A solicitation of the participants to negotiate in good faith and the signing of the Mediation Agreement
- Opportunity for opening statements

GIVING YOUR OPENING STATEMENT

In recent years, mediators and counsel have moved away from joint session presentations. Some fear that it causes more polarization and that a wrong word or sideways glance might torpedo the talks. In certain cases, the emotional well being of a party is threatened by being in the same room with the other side. In those situations, we dispense with a joint session presentation and allow the mediator to do all the communicating. However, a well-stated presentation can move the other side to reconsider their position. Another plus is that you get to speak directly to the other decision maker. The following applies to situations where both sides and the mediator feel it worthwhile to make and hear presentations in joint session.

In mediation, the ultimate target of persuasion is not the mediator. The one who must find your arguments convincing is the party who must compromise their claim (or defense). It makes sense to address your remarks to the other party. Politely demonstrate that you mean business, that you will take this "all the way" if you must, but let them know that you are here in good faith to negotiate a fair settlement. This is not the place for grandstanding but it is an opportunity to communicate. Keep your objective in mind – to negotiate in a manner that will ultimately lead to both parties agreeing upon a resolution. Be direct, concise, and clear.

When the opposing party or counsel has completed their presentation, ask non-argumentative questions to clarify any matters. Communicate to the other side that you understand their interests. There is a difference between understanding and agreeing. If you can articulate their perspective (and do so in their presence), you are closer to achieving a meaningful settlement.

- Cover only key points -- do not be distracted by subsidiary issues that, in all likelihood, will never be

resolved. The whole is greater than the sum of its parts.

- Be courteous, and persuasive

- Practice active listening skills (an excellent beginning is to restate what the other said to show you fully understand–although not necessarily agree—with the other's point of view).

Consider allowing your party to speak on his/her own behalf, if it will move the other side.

- Showcase the ability of the party to tell their story.

- It is a cathartic experience to relate your story to the other side – without filters or interruptions.

- Involve the party in the mediation process and thereby create "ownership" of the dispute and ultimate resolution.

FIRST CAUCUS PRIVATE SESSION

This is primarily an "information-gathering" session by the mediator and the parties will have the opportunity to "vent," if needed, in this private setting.

- Confirm that the mediator will maintain confidences.

- Be candid and honest with the mediator.

- Be prepared for a thorough analysis of case—from your perspective as well as the perspective of the other party.

- Be ready to analyze the alternative, the consequences of failing to reach agreement. Estimate cost and expenses, likelihood of recovery, range of probable outcomes, and other aspects associated with continued conflict.

- Brainstorm settlement options.

- Begin the negotiation process. It is helpful to start the negotiations with a meaningful proposal. (Note: Some mediators do not request demands/offers until the second caucus.)

- Opening demands/offers are just that—an opening, a beginning. A good proposal is supported by objective criteria or legitimate standards. It can be explained with reference to a rational basis or formula (not just a feeling). With every offer, it is helpful to consider what response you believe the proposal will elicit in the other party, and whether it will further the negotiation.

- OPTIONS -- "Only Proposals That Include Others' Needs Succeed." Can you articulate a benefit to the other side?

SECOND (& LATER) CAUCUSES

The mediator will use these sessions to create momentum toward settlement by refocusing the parties on: previous areas of agreement, their underlying interests, the underlying interests of the other party,

option analysis, risk analysis and transmittal of reasonable proposals.

- Be willing to listen to different points of view.
- Consider the information transmitted from the other side.
- If appropriate, allow new information to influence your risk analysis/settlement parameters.
- Use the mediator as a sounding board for "reality testing" and to "float" settlement proposals.
- Be willing to explore creative solutions to the problem.

The mediator may give you assignments to work on between caucuses. You may be asked to explore the risk analysis in further detail and generate additional options for settlement that have not yet been proposed to the other side. As the caucus sessions continue, the mediator will build the momentum and assist in clarifying the common ground. Sometimes, the mediator will recommend a joint session to hammer out details.

CLOSURE (POST AGREEMENT)

The mediator may recall the parties to the joint session format if they have been in caucus to summarize essential terms of the agreement. Each participant will be asked if the mediator's summary was accurate and whether they agree that the matter has been settled.

Ask yourself:

- Have all bases been covered—are there any loose ends? Do you have a binding and enforceable settlement?
- Who will prepare the final documents—when & how transmitted?
- What will happen if something breaks down in the post-mediation phase?
- How and under what circumstances should the mediator be brought into the discussions?

In order to avoid unanticipated problems occasionally created by "settlement remorse," it is good mediator practice to have the parties sign a memorandum of essential terms. Even better, some advocates come prepared with final settlement documents to be executed at the conclusion of the mediation. Let the mediator stay involved until completion. FINRA is notified about the fact of settlement (not the terms of settlement) and the matter is closed.

Mediation is here to stay. Lawyers and parties recognize the special role that a mediator can play to bridge differences and bring about solutions. As confidante to both sides, the mediator stands in a unique position to assess the likelihood of settlement, and as facilitator of negotiations, the mediator can do more than the parties may be comfortable doing by themselves. Mediation works! Effective advocates make the process their own.

Jeff Abrams has been an attorney for over 39 years and a mediator/arbitrator for the past 33 years. He is an active FINRA mediator and arbitrator (often serving as Chair). His practice is dedicated exclusively to mediation, arbitration, and settlement counsel work (100% ADR). Jeff specializes in securities, complex commercial, employment, healthcare, and general business disputes. He is passionate about mediation.

Jeff is a pioneer in the mediation field. He served on the legislative task force that drafted the landmark Texas ADR law. In 1990, he worked closely with FINRA (then NASD) to design its national mediation program. He has provided mediation training for FINRA in NYC and across the country, for the U.S. Bankruptcy Court for the Southern District of New York, and for state and federal courts, state and local bar associations, and private institutions.

Before becoming a mediator, Jeff worked as a trial lawyer handling complex business litigation. He is a member of the Texas Bar, and a former member of the Florida and Oregon Bars. He is a current member of the National Academy of Distinguished Neutrals, an invitation-only professional organization.

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ETHICAL ISSUES IN GROUP CLAIMS

Initial Practice Point

- Model Rule 1.6 cmt. 4 allows a lawyer to use hypotheticals to discuss issues related to the representation of a client
- Most, if not all, states have an analogous provision
- Attorneys are *strongly recommended* to discuss, via hypothetical, issues relating to group claims with the relevant regulator

Introduction

"An advocate, in the discharge of his duty, knows but one person in all the world, and that person is his client. To save that client by all means and expedients, and at all hazards and costs to other persons, and amongst them to himself, is his first and only duty; and in performing this duty he must not regard the alarm, the torments, the destruction which he may bring upon others."

– Lord Henry Brougham, 1st Baron Brougham and Vaux (1820)

A Lawyer's Duty to the Client

- Lawyers owe their clients various fiduciary duties:
  - Duty to inform
  - Duty of loyalty
  - Duty of honesty
  - Duty of due care (competent representation)
- Given these duties, do the Rules[1] prohibit one lawyer's representation of multiple clients regarding the same matter?

[1] All references to the "Rules" are to the ABA Model Rules of Professional Conduct. Check your jurisdiction's rules to confirm accordance

No Categorical Prohibition on Joint Representation

- Rule 1.7(a) contemplates a threshold question: Is there a "concurrent conflict of interest?"
- If there is no "concurrent conflict of interest," the representation is permissible with no further action

An Issue for Joint Representation

- "Ordinarily, the lawyer will be forced to withdraw from representing all of the clients if the common representation fails."
- *See* R. 1.7, Cmt 29

Concurrent Conflict of Interest

- Pursuant to Rule 1.7(a), a concurrent conflict of interest occurs when:
  - The representation of one party will be directly adverse to the other party(ies); OR
  - There is a "significant risk" that the representation will be limited by obligations to other clients (current or former), third parties (e.g. the beneficiaries of a trust administered by the attorney), or by the attorney's personal interest
  - *See* R. 1.7, cmts. 6, 8

Representing Multiple Clients Notwithstanding Concurrent Conflict

- Existence of concurrent conflict, by itself, does not foreclose joint representation
- Rule 1.7(b) sets forth four requirements to obtain clients' consent to a conflicted representation:
  - Representation is not prohibited by law
  - Representation does not involve litigation by one client against the other(s)
  - Lawyer believes in ability to give "competent, diligent representation" to each client; and
  - Each client gives "informed consent"

Representation not Prohibited by Law

- Clients cannot consent to a conflict of interest where the joint representation is prohibited by law
- Likely will not occur in context of securities litigation
- *See* R. 1.7, cmt. 16 for examples:
  - Representing co-defendants in a capital case
  - Violations of certain federal criminal statutes
  - Some states limit ability of governmental client to consent to conflict

Representation Involving Directly Adverse Clients

- Clients cannot consent to joint representation when they are directly adverse to each other in the same litigation or other tribunal proceeding
- Whether interest is "directly adverse" requires examination of the context of the case (R. 1.7, cmt. 17)
- Unlikely to arise in context of securities-litigation
- *But see* Hypothetical #3 (below)

Lawyer Must Give Competent, Diligent Representation

- Lawyer cannot represent multiple parties to litigation unless the lawyer can provide to each party the same level of competent, diligent representation that the lawyer would give to a single party
- *See* R. 1.1 (Competence):
  - "Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation"
- *See* R. 1.3 (Diligence):
  - "A lawyer shall act with reasonable diligence and promptness in representing a client"

Lawyer Must Give Competent Representation

- Competency requires the lawyer to inquire into, and analyze, the factual and legal issues presented *by each client*
- Before accepting joint representation, lawyer must determine competency to manage multiple parties, each with their own (sometimes unique) factual and legal issues
- Practice considerations:
  - File management
  - Correspondence
  - Settlement Administration
  - Document/discovery management

Lawyer Must Give Diligent Representation

- Diligence requires the lawyer to use all lawful, ethical measures in pursuit of the client's interest (subject to the lawyer's professional discretion). *See* R. 1.3, cmt. 1
- Lawyers should ask themselves if they have the time and resources available to represent multiple parties to one suit
- Lawyer must be prepared to represent clients to the conclusion of the litigation

Each Client Must Give Informed Consent

- Assuming other requirements of R. 1.7(b) are met, lawyer must still obtain "informed consent" from all clients
- R. 1.0(e): "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.

Informed Consent

- Must include lawyer's explanation of advantages and disadvantages of joint representation. *See* R. 1.0, cmt. 6
  - Sufficient information to allow client to weigh costs/benefits of joint vs. sole representation and make informed decision
- Must be "affirmative;" lawyer cannot assume consent via silence *See* R. 1.0, cmt. 7
- Informed consent must be "confirmed in writing:"
  - A written confirmation of the informed consent that is sent to the client, contemporaneous to the consent
  - Should be signed by the client, but not required
  - *See* R. 1.0(b), cmt. 1

Waiver of Confidentiality

- A lawyer will not be able to keep information confidential from commonly represented clients
  - “A lawyer has an equal duty of loyalty to each client, and each client has the right to be informed of anything bearing on the representation that might affect that client’s interests and the right to expect that the lawyer will use that information to that client’s benefit.”
  - See R 1.7, Cmt 31

Confidentiality Between Clients

- Communications may be discoverable in litigation between clients
- The attorney client privilege may not attach between commonly represented clients
  - Clients should be informed that if litigation eventuates between clients, the privilege will not protect such communications
    - *See* R. 1.7 Cmt 30
- If the relationship between the parties/clients is antagonistic, it undermines the lawyer's ability to represent the interests of clients in a common representation, i.e., divorcing parties, business terminations, etc.

Informed Consent

- At the onset of the common representation and, as part of the process of obtaining each client's informed consent, the lawyer should advise each client that information will be shared and that the lawyer will have to withdraw if one client decides that some matter material to the representation should be kept from the other.
  - *See* R 1.7, CMT 31

A Lawyers role in Common Representation

- A lawyer's role is limited in common representation of clients
  - R 1.7 Cmt. 32 provides that when the attorney-client relationship is established or adjusted, certain disclosure must be made to the client
  - The attorney client relationship in a common representation case, does not have the same extent of partisanship normally expected in such relationships
  - Clients in a group representation may need to assume greater responsibility for decisions than clients would ordinarily expect to have in a separate representation.
  - Limitations on the scope of representation should be fully explained at the outset of representation.
    - *See* R 1.7 Cmt. 32 and R 1.2

Advantages to Joint Representation

- Additional clients reveal additional facts about the subject matter of the litigation
  - Provides more resolution to the complaint/statement
  - Easier to obtain additional facts from clients, instead of engaging in pre-litigation fact discovery
- Allows clients to pool resources to create more cost-effective litigation (e.g. to pay for deposition transcripts and expert analysis)
  - Lawyers are reluctant to accept clients with small-dollar damages (i.e. under $50k) on contingency, but for the client's membership as part of a larger group
- Lends credibility to otherwise-incredible factual contentions (e.g., the "reasonableness" of an investor's reliance on a representation)

Disadvantages to Joint Representation

- No privacy (with limited exception) between clients
  - Lawyer has duty to share facts with all clients, including the amounts of damage and any settlement offers
- No attorney-client privilege between clients
  - Privilege is waived if clients litigate against each other
- Clients may have different litigation tolerances
  - E.g., wealthy 80-year-old bachelor will have different risk tolerance than couple in their 40s with kids to put through college
  - Some clients may want to settle, while others want to try the case
- Clients may have different litigation risks, which will affect decisions to settle or try the case
- Lawyer focuses on common, not individual goals
  - Cannot use facts/argument to benefit one client at the expense of another
  - Defendant(s) may only have funds sufficient to make portion of clients whole

Consent to Future Conflicts

- Lawyer must disclose all known conflicts as part of obtaining “informed consent”
- Lawyer must obtain informed consent from clients as each new conflict(s) arise(s)
  - E.g. one client gets litigation-fatigue and wants to settle, others do not. Lawyer must disclose conflicts and obtain informed consent from all parties before continuing representation
- Waivers regarding future (unknown) conflicts are ineffective, unless:
  - Client is sophisticated, experienced litigator;
  - Conflict-waiver identifies category of conflict; and
  - Client obtains independent legal advice regarding waiver of future conflicts
  - *See* R. 1.7, cmt. 22

HYPOTHETICALS

Hypothetical #1

- Attorney represents collection of racially-identical longshoremen in racial-discrimination case against common defendant, on failure-to-promote theory
- Plaintiffs are members of different unions, worked in different locations, and held different jobs

Hypothetical #1

- Issue: Does concurrent conflict of interest exist among plaintiffs, such that Attorney is required to disclose conflicts and obtain informed consent prior to representation?

Hypothetical #1

- Court held that, yes, Attorney was required to disclose conflicts and obtain informed consent
- Court found that although "broad interests" among clients were aligned, the clients' individual issues, needs, and claims were different
- Court suspended Attorney for 18 months and ordered restitution of $82,487.98
- *In re Disciplinary Proceeding Against Marshall*, 160 Wn. 2d 317 (2007)

Hypothetical #2

- Mortgagee files foreclosure action against mortgagor and condo association (as junior lienholder)
- Association is represented by Attorney
- After Complaint is filed, Successors (also represented by Attorney) file Notice of Substitution of Party, claiming that they are successors-in-interest to Mortgagee
- No prejudice to any Party by Attorney's dual representation
- In brief regarding potential disqualification, Attorney argues that Association was named only because state law required naming of all junior lienholders in foreclosure suit

Hypothetical #2

- Issue: Is Attorney disqualified from representing Successors and Association due to nonconsentable conflict of interest?

Hypothetical #2

- Court ordered disqualification, and found that Rule 1.7 does not turn on "adversity" but can include situations in which one client sues another in the same litigation
- Court noted too much potential for one party's interests to be advanced at the expense of the other
- *Nunez v. Lovell*, No. 2005-7, 2008 U.S. Dist. LEXIS 77902 (D.V.I. Oct. 3, 2008)

Hypothetical #3

- State sues brokerage firms to recover losses incurred by State's Consolidated Fund
- Complaint alleges that staff of State's Treasurer's Office conspired with Brokerages to commit fraud, thus causing the losses in the Fund, but did not name Employees as defendants in the suit
- Attorney representing State also represented Treasurer's Employees in connection with their depositions
- Brokerages allege that Employees had trading discretion, while State alleges that Brokerages exercised trading discretion
- Brokerages moved to disqualify Attorney from representing State

Hypothetical #3

- Issue: Is a conflict of interest presented by Attorney representing Plaintiff and non-party unnamed co-conspirators?

Hypothetical #3

- Court held that parties do not have to be named in a lawsuit to have directly adverse interests, and thus a conflict of interest was present
- Court found that complaint implicated Employees as responsible for the Fund's losses
- Court also held that under the State's law, State cannot waive conflicts of interest
- Court held that Attorney could represent the State, or the Employees, but not both
- Court held that if Attorney amended complaint to remove allegations against Employee, any conflict would vanish
  - Was this the correct result? *See* R. 1.7, cmt. 6
  - Removing allegations against Employees would only serve Employees' interests, not necessarily the State's interest
  - Is such conduct a "material limitation" to the lawyer's ability to prosecute?
- *State ex rel. Morgan Stanley & Co. v. MacQueen*, 187 W. Va. 97 (Sup. Ct. App. 1992)

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.

Legal Knowledge and Skill

1.1: Comments

1) In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances.

2) A lawyer need not necessarily have special training or prior experience to handle legal problems of a type with which the lawyer is unfamiliar. A newly admitted lawyer can be as competent as a practitioner with long experience. Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems. Perhaps the most fundamental legal skill consists of determining what kind of legal problems a situation may involve, a skill that necessarily transcends any particular specialized knowledge. A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can also be provided through the association of a lawyer of established competence in the field in question.

Legal Knowledge and Skill

1.1: Comments

3) In an emergency a lawyer may give advice or assistance in a matter in which the lawyer does not have the skill ordinarily required where referral to or consultation or association with another lawyer would be impractical. Even in an emergency, however, assistance should be limited to that reasonably necessary in the circumstances, for ill-considered action under emergency conditions can jeopardize the client's interest.

4) A lawyer may accept representation where the requisite level of competence can be achieved by reasonable preparation. This applies as well to a lawyer who is appointed as counsel for an unrepresented person. See also Rule 6.2.

Thoroughness and Preparation

1.1: Comments

5) Competent handling of a particular matter includes inquiry into and analysis of the factual and legal elements of the problem, and use of methods and procedures meeting the standards of competent practitioners. It also includes adequate preparation. The required attention and preparation are determined in part by what is at stake; major litigation and complex transactions ordinarily require more extensive treatment than matters of lesser complexity and consequence. An agreement between the lawyer and the client regarding the scope of the representation may limit the matters for which the lawyer is responsible. See Rule 1.2(c).

Retaining or Contracting With Other Lawyers

1.1: Comments

6) Before a lawyer retains or contracts with other lawyers outside the lawyer's own firm to provide or assist in the provision of legal services to a client, the lawyer should ordinarily obtain informed consent from the client and must reasonably believe that the other lawyers' services will contribute to the competent and ethical representation of the client. See also Rules 1.2 (allocation of authority), 1.4 (communication with client), 1.5(e) (fee sharing), 1.6 (confidentiality), and 5.5(a) (unauthorized practice of law). The reasonableness of the decision to retain or contract with other lawyers outside the lawyer's own firm will depend upon the circumstances, including the education, experience and reputation of the nonfirm lawyers; the nature of the services assigned to the nonfirm lawyers; and the legal protections, professional conduct rules, and ethical environments of the jurisdictions in which the services will be performed, particularly relating to confidential information.

Retaining or Contracting With Other Lawyers

1.1: Comments

7) When lawyers from more than one law firm are providing legal services to the client on a particular matter, the lawyers ordinarily should consult with each other and the client about the scope of their respective representations and the allocation of responsibility among them. See Rule 1.2. When making allocations of responsibility in a matter pending before a tribunal, lawyers and parties may have additional obligations that are a matter of law beyond the scope of these Rules.

Maintaining Competence

1.1: Comments

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.

Rule 1.2: Scope of Representation & Allocation of Authority Between Client & Lawyer

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

Allocation of Authority between Client and Lawyer

1.2 Comments

1) Paragraph (a) confers upon the client the ultimate authority to determine the purposes to be served by legal representation, within the limits imposed by law and the lawyer's professional obligations. The decisions specified in paragraph (a), such as whether to settle a civil matter, must also be made by the client. See Rule 1.4(a)(1) for the lawyer's duty to communicate with the client about such decisions. With respect to the means by which the client's objectives are to be pursued, the lawyer shall consult with the client as required by Rule 1.4(a)(2) and may take such action as is impliedly authorized to carry out the representation.

2) On occasion, however, a lawyer and a client may disagree about the means to be used to accomplish the client's objectives. Clients normally defer to the special knowledge and skill of their lawyer with respect to the means to be used to accomplish their objectives, particularly with respect to technical, legal and tactical matters. Conversely, lawyers usually defer to the client regarding such questions as the expense to be incurred and concern for third persons who might be adversely affected. Because of the varied nature of the matters about which a lawyer and client might disagree and because the actions in question may implicate the interests of a tribunal or other persons, this Rule does not prescribe how such disagreements are to be resolved. Other law, however, may be applicable and should be consulted by the lawyer. The lawyer should also consult with the client and seek a mutually acceptable resolution of the disagreement. If such efforts are unavailing and the lawyer has a fundamental disagreement with the client, the lawyer may withdraw from the representation. See Rule 1.16(b)(4). Conversely, the client may resolve the disagreement by discharging the lawyer. See Rule 1.16(a)(3).

Allocation of Authority between Client and Lawyer

1.2 Comments

3)At the outset of a representation, the client may authorize the lawyer to take specific action on the client's behalf without further consultation. Absent a material change in circumstances and subject to Rule 1.4, a lawyer may rely on such an advance authorization. The client may, however, revoke such authority at any time.

4) In a case in which the client appears to be suffering diminished capacity, the lawyer's duty to abide by the client's decisions is to be guided by reference to Rule 1.14.

Independence from Client's Views or Activities

1.2 Comments

5) Legal representation should not be denied to people who are unable to afford legal services, or whose cause is controversial or the subject of popular disapproval. By the same token, representing a client does not constitute approval of the client's views or activities.

Agreements Limiting Scope of Representation

1.2 Comments

6) The scope of services to be provided by a lawyer may be limited by agreement with the client or by the terms under which the lawyer's services are made available to the client. When a lawyer has been retained by an insurer to represent an insured, for example, the representation may be limited to matters related to the insurance coverage. A limited representation may be appropriate because the client has limited objectives for the representation. In addition, the terms upon which representation is undertaken may exclude specific means that might otherwise be used to accomplish the client's objectives. Such limitations may exclude actions that the client thinks are too costly or that the lawyer regards as repugnant or imprudent.

7) Although this Rule affords the lawyer and client substantial latitude to limit the representation, the limitation must be reasonable under the circumstances. If, for example, a client's objective is limited to securing general information about the law the client needs in order to handle a common and typically uncomplicated legal problem, the lawyer and client may agree that the lawyer's services will be limited to a brief telephone consultation. Such a limitation, however, would not be reasonable if the time allotted was not sufficient to yield advice upon which the client could rely. Although an agreement for a limited representation does not exempt a lawyer from the duty to provide competent representation, the limitation is a factor to be considered when determining the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation. See Rule 1.1.

8) All agreements concerning a lawyer's representation of a client must accord with the Rules of Professional Conduct and other law. See, e.g., Rules 1.1, 1.8 and 5.6.

Criminal, Fraudulent and Prohibited Transactions

1.2 Comments

9) Paragraph (d) prohibits a lawyer from knowingly counseling or assisting a client to commit a crime or fraud. This prohibition, however, does not preclude the lawyer from giving an honest opinion about the actual consequences that appear likely to result from a client's conduct. Nor does the fact that a client uses advice in a course of action that is criminal or fraudulent of itself make a lawyer a party to the course of action. There is a critical distinction between presenting an analysis of legal aspects of questionable conduct and recommending the means by which a crime or fraud might be committed with impunity.

10) When the client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate. The lawyer is required to avoid assisting the client, for example, by drafting or delivering documents that the lawyer knows are fraudulent or by suggesting how the wrongdoing might be concealed. A lawyer may not continue assisting a client in conduct that the lawyer originally supposed was legally proper but then discovers is criminal or fraudulent. The lawyer must, therefore, withdraw from the representation of the client in the matter. See Rule 1.16(a). In some cases, withdrawal alone might be insufficient. It may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm any opinion, document, affirmation or the like. See Rule 4.1.

Criminal, Fraudulent and Prohibited Transactions

1.2 Comments

11) Where the client is a fiduciary, the lawyer may be charged with special obligations in dealings with a beneficiary.

12) Paragraph (d) applies whether or not the defrauded party is a party to the transaction. Hence, a lawyer must not participate in a transaction to effectuate criminal or fraudulent avoidance of tax liability. Paragraph (d) does not preclude undertaking a criminal defense incident to a general retainer for legal services to a lawful enterprise. The last clause of paragraph (d) recognizes that determining the validity or interpretation of a statute or regulation may require a course of action involving disobedience of the statute or regulation or of the interpretation placed upon it by governmental authorities.

13) If a lawyer comes to know or reasonably should know that a client expects assistance not permitted by the Rules of Professional Conduct or other law or if the lawyer intends to act contrary to the client's instructions, the lawyer must consult with the client regarding the limitations on the lawyer's conduct. See Rule 1.4(a)(5).

Rule 1.3: Diligence

Client-Lawyer Relationship

A lawyer shall act with reasonable diligence and promptness in representing a client.

Client-Lawyer Relationship

1.3 Comments

1) A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf. A lawyer is not bound, however, to press for every advantage that might be realized for a client. For example, a lawyer may have authority to exercise professional discretion in determining the means by which a matter should be pursued. See Rule 1.2. The lawyer's duty to act with reasonable diligence does not require the use of offensive tactics or preclude the treating of all persons involved in the legal process with courtesy and respect.

2) A lawyer's work load must be controlled so that each matter can be handled competently.

Client-Lawyer Relationship

1.3 Comments

3) Perhaps no professional shortcoming is more widely resented than procrastination. A client's interests often can be adversely affected by the passage of time or the change of conditions; in extreme instances, as when a lawyer overlooks a statute of limitations, the client's legal position may be destroyed. Even when the client's interests are not affected in substance, however, unreasonable delay can cause a client needless anxiety and undermine confidence in the lawyer's trustworthiness. A lawyer's duty to act with reasonable promptness, however, does not preclude the lawyer from agreeing to a reasonable request for a postponement that will not prejudice the lawyer's client.

Client-Lawyer Relationship

1.3 Comments

4) Unless the relationship is terminated as provided in Rule 1.16, a lawyer should carry through to conclusion all matters undertaken for a client. If a lawyer's employment is limited to a specific matter, the relationship terminates when the matter has been resolved. If a lawyer has served a client over a substantial period in a variety of matters, the client sometimes may assume that the lawyer will continue to serve on a continuing basis unless the lawyer gives notice of withdrawal. Doubt about whether a client-lawyer relationship still exists should be clarified by the lawyer, preferably in writing, so that the client will not mistakenly suppose the lawyer is looking after the client's affairs when the lawyer has ceased to do so. For example, if a lawyer has handled a judicial or administrative proceeding that produced a result adverse to the client and the lawyer and the client have not agreed that the lawyer will handle the matter on appeal, the lawyer must consult with the client about the possibility of appeal before relinquishing responsibility for the matter. See Rule 1.4(a)(2). Whether the lawyer is obligated to prosecute the appeal for the client depends on the scope of the representation the lawyer has agreed to provide to the client. See Rule 1.2.

Client-Lawyer Relationship

1.3 Comments

5) To prevent neglect of client matters in the event of a sole practitioner's death or disability, the duty of diligence may require that each sole practitioner prepare a plan, in conformity with applicable rules, that designates another competent lawyer to review client files, notify each client of the lawyer's death or disability, and determine whether there is a need for immediate protective action. Cf. Rule 28 of the American Bar Association Model Rules for Lawyer Disciplinary Enforcement (providing for court appointment of a lawyer to inventory files and take other protective action in absence of a plan providing for another lawyer to protect the interests of the clients of a deceased or disabled lawyer).

Rule 1.4 Communications

(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.

Communicating with Client

1.4 Comments

1) Reasonable communication between the lawyer and the client is necessary for the client effectively to participate in the representation.

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

1.4 Comments

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

1.4 Comments

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 1.5 Fees

(a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include the following:

(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;

(2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;

(3) the fee customarily charged in the locality for similar legal services;

(4) the amount involved and the results obtained;

(5) the time limitations imposed by the client or by the circumstances;

(6) the nature and length of the professional relationship with the client;

(7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and

(8) whether the fee is fixed or contingent.

(b) The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation, except when the lawyer will charge a regularly represented client on the same basis or rate. Any changes in the basis or rate of the fee or expenses shall also be communicated to the client.

Rule 1.5 Fees

(c) A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter in which a contingent fee is prohibited by paragraph (d) or other law. A contingent fee agreement shall be in a writing signed by the client and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal; litigation and other expenses to be deducted from the recovery; and whether such expenses are to be deducted before or after the contingent fee is calculated. The agreement must clearly notify the client of any expenses for which the client will be liable whether or not the client is the prevailing party. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

Rule 1.5 Fees

d) A lawyer shall not enter into an arrangement for, charge, or collect:

(1) any fee in a domestic relations matter, the payment or amount of which is contingent upon the securing of a divorce or upon the amount of alimony or support, or property settlement in lieu thereof; or

(2) a contingent fee for representing a defendant in a criminal case.

(e) A division of a fee between lawyers who are not in the same firm may be made only if:

(1) the division is in proportion to the services performed by each lawyer or each lawyer assumes joint responsibility for the representation;

(2) the client agrees to the arrangement, including the share each lawyer will receive, and the agreement is confirmed in writing; and

(3) the total fee is reasonable.

Reasonableness of Fee and Expenses

1.5 Comments

1) Paragraph (a) requires that lawyers charge fees that are reasonable under the circumstances. The factors specified in (1) through (8) are not exclusive. Nor will each factor be relevant in each instance. Paragraph (a) also requires that expenses for which the client will be charged must be reasonable. A lawyer may seek reimbursement for the cost of services performed in-house, such as copying, or for other expenses incurred in-house, such as telephone charges, either by charging a reasonable amount to which the client has agreed in advance or by charging an amount that reasonably reflects the cost incurred by the lawyer.

Basis or Rate of Fee

1.5 Comments

2) When the lawyer has regularly represented a client, they ordinarily will have evolved an understanding concerning the basis or rate of the fee and the expenses for which the client will be responsible. In a new client-lawyer relationship, however, an understanding as to fees and expenses must be promptly established. Generally, it is desirable to furnish the client with at least a simple memorandum or copy of the lawyer's customary fee arrangements that states the general nature of the legal services to be provided, the basis, rate or total amount of the fee and whether and to what extent the client will be responsible for any costs, expenses or disbursements in the course of the representation. A written statement concerning the terms of the engagement reduces the possibility of misunderstanding.

3) Contingent fees, like any other fees, are subject to the reasonableness standard of paragraph (a) of this Rule. In determining whether a particular contingent fee is reasonable, or whether it is reasonable to charge any form of contingent fee, a lawyer must consider the factors that are relevant under the circumstances. Applicable law may impose limitations on contingent fees, such as a ceiling on the percentage allowable, or may require a lawyer to offer clients an alternative basis for the fee. Applicable law also may apply to situations other than a contingent fee, for example, government regulations regarding fees in certain tax matters.

Terms of Payment

1.5 Comments

4) A lawyer may require advance payment of a fee, but is obliged to return any unearned portion. See Rule 1.16(d). A lawyer may accept property in payment for services, such as an ownership interest in an enterprise, providing this does not involve acquisition of a proprietary interest in the cause of action or subject matter of the litigation contrary to Rule 1.8 (i). However, a fee paid in property instead of money may be subject to the requirements of Rule 1.8(a) because such fees often have the essential qualities of a business transaction with the client.

5) An agreement may not be made whose terms might induce the lawyer improperly to curtail services for the client or perform them in a way contrary to the client's interest. For example, a lawyer should not enter into an agreement whereby services are to be provided only up to a stated amount when it is foreseeable that more extensive services probably will be required, unless the situation is adequately explained to the client. Otherwise, the client might have to bargain for further assistance in the midst of a proceeding or transaction. However, it is proper to define the extent of services in light of the client's ability to pay. A lawyer should not exploit a fee arrangement based primarily on hourly charges by using wasteful procedures.

Prohibited Contingent Fees
1.5 Comments

1.5 Comments

6) Paragraph (d) prohibits a lawyer from charging a contingent fee in a domestic relations matter when payment is contingent upon the securing of a divorce or upon the amount of alimony or support or property settlement to be obtained. This provision does not preclude a contract for a contingent fee for legal representation in connection with the recovery of post-judgment balances due under support, alimony or other financial orders because such contracts do not implicate the same policy concerns.

Division of Fee

1.5 Comments

7) A division of fee is a single billing to a client covering the fee of two or more lawyers who are not in the same firm. A division of fee facilitates association of more than one lawyer in a matter in which neither alone could serve the client as well, and most often is used when the fee is contingent and the division is between a referring lawyer and a trial specialist. Paragraph (e) permits the lawyers to divide a fee either on the basis of the proportion of services they render or if each lawyer assumes responsibility for the representation as a whole. In addition, the client must agree to the arrangement, including the share that each lawyer is to receive, and the agreement must be confirmed in writing. Contingent fee agreements must be in a writing signed by the client and must otherwise comply with paragraph (c) of this Rule. Joint responsibility for the representation entails financial and ethical responsibility for the representation as if the lawyers were associated in a partnership. A lawyer should only refer a matter to a lawyer whom the referring lawyer reasonably believes is competent to handle the matter. See Rule 1.1.

8) Paragraph (e) does not prohibit or regulate division of fees to be received in the future for work done when lawyers were previously associated in a law firm.

Disputes over Fees

1.5 Comments

9) If a procedure has been established for resolution of fee disputes, such as an arbitration or mediation procedure established by the bar, the lawyer must comply with the procedure when it is mandatory, and, even when it is voluntary, the lawyer should conscientiously consider submitting to it. Law may prescribe a procedure for determining a lawyer's fee, for example, in representation of an executor or administrator, a class or a person entitled to a reasonable fee as part of the measure of damages. The lawyer entitled to such a fee and a lawyer representing another party concerned with the fee should comply with the prescribed procedure.

Rule 1.6: Confidentiality of Information

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these Rules;

(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;

(6) to comply with other law or a court order; or

(7) to detect and resolve conflicts of interest arising from the lawyer’s change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

Client-Lawyer Relationship

1.6 Comment

[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 client-lawyer 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.

Client-Lawyer Relationship

1.6 Comment

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

1.6 Comments

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

1.6 Comments

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.

Disclosure Adverse to Client

1.6 Comments

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.

Disclosure Adverse to Client

1.6 Comments

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.

Rule 1.7 Conflict of Interest: Current Clients

a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

2) the representation is not prohibited by law;

3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

4) each affected client gives informed consent, confirmed in writing.

Client-Lawyer Relationship: General Principles

1.7 Comments

1) Loyalty and independent judgment are essential elements in the lawyer's relationship to a client. Concurrent conflicts of interest can arise from the lawyer's responsibilities to another client, a former client or a third person or from the lawyer's own interests. For specific Rules regarding certain concurrent conflicts of interest, see Rule 1.8. For former client conflicts of interest, see Rule 1.9. For conflicts of interest involving prospective clients, see Rule 1.18. For definitions of "informed consent" and "confirmed in writing," see Rule 1.0(e) and (b).

2) Resolution of a conflict of interest problem under this Rule requires the lawyer to: 1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentable; and 4) if so, consult with the clients affected under paragraph (a) and obtain their informed consent, confirmed in writing. The clients affected under paragraph (a) include both of the clients referred to in paragraph (a)(1) and the one or more clients whose representation might be materially limited under paragraph (a)(2).

3) A conflict of interest may exist before representation is undertaken, in which event the representation must be declined, unless the lawyer obtains the informed consent of each client under the conditions of paragraph (b). To determine whether a conflict of interest exists, a lawyer should adopt reasonable procedures, appropriate for the size and type of firm and practice, to determine in both litigation and non-litigation matters the persons and issues involved. See also Comment to Rule 5.1. Ignorance caused by a failure to institute such procedures will not excuse a lawyer's violation of this Rule. As to whether a client-lawyer relationship exists or, having once been established, is continuing, see Comment to Rule 1.3 and Scope.

Client-Lawyer Relationship: General Principles

1.7 Comments

4) If a conflict arises after representation has been undertaken, the lawyer ordinarily must withdraw from the representation, unless the lawyer has obtained the informed consent of the client under the conditions of paragraph (b). See Rule 1.16. Where more than one client is involved, whether the lawyer may continue to represent any of the clients is determined both by the lawyer's ability to comply with duties owed to the former client and by the lawyer's ability to represent adequately the remaining client or clients, given the lawyer's duties to the former client. See Rule 1.9. See also Comments [5] and [29].

5) Unforeseeable developments, such as changes in corporate and other organizational affiliations or the addition or realignment of parties in litigation, might create conflicts in the midst of a representation, as when a company sued by the lawyer on behalf of one client is bought by another client represented by the lawyer in an unrelated matter. Depending on the circumstances, the lawyer may have the option to withdraw from one of the representations in order to avoid the conflict. The lawyer must seek court approval where necessary and take steps to minimize harm to the clients. See Rule 1.16. The lawyer must continue to protect the confidences of the client from whose representation the lawyer has withdrawn. See Rule 1.9(c).

Identifying Conflicts of Interest: Directly Adverse

1.7 Comments

6) Loyalty to a current client prohibits undertaking representation directly adverse to that client without that client's informed consent. Thus, absent consent, a lawyer may not act as an advocate in one matter against a person the lawyer represents in some other matter, even when the matters are wholly unrelated. The client as to whom the representation is directly adverse is likely to feel betrayed, and the resulting damage to the client-lawyer relationship is likely to impair the lawyer's ability to represent the client effectively. In addition, the client on whose behalf the adverse representation is undertaken reasonably may fear that the lawyer will pursue that client's case less effectively out of deference to the other client, i.e., that the representation may be materially limited by the lawyer's interest in retaining the current client. Similarly, a directly adverse conflict may arise when a lawyer is required to cross-examine a client who appears as a witness in a lawsuit involving another client, as when the testimony will be damaging to the client who is represented in the lawsuit. On the other hand, simultaneous representation in unrelated matters of clients whose interests are only economically adverse, such as representation of competing economic enterprises in unrelated litigation, does not ordinarily constitute a conflict of interest and thus may not require consent of the respective clients.

7) Directly adverse conflicts can also arise in transactional matters. For example, if a lawyer is asked to represent the seller of a business in negotiations with a buyer represented by the lawyer, not in the same transaction but in another, unrelated matter, the lawyer could not undertake the representation without the informed consent of each client.

Identifying Conflicts of Interest: Material Limitation

1.7 Comments

8) Even where there is no direct adverseness, a conflict of interest exists if there is a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests. For example, a lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer's ability to recommend or advocate all possible positions that each might take because of the lawyer's duty of loyalty to the others. The conflict in effect forecloses alternatives that would otherwise be available to the client. The mere possibility of subsequent harm does not itself require disclosure and consent. The critical questions are the likelihood that a difference in interests will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.

Lawyer's Responsibilities to Former Clients and Other Third Persons

1.7 Comments

9) In addition to conflicts with other current clients, a lawyer's duties of loyalty and independence may be materially limited by responsibilities to former clients under Rule 1.9 or by the lawyer's responsibilities to other persons, such as fiduciary duties arising from a lawyer's service as a trustee, executor or corporate director.

Interest of Person Paying for a Lawyer's Service

1.7 Comments

13) A lawyer may be paid from a source other than the client, including a co-client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty or independent judgment to the client. See Rule 1.8(f). If acceptance of the payment from any other source presents a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's own interest in accommodating the person paying the lawyer's fee or by the lawyer's responsibilities to a payer who is also a co-client, then the lawyer must comply with the requirements of paragraph (b) before accepting the representation, including determining whether the conflict is consentable and, if so, that the client has adequate information about the material risks of the representation.

Prohibited Representations

1.7 Comments

14) Ordinarily, clients may consent to representation notwithstanding a conflict. However, as indicated in paragraph (b), some conflicts are nonconsentable, meaning that the lawyer involved cannot properly ask for such agreement or provide representation on the basis of the client's consent. When the lawyer is representing more than one client, the question of consentability must be resolved as to each client.

15) Consentability is typically determined by considering whether the interests of the clients will be adequately protected if the clients are permitted to give their informed consent to representation burdened by a conflict of interest. Thus, under paragraph (b)(1), representation is prohibited if in the circumstances the lawyer cannot reasonably conclude that the lawyer will be able to provide competent and diligent representation. See Rule 1.1 (competence) and Rule 1.3 (diligence).

16) Paragraph (b)(2) describes conflicts that are nonconsentable because the representation is prohibited by applicable law. For example, in some states substantive law provides that the same lawyer may not represent more than one defendant in a capital case, even with the consent of the clients, and under federal criminal statutes certain representations by a former government lawyer are prohibited, despite the informed consent of the former client. In addition, decisional law in some states limits the ability of a governmental client, such as a municipality, to consent to a conflict of interest.

17) Paragraph (b)(3) describes conflicts that are nonconsentable because of the institutional interest in vigorous development of each client's position when the clients are aligned directly against each other in the same litigation or other proceeding before a tribunal. Whether clients are aligned directly against each other within the meaning of this paragraph requires examination of the context of the proceeding. Although this paragraph does not preclude a lawyer's multiple representation of adverse parties to a mediation (because mediation is not a proceeding before a "tribunal" under Rule 1.0(m)), such representation may be precluded by paragraph (b)(1).

Informed Consent

1.7 Comments

18) Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. See Rule 1.0(e) (informed consent). The information required depends on the nature of the conflict and the nature of the risks involved. When representation of multiple clients in a single matter is undertaken, the information must include the implications of the common representation, including possible effects on loyalty, confidentiality and the attorney-client privilege and the advantages and risks involved. See Comments [30] and [31] (effect of common representation on confidentiality).

19) Under some circumstances it may be impossible to make the disclosure necessary to obtain consent. For example, when the lawyer represents different clients in related matters and one of the clients refuses to consent to the disclosure necessary to permit the other client to make an informed decision, the lawyer cannot properly ask the latter to consent. In some cases the alternative to common representation can be that each party may have to obtain separate representation with the possibility of incurring additional costs. These costs, along with the benefits of securing separate representation, are factors that may be considered by the affected client in determining whether common representation is in the client's interests.

Consent Confirmed in Writing

1.7 Comments

20) Paragraph (b) requires the lawyer to obtain the informed consent of the client, confirmed in writing. Such a writing may consist of a document executed by the client or one that the lawyer promptly records and transmits to the client following an oral consent. See Rule 1.0(b). See also Rule 1.0(n) (writing includes electronic transmission). If it is not feasible to obtain or transmit the writing at the time the client gives informed consent, then the lawyer must obtain or transmit it within a reasonable time thereafter. See Rule 1.0(b). The requirement of a writing does not supplant the need in most cases for the lawyer to talk with the client, to explain the risks and advantages, if any, of representation burdened with a conflict of interest, as well as reasonably available alternatives, and to afford the client a reasonable opportunity to consider the risks and alternatives and to raise questions and concerns. Rather, the writing is required in order to impress upon clients the seriousness of the decision the client is being asked to make and to avoid disputes or ambiguities that might later occur in the absence of a writing.

Revoking Consent

1.7 Comments

21) A client who has given consent to a conflict may revoke the consent and, like any other client, may terminate the lawyer's representation at any time. Whether revoking consent to the client's own representation precludes the lawyer from continuing to represent other clients depends on the circumstances, including the nature of the conflict, whether the client revoked consent because of a material change in circumstances, the reasonable expectations of the other client and whether material detriment to the other clients or the lawyer would result.

Consent to Future Conflict

1.7 Comments

22) Whether a lawyer may properly request a client to waive conflicts that might arise in the future is subject to the test of paragraph (b). The effectiveness of such waivers is generally determined by the extent to which the client reasonably understands the material risks that the waiver entails. The more comprehensive the explanation of the types of future representations that might arise and the actual and reasonably foreseeable adverse consequences of those representations, the greater the likelihood that the client will have the requisite understanding. Thus, if the client agrees to consent to a particular type of conflict with which the client is already familiar, then the consent ordinarily will be effective with regard to that type of conflict. If the consent is general and open-ended, then the consent ordinarily will be ineffective, because it is not reasonably likely that the client will have understood the material risks involved. On the other hand, if the client is an experienced user of the legal services involved and is reasonably informed regarding the risk that a conflict may arise, such consent is more likely to be effective, particularly if, e.g., the client is independently represented by other counsel in giving consent and the consent is limited to future conflicts unrelated to the subject of the representation. In any case, advance consent cannot be effective if the circumstances that materialize in the future are such as would make the conflict nonconsentable under paragraph (b).

Conflicts in Litigation

1.7 Comments

23) Paragraph (b)(3) prohibits representation of opposing parties in the same litigation, regardless of the clients' consent. On the other hand, simultaneous representation of parties whose interests in litigation may conflict, such as coplaintiffs or codefendants, is governed by paragraph (a)(2). A conflict may exist by reason of substantial discrepancy in the parties' testimony, incompatibility in positions in relation to an opposing party or the fact that there are substantially different possibilities of settlement of the claims or liabilities in question. Such conflicts can arise in criminal cases as well as civil. The potential for conflict of interest in representing multiple defendants in a criminal case is so grave that ordinarily a lawyer should decline to represent more than one codefendant. On the other hand, common representation of persons having similar interests in civil litigation is proper if the requirements of paragraph (b) are met.

24) Ordinarily a lawyer may take inconsistent legal positions in different tribunals at different times on behalf of different clients. The mere fact that advocating a legal position on behalf of one client might create precedent adverse to the interests of a client represented by the lawyer in an unrelated matter does not create a conflict of interest. A conflict of interest exists, however, if there is a significant risk that a lawyer's action on behalf of one client will materially limit the lawyer's effectiveness in representing another client in a different case; for example, when a decision favoring one client will create a precedent likely to seriously weaken the position taken on behalf of the other client. Factors relevant in determining whether the clients need to be advised of the risk include: where the cases are pending, whether the issue is substantive or procedural, the temporal relationship between the matters, the significance of the issue to the immediate and long-term interests of the clients involved and the clients' reasonable expectations in retaining the lawyer. If there is significant risk of material limitation, then absent informed consent of the affected clients, the lawyer must refuse one of the representations or withdraw from one or both matters.

25) When a lawyer represents or seeks to represent a class of plaintiffs or defendants in a class-action lawsuit, unnamed members of the class are ordinarily not considered to be clients of the lawyer for purposes of applying paragraph (a)(1) of this Rule. Thus, the lawyer does not typically need to get the consent of such a person before representing a client suing the person in an unrelated matter. Similarly, a lawyer seeking to represent an opponent in a class action does not typically need the consent of an unnamed member of the class whom the lawyer represents in an unrelated matter.

Nonlitigation Conflicts

1.7 Comments

26) Conflicts of interest under paragraphs (a)(1) and (a)(2) arise in contexts other than litigation. For a discussion of directly adverse conflicts in transactional matters, see Comment [7]. Relevant factors in determining whether there is significant potential for material limitation include the duration and intimacy of the lawyer's relationship with the client or clients involved, the functions being performed by the lawyer, the likelihood that disagreements will arise and the likely prejudice to the client from the conflict. The question is often one of proximity and degree. See Comment [8].

27) For example, conflict questions may arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and, depending upon the circumstances, a conflict of interest may be present. In estate administration the identity of the client may be unclear under the law of a particular jurisdiction. Under one view, the client is the fiduciary; under another view the client is the estate or trust, including its beneficiaries. In order to comply with conflict of interest rules, the lawyer should make clear the lawyer's relationship to the parties involved.

28) Whether a conflict is consentable depends on the circumstances. For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them. Thus, a lawyer may seek to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest or arranging a property distribution in settlement of an estate. The lawyer seeks to resolve potentially adverse interests by developing the parties' mutual interests. Otherwise, each party might have to obtain separate representation, with the possibility of incurring additional cost, complication or even litigation. Given these and other relevant factors, the clients may prefer that the lawyer act for all of them.

Special Considerations in Common Representation

1.7 Comments

29) In considering whether to represent multiple clients in the same matter, a lawyer should be mindful that if the common representation fails because the potentially adverse interests cannot be reconciled, the result can be additional cost, embarrassment and recrimination. Ordinarily, the lawyer will be forced to withdraw from representing all of the clients if the common representation fails. In some situations, the risk of failure is so great that multiple representation is plainly impossible. For example, a lawyer cannot undertake common representation of clients where contentious litigation or negotiations between them are imminent or contemplated. Moreover, because the lawyer is required to be impartial between commonly represented clients, representation of multiple clients is improper when it is unlikely that impartiality can be maintained. Generally, if the relationship between the parties has already assumed antagonism, the possibility that the clients' interests can be adequately served by common representation is not very good. Other relevant factors are whether the lawyer subsequently will represent both parties on a continuing basis and whether the situation involves creating or terminating a relationship between the parties.

30) A particularly important factor in determining the appropriateness of common representation is the effect on client-lawyer confidentiality and the attorney-client privilege. With regard to the attorney-client privilege, the prevailing rule is that, as between commonly represented clients, the privilege does not attach. Hence, it must be assumed that if litigation eventuates between the clients, the privilege will not protect any such communications, and the clients should be so advised.

Special Considerations in Common Representation

1.7 Comments

31) As to the duty of confidentiality, continued common representation will almost certainly be inadequate if one client asks the lawyer not to disclose to the other client information relevant to the common representation. This is so because the lawyer has an equal duty of loyalty to each client, and each client has the right to be informed of anything bearing on the representation that might affect that client's interests and the right to expect that the lawyer will use that information to that client's benefit. See Rule 1.4. The lawyer should, at the outset of the common representation and as part of the process of obtaining each client's informed consent, advise each client that information will be shared and that the lawyer will have to withdraw if one client decides that some matter material to the representation should be kept from the other. In limited circumstances, it may be appropriate for the lawyer to proceed with the representation when the clients have agreed, after being properly informed, that the lawyer will keep certain information confidential. For example, the lawyer may reasonably conclude that failure to disclose one client's trade secrets to another client will not adversely affect representation involving a joint venture between the clients and agree to keep that information confidential with the informed consent of both clients.

32) When seeking to establish or adjust a relationship between clients, the lawyer should make clear that the lawyer's role is not that of partisanship normally expected in other circumstances and, thus, that the clients may be required to assume greater responsibility for decisions than when each client is separately represented. Any limitations on the scope of the representation made necessary as a result of the common representation should be fully explained to the clients at the outset of the representation. See Rule 1.2(c).

33) Subject to the above limitations, each client in the common representation has the right to loyal and diligent representation and the protection of Rule 1.9 concerning the obligations to a former client. The client also has the right to discharge the lawyer as stated in Rule 1.16.

Organizational Clients

1.7 Comments

34) A lawyer who represents a corporation or other organization does not, by virtue of that representation, necessarily represent any constituent or affiliated organization, such as a parent or subsidiary. See Rule 1.13(a). Thus, the lawyer for an organization is not barred from accepting representation adverse to an affiliate in an unrelated matter, unless the circumstances are such that the affiliate should also be considered a client of the lawyer, there is an understanding between the lawyer and the organizational client that the lawyer will avoid representation adverse to the client's affiliates, or the lawyer's obligations to either the organizational client or the new client are likely to limit materially the lawyer's representation of the other client.

35) A lawyer for a corporation or other organization who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called on to advise the corporation in matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential intensity of the conflict, the effect of the lawyer's resignation from the board and the possibility of the corporation's obtaining legal advice from another lawyer in such situations. If there is material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as a director or should cease to act as the corporation's lawyer when conflicts of interest arise. The lawyer should advise the other members of the board that in some circumstances matters discussed at board meetings while the lawyer is present in the capacity of director might not be protected by the attorney-client privilege and that conflict of interest considerations might require the lawyer's recusal as a director or might require the lawyer and the lawyer's firm to decline representation of the corporation in a matter.

Rule 1.8: Current Clients: Specific Rules

(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.

Rule 1.8: Current Clients: Specific Rules

(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; and

(2) a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.

(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.

Rule 1.8: Current Clients: Specific Rules

(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.

Business Transactions Between Client and Lawyer

1.8 Comments

[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.

Business Transactions Between Client and Lawyer

1.8 Comments

[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

1.8 Comments

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

1.8 Comments

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

1.8 Comments

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

1.8 Comments

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.

Person Paying for a Lawyer's Services

1.8 Comments

11) 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).

12) 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

1.8 Comments

13) 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

1.8 Comments

14) 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.

15) 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

1.8 Comments

16) 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

1.8 Comments

17) 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.

18) 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).

19) 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

1.8 Comments

20) 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.

Rule 1.15 Safekeeping Property

(a) A lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from the lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. Other property shall be identified as such and appropriately safeguarded. Complete records of such account funds and other property shall be kept by the lawyer and shall be preserved for a period of [five years] after termination of the representation.

(b) A lawyer may deposit the lawyer's own funds in a client trust account for the sole purpose of paying bank service charges on that account, but only in an amount necessary for that purpose.

(c) A lawyer shall deposit into a client trust account legal fees and expenses that have been paid in advance, to be withdrawn by the lawyer only as fees are earned or expenses incurred.

(d) Upon receiving funds or other property in which a client or third person has an interest, a lawyer shall promptly notify the client or third person. Except as stated in this rule or otherwise permitted by law or by agreement with the client, a lawyer shall promptly deliver to the client or third person any funds or other property that the client or third person is entitled to receive and, upon request by the client or third person, shall promptly render a full accounting regarding such property.

(e) When in the course of representation a lawyer is in possession of property in which two or more persons (one of whom may be the lawyer) claim interests, the property shall be kept separate by the lawyer until the dispute is resolved. The lawyer shall promptly distribute all portions of the property as to which the interests are not in dispute.

Client-Lawyer Relationship

1. 15 Comment

1) A lawyer should hold property of others with the care required of a professional fiduciary. Securities should be kept in a safe deposit box, except when some other form of safekeeping is warranted by special circumstances. All property that is the property of clients or third persons, including prospective clients, must be kept separate from the lawyer's business and personal property and, if monies, in one or more trust accounts. Separate trust accounts may be warranted when administering estate monies or acting in similar fiduciary capacities. A lawyer should maintain on a current basis books and records in accordance with generally accepted accounting practice and comply with any recordkeeping rules established by law or court order. See, e.g., Model Rules for Client Trust Account Records.

2) While normally it is impermissible to commingle the lawyer's own funds with client funds, paragraph (b) provides that it is permissible when necessary to pay bank service charges on that account. Accurate records must be kept regarding which part of the funds are the lawyer's.

3) Lawyers often receive funds from which the lawyer's fee will be paid. The lawyer is not required to remit to the client funds that the lawyer reasonably believes represent fees owed. However, a lawyer may not hold funds to coerce a client into accepting the lawyer's contention. The disputed portion of the funds must be kept in a trust account and the lawyer should suggest means for prompt resolution of the dispute, such as arbitration. The undisputed portion of the funds shall be promptly distributed.

Client-Lawyer Relationship

1. 15 Comment

4) Paragraph (e) also recognizes that third parties may have lawful claims against specific funds or other property in a lawyer's custody, such as a client's creditor who has a lien on funds recovered in a personal injury action. A lawyer may have a duty under applicable law to protect such third-party claims against wrongful interference by the client. In such cases, when the third-party claim is not frivolous under applicable law, the lawyer must refuse to surrender the property to the client until the claims are resolved. A lawyer should not unilaterally assume to arbitrate a dispute between the client and the third party, but, when there are substantial grounds for dispute as to the person entitled to the funds, the lawyer may file an action to have a court resolve the dispute.

5) The obligations of a lawyer under this Rule are independent of those arising from activity other than rendering legal services. For example, a lawyer who serves only as an escrow agent is governed by the applicable law relating to fiduciaries even though the lawyer does not render legal services in the transaction and is not governed by this Rule.

6) A lawyers' fund for client protection provides a means through the collective efforts of the bar to reimburse persons who have lost money or property as a result of dishonest conduct of a lawyer. Where such a fund has been established, a lawyer must participate where it is mandatory, and, even when it is voluntary, the lawyer should participate.

WHAT CONFLICTS CAN BE WAIVED? A UNIFIED UNDERSTANDING OF COMPETENCE AND CONSENT

*Kevin H. Michels**

ABSTRACT

Attorneys are frequently asked to represent more than one client in the same or related matters. The request can arise in nearly every practice setting, from criminal defense, to civil litigation, to complex transactions. Regardless of the setting, attorneys face the same challenge in deciding whether the conflict of interest posed by the joint representation can be waived by the clients. Under the Model Rules of Professional Conduct, the conflict of interest can be waived if (1) the clients provide knowing, informed consent to the joint representation, and (2) the attorney's representation of the multiple clients will be competent and diligent (these latter elements are referred to collectively as "competent" or "competence"). In assessing whether the joint representation will be competent, however, the attorney encounters the enigma that has bedeviled practitioners, courts, and commentators since the adoption of the Model Rules. A joint representation hampered by a conflict of interest materially limits the services that the attorney can perform for one client because of her competing duties to the other client. Thus, the challenge: how can we know which joint representations are competent (and therefore "consentable") when nearly all suffer from material limits on the services that counsel can undertake for the clients?

Courts cannot fashion a principled standard to assess conflict waivers if they cannot reconcile the consent and competence elements of Model Rule 1.7(b). Without the guidance of a clear standard, attorneys risk discipline and malpractice claims for proceeding under a conflict waiver that a tribunal may later deem invalid. Clients, in turn, may be deprived of their choice of counsel by courts that strike down waiver consents under a standard that is more visceral than reasoned. This Article searches for principles to

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explain and unify our seemingly contradictory commitments to client choice and client protection.

Drawing on the distinction between ends and means that grounds a limited form of paternalism and the emphasis of the Model Rules on client control over the objectives of the representation, this Article proposes a new test by which courts and practitioners can honor both the consent and competence elements of Model Rule 1.7(b). An informed conflict waiver must be rejected as incompetent if limitations on the means or procedures by which the attorney pursues the matter caused by the conflict of interest are likely to defeat the client's objectives for the representation (the "client-objectives" or "proposed" test).

Under this approach, we defer to the client's objectives, long understood as the sole province of the client; we intervene when the client makes decisions about means that are likely to undermine those objectives. The test of competency is not whether the representation has a material deficiency—the very reason why client consent was necessary in the first place. Moreover, the question is not whether the client would have been better off without the consent, a decision that belongs to the client. By identifying what the client hopes to accomplish with the representation, the proposed test provides a baseline against which to measure the significance of the limitations caused by the joint representation. Not just any limits on means—even material ones—will invalidate a client's consent. When a client consents to limitations that are likely to undermine her own objectives for the representation, the representation is incompetent—by dint of the client's own more fundamental commitment. The client-objectives test accommodates both elements of Model Rule 1.7(b): competency and consent in tandem determine whether a client's consent to a joint representation should be upheld or disregarded.

In application, the client-objectives test calls for a rethinking of: the Supreme Court's approach to conflict waiver in the criminal-defense setting; the analysis of courts that have considered conflict waivers in civil litigation and transaction matters; and the approach of attorneys who are charged with determining in the first instance whether to accede to client requests for a joint representation. Given the stakes for clients and counsel, it is time we understood why and when a conflict can be waived.

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INTRODUCTION

As attorneys learn quickly in practice, prospective clients do not always arrive alone at the law office for the initial meeting with counsel. Surprisingly often, they arrive with their co-plaintiffs or co-defendants in civil litigation matters, with business partners or those with whom they propose to enter into a transaction, and—if they are at liberty to do so—with their co-defendants in criminal-defense matters. Under the *Model Rules of Professional Conduct* ("*Model Rules*" or "*Rules*"),[1] an attorney cannot represent these clients jointly unless (1) the affected clients consent to such joint representation after a disclosure of the disadvantages and limitations posed by proceeding jointly; and (2) the representation of clients will be

1. The American Bar Association promulgated the *Model Rules of Professional Conduct* in 1983, and it has amended them frequently since, including substantial revisions in 2002, based on the recommendations of the ABA Commission on Evaluation of the Rules of Professional Conduct ("Ethics 2000 Commission"), chaired by Chief Justice E. Norman Veasey. CTR. FOR PROF'L RESPONSIBILITY AM. BAR ASS'N, ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT (7th ed. 2011). The *Model Rules* are the subject of our discussion because of their widespread adoption by the states. Forty-nine states have adopted some version of the *Model Rules*, often with amendments. *See* Law. Man. on Prof. Conduct (ABA/BNA) 51:303 to 51:304 (Mar. 31, 2010) [hereinafter Lawyers' Manual] (summarizing the changes of each state in adopting the *Model Rules*). California is also considering adoption of the *Model Rules*. *See Proposed Rules of Professional Conduct*, THE ST. BAR OF CAL., http://ethics.calbar.ca.gov/Committees/RulesCommission/ProposedRulesofProfessionalConduct.aspx (last visited Jan. 27, 2013).

competent and diligent despite the joint representation.[2]

Honoring these elements, the attorney should discuss with each of the prospective clients (hereinafter "clients") the problems posed by the joint representation, describing the material limitations on the services the attorney can provide for each client resulting from her competing obligation to the other.[3] The attorney might warn the clients, for example, that she will not be able preserve the confidences of one from the other, advise one client about matters that will disadvantage the other, pursue certain claims for one client that could harm the other, negotiate on behalf of one client against the other, and describe a host of other limitations arising out the particulars of the proposed joint representation.[4] Despite these material limitations, the clients may wish to consent to the conflict of interest because of the perceived or actual advantages of a joint representation, including the effectiveness of their chosen attorney, the tactical advantages of uniting, a belief that their transaction interests are more aligned than adverse, and a belief that joint representation will be less costly.[5]

The attorney must then turn to the second element of a valid conflict waiver under the *Model Rules*—whether the joint representation will be competent despite the material limitations that the attorney has described. This is where the attorney needs guidance. The attorney has just explained that she will not be able to provide material services and protections that the clients would have

2. MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (2012). In order for a consent to be valid and enforceable, the attorney must: (1) obtain the "informed consent" of the clients; and (2) "reasonably believe" that she can represent the interests of the clients "competently" and "diligently." *Id*. This Article will generally assume that the lawyer has obtained informed consent in order to ask when and whether a conflicted representation will satisfy the demands of element (2). For convenience, this Article will use the term "competence" to refer to *both* the competence and diligence demands of element (2). *See infra* text accompanying notes 42-43. This Article principally examines joint or multiple representation conflicts of interest under Model Rule 1.7(b), i.e., whether conflicts posed by the simultaneous representation of two or more clients in the same or related matter will render the representation incompetent and therefore incurable even with informed client consent. *See id.* Model Rule 1.7(b) also allows for informed waivers of certain conflicts of interest posed by the simultaneous representation of adverse clients in unrelated matters. *See id.* While the client-objectives test proposed herein should also determine whether informed waivers of "adverse-unrelated" conflicts should be overturned on competency grounds, application of the test to these circumstances will have to await a future work. Waivers of conflicts posed by obligations to a *former* client, the subject of Model Rule 1.9(a), are outside the scope of this Article.

3. *See* MODEL RULES OF PROF'L CONDUCT R. 1.0 (e) (2012) ("'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.").

4. *See infra* notes 133-138 and accompanying text.

5. *See infra* notes 69-72 and accompanying text.

received if each were represented by separate counsel. A joint representation that poses a conflict of interest—by its very nature—materially limits the services that the attorney can perform for one client because of her competing duties to the other client. Thus, the challenge: how can the attorney know which joint representations are competent (and therefore "consentable") when nearly all are hampered by material limits on what counsel can do for the clients?

The conflict-waiver rules would seemingly have it both ways: they allow the client to make an informed decision to retain counsel despite a conflict of interest, but would take away that choice when the representation renders the representation incompetent. When we ask what conflicting representations are incompetent, however, we realize that the distinction between a competent and incompetent representation is unclear because it lacks a conceptual foundation. In choosing to proceed with a conflicted representation, the client presumably has a right to accept material deficiencies in the representation. Otherwise, a client would be allowed to waive a conflict of interest only when there is nothing of consequence to waive. Thus, the *Model Rules* are committed to the seemingly inconsonant notions that a representation can have material deficiencies and still be competent.

Not surprisingly, these conceptual difficulties have translated into grave problems for courts in determining whether a knowing waiver of a conflict of interest should be struck down as incompetent. In *Wheat v. United States*,[6] a leading Supreme Court case on conflict waiver in the criminal-defense setting,[7] a defendant waived a conflict of interest posed by his attorney's representation of other defendants in related but separate cases.[8] The trial court rejected the defendant's conflict waiver, requiring him to proceed at trial with other counsel, and the defendant was convicted.[9] Assuming without discussion that the waiver was informed,[10] the Court framed the issue as "when a district court may override a defendant's waiver of

6. 486 U.S. 153 (1988).

7. *See generally* WAYNE R. LAFAVE ET AL., CRIMINAL PROCEDURE § 11.9(c) (3d ed. 2011) (describing the effect of the *Wheat* decision on federal district court and state court approaches to conflict waiver in the criminal-defense setting). For recent examples of conflict-waiver questions considered by courts in the criminal-defense setting, see U.S. v. Massimino, 832 F. Supp. 2d 510, 515-16 (E.D. Pa. 2011) (co-defendants); State *ex rel.* Horn v. Ray, 325 S.W.3d 500, 514-15 (Mo. Ct. App. 2010) (Norton, J., dissenting) (defendant and victim); People v. Glinton, 900 N.Y.S.2d 264, 265 (N.Y. App. Div. 2010) (defendant and witnesses).

8. *Wheat,* 486 U.S. at 157.

9. *Id.*

10. *See id.* at 172 (Stevens, J., dissenting) (objecting to majority's failure to give sufficient "weight to the informed and voluntary character of the clients' waiver" and noting that client had separate counsel advising him on "the wisdom of a waiver").

his attorney's conflict of interest."[11] The question, as the *Wheat* Court noted, implicated the Sixth Amendment right of the defendant to counsel of his choosing[12] as well as the attorney-ethics rules on conflict of interest.[13] Citing concerns about whether the representation would be adequate in light of the conflict of interest,[14] a five-to-four majority of the Court upheld the trial court's rejection of the defendant's conflict waiver.[15]

Although the majority and dissenting opinions in *Wheat* differed profoundly on the applicable standard and the correct outcome, they shared one telling characteristic: neither sought to justify the standard they applied in assessing the validity of the client waiver.[16] In fact, Justice Rehnquist, writing for the majority, went so far as to suggest that different district courts might decide these matters differently and not be "right" or "wrong,"[17] implying that the Court had nearly abandoned the search for a principled standard by which to determine when knowing waivers should be affirmed or rejected. The stakes, however, demand principles, not impressions. The District Court denied Wheat his choice of an attorney who—by the prosecution's own characterization—had already proven extremely effective in gaining the acquittal of another defendant in the alleged conspiracy.[18] If we are to reject a client's choice of counsel despite an informed and voluntary conflict waiver, we need a genuine understanding of what renders a representation incompetent and therefore beyond client consent.

The problem is no less vexing in the civil litigation and transaction settings. [19] Except when a court or a committee opinion has expressly declared a certain representation unwaivable,

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11. *Id*. at 158.

12. *Id*. at 159.

13. *Id*. at 160 ("Federal courts have an independent interest in ensuring that criminal trials are conducted within the ethical standards of the profession . . . .").

14. *Id*. at 162 (quoting United States v. Dolan, 570 F.2d 1177, 1184 (3d Cir. 1978)).

15. *Id*. at 164.

16. *See infra* note 219 and accompanying text.

17. *Wheat*, 486 U.S. at 164.

18. *Id*. at 170 n.3 (Marshall, J., dissenting) (quoting prosecutor: "Were I in [petitioner's] position I'm sure I would want Mr. Iredale representing me, too. He did a fantastic job in that . . . trial") (alteration in original).

19. There are several examples in the civil litigation setting of conflict waivers being obtained by counsel and then later challenged. *See, e.g.,* Unified Sewerage Agency v. Jelco Inc., 646 F.2d 1339, 1351 (9th Cir. 1981) (litigation involving general contractor and subcontractor); SEC v. King Chuen Tang, 831 F. Supp. 2d 1130, 1144 (N.D. Cal. 2011) (SEC enforcement action). There are also similar examples in the transaction setting. *See, e.g.,* Baldasarre v. Butler, 625 A.2d 458, 460 (N.J. 1993) (commercial real estate transaction); Ass'n of the Bar of the City of New York Comm. on Prof'l & Judicial Ethics, Formal Op. 2001-2 (2001) (corporate transaction); Illinois State Bar Ass'n Advisory Op. on Prof'l Conduct, Op. 96-05 (1996) (estate).

attorneys have no clear standard by which to determine whether a concurrent conflict of interest can be waived by the client. A confused conflict-consent standard poses fairness problems for attorneys who may face discipline or malpractice not because a standard has been flouted but because of the difficulty of predicting whether it will be invalidated on later challenge.[20] Unable to predict whether a tribunal will later deem the conflict unwaivable, attorneys may be less likely to provide clients with the option to accept a dual representation—even in those instances when knowing client consent *should* be sufficient. While there are often good reasons not to seek a conflict consent, incoherence in the doctrine that assesses their validity is not among them. Courts, in turn, may wrongfully deprive clients of their choice of counsel by rejecting conflict waivers without the guidance of a principled standard by which to assess their validity.[21]

Thus, whether a conflict can be waived is a concern for both courts and practitioners: courts need a standard by which to assess the competence of representations that are the subject of conflict waivers in the civil and criminal setting, and practitioners need guidance on whether to seek conflict waivers in the first place. In every setting, the problem is the same: why are some material risks posed by a conflict of interest acceptable and waivable by the client, while others render the representation incompetent and therefore warrant depriving the client of his choice of counsel?[22] This Article takes up the search for a principled answer.

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20. In a later malpractice claim, the former client may assert that the consent, even if preceded by full disclosure of the risks, did not cure the attorney's conflict of interest because the representation was incompetent as a result of the conflict. *See* Lawyers' Manual, *supra* note 1, at 51:308 (cautioning that analysis of competency is "critical since clients who become unhappy with multiple representation frequently claim at some point that the lawyer should not have served as joint counsel despite the clients' assent"). A breach of the attorney ethics rules may be evidence of malpractice. MODEL RULES OF PROF'L CONDUCT pmbl. and scope (2012) ("[A] lawyer's violation of a Rule may be evidence of breach of the applicable standard of conduct."); Note, *Lawyers' Responsibilities and Lawyers' Responses*, 107 HARV. L. REV. 1547, 1557-67 (1994). Ironically, the disclosure necessary to gain an informed consent under Model Rule 1.0(e)–in effect a listing of problems that can befall the client as a result of the multiple representation–may provide courts and clients (who later challenge the multiple representation despite their consent) with a host of reasons why, under the competency requirement, consent should not have been sought in the first place. *See* MODEL RULES OF PROF'L CONDUCT R. 1.0 cmt. 6 (2012).

21. *See infra* Part IV.B.2 (arguing that the *Wheat* court wrongfully deprived the client of his choice of counsel). A confused standard may also make it easier for adversaries who seek tactical advantage to gain disqualification of opposing counsel on the grounds that the conflict waiver is invalid, a possible motive in the *Wheat* case. *Wheat,* 486 U.S. at 170 n.3 (Marshall, J., dissenting).

22. *See* Peter R. Jarvis & Bradley F. Tellam, *When Waiver Should Not Be Good Enough: An Analysis of Current Client Conflicts Law*, 33 WILLAMETTE L. REV. 145, 173 (1997) (noting the difficulty of framing a clear rule to determine when conflicts are consentable).

Part I sets the stage by describing the current conflict-waiver rule, and the conceptual confusion that bedevils conflict consents. It contends that without some deeper understanding of how to integrate competency and consent, we are left either to defer to the client's informed consent or to reject the representation on competence grounds—without any basis for deciding why or when consent or competence should prevail over the other. [23] Part I finishes with a discussion of the nature of interpretation in the attorney-ethics setting, examining the various sources of interpretative insight into the *Model Rules* and the special demands and opportunities to forge a coherent account of competing demands in a codified system.

Part II undertakes the search for principles to ground a viable standard by which to determine whether a conflict can be waived. First, it asks why we allow clients to consent to *any* conflicted representation, an inquiry that highlights our profession's deep commitment to client autonomy. Part II next asks why we reject the informed decision of a client to enter into a representation that is incompetent. The goal is not only to understand why we insist on competence, but also to understand how this understanding fits with the commitment to client autonomy that undergirds the consent element. A viable standard, Part II contends, must integrate each of these elements.

Part II next identifies and turns a critical eye to the various rationales for our insistence on competency despite a knowing consent. One theory has it that an attorney can never adequately describe the risks associated with an incompetent representation, a claim that is suspect for empirical and conceptual reasons. The next rationale holds that courts insist on competent representation in order to arrive at the truth or a just outcome, a rationale that conflates a client's right to present a vigorous argument with a duty to do so, and holds no force in the transaction setting, which is also subject to the competency standard.

Part II turns next to the remaining rationale for rejecting incompetent representations despite client consent: to protect the client against his own faulty decision making—a form of paternalism. This rationale holds promise and it avoids the problems posed by other rationales but—without a deeper understanding—it is

23. *See* Fred C. Zacharias, *Waiving Conflicts of Interest*, 108 YALE L. J. 407, 409-10 (1998) (stating that the conflict rules serve "contradictory purposes"); Nancy J. Moore, *Conflicts of Interest in the Simultaneous Representation of Multiple Clients: A Proposed Solution to the Current Confusion and Controversy*, 61 TEX. L. REV. 211, 213 (1982) (noting that the waiver standard under the predecessor disciplinary rule, which allowed a conflict waiver only if it was "obvious" that the representation was nonetheless "adequate," was "at best, ambiguous"); Jarvis & Bradley, *supra* note 22, at 146 (suggesting that the *Model Rules* and the *Restatement* do not provide sufficient clarity for determining which joint representations cannot be waived).

insufficient to reconcile our commitment to client autonomy and our insistence on overruling client decisions on competency grounds. As a result, it does not show us how to distinguish between conflict consents that are allowed and those that are prohibited.

Part II unravels this mystery and offers a new way to understand why we prohibit client consent to an incompetent representation. It begins by distinguishing between various types of paternalism based on the nature of the intervention into another's decision making. Paternalism is typically understood as an *affront* to autonomy, and thus at odds with the legal profession's emphasis on the client's right to control the representation. Part II argues, however, that "means paternalism" explains how our intervention to protect clients can be squared with a commitment to client autonomy. Means paternalism distinguishes between a person's objectives and the means by which they are achieved. When a person has a certain goal and undertakes means that are likely to defeat that goal, intervention to prevent the person from undertaking such means can be understood as *preserving* or *enhancing* the person's autonomy. Means paternalism explains why courts should strike down conflict waivers that render the representation incompetent: it reconciles our twin commitments to client consent and competency, and it offers a basis by which to distinguish competent from incompetent representations.

Part III translates this understanding into a proposed legal standard: a conflict waiver must be rejected as incompetent under Model Rule 1.7(b) if limitations on the means or procedures by which the attorney pursues the matter resulting from a conflict of interest are likely to defeat the client's objectives for the representation (the "client-objectives" or "proposed" test). Part III elaborates on the elements of this test, showing how it resolves the paradox that has confounded court analysis of conflict waivers. The test of competency is not whether the representation has a material deficiency, the very reason why a waiver was required in the first place. Moreover, the question is not whether the client would be better off without the consent, a decision that belongs solely to the client. When a client consents to limitations that are likely to undermine her own objectives for the representation, the representation is incompetent—by dint of the client's own more fundamental commitment. Part III explains why the proposed test accommodates both elements of Model Rule 1.7(b): competency and consent *in tandem* determine when and whether a client's consent to a joint representation should be upheld or disregarded.

Part IV applies the client-objectives test across the major practice areas. It begins with the *Wheat* case, explaining how the test fundamentally changes the analysis and outcome in the case, and how it would allow us to impose an enforceable, reviewable

standard on trial courts for client waivers in criminal-defense matters. It next considers, in turn, the civil litigation and transaction settings, where a careful inquiry into client objectives and conflict limitations explains when to accept or reject an informed client consent. Part IV also discusses how the proposed test will change our approach in still another setting—the law office, where attorneys need a clear standard by which to assess the competency of a proposed joint representation.

The conclusion will provide a brief overview of the proposed test and its rationale. It will distill much of the learning from the Article into a decision guide to aid practitioners and courts in determining what concurrent conflicts of interest can be waived.

I. THE PROBLEM

A. The Dual Role of Material Limitations

Model Rule 1.7 sets forth the general rule on "concurrent" conflicts of interest.[24] Subject to the exception for consent, Rule 1.7(a) prohibits client representations that are directly adverse or present a "significant risk" that the attorney's duties to the client will be materially limited by the attorney's "responsibilities to another client, a former client or a third person or by a personal interest of the lawyer."[25] With exceptions for assertion of claims against a current client in the same litigation matter[26] and representations prohibited by law,[27] the Rule allows representations despite a concurrent conflict if "the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;"[28] and the client provides "informed consent,

24. MODEL RULES OF PROF'L CONDUCT R. 1.7 (2012). The *Model Rules* parse conflicts of interests into two main categories—(i) conflicts between present interests or obligations of the lawyer to other clients or herself, termed "concurrent" conflicts, which are addressed by Rules 1.7 and 1.8; and (ii) conflicts between a current and a prior client, which are addressed by Rule 1.9. This Article asks when concurrent conflicts of interest can be waived. Conflicts with prior clients present no such question because—unlike concurrent conflicts—they can be waived on the informed consent of the client without satisfying an additional competency demand. *Id*. R. 1.9(a); *see* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 122 cmt. g(iv) (2000) ("[W]hen the representation involves the same matter or the matters are significantly related, it may be more difficult for the lawyer to provide adequate legal assistance to multiple clients.").

25. MODEL RULES OF PROF'L CONDUCT R. 1.7(a) (2012).

26. *Id*. R. 1.7(b)(3).

27. *Id*. R. 1.7(b)(2).

28. *Id*. R. 1.7(b)(1). Forty-seven states prohibit conflict waivers that will render the representation incompetent, although some vary the language describing the competency element. The overwhelming majority of states have adopted the exact language of the *Model Rules* with respect to this requirement. *See* Lawyers' Manual, *supra* note 1, at 51:303-04. The *Model Code of Professional Responsibility*, which was

confirmed in writing."[29] Informed consent, in turn, is defined as an agreement "after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct."[30] Thus, with exceptions, the ethics rules allow consent to cure conflicts of interest if (1) the consent is informed; and (2) the representation of each client will be "competent and diligent."[31]

A close examination of the two conditions of consent reveals the tension encoded in the *Model Rules*. A conflict of interest is one that poses direct adversity with another client or a substantial risk of a material limitation on the work that the attorney can do for one or more clients.[32] In order to elicit consent to proceed with the representation despite the conflict, the attorney must disclose these risks to the prospective clients.[33] Thus, a client who consents to a concurrent conflict has agreed to accept the material risks of a "[m]aterial [l]imitation" on the representation by direct adversity with another client.[34] Notwithstanding that material limitation, the attorney must reasonably believe that she can perform the representation competently and diligently.[35] Thus, the representation must be *objectively* competent and diligent even though it is hobbled by direct adversity or the significant risk of a material limitation.[36]

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in effect in most states prior to adoption of the *Model Rules*, provided in part that an attorney could seek consent to a multiple representation "if it is obvious that he can adequately represent the interest of each." MODEL CODE OF PROF'L RESPONSIBILITY DR 5-105(c) (1980); *see also* Lawyers' Manual*, supra* note 1, at 51:303. Seven states have retained either the language of that provision or a variation thereof. *See, e.g.*, MASS. RULES OF PROF'L CONDUCT R. 1.7(b)(1) (2012) (providing that a conflict can be cured by consent if "the lawyer reasonably believes the representation will not be adversely affected"). These standards likewise implicate the question addressed in this Article, namely, which conflicts can be cured by consent? Only Florida, Georgia, and California impose no competency requirement on a conflict waiver. *See* FL. RULES OF PROF'L CONDUCT R. 4-1.7 (2012); GA. RULES OF PROF'L CONDUCT R. 1.7 (2012); CAL. RULES OF PROF'L CONDUCT R. 3-310 (2012) (showing omission of competency requirement on a conflict waiver). California is considering adoption of the *Model Rules*, however, and its proposed version of Rule 1.7(b) would match the competency requirement of the *Model Rules*. *See* CAL. RULES OF PROF'L CONDUCT R. 1.7(b) (Proposed Official Draft 2010), *available at* http://ethics.calbar.ca.gov/LinkClick.aspx?fileticket=7MbhFr6ih-w%3D&tabid=2161.

29. MODEL RULES OF PROF'L CONDUCT R. 1.7(b)(4) (2012).

30. *Id*. R. 1.0(e).

31. *Id*. R. 1.7(b)(1); *see also supra* note 1 and accompanying text.

32. *Id*. R. 1.7.

33. *Id*. R. 1.8(a)(1).

34. *See id.* R. 1.7 cmt. 8 (requiring consent to a material limitation "[e]ven where" there is no direct adverseness," implying that the latter poses even greater concern)

35. *Id*. R. 1.7(b)(1).

36. Ill. State Bar Ass'n Advisory Op. on Prof'l Conduct, Op. 96-05 (1996) ("Whether a lawyer 'reasonably believes' his dual representation will not adversely

How can a representation that suffers from direct adversity or a material limitation be "competent and diligent"?[37] If we cannot reconcile this seeming inconsistency, we cannot evaluate conflict waivers under Rule 1.7. Competence, which is required in all representations by Model Rule 1.1, requires in part "thoroughness . . . reasonably necessary for the representation."[38] Diligence, which is required by Model Rule 1.3, requires "reasonable diligence and promptness in representing a client" or—as the comments to the Rule state—"whatever lawful and ethical measures are required to vindicate a client's cause or endeavor."[39] (As noted earlier, for ease of reference, we will use the term *competence* to refer collectively to the closely related demands of competence and diligence, unless a distinction between the two bears on the analysis.) Thus the definitions shed little light on the problem: how can an attorney be said to have acted thoroughly or to have taken whatever measures are reasonably required to vindicate the client's interests when she is, by definition, not pursuing a material element of the representation due to a conflict?

Some examples may help to illuminate the challenge posed by the dual demands of informed consent and competence. Suppose that an attorney obtains informed consent to represent:

- A criminal defendant, disclosing that the attorney will

affect his relationship is determined by an objective, not subjective, standard based upon what the 'reasonable lawyer' would believe.").

37. MODEL RULES OF PROF'L CONDUCT R. 1.7(b)(1) (2012). Let us clear away one tempting argument. Perhaps the client, in consenting to a concurrent representation, does not agree to a material limitation but merely the *risk* of such limitation rather than its eventuality. A literal reading of Rule 1.0(e), which requires disclosure of "material risks" could support this view. *See id.* R. 1.0(e). Moreover, lawyers sometimes seek waiver of potential conflicts, which might be understood as acceptance of risks that may or may not eventuate. Nonetheless, it is questionable whether a risk and its occurrence can be separated conceptually for conflict waiver purposes. If the client accepts only the risk but not the eventuality of a limitation resulting from a conflict of interest, presumably the attorney would have to withdraw or seek a new consent if and when the risk eventuates. If this is the case, then it is unclear why client consent is worth obtaining in the first place. Moreover, there would be no reason for Model Rule 1.7 to insist on competence in the representation despite the consent if the client accepted no actual (as distinct from possible) limitation, since a new consent would be required if the risk eventuated. *See id.* R. 1.7(b)(1). Moreover, the new waiver for an actual as distinct from potential conflict would be subject to the same competency demands of Rule 1.7(b), and thus the question remains: how can a representation be subject to a material limitation and still be competent? *See generally* GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING § 10.4 (3d ed. 2001 & Supp. 2004) [hereinafter HAZARD & HODES] (noting that modern understanding of conflicts of interest emphasizes the degree of risk of harm, and that "it is no longer appropriate to speak of 'potential' versus 'actual' *conflicts of interest*").

38. MODEL RULES OF PROF'L CONDUCT R. 1.1 (2012).

39. *Id.* R. 1.3 cmt. 1 (requiring "commitment and dedication to the interests of the client . . . with zeal in advocacy upon the client's behalf").

not be able to cross-examine a witness at trial because he represents the witness in the defense of related charges in a separate proceeding;

- Two clients in a suit against various tortfeasors, disclosing that the attorney cannot name either co-client as a third-party defendant even though one may have potential liability to the other arising out of the tort;
- Two parties to a shareholder agreement, disclosing that the attorney cannot counsel the clients on an individual, confidential basis; and
- The buyer and seller in a complex commercial real estate transaction, disclosing that the attorney cannot negotiate on behalf of either party or assist one party in advancing terms that may disadvantage the other.[40]

While these examples range widely across the practice spectrum, their common elements expose the tension that bedevils waiver analysis. In each instance, (1) the attorney gained the informed consent of the client to a conflict of interest;[41] (2) the conflicts are "concurrent," that is, they involve an ongoing representation of two or more clients as distinct from a current and a prior client;[42] (3) in seeking the informed consent of the clients, the attorney has disclosed that she will be unable to perform a material aspect of the representation because of the conflict (the "material limitation"); (4) the clients have chosen to retain the attorney despite the material limitation; and (5) the attorney or ultimately a tribunal is asked to determine whether the representation is competent and therefore "consentable" or "waivable" despite this material limitation.

Readers will bring a variety of intuitions to these examples. Some may reject one or more of the representations despite disclosure and consent because the quality of representation has fallen below acceptable limits. The well runs dry, however, when we probe a bit deeper into what makes one limitation acceptable and another not when both are, by definition, material limits on what the lawyer will perform for the client.[43] Does waiver analysis commit us to developing two standards of incompetence—one for

40. We will examine and offer solutions to these and other conflict-waiver scenarios in Part IV, *infra*.

41. In order to constitute informed consent, the disclosures would no doubt require more than the brief descriptions provided in the above scenarios. *See infra* notes 132-37 and accompanying text.

42. *See supra* note 24 and accompanying text.

43. Competency requires "thoroughness . . . reasonably necessary for the representation." MODEL RULES OF PROF'L CONDUCT R. 1.1 (2012). Absent a theory of how conflict consent and competency relate, it is difficult to explain how a failure to perform a material aspect of a representation can *ever* be consistent with the competency demands of Model Rule 1.1.

representations generally and another for conflicts? If so, by what rationale would such dual definition be justified, and how would we fashion a principled distinction between differing levels of incompetence without simply imposing on the client our own view of her best interests?[44]

Others might focus on the quality of the disclosure that preceded the client's agreement to the representation. [45] That approach leads to a new challenge, however. If client consent is sufficient to wash away concerns about the attorney's failure to perform a material aspect of the representation, then the competence standard of Model Rule 1.7(b) has been rendered a nullity. By this light, incompetence would *never* be reason to invalidate an informed consent since the client will already have consented to the failings in the representation. While some have argued that competence should not be a concern if the client's consent is informed,[46] the *Model Rules* reject this approach by insisting on *both* informed consent and competence.

What is striking about the approaches of our hypothetical observers is their shared indifference to the concerns of the other. Each would attempt to evaluate the enforceability of the client's waiver on the basis of *either* competency or consent, but not both, a tension that is reflected in the caselaw.[47] Unless we have a theory of how consent and competence *interrelate*, courts are left to select which value to elevate over the other. An analysis based on competence or consent alone leaves us with stark poles: representations that are invalidated because of material limitations

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44. For a discussion of the best-interests approach, *see infra* notes 104-08 and accompanying text.

45. Indeed, the *Restatement* notes that consents are often struck down because they are ill-informed and "[d]ecisions involving clients sophisticated in the use of lawyers, particularly when advised by independent counsel, such as by inside legal counsel, rarely hold that a conflict is nonconsentable." RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 122 cmt. g(iv) (2000). Why, however, should the quality of consent bear on the competency of a representation when consent and competency are distinct elements of a conflict waiver under Model Rule 1.7(b)?

46. *See infra* note 75 and accompanying text.

47. *Compare In re* Jans, 666 P.2d 830, 833 (Or. 1983) ("It is never proper for a lawyer to represent clients with conflicting interests no matter how carefully and thoroughly the lawyer discloses the possible effect and obtains consent."), *with* Unified Sewarage Agency of Washington Cnty., Or. v. Jelco Inc., 646 F.2d 1339, 1350 (9th Cir. 1981) ("We do not find it necessary to create a paternalistic rule that would prevent the client in every circumstance from hiring a particular attorney if the client knows that some detriment may result from that choice in a later suit. Clients who are fully advised should be able to make choices of this kind if they wish to . . . ."). A third approach would be to ban joint representations altogether, regardless of circumstance or consent. *See* Debra Lyn Bassett, *Three's a Crowd: A Proposal to Abolish Joint Representations*, 32 RUTGERS L.J. 387, 456 (2001) (citing inadequacy of waiver and the "inherent dangers of joint representation" in support of a categorical ban).

despite informed consent; or representations that are upheld because of informed consent despite material limitations. The *Model Rules*, however, implicitly demand integration of consent and competence in evaluating the validity of a conflict waiver.

B. Interpretation and Coherence

While lawyers and tribunals may not agree with all of the normative commitments of the *Model Rules* as modified and adopted by their jurisdiction, they are nonetheless charged, respectively, with behaving and judging attorney behavior in accordance with their provisions.[48] As with any legal authority, however, the *Model Rules* are not self-applying— lawyers and those who would judge their behavior often have to interpret the *Model Rules* to determine what they demand under a particular set of facts.[49] When a provision of the *Model Rules* is less than determinative of a particular outcome, we must turn elsewhere for interpretative insight.

The drafters' comments offer an important source of interpretive guidance on the meaning of the *Model Rules*.[50] The evolution and history of a rule may also provide clues to its purpose and meaning.[51] In addition, the framers of the *Model Rules* hoped to achieve a measure of consistency and integration by codifying a set of ethical

48. *See* HAZARD & HODES, *supra* note 37, § 1.16, at 30 (Supp. 2012) ("The *Model Rules*, as modified in each specific jurisdiction, have thus been elevated to a status that makes them the equivalent of rules of court. In jurisdictions adopting the *Model Rules*, these provisions of the law of lawyering therefore have the force of law."). Moreover, most federal courts apply the *Model Rules* or those adopted by the state in which they sit to govern the behavior of attorneys before the court. *Id*. § 1.17, at 32-33 (Supp. 2012).

49. *See* MODEL RULES OF PROF'L CONDUCT pmbl. 9 (2012) ("Within the framework of these Rules, however, many difficult issues of professional discretion can arise. Such issues must be resolved through the exercise of sensitive professional and moral judgment guided by the basic principles underlying the Rules."); HAZARD & HODES, *supra* note 37, § 1.24, at 53 (Supp. 2012).

50. *See* MODEL RULES OF PROF'L CONDUCT scope 14 (2012) ("Comments do not add obligations to the Rules but provide guidance for practicing in compliance with the Rules."); *id*. scope 21 ("The Comments are intended as guides to interpretation, but the text of each Rule is authoritative."). To date, forty states have adopted the Comments to aid in interpretation of the *Model Rules*. AM. BAR ASS'N, CPR POLICY IMPLEMENTATION COMM., STATE ADOPTION OF THE ABA MODEL RULES OF PROFESSIONAL CONDUCT AND COMMENTS (2011), *available at* http://www.americanbar.org/content/dam/aba/migrated/cpr/pic/comments.authcheckdam.pdf; *see also* Brooks Holland, *Confidentiality and Candor Under the 2006 Washington Rules of Professional Conduct*, 43 GONZ. L. REV. 327, 329 (2008) (noting that in Washington State the "inclusion of Model Rules-based commentary was viewed as critical because of the added substance and clarity that commentary would provide to practitioners and courts").

51. *See* HAZARD & HODES, *supra* note 37, § 29.12, at 20 (Supp. 2007) (discussing the evolution of Rule 3.3).

standards.[52] That ambition, in turn, can guide our analysis of a difficult interpretative problem arising under the *Rules*, including the challenge of reconciling consent and competence in conflict waivers.

To the extent that the drafters of the *Model Rules* satisfied their charge, we should expect the Rules to exhibit consistency and coherence. The demand of consistency is straightforward: an attorney's compliance with one rule must not contravene another rule. A modest claim for coherence is that rules reflect, at a minimum, an awareness of each other.[53] For example, one rule should not empty another of consequence. A stronger claim for coherence asks that related rules work to fulfill some deeper purpose. In the *Model Rules*, that purpose might be found in the drafters' comments, the history of the Rules, or it might be inferred or "constructed" from the Rules themselves, individually and in tandem. In other words, it may be possible to tease out the meaning of a provision by considering how it and related provisions work together to further a core objective.

Conflict waivers present questions of consistency and coherence under the *Model Rules*. Informed client consent to a conflict presumably accepts material limitations on the attorney's services; the competency requirement strikes down conflicting representations because they are subject to material limitations. If (1) a conflict waiver presupposes a material limitation on the representation to be waived, and (2) incompetency is understood as a material deficiency in the representation, then (3) an attorney cannot cure a conflict of interest by obtaining a client's consent without violating the competency requirement of Rule 1.7.[54] Are competence and consent consistent?

Likewise, there is reason to question whether the demands of competence and consent are coherent. Given the seeming

52. The Commission that drafted the *Model Rules* "was charged with evaluating whether existing standards of professional conduct provided comprehensive and consistent guidance for resolving the increasingly complex ethical problems in the practice of law." MODEL RULES OF PROF'L CONDUCT intro. (1983). The Commission concluded that "piecemeal amendment" of the prior code would be insufficient. *Id.* After "public hearings, the Commission conducted a painstaking analysis of the submitted comments and attempted to integrate into the draft those which seemed consistent with its underlying philosophy." *Id.* The proposed final draft of the *Model Rules* was the result of this "analysis and integration." MODEL RULES OF PROF'L CONDUCT intro. (1983).

53. *See* Julie Dickson, *Interpretation and Coherence in Legal Reasoning*, *THE STAN. ENCYCLOPEDIA OF PHIL.,* http://plato.stanford.edu/archives/Spr2010/entries/legal-reas-interpret/ *(last updated Feb. 10, 2010).*

54. *See supra* note 21 (citing concern that attorney's disclosure of material deficiencies in seeking a waiver could be used to invalidate the waiver later on competency grounds).

irreconcilability of competency and consent, [55] courts may focus on one condition to the exclusion of the other in evaluating conflict waivers, rendering one or the other element superfluous.[56] The search for a deeper rationale that explains competency and consent presents even greater challenges. On the surface, Model Rule 1.7(b) seems to embrace two distinctive and irreconcilable commitments: a willingness to allow the client to control decisions about the representation, and a refusal to embrace client decision making when the decision is unsatisfactory.[57]

We must not assume, however, that these are failings of the *Model Rules*. The *Model Rules* have established the two standards by which conflict waivers are to be evaluated, and it is the role of the interpretative authority to find a way to do so. Of course, it is possible that there is *no* way to reconcile these notions into a viable account; consent and competence may serve two ideals that cannot coexist. As interpreters of the *Model Rules*, however, we must presume otherwise.

For a variety of reasons, it is the interpreter's job to listen for traces of harmony amid seeming discord—to impose order on principles that struggle to coexist. First, given the charge and objectives of the drafters,[58] an interpretation that fails the tests of consistency and coherence is unlikely to fulfill the *Model Rules*' objectives. Second, the *Model Rules* expressly direct that *both* competency and client consent be brought to bear on the enforceability of a client waiver.[59] Thus, an interpretation that enforces one element while dismissing the other flouts the express mandate of the *Model Rules*. Third, a lawyer cannot fulfill inconsistent, concurrent demands, and lawyers cannot be charged with the impossible. Reconciliation of competence and consent is thus a precondition of their enforcement.

Finally, a coherent account of the relation between consent and competence will allow courts to assess the enforceability of conflict waivers on principled grounds. We must not conflate the interpretative challenges posed by *any* rule, and those posed by dual demands that address the same conduct but do not cohere. In the former case, court[60] and ethics committee[61] interpretations of the

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55. *See supra* note 48 and accompanying text.

56. *See supra* notes 44-48 and accompanying text.

57. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (2012).

58. *See supra* note 53 and accompanying text.

59. MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (2012).

60. *See generally* Lawyers' Manual, *supra* note 1, at 799:201 to 799:310 (collecting court cases construing attorney ethics rules in various jurisdictions).

61. See Peter A. Joy, *Making Ethics Opinions Meaningful: Toward More Effective Regulation of Lawyers' Conduct*, 15 GEO. J. LEGAL ETHICS 313 (2002) (describing the role of bar association or other ethics committees that interpret the

ethics rules can close gaps and provide real guidance to practitioners. When courts are not guided by principles, however, their decisions offer less predictability and guidance.[62]

Because the conflict-waiver standards provide limited guidance, lawyers: (1) face the risk of malpractice and disciplinary actions despite good faith efforts at compliance; (2) have insufficient tools for determining when concerns about competence *should* trump the clients' preference to proceed under a waiver; and (3) will be less willing to proceed on the basis of a waiver even when all of the affected clients would prefer, and will not be unduly harmed by, the multiple representation. The question, therefore, is whether we can integrate two seemingly inconsonant notions–consent and competence—into a consistent and coherent evaluation of conflict waivers. Such an account will not remove the interpretative challenges for practitioners and courts; it will, however, allow courts to construct an edifice of interpretation grounded on principle rather than preference, which in turn will provide genuine guidance to lawyers.

Our inquiry must begin with a search for the principles that undergird the *Model Rules*' dual commitments to informed consent and to competence. Once we have a deeper understanding of the interests served by these two notions, we can attempt to unify these concepts into an understanding of how competence and consent can work *together* to assess client waiver.

II. THE SEARCH FOR PRINCIPLES

A. Introduction

Before we can begin to develop a theory of how consent and competence relate, we need to understand the rationale of each. We will begin with the seemingly simpler of the two questions: why do we allow clients to consent to conflicts of interest? This question will allow us to explore our commitment to client autonomy in the attorney-client relationship. Our inquiry will turn next to the question at the core of our inquiry: why do the *Model Rules* reject the informed decision of a client to enter into a representation that is incompetent?

B. Why Consent?

The traditional or agency conception of lawyering places considerable emphasis on client autonomy.[63] Within important

ethics rules in various jurisdictions).

62. *See* A. Benjamin Spencer, *Understanding Pleading Doctrine*, 108 MICH. L. REV. 1, 26 (2009) ("Incoherence from the courts has the potential to create an unpredictability . . . .").

63. *See* Eugene R. Gaetke, *Expecting Too Much and Too Little of Lawyers*, 67 U.

limits, the client—as principal—decides the objectives of the representation,[64] makes the important decisions throughout the course of the representation,[65] including settlement,[66] and can terminate the representation for any reason.[67] Given the extent of their control over the representation itself, it is thus hardly surprising that clients have the authority to retain an attorney despite a conflict of interest. In the words of the *Restatement of the Law Governing Lawyers* ("*Restatement*"), "[c]oncern for client autonomy generally warrants respecting a client's informed consent."[68]

Clients may perceive that the benefits of proceeding jointly despite a conflict of interest outweigh the disadvantages of retaining separate counsel. In the litigation setting, whether civil or criminal defense, the clients may consider their interests to be largely aligned, and see tactical advantage in cooperation rather than adversity.[69] A client may believe that one particular attorney is so effective that the advantages of representation by that attorney outweigh the disadvantages posed by the attorney's conflicting obligations to another client.[70] Clients may believe that representation by one rather than multiple attorneys will be less costly.[71] Moreover, transaction clients may believe that they are better served by a joint representation because it will emphasize the consistency rather than the tension in their interests.[72]

The client's power of consent is subject to important limits, however. For example, the client's decision to retain counsel despite a conflict of interest must be informed.[73] If the client is not advised of the limitation or its significance, whether because of the attorney's

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PITT. L. REV. 693, 717-18 (2006) (noting that lawyer's agency role is both a legal obligation and part of the "narrative" of the legal profession); *see also* DAVID A. BINDER ET AL., LAWYERS AS COUNSELORS: A CLIENT-CENTERED APPROACH 18 (1991) (emphasizing the client's self-determination and autonomy).

64. MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (2012).

65. *Id.*

66. *Id.*

67. *Id.* R. 1.16(a)(3).

68. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 122 cmt. g(iv) (2000).

69. *See* Glasser v. United States, 315 U.S. 60, 92 (1942) (Frankfurter, J., dissenting in part) ("A common defense often gives strength against a common attack.").

70. *See* Peter W. Tague, *Multiple Representation and Conflicts of Interest in Criminal Cases*, 67 GEO. L.J. 1075, 1124 (1979). In *Wheat*, considered at length in Part IV.B. *infra*, the effectiveness of counsel in gaining an acquittal in a related case presumably motivated the defendant to retain him despite conflict concerns. *See infra* note 172 and accompanying text.

71. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 19 (2012).

72. *See id.* cmt. 28.

73. *Id.* R. 1.7(b)(4), 1.0(e).

indifference, lack of care, or overreaching, then the client's decision will not reflect the client's real intentions.[74] The insight is consistent with our understanding of informed consent elsewhere in law and ethics: informed consent is best understood not as a *limit* on autonomy, but as an assurance of it.[75] Thus, Model Rule 1.7(b) insists on informed consent in waiving a conflict to ensure that the client's decision is, in fact, her own.[76]

Model Rule 1.7(b) insists on more than informed consent, however; the concurrent representation must be competent as well. Thus, the next question is why informed client consent alone is not enough to cure a conflict of interest. In due course, we will discover—surprisingly perhaps—that client autonomy can explain not only our commitment to informed consent, but competency as well.

C. Why Competence?

Our next question is why Model Rule 1.7(b) rejects the client's informed decision to waive a conflict of interest when the representation will be incompetent. Of course, some would prefer that the *Model Rules* place *no* restriction on the client's control over the representation, and that a fully informed consent should carry the day regardless of competency concerns.[77] The *Model Rules*, however, have already passed judgment on this question, leaving us to search for the rationale for competence that might be reconciled with the right of the client to consent to a conflict of interest.

We can identify three rationales for the *Model Rules'* insistence on competence in the representation notwithstanding the client's informed consent. The first contends that competence is a prerequisite of consent—in effect, that no client would ever voluntarily consent to incompetence. The second contends that the

74. As Justice Story wrote nearly two centuries ago, "No man can be supposed to be indifferent to the knowledge of facts, which work directly on his interests, or bear on the freedom of his choice of counsel." Williams v. Reed, 29 F. Cas. 1386, 1390 (C.C.D. Me. 1824) (No. 17,733).

75. TOM L. BEAUCHAMP & JAMES F. CHILDRESS, *PRINCIPLES OF BIOMEDICAL ETHICS* 99 (6th ed. 2009) ("Personal autonomy encompasses, at a minimum, self-rule that is free from both controlling interference by others and from certain limitations such as an inadequate understanding that prevents meaningful choice."); *see also* JOEL FEINBERG, THE MORAL LIMITS OF THE CRIMINAL LAW: HARM TO SELF 12 (1986) (noting that when a person's decision "stems from ignorance . . . there are grounds for suspecting that it does not come from his own will").

76. Zacharias, *supra* note 23, at 416-17 ("A lawyer, disciplinary agency, or court that believes the client is insufficiently informed to make an intelligent choice is justified in concluding that the client's choice does not represent a fair exercise of the client's freedom.") (footnote omitted).

77. For example, the American Trial Lawyers Association proposed that consent alone should be sufficient to cure concurrent conflicts. AM. LAWYER'S CODE OF CONDUCT R. 2.4 (Discussion Draft 1980).

legal system cannot function properly unless counsel performs competently. The third emphasizes client protection. We will examine each of these rationales in turn.

1. No Informed Client Consents to Incompetence

One argument for insisting on competence despite a client waiver is that "it seems unlikely that informed rational clients will often choose representation that is 'objectively inadequate.'"[78] The suggestion is that an attorney cannot adequately describe the risks associated with an incompetent representation.[79] Incompetency, on this view, serves as a test of the quality of the disclosure—we infer from incompetence that something was askew in the disclosure that gave rise to the client's approval in the first place.

This rationale exhibits the structural element that is a precondition to solving the question at the center of our inquiry: it offers a way of understanding consent and competence together.[80] Consent and competence fit hand and glove under this approach—since agreement to an incompetent representation is vicarious proof that disclosure was insufficient. Under this rationale, both competence and consent fly under the banner of client autonomy: we are ensuring rather than limiting client autonomy by rejecting consents to incompetent representations.

Nonetheless, the rationale faces substantial empirical and conceptual hurdles. As an empirical matter, it is presumably *more difficult* to explain the consequences of a representation that is "incompetent"—whatever that term may mean—and thus incompetent representations may fail the informed consent test more often.[81] But the claim that an incompetent representation can *never* be explained adequately, and, therefore, that all such consents are per force invalid, is suspect. If the goal is simply to view competence as a vicarious test of consent, presumably the *Model Rules* would have required only informed consent, and noted in the drafters' comments that lawyers bear a high burden to show that the client fully understood the implications of an incompetent representation before executing the waiver. Why fuse informed consent to a competency standard that introduces a veritable hornet's nest of interpretive problems while providing, at best, an indirect measure of whether the client understood the risks of the representation?

The rationale poses a deeper concern. Client consent to a conflict

78. Zacharias, *supra* note 23, at 422 (proffering but questioning this rationale).

79. Jarvis & Tellam, *supra* note 232, at 174 ("[I]n some circumstances, it is too difficult to explain all the potential conflicts with sufficient clarity and detail to allow the potentially affected clients to make an informed choice.").

80. *See supra* Part II.B (explaining the importance of an integrated understanding of competence and consent).

81. *See*, *e.g.*, *In re* Boivin, 533 P.2d 171, 174-75 (Or. 1975).

of interest—if it is to have any significance—presupposes a waiver of something of value. Otherwise, there would be no reason to obtain a waiver. By treating incompetence as a variety of nondisclosure, the rationale provides no insight into the central question posed by the competency standard of Model Rule 1.7(b): how are we to distinguish deficiencies in a representation that a client has a right to waive from the incompetence that no client would—by its supposition—willingly accept?

2. Competence and Justice

Another possible reason for insisting on competence, notwithstanding the client's informed consent to the contrary, is that competent representation is essential to the administration of justice. Our justice system presupposes that the truth will emerge from the clash of adversaries. If an adversary presents his case incompetently, then we have less confidence that the truth will emerge from the process. Thus, a conflict of interest that precludes counsel from competently presenting the case is likely to undermine the "truth finding" function of the court.[82]

The drafters cite this rationale in connection with the *Model Rules*' blanket prohibition on the representation of adverse parties in the same proceeding despite client consent.[83] The drafters' comments note that this conflict cannot be cured by consent "because of the institutional interest in vigorous development of each client's position."[84] Because this rationale is cited only in support of the blanket prohibition on adversity in the same litigation matter,[85] it appears that the drafters did not intend this rationale to inform our understanding of the competency constraint on consent in other instances.

While the justice rationale has initial appeal, it loses force as a basis for the rejection of conflict consents when we consider its inconsistency with our understanding of client prerogatives elsewhere in the adversary process. Clients may decide not to pursue actions even when their rights have been violated; they may not name all responsible parties, present all material arguments, or call all material witnesses; and they may decide to settle a case on terms that we may not consider just.[86] While these client decisions may

82. *See* HAZARD & HODES, *supra* note 37, § 11.19 (Supp. 2004) ("[T]he tribunal has an interest in basing its decisionmaking on a full and vigorous presentation of the competing positions.").

83. MODEL RULES OF PROF'L CONDUCT R. 1.7(b)(3) (2012).

84. *Id*. cmt. 17.

85. *See id* 1.7(b)(3) (stating that its rationale relates to the limitation in Model Rule 1.7(a), and that 1.7(b) operates as an exception).

86. *See* Moore, *supra* note 23, at 235 ("In many important situations—such as defining the lawful objectives of the representation and accepting or rejecting

well keep a court from arriving at the most accurate outcome (or any outcome at all), we do not reject client decisions in these matters to ensure that justice prevails.[87] To do so would be to conflate rights and duties.[88] We afford clients the right to pursue their case vigorously, but we do not *require* them to do so.

Moreover, when clients engage in transactions with others, there is no tribunal in search of the truth. Thus, the truth-finding rationale is of no value in explaining the decisions of courts that strike down consents in nonlitigation matters under the competency standard of Model Rule 1.7.[89] While it is possible that a rationale for striking down client consents varies across practice areas, the lack of a unified understanding suggests that we need another principle to explain our commitment to competence despite client consent.[90] In Part III, we will offer an understanding of competence and consent that holds true across all areas of practice.[91]

None of this is to deny that the vigorous development of positions helps courts arrive at the correct outcome. The point here is narrower: we do not *force* clients to develop their arguments vigorously as a condition of their participation in the adversary process. We afford clients the right to present their case vigorously, and trust that they and their attorneys will avail themselves of this opportunity in accordance with the client's objectives. When we suspect that an attorney is undermining her client's interests, we intervene principally to protect the client[92]—the subject of our next

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settlement offers—clients already retain the right to make unwise choices.") (footnotes omitted).

87. For example, when a criminal defendant pleads guilty, trial judges assess whether the defendant's decision is voluntary and knowing but do inquire into whether the guilty plea is just. *See* North Carolina v. Alford, 400 U.S. 25, 37 (1970) ("An individual accused of crime may voluntarily, knowingly, and understandingly consent to the imposition of a prison sentence even if he is unwilling or unable to admit his participation in the acts constituting the crime."); Commonwealth v. Berrios, 856 N.E.2d 857, 863 (Mass. 2006) (focusing solely on whether the plea was voluntary). Likewise, Model Rule 1.2(a) requires lawyers to abide by the client's decision to settle a civil litigation or a criminal matter but does not direct lawyers to assess whether the decision is just before proceeding. MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (2012).

88. For a classic statement of the relations between rights and duties and other "jural relations," see WESLEY NEWCOMB HOHFELD, FUNDAMENTAL LEGAL CONCEPTIONS AS APPLIED IN JUDICIAL REASONING 13 (David Campbell & Phillip Thomas eds., 2001), which notes, for example, that if landowner X has a right enforceable against Y that requires Y to stay off X's land, then Y has a *duty* to stay off the land. Thus, X's right creates a duty in Y; it does not *obligate* X.

89. *See, e.g.*, Baldasarre v. Butler, 625 A.2d 458, 467 (N.J. 1993) (representing buyer and seller of commercial real estate); *In re* Jans, 666 P.2d 830, 833 (Or. 1983) (representing employer and employee regarding employment agreement).

90. *See supra* Part I.B. (arguing that the search for a deeper rationale that unites related rules—or coherence—should inform interpretation of the *Model Rules*).

91. *See infra* Part III.A.

92. *See* MODEL RULES OF PROF'L CONDUCT R. 1.3 cmt. 3 (2012) (citing client

inquiry.

3. Client Protection

Another possible rationale for insisting on competence is to protect the client. As a general matter, client protection is hardly a controversial rationale; in fact, it justifies much of the regulation of the attorney-client relationship. Our regulation is directed largely toward ensuring that the attorney serves as a proper agent of the client, who—as principal—makes the central decisions regarding the representation.[93]At first blush, competence might seem to be a variety of this general client protection scheme: we insist that the attorney handle a matter competently, after all, to ensure that the attorney performs satisfactorily as agent of the client.[94] The competence element of Model Rule 1.7(b) cannot, however, be understood as simply another element of agency law. Because the Rule eliminates the client's power to waive competence in the representation, it overturns the bedrock concept of agency—principal control.[95] Rule 1.7(b) is not concerned with protecting the client against the attorney's failure to work as directed; instead, it limits the directions that the client can impose on the attorney. Nor is the Rule motivated by the traditional objectives that justify limits on client choice—to protect an opposing or third party against wrongdoing.[96]Thus, while the *Model Rules*' insistence on competence may be a form of client protection, it is categorically distinct from the types of client or third-party protections that are the cornerstone of the *Model Rules*.

Perhaps we may insist on competence despite a knowing conflict waiver not to protect the client from the attorney, but to protect the client from *herself*. This rationale openly embraces the idea that—in some instances—clients require protection against their own faulty decision making. Thus understood, the rationale for insisting on competence is of a different kind of client protection—it is a form of paternalism. Paternalism might be defined as the "interference of a state or an individual with another person, against their will, and

protection but not the interest of the tribunal in explaining why the attorney must act diligently).

93. *See* Kevin H. Michels, *Lawyer Independence: From Ideal to Viable Legal Standard*, 61 CASE W. RES. L. REV. 85, 92-96 (2011) (describing "the agency or client-autonomy vision of lawyering").

94. *See* MODEL RULES OF PROF'L CONDUCT R. 1.1 (2012) (requiring competence in a representation).

95. A principal-agent relationship exists when one person agrees to "act on the principal's behalf and subject to the principal's control." RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006); *see also id*. § 8.09 (requiring agent "to comply with principal's lawful instructions").

96. *See, e.g.,* MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2012) (prohibiting attorney from, inter alia, knowingly assisting client fraud or crime).

defended or motivated by a claim that the person interfered with will be better off or protected from harm."[97] Clearly, the demand of competency in Model Rule 1.7(b) is a form of interference with the client's decision making since courts must strike down conflicting, incompetent representations under the *Model Rules* notwithstanding the client's informed consent to the conflict. Paternalistic rules are often designed to protect persons from making a decision that is "less than fully rational."[98]

The paternalistic understanding avoids the problems posed by the prior justifications for denying the client the right to consent to an incompetent representation. It does not make sweeping assumptions about the lawyer's capacity (or willingness) to disclose the implications of a representation that is "incompetent." It does not treat competency as another test of informed consent; instead, consistent with Model Rule 1.7, it treats consent as a distinct condition that must be satisfied in order for a waiver to be valid.[99] Moreover, it is immune from the critiques leveled at the truth-finding rationale because it does not rely on an institutional interest in vigorous representation that is best understood as a right rather than an obligation.[100]

In addition, paternalism explains both the "informed" consent and competency elements of the *Model Rules*. Philosophers distinguish between soft and hard paternalism: the former concerns interventions to ensure that the decision maker's actions are voluntary and the latter restrains behavior even though it is voluntary.[101] For example, soft paternalism justifies the requirement of a prospectus before investing.[102] Hard paternalism, by contrast, would justify the prohibition on the manufacturing of drugs that

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97. Gerald Dworkin, *Paternalism*, *THE STAN. ENCYCLOPEDIA OF PHIL.,* http://plato.stanford.edu/entries/paternalism/ (last updated June 1, 2010)[hereinafter Dworkin]Examples include seat belt and motorcycle helmet laws, mandatory pension contributions, and bans on swimming when lifeguards are absent. While nonpaternalistic rationales can be cited for each of these examples, a central justification of these rules on many accounts is the protection of the individual against an unwise decision. *Id*.; *see also* Douglas N. Husak, *Legal Paternalism*, *in* THE OXFORD HANDBOOK OF PRACTICAL ETHICS 387, 388 (Hugh LaFollette ed., 2003) ("As a rough approximation, one person *A* treats another person *B* paternalistically when *A* interferes with *B*'s freedom for *B*'s own good.").

98. Dworkin, *supra* note 97.

99. *See supra* Part II.C.1.

100. *See supra* Part II.C.2.

101. JOEL FEINBERG, HARM TO SELF 12 (1986); *see also* Dworkin, *supra* note 97 (distinguishing soft and harm paternalism by whether consent is informed).

102. *See* Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 343 (1988) (the purpose of the prospectus requirement is "to give potential buyers an effective means to understand the intricacies of the transaction in which they are asked to invest").

have not been FDA approved.[103] Model Rule 1.7(b) exhibits both forms of paternalism. It requires that the client's consent be informed—a soft intervention. By contrast, the competency element of Model Rule 1.7 is a form of hard paternalism because it prevents clients from entering into certain representations—those that are incompetent—despite being fully apprised of the implications of that decision.[104]

Some commentators have embraced paternalism as an important justification for rejecting waivers that are not competent.[105] These commentators are correct in emphasizing the paternalist rationale of the conflict consent rule. As Fred Zacharias suggests, a concern for the "best interests" of the client motivates our refusal to accept client consents that render the representation incompetent.[106] And yet two critical concerns remain. First, given that the client accepts material deficiencies in the representation by waiving a conflict of interest, how can we know *which* material deficiencies warrant disregarding the client's consent? In other words, how can paternalism ground a principled distinction between those waivers we accept and those we reject? Second, how can we reconcile our rejection of an informed client decision with the contrary sweep of the *Model Rules*, which generally allow for client control of the representation.[107] Why is the client—as principal—generally given free range over the representation but deemed incapable of consenting with full disclosure to a joint representation unless it is in his best interest? We do not impose a best-interest standard on client decisions outside the conflict setting, not even decisions that are profoundly significant for the client.[108] An intervention that deprives the client of decision-

103. *See* 21 U.S.C. § 505(c) (2006).

104. One might object, however, that the *Model Rules* restrict only the behavior of *attorneys* and not clients, and thus they cannot be designed to protect the client against his own bad decisions. The distinction between "pure" and "impure" paternalism can help us understand how the paternalism goals are reflected in a rule-making scheme that applies only lawyers. A "pure" paternalistic intervention restricts the behavior of only the protected person, while an "impure" paternalistic restricts one person or group, say "X," for the purpose of protecting another person or group, "Y," against Y's bad choice. For example, a pure paternalistic intervention would be to prohibit minors from drinking alcohol; an impure intervention would be to prohibit liquor establishments from selling to minors. *See* Dworkin, *supra* note 97. The conflict waiver rule is an example of the latter: we prohibit attorneys on pain of discipline and malpractice from entering into representations that are "incompetent" despite informed client consent to protect the *client* against her own bad decision.

105. *E.g.*, Zacharias, *supra* note 23, at 417, 436 (noting that protection of clients from their "own poor choices" explains the approach of the *Model Rules* and the *Restatement*); Moore, *supra* note 23, at 236-37.

106. Zacharias, *supra* note 23, at 432-33.

107. *See* MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (2012) (requiring lawyer to comply with client's decisions regarding objectives of the representation).

108. *See* Moore, *supra* note 23, at 236 ("The obvious question is why the client

making authority, even though the client has been provided full information, faces a considerable burden of reconciliation with our principal-agency view of lawyering.

The solution lies in another critical distinction between types of paternalism, which can lead to a deeper understanding of Model Rule 1.7(b). We can distinguish paternalistic interventions by whether they limit the *means* or the *ends* of the actor. "Strong" paternalism intervenes to correct the actor's *ends*. By contrast, "weak" paternalism defers to the ends of the agent, but is willing to intervene if the *means* the agent adopts are "likely to defeat those ends."[109] "Strong" paternalists might favor laws against Russian roulette:[110] even though a participant may privilege his enjoyment of the game over the catastrophic risks it entails, the strong paternalist would intervene on the grounds that the actor's objectives (wanting to play a life-threatening game) are wrong. By contrast, if a driver values safety over convenience, a weak paternalist would support a seatbelt requirement on the grounds that failure to buckle up is likely to defeat the driver's safety goal.[111]

Strong paternalism is far afield from the client autonomy that grounds our understanding of legal ethics. As we have noted, in the attorney-client setting, for important reasons we are generally reluctant to interfere with or direct the *ends* that a client can seek from the representation.[112] The "best interests" test of competency is more akin to the strong paternalist approach. In asking whether the tradeoffs that the client has made are sensible or wise, it asks the court to focus on the *ends* that the client seeks from the representation. The client is the principal, however, and the ends or objectives of a representation are hers to define.[113] By contrast, the *weak* version of paternalism—which focuses on means and not ends—is entirely compatible with our best understanding of the client's role, and it offers powerful insight into why and when conflicts are unwaivable. It lets the client be the judge of what *goal* is best, proscribing only decisions about *means* that are likely to undermine the client's objectives. (To emphasize the concern with means rather than objectives that grounds weak paternalism, we will refer to this form of intervention henceforth as *means paternalism*.)

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protection rationale currently succeeds when the issue is conflicts of interest but not when the issue is the overall objectives of the representation or the acceptance or rejection of settlement offers; clearly, the latter are more fundamentally significant to the client because the implications of a 'wrong' decision could be far more severe than in most common examples of conflicting interests.").

109. Dworkin, *supra* note 97, at 4.

110. *See id*.

111. *Id*.

112. *See supra* notes 61-65 and accompanying text.

113. *See supra* note 107.

Consider the logic of means paternalism in the conflict-waiver setting. The client wishes to accomplish an objective (O) in the representation. In waiving a conflict of interest, the client accepts (after full disclosure) limitations on the representation that prevent the attorney from undertaking certain actions on his behalf (L) that are likely to *undermine* O. By accepting L, the client has made it less likely that he will obtain O than if he had not accepted L. O is presumably (far) more important to the client than L, which—after all—concerns limits on a representation resulting from a conflict rather than the client's desired outcome from the representation.[114] We reject the client's informed choice to accept L because it defeats the client's own, (far) stronger commitment to O.

We can identify a number of rationales for means paternalism in the client setting. The respect for client objectives that grounds means paternalism is consistent with the client autonomy vision of the legal profession. It is the client's case, after all, and the client ought to be afforded control over the objectives of the representation.[115] The fact that the client's choice is not the best or "optimal" choice is not sufficient reason to overrule it. While we remain concerned about the client's best interests, the *client* identifies those interests in establishing the objectives for the representation. When a client's decision about *means* crosses the line from *less than optimal* to *likely to defeat the client's objectives*, the choice has moved from unwise to self-defeating, the point where intervention is more readily reconciled with our commitment to client autonomy. Moreover, given that clients typically have no special training in evaluating legal procedures or their significance, we have reason for concern when they accept procedures, even after full disclosure, that undermine their objectives. We will elaborate on these rationales in our later discussion of the *Model Rules* and their relation to the means-paternalism interpretation of Model Rule 1.7(b).[116]

Rather than constricting client autonomy, means paternalism can be understood as *enhancing* the client's autonomy by preventing him from accepting means that will frustrate his objectives. The client's objectives for the representation, which means paternalism

114. While it is possible that a client could elevate the means over the ends in some instances (often laudably) in representation situations, we are not referring here to means concerns generally, but to limitations on means posed by an attorney's conflict of interest, which will rarely trump client objectives.

115. As Gerald Dworkin notes, when a person "neglects to act in accordance with his actual preferences and desires . . . there is a stronger and more persuasive argument for paternalism." In this instance, we are not "imposing a good on another person." Gerald Dworkin, *Paternalism*, *in* MORALITY AND THE LAW 107, 122 (Richard A. Wasserstrom ed., 1971) [hereinafter *Paternalism*].

116. MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (2012).

seeks to protect, are typically far more important to the client than the means by which they are pursued.[117] Moreover, the client who accepts means that are likely to frustrate his objectives for the representation is mistaken by his own lights. Thus, "there is a sense in which if I could convince him of the consequences of his action he also would not wish to continue his present course of action."[118] The client would in some sense *want* us to intervene to prevent him from making this mistake, since the error is undermining his objective for the representation.[119] And finally, if inadequate understanding prevents "meaningful choice,"[120] then the client's autonomy is arguably advanced by an intervention to cure a misunderstanding about means that will undermine the client's objectives.

Means paternalism not only keeps us from imposing our own outcomes for the representation on the client in judging what conflicts can be waived, it also avoids the conceptual errors of the other rationales described above. First, it does not depend on the suspect empirical assertion that an attorney cannot adequately describe the risks of an incompetent representation.[121] We would do well to admit that clients can, on occasion, make faulty decisions about whether to consent to a conflict of interest even after they have been provided full information. And by distinguishing ends and means, means paternalism allows us to identify those informed client decisions that are faulty—those that are likely to undermine the *client's* desired ends.

Second, means paternalism does not require us to construct a justice-based rationale for rejecting incompetent representations.[122] Outside the conflict setting, we do not insist on competent representation in order to ensure a correct outcome in the case, any more than we require a client to raise all material claims in litigation to ensure a correct outcome in the case. Moreover, the justice-based rationale has no bearing in the transaction setting, where Model

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117. *See* Dworkin, *supra* note 97 ("[S]ometimes the individuals [sic] (long-run) autonomy is advanced by restricting his autonomy (short-run)".).

118. *Paternalism*, *supra* note 115, at 122; *see also* Moore, *supra* note 23, at 237 ("[I]t is equally arguable that paternalism is morally justifiable when the recipient would probably have agreed in advance to be protected against certain unwise future decisions.").

119. Although the types of paternalism differ, a similar justification has been offered for restraining a person from acting on an impulse that will contravene that person's values. *See* David Luban, *Paternalism and the Legal Profession*, 1981 WIS. L. REV. 454, 473 (1981) ("[K]nowing your values, and seeing you about to give in to an impulse that violates those values, I restrain you: I force you to be free."). By analogy, we restrict incompetent representations because the client values his objectives for the representation more than his choice of incompatible means.

120. *See* BEAUCHAMP & CHILDRESS, *supra* note 75, at 99.

121. *See supra* Part II.C.1.

122. See *supra* Part II.C.2.

Rule 1.7(b) also applies.[123]

An interesting question is why courts have cited these suspect rationales for the competency element in Model Rule 1.7(b). One possibility, of course, is their superficial appeal: they reveal their deficiencies only on close inspection. A more likely reason, however, is the long shadow cast by client autonomy, a bedrock assumption of the legal profession.[124] Consciously or otherwise, courts may be loath to embrace a paternalistic rationale for the rejection of client consent to an incompetent representation for fear that it is inconsistent with client control over the representation. The error stems from the failure to distinguish among various types of paternalism. As we have noted, means paternalism is of a special variety. It is the weakest form of intervention, since it leaves the client's objectives intact and concerns itself only with means.[125] Second, in an important sense, means paternalism enhances client autonomy since it rejects only those means that undermine the client's objectives.

Means paternalism explains why we insist on competency despite a client's informed consent to a conflict of interest. From this understanding, we can develop a test of when a client's informed consent to a conflict of interest should be rejected, which we turn to next.

III. A PROPOSED TEST OF COMPETENCY

A. Introduction

In this Part, we will present and elaborate on the elements of a test to determine when a concurrent conflict of interest can be waived. Thereafter, we will ask whether the proposed test fits with the *Model Rules* and the commitments of the legal profession that inform the *Model Rules*.

B. The Test

The analysis developed above leads directly to a test for evaluating whether a knowing and voluntary conflict waiver must be struck down as incompetent under Model Rule 1.7(b). *An informed conflict waiver must be rejected as incompetent if limitations on the means or procedures by which the attorney pursues the matter caused by the conflict of interest are likely to defeat the client's objectives for the representation.* In the subsections that follow, we will elaborate on the core elements of the proposed test: (1) the identification of client objectives; (2) the limits on the means that can be undertaken by counsel as a result of the conflict; and (3) the "likely to defeat"

123. MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 7 (2012).

124. *See supra* note 61 and accompanying text.

125. *See supra* note 114 and accompanying text.

standard.

1. Client Objectives

Clients retain lawyers in large part to carry out client objectives. While lawyers can offer valuable input on what the client might hope to achieve from the representation,[126] decisions about what to accomplish in the representation lie ultimately with the client.[127] Once the attorney understands the client's objectives, the proposed test offers a critical new path for defining and assessing competency. Competency is no longer a free-floating referendum on whether the representation is "good enough" despite material limitations. The clients' objectives provide the baseline against which to measure the effect or significance of the conflict of interest. Thus, under the proposed test, conflict waivers begin with the attorney's careful inquiry into the client's objectives for the representation.[128]

Because the current approach to conflict waivers does not overtly distinguish between objectives and means, practitioners have not engaged in the critical first step required by the proposed test. Rather than inquiring carefully into the client's objectives to frame the waiver discussion, attorneys emphasize the limitations on the representation resulting from the conflict.[129] Courts too tend to elide this critical first question, focusing instead on the problems posed by the conflict.[130] If we are to determine whether a conflict is waivable, however, the significance of the conflict of interest must be measured against *something*. Without a clear understanding of the client's objectives, lawyers and courts are relegated to impressionistic rather than reasoned accounts of whether conflict can be waived.

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126. *See* MODEL RULES OF PROF'L CONDUCT R. 2.1 (2012) ("In representing a client, a lawyer shall…render candid advice."). The attorney can help the client identify and assess the various objectives the client might seek from the representation, and—when the client is considering a limited objective—the attorney can explain the implications and possible disadvantages of the limited objective. *See id*. R. 2.1 cmt. 1. For an articulate case that the lawyer must not assume that the client is interested strictly in pressing her legal rights and interests regardless of the implications, see Katherine R. Kruse, *Beyond Cardboard Clients in Legal Ethics*, 23 GEO. J. LEGAL ETHICS 103, 132-33 (2010).

127. *See* MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (2012); RESTATEMENT (THIRD) LAW OF GOVERNING LAWYERS § 16 cmt. c (2000) ("The client, not the lawyer, determines the goals to be pursued . . . .").

128. In Part IV.E., we will discuss how this inquiry into objectives should be conducted.

129. For an example of a CLE guide that emphasizes disclosure of risks and limitations but makes no mention of client objectives in assessing the consentability of a conflict, see Lucian T. Pera & Pamela A. Bresnahan, ALI-ABA Live Telephone Seminar, Just Sign Here: Conflict Waiver Basics (Nov. 22, 2011). Of course, these practitioner materials correctly reflect the approach of courts to the waiver question, which the proposed test would revise.

130. *See*, *e.g.*, Baldasarre v. Butler, 625 A.2d 458 (N.J. 1993).

Moreover, by identifying the client's objectives, the proposed test allows us to tailor waiver analysis to the *client's* situation rather than some abstract concern about the "type" of representation. Different clients have different objectives,[131] and a client may have a focused goal that is unaffected by the limitation posed by a conflict. A genuine understanding calls for inquiry into the client's unique, personal circumstances and objectives, rather than assumptions and generalities. Commentators and courts have long realized that whether a situation presents a conflict of interest requires a careful analysis of the particulars.[132] It is time that a similar understanding be brought to the closely related question of whether a conflicted representation is waivable: the answer turns not on generalities about the type of representation, but on how the limitations resulting from the conflict will affect the client's particular objectives. In time, the caselaw applying the proposed test could represent a virtual catalog of varied representation objectives coupled with careful analysis of how these objectives are affected by specific conflict limitations—a genuine source of guidance for courts and practitioners alike.

2. Limitations

The second step in applying the proposed test is to identify the material limitations on the actions the lawyer can undertake for the client as a result of the conflict of interest. For example, in the litigation setting, the dual representation may preclude a lawyer from raising or counseling the clients about certain claims or defenses that affect the other client,[133] one client's testimony may adversely affect the other, or the attorney may not be able to cross-examine a co-client who provides adverse testimony.[134] In the transaction setting, a conflict will preclude a lawyer from negotiating on behalf of one client against the other,[135] or from suggesting

131. RESTATEMENT (THIRD) LAW OF GOVERNING LAWYERS § 16 cmt. c (2000) ("Individual clients define their objectives differently. One litigant might seek the greatest possible personal recovery, another an amicable or speedy resolution of the case, and a third a precedent implementing the client's view of the public interest.").

132. *Id.* § 121 cmt. c (offering a multi-part test focusing on "factual predicates and practical consequences" to assess whether a situation presents a conflict of interest).

133. *See* Rice v. Baron, 456 F. Supp. 1361, 1374 (S.D.N.Y. 1978).

134. For a discussion of these and other concerns in the criminal defense setting, see LAFAVE ET AL., *supra* note 7, at § 11.9(a).

135. MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 32 (2012) ("When seeking to establish or adjust a relationship between clients, the lawyer should make clear that the lawyer's role is not that of partisanship normally expected in other circumstances . . . ."); *see also* People v. Bollinger, 681 P.2d 950, 952 (Colo. 1984) (disciplining attorney for favoring one client over another in a transaction); *In re* Jans, 666 P.2d 830, 833 (Or. 1983) (describing problems posed by attorney representing employer and

alternatives to one client that could disadvantage another.[136] In concurrent representations, an overriding limitation is the lawyer's inability to preserve client confidences from the co-client.[137] To identify limitations that may affect the representation, the lawyer should ask herself what services will be necessary for the client over the predicted course of the representation, and which of these services cannot be conducted because of the conflict of interest.[138]

A client may request or even insist on a limitation in the representation. For example, the client may insist that the lawyer not negotiate on his behalf, or not cross-examine a particular witness, or not maintain information in confidence from his co-client. A lawyer or court may be tempted to characterize such limitation as a goal, since it originated with the client. The fact that a client prefers or even insists on a limitation does not render it a goal, however. Objectives are the ultimate ends that the client seeks from the representation.[139] Means relate to the procedures by which such objectives will be pursued.[140] If we conflate procedures and objectives, the client's consent to a procedural limitation would insulate the conflict consent entirely from the competency review required by Model Rule 1.7(b) and the proposed test.

Occasionally, a client will have special circumstances that warrant elevation of a procedural aspect of the representation to a client goal for purposes of the proposed test. For example, a client may not wish to sue a family member, and while the choice of defendants typically relates to means rather than ends, the special circumstance of family relation warrants elevation of this procedural concern to a goal.[141] The question is whether the client would have insisted on this limitation regardless of the conflict of the interest. It is also incumbent on the attorney to document the grounds for treating this procedural limitation as a client-objective, as we shall

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employee in connection with employment agreement); Attorney Grievance Comm'n v. Collins, 457 A.2d 1134, 1145 (Md. App. 1983) (disciplining lawyer for failure to serve as neutral adviser in representing two clients in same transaction).

136. MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 8 (2012) ("[A] lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer's ability to recommend or advocate all possible positions that each might take because of the lawyer's duty of loyalty to the others.").

137. *See id.* R. 1.7 cmt. 30 (citing confidentiality as a "particularly important factor in determining the appropriateness of common representation"); HAZARD & HODES, *supra* note 37, § 11.22 (Supp. 2004) ("[C]lients who have shared a lawyer generally cannot confide secrets that *the lawyer* may withhold from the other client.") .

138. *See* Kevin H. Michels, *Third-Party Negligence Claims Against Counsel: A Proposed Unified Liability Standard*, 22 GEO. J. LEGAL ETHICS 143, 168 (2009).

139. *See supra* note 127 and accompanying text.

140. *See infra* notes 157-58 and accompanying text.

141. For an example, see *infra* Part IV.C.

discuss in due course.[142]

3. Likely to Defeat the Client's Goal

Once we identify the client's objectives and the limitations on means resulting from the conflict of interest, the proposed test asks whether the limitations are likely to defeat the client's objectives. The "likely to defeat" standard derives from the central insight of means paternalism discussed earlier. We enhance the client's autonomy by identifying and deferring to his objectives and rejecting his decisions about means that are likely undermine those objectives.[143]

A critical implication of the proposed test is that not all limitations on the representation resulting from a conflict—even if material—can render a representation incompetent. A material limitation may make it more difficult for the attorney to achieve the client's goal, and it may even render it less likely that the goal will be achieved. This is not enough, however, to render a conflict-waiver incompetent. It is not the job of the court to revisit the client's cost-benefit calculation, or to reject waivers because they do not maximize the client's prospects or serve the client's "best interests." It is only when the limitations reach the level where they are more likely than not to defeat the client's goal that courts have reason to intervene on competence grounds. The "likely to defeat" standard identifies the point where limitations do not merely lessen the client's prospects but become, in a real sense, self-defeating and therefore incompetent.[144]

The "likely to defeat" standard replaces our subjective sense of whether the representation is "good enough" with an objective standard. The validity of an informed conflict waiver turns not on our visceral impressions but on a standard external to the observer—whether the limitations resulting from the conflict are likely to defeat the client's objective.

C. The Proposed Test and the Model Rules

As we have discussed, Model Rule 1.7(b) presents an enigma: how can we reconcile (i) the client's right to enter into an informed consent to a conflict waiver with (ii) the obligation of lawyers and courts, respectively, to reject and to strike down client consents that render the representation incompetent? A viable interpretation must

142. *See infra* Part IV.E.

143. *See supra* notes 115-120 and accompanying text.

144. In effect, the representation is deemed incompetent under the proposed test because the client would be more likely to achieve his objectives for the representation if he had not accepted the waiver. For a discussion of the rationale to support the "likely to defeat" standard, see *supra* notes 109-120 and accompanying text.

harmonize the seemingly disparate competency and consent elements of Model Rule 1.7(b). In addition, the interpretation should cohere with the remainder of the *Model Rules* and the deeper commitments of the legal profession that the *Rules* purport to codify.[145] Here, we ask whether the proposed test meets these objectives.

We begin with the paradox of competency and consent posed by Model Rule 1.7.[146] Informed consent requires the disclosure of the material risks and limits posed by the representation.[147] But how can a conflicted representation *ever* be competent if it is subject to a material limitation? In other words, if the purpose of a conflict waiver is the client's acceptance of material limitations on the representation resulting from the conflict, and if representations with material deficiencies are incompetent, how could *any* waiver withstand scrutiny under the competence standard?[148]

The proposed test explains how. A limitation resulting from a conflict could prevent the attorney from taking certain, material steps to achieve the client's goal without being *likely to defeat* the client's goal. The question is not whether the limitations are material. We presume as much: if the limitations were not material, they would not have been the subject of disclosure and consent under Model Rule 1.7 in the first place. The question instead is whether the limitations are likely to be goal defeating. Thus, the *magnitude* rather than the materiality of the limitation determines whether a representation is competent under Model Rule 1.7.[149]

The competency required of a representation that is subject to an informed waiver needs to reflect the fact that the client has *accepted* the limitations in question. In a standard representation, where there is no conflict of interest and the client has not accepted any limitations on the lawyer's performance, *any* material deficiency in the representation can be understood as incompetence under Model Rule 1.1.[150] When the client accepts limitations on the lawyer's

145. *See supra* Part I.B.

146. *See supra* Introduction.

147. MODEL RULES OF PROF'L CONDUCT R. 1.0(e) (2012).

148. *See supra* notes 36-40 and accompanying text.

149. The proposed test also gives rise to a second reason why a limitation can be "material" but not justify invalidating a waiver as incompetent. Clients differ in their objectives for their representations. As a result, certain limitations resulting from a conflict that are material for a *type* of representation may present no limitation on pursuit of the client's particular objectives in a *given* representation. These limitations should not render a representation incompetent under Model Rule 1.7(b).

150. *See* MODEL RULES OF PROF'L CONDUCT R. 1.1 (2012) (requiring competent representation to include "the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation"); *id.* R. 1.3 (requiring diligence in the representation); *see also* R. 1.3 cmt. 1 (requiring "whatever lawful and ethical measures are required to vindicate a client's cause or endeavor" and "commitment and

performance as a result of a conflict, however, those accepted deficiencies cannot render the representation incompetent simply because they are material, otherwise the client's consent will be given no force or effect. The proposed test reconciles the consent and competence elements of Model Rule 1.7: the materiality of a deficiency, standing alone, does not defeat consent; and consent, standing alone, does not sanctify all deficiencies in a representation. Limitations should render the representation incompetent only when they are likely to undermine the client's goal.

While the proposed test defers to the client's objectives for the representation, it acknowledges that even informed clients can be mistaken about the implications of a conflict of interest. A rational client who accepts means limitations that are likely to frustrate her objectives presumably misunderstands the consequences of the means limitations she has accepted. That misunderstanding is not entirely surprising given that attorneys are trained on matters of legal procedure, and clients typically are not. "Informed consent," as defined in the *Model Rules*, requires that the attorney adequately disclose the risks posed by the conflict; it does not, however, turn on the client's *understanding* of those risks.[151] The proposed interpretation of Model Rule 1.7(b) closes this gap: it protects the client when her consent to limitations resulting from a conflict is informed—since it was grounded on full disclosure—but improvidently granted, *as measured against the client's own objectives*.

The proposed test can also help us understand the relationship between the informed consent and competency elements of Model Rule 1.7(b). Both protect client autonomy. The insistence that a waiver be "informed" is premised on the insight that an uninformed decision is not a fully autonomous act.[152] The competency demand on the analysis developed earlier adds a second level of inquiry into the autonomy of the client's waiver decision: the client's acceptance of limits on the representation, even when informed, poses a real threat to the client's autonomy when the client misunderstands that he has consented to limits on the representation that are likely to defeat his objectives for the representation.[153]

The next question is whether the proposed test coheres with the remainder of the *Model Rules*. The *Model Rules* expressly affirm the critical premise of the proposed test, namely that objectives and means are distinct elements of the representation, and that

dedication to the interests of the client . . . with zeal in advocacy upon the client's behalf").

151. *See* MODEL RULES OF PROF'L CONDUCT R. 1.0(e) (2012).

152. *See* BEAUCHAMP & CHILDRESS, *supra* note 75, at 99; text accompanying *supra* note 75.

153. *See supra* notes 109-20 and accompanying text.

objectives are, within ethical limits,[154] uniquely the client's to shape. Model Rule 1.2(a) provides that the "lawyer shall abide by a client's decisions concerning the objectives of representation,"[155] which is consistent with the proposed test's deference to client objectives. The *Rules* also require that the lawyer "consult with the client as to the means by which [the client's objectives] are to be pursued,"[156] suggesting that on matters of procedure, the lawyer has strong input.[157] Thus, the proposed test eliminates the apparent tension between the competency element of Model Rule 1.7(b) and the client's right to shape the objectives of the representation under Model Rule 1.2(d). The competency demand of Model Rule 1.7(b) is not a channel through which we impose our view of what is best for the client. It is a protection against the client's acceptance of means limitations that are likely to prevent the client from achieving her objectives in the representation. The competency demand of Model Rule 1.7(b) is designed to *enhance* the client's control over objectives by ensuring that such objectives are not undermined by limitations on means resulting from the conflict. And client control over objectives, in turn, is a core commitment of the *Model Rules* generally.[158]

The proposed test likewise provides a close fit with Model Rule 1.2(c), which allows the lawyer and client to limit the "scope of the representation."[159] In limiting the scope of the representation under Model Rule 1.2(c), the client may not waive competent representation,[160] a restriction that is analogous to the competency

154. *E.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2012) (prohibiting knowing attorney assistance of client fraud or crime).

155. MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (2012).

156. *Id.*

157. *Id.* R. 1.2 cmt. 2 ("Clients normally defer to the special knowledge and skill of their lawyer with respect to the means to be used to accomplish their objectives, particularly with respect to technical, legal and tactical matters."); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 21 cmt. e (2000) ("A lawyer has authority to take any lawful measure within the scope of representation that is reasonably calculated to advance a client's objectives as defined by the client, unless the there is a contrary agreement or instruction and unless a decision is reserved to the client."); *see also* Jones v. Barnes, 463 U.S. 745, 754 (1983) (rejecting a per se rule that appellate counsel appointed for indigent criminal defendant must raise every nonfrivolous argument requested by client). *See generally* Lawyers' Manual, *supra* note 1, at 31:304 (offering examples of tactical decisions that lawyer can make on behalf of client).

158. MODEL RULES OF PROF'L CONDUCT R. 1.2(a) (2012) ("[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.").

159. *Id.* R. 1.2(c). As the drafters' comments note, a "limited representation may be appropriate because the client has limited objectives for the representation." *Id.* R. 1.2 cmt. 6.

160. *Id.* R. 1.2 cmt. 7 (noting that although client and lawyer have substantial latitude to limit representation, "an agreement for a limited representation does not exempt a lawyer from the duty to provide competent representation").

constraint on conflict waivers in Model Rule 1.7(b). In offering an example of a limitation that would be deemed unacceptable under the Model Rule 1.2(c), the comments implicitly adopt an objectives/means approach. The comments offer by way of example a representation in which a client seeks general advice on a matter, and the lawyer and client agree that the advice will be provided in a short telephone discussion.[161] The comments note that such arrangement "would not be reasonable if the time allotted was not sufficient to yield advice upon which the client could rely."[162] In other words, because the client's goal is advice that is reliable, a restriction on the means by which that goal is pursued (a short phone call) is void under Model Rule 1.2(c) if it undermines the client's goal. Thus, even outside the conflict-waiver setting, the client controls the objectives of the representation, and we limit the client's control over means when they undermine the client's objectives.[163] Again, the proposed test of competency for a conflict waiver helps integrate the *Model Rules* into a coherent, consistent scheme.

Finally, the proposed test offers a way of understanding Model Rule 1.7(b) in accordance with the agency or client autonomy vision of lawyering that remains a core commitment of the legal profession.[164] It is the client's case or transaction, after all, and the client—as principal—ought to retain control over what is pursued on her behalf. The proposed test's emphasis on the distinction between client objectives and means squares this general commitment to client control with the refusal of Rule 1.7(b) to accept client consent to an incompetent representation—even if the consent is informed. When the means are inconsistent with the client's goal as the result of a conflict, we have strong reason to believe that the goal, and not the means, represents the true and deepest objective of the client. When courts reject waivers on competency grounds under the proposed test, therefore, they are not superimposing their objectives for the representation on the client. Incompetence, understood through this lens, is a failure of means—limitations that are likely to prevent the attorney from undertaking the steps necessary to fulfill the client's goal. Thus, in an important sense, we *preserve* client autonomy by refusing to accept client-approved lawyering means that undermine client objectives.

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161. *Id*.

162. *Id*.

163. The reasoning developed herein in support of the proposed test presumably would warrant adoption of the same "likely to defeat the client's objectives" standard for determining whether a limitation on the scope of the representation is "reasonable" under Model Rule 1.2(c).

164. *See* Gaetke, *supra* note 63, at 717; text accompanying note 63.

IV. THE PROPOSED TEST APPLIED

A. Introduction

In this Part, we will offer examples of conflict waivers and ask whether they are competent and therefore enforceable under the proposed interpretation of Model Rule 1.7(b). In each instance, we will presume that the attorney has disclosed sufficient information to gain the informed consent of the client.[165] The question will be whether the conflict of interest nonetheless renders the representation incompetent and the waiver therefore invalid.

We will consider conflict-waiver situations in three major areas of practice—criminal defense, civil litigation and transactions. In addition to asking how the proposed test analyzes conflict waivers in concrete situations, the hypotheticals will also allow us to refine our understanding of the proposed test, just as courts do when they develop a test and apply it in subsequent cases.[166] Finally, we will ask how the client-objectives test should shape the behavior of lawyers in practice, the setting where much of the day-to-day consideration of conflict waivers takes place.

Some caveats before we begin. First, in analyzing the enforceability of a conflict waiver, the proposed test directs us to determine the objectives of *each* client, and then determine whether those objectives are likely to be undermined by the limitations resulting from the conflict.[167] In the analysis that follows, due to space constraints, we will restrict our analysis to one of the clients in the multiple representation, unless analysis of both clients will illustrate a valuable point.[168] In practice, the lawyer must conclude that the circumstances of each client satisfy the proposed test before entering into the multiple representation. Finally, space constraints allow us to provide examples, but not a complete treatment, of the waiver issues arising in the practice areas that follow.

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165. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7(b) (2012) (requiring informed consent of client as one prerequisite of conflict waiver); *see also id.* R. 1.0(e) (defining informed consent).

166. Although the examples are organized by subject area, many of the insights from one subject area apply to the others. Part V will conclude by combining the principles learned from each of the hypotheticals into a decision guide for courts, disciplinary committees, and practitioners for determining when consent can cure a concurrent conflict of interest.

167. Under the proposed test, competency is not a general analysis of how the waiver will affect the group of clients; it is a protection that must be satisfied for *each* client.

168. Because client objectives can differ, one should not assume that the same analysis would hold for each client in the proposed dual representation.

B. The Criminal Setting

1. The Supreme Court's Approach

Consider these facts from *Wheat v. United States*,[169] a leading Supreme Court case on when a criminal defendant can waive a conflict of interest.[170] Wheat was charged with participating in a drug-distribution conspiracy. In an earlier trial, another alleged conspirator, Gomez-Barajas, was tried and acquitted on charges relating to the conspiracy. In that trial, Gomez-Barajas was represented by attorney Eugene Iredale.[171] A prosecutor stated that Iredale "did a fantastic job" in representing Gomez-Barajas.[172] To avoid charges on another matter, Gomez-Barajas pleaded guilty to tax evasion and illegal importation of merchandise, a plea that had not yet been approved by the court. In lieu of trial, another alleged conspirator, Bravo, who was also represented by Iredale, pled guilty to transporting 2400 pounds of marijuana to the residence of Victor Vidal. The government offered to "modify its position"[173] with regards to Bravo's sentencing in exchange for his testimony in the Wheat case.[174]

Wheat retained Iredale as his counsel, waiving his "right to conflict-free counsel."[175] The government moved to disqualify Iredale, arguing that a portion of what Bravo delivered to Vidal was later delivered to Wheat. The government also argued that if the court did not accept Gomez-Barajas guilty plea, the government could call Wheat as a witness on "the sources and size of Gomez-Barajas' income."[176] Because Iredale would be unable to cross examine Wheat, he would be conflicted out of representing Gomez Barajas.[177] Wheat countered that he (and the others) had waived his right to conflict-free counsel, and that the allegations of conflict were "highly speculative" and designed to remove Iredale from Wheat's defense team because he had proven so effective in defending Gomez-Barajas.[178]

The trial court rejected Wheat's waiver and required him to proceed with counsel other than Iredale. Wheat was convicted, and he challenged the ruling on the grounds that he was wrongfully

169. 486 U.S. 153 (1988).
170. *See* LAFAVE ET AL., *supra* note 7.
171. *Wheat,* 486 U.S. at 154-56.
172. *Id*. at 170 n.3 (Marshall, J., dissenting).
173. *Id*. at 155.
174.*Id*. at 156.
175.*Id.*
176.*Id.* at 155-56
177.*Id*. at 153-56.
178. *Id*. at 156-57.

denied his choice of counsel.[179] The Court upheld the trial court's refusal to allow Iredale to serve as counsel, despite defendant's conflict waiver because: (1) the "[g]overnment might readily have tied certain deliveries of marijuana by Bravo" to Wheat, which would have required vigorous cross examination by Iredale that his representation of Bravo would have foreclosed; and (2) if Gomez-Barajas's pleas were rejected by the trial court, Wheat's probable testimony in that case "would create an ethical dilemma" for one of the defendants.[180]

In the criminal defense setting, the question of how courts should treat a client's waiver of his attorney's conflict of interest is inexorably fused with constitutional questions arising under the Sixth Amendment. The Sixth Amendment entitles a criminal defendant to effective assistance of counsel in criminal prosecutions,[181] a right that extends to the accused regardless of his ability to pay.[182] When the court appoints counsel to represent a defendant, "the Sixth Amendment contemplates that such assistance be untrammeled and unimpaired by a court order requiring that one lawyer shall simultaneously represent conflicting interests."[183] While it is clear that the criminal defendant has a right to counsel who is not hampered by a conflict of interest, complexities surround client waivers of that right. The *Wheat* Court observed that trial courts "face the prospect of being 'whip-sawed' by assertions of error no matter which way they rule."[184] If courts accept the proposed waiver, the *Wheat* Court reasoned, they might face a later challenge from the defendant on Sixth Amendment ineffective assistance of counsel grounds. Conversely, if they reject the waiver, the defendant might claim that the court has deprived him of his Sixth Amendment right to choice of counsel.[185]

The *Wheat* Court began by acknowledging what is no doubt correct: the right to counsel of one's choice has limits and not every waiver is enforceable.[186] The Court then identified five reasons that justify rejection of certain waivers. First, courts have an interest in ensuring that trials are conducted in accordance with the "ethical standards of the profession."[187] Second, courts have an interest "that

179. *Id*. at 157-58.

180. *Id*. at 164.

181. U.S. CONST. amend. VI ("In all criminal prosecutions, the accused shall enjoy the right . . . to have the Assistance of Counsel for his defence.").

182. Gideon v. Wainwright, 372 U.S. 335, 339–40 (1963).

183. Glasser v. United States, 315 U.S. 60, 70 (1942).

184. *Wheat*, 486 U.S. at 161.

185. *See id*. at 161.

186. *Id*. at 160.

187. *Id*. In support of this proposition, the Court cites the attorney ethics rules, including Model Rule 1.7, which, as discussed earlier, invalidates even knowing and

legal proceedings appear fair to all who observe them."[188] Third, the "interest of a criminal defendant" may be reason to reject a waiver.[189] Fourth, courts may reject waivers because of "the institutional interest in the rendition of just verdicts in criminal cases."[190] Fifth, courts have an interest in not having their waiver decisions overturned on appeal.[191] *Wheat* infers from these concerns that a court may reject a proposed conflict waiver when there is an actual or potential conflict of interest.[192]

The *Wheat* Court's "standard" warrants closer scrutiny. A waiver, by definition, is a knowing acceptance of a material limitation on the representation caused by a conflict of interest.[193] If a conflict of interest is sufficient to invalidate a waiver, then *every* waiver is suspect. Perhaps because it had offered no viable means by which to determine whether conflict waiver should be rejected, the Court made an extraordinary pronouncement:

> Other district courts might have reached differing or opposite conclusions with equal justification, but that does not mean that one conclusion was "right" and the other "wrong". The District Court must recognize a presumption in favor of petitioner's counsel of choice, but that presumption may be overcome not only by a demonstration of actual conflict but by a showing of a serious potential for conflict. The evaluation of the facts and circumstances of each case under this standard must be left primarily to the informed judgment of the trial court.[194]

Thus, after *Wheat*, whether a criminal defendant is to be deprived of his choice of counsel despite a voluntary, knowing waiver of a conflict of interest is left to the discretion of the trial court, under a standard so unrefined that it cannot distinguish "right" from "wrong," and accepts opposing conclusions on the same question.

The *Wheat* Court offers an array of rationales for rejecting a consent—some valid, some suspect—without asking how those rationales relate to a legal standard for assessing competence. Let us review each of these rationales in turn. The Court's concern with the appearance of fairness presupposes that an observer would not be equally troubled by the *denial* of a defendant's choice of counsel without sufficient reason. Moreover, if an observer would deem a proceeding unfair because counsel had a conflict of interest, even

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voluntary conflict waivers if they render the representation incompetent. *See supra* notes 30-34 and accompanying text.

188. *Wheat*, 486 U.S. at 160.

189. *Id*.

190. *Id*.

191. *Id*. at 161.

192. *Id*. at 163.

193. *See supra* notes 29-30 and accompanying text.

194. *Wheat*, 486 U.S. at 164.

though it was knowingly waived, then *all* waivers should be rejected—a standard that neither *Wheat* nor the ethics rules accepts. Apparently, *Wheat* imagines a more nuanced observer, who can distinguish between appropriate and inappropriate waivers. The Court, however, offers no basis for distinguishing these waivers, and in fact holds that either acceptance or rejection of the waiver on its facts would be justified.

The *interest of a criminal defendant*, as argued earlier, is the central reason to reject certain client waivers.[195] The challenge is to reconcile a concern for protection of clients with the rights of clients to control the representation—a question the Court does not address. Part II of this Article seeks to reconcile our commitments to client protection and client autonomy, and Part III proposes a test derived from this understanding.

The Court's concern with "the rendition of just verdicts in criminal cases"[196] is also problematic. In addition to the critique of this rationale developed earlier,[197] it is worth observing, once again, the overriding challenge posed by this and many of the other rationales offered by the Court. Unless we are to reject all waivers, the "just verdict" rationale—even if valid—would require an explanation of which waivers are consistent with justice, which ones are not, and why. If justice is our concern, and a conflict undermines justice, then why do we accept *any* waivers?

The Court's final rationale—ensuring that trial courts' waiver decisions withstand appeal—need not detain us long. The concern itself is misplaced: trial courts do not have a legitimate interest in ensuring that their decisions are upheld on appeal; they have a

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195. *See supra* Part II.C.3.

196. *Wheat*, 486 U.S. at 160.

197. *See supra* Part II.C.2 (arguing that this rationale conflates the client's *right* to pursue a vigorous defense with a *duty* to do so). In Faretta v. California, 422 U.S. 806, 819 (1975), the Court held that criminal defendants have a sixth amendment right of self-representation. The Court's reasoning in part emphasizes the distinction between a right and a duty: "[I]t is one thing to hold that every defendant, rich or poor, has the right to the assistance of counsel, and quite another to say that a State may compel a defendant to accept a lawyer he does not want." *Id.* at 833. While counsel may be necessary to ensure a fair trial, the Court held that the choice belongs to the client, "for it is he who suffers the consequences if the defense fails." *Id.* at 820. The client's choice, the Court reasoned, "must be honored out of that respect for the individual which is the lifeblood of the law." *Id.* at 834 (Brennan, J., concurring) (quoting Illinois v. Allen, 397 U.S. 337, 350-51 (1970) (internal quotations omitted). The criminal defendant's decision to proceed pro se implicates different concerns than the decision to proceed with conflicted counsel, and comparisons may be facile. Nonetheless, if client autonomy outweighs the state's interest in a fair trial in determining whether an informed criminal defendant can proceed *entirely* without counsel, then the state's interest in a "just verdict" faces considerable burden in justifying the rejection of a client's informed decision to *retain* counsel subject to a conflict of interest.

legitimate interest in ensuring that their decisions are *correct*, a by-product of which is their affirmation on appeal. Thus, the solution is not to afford trial courts latitude to rule either way on a matter of critical and constitutional importance to criminal defendants. Instead, we must reconcile the competing concerns at stake into a principled, workable standard by which trial courts can determine whether a conflict waiver is valid. Efficiency at the appellate stage derives not from deference to the trial court's decisions, but from the imposition of a clear standard to guide trial courts in the first place.

Justice Marshall issued a stinging dissent, which was joined by Justice Brennan.[198] Marshall argued that the likelihood of the government rejecting Gomez-Barajas's plea was "speculation of the most dubious kind," and that the "most likely" occurrence was that the trial court would accept the plea.[199] Turning to Wheat's matter, Bravo's testimony, if relevant at all, was unlikely to implicate Wheat or warrant cross-examination: prior to the start of legal proceedings, "the two men never had heard of each other."[200] In fact, Marshall noted, there is troubling evidence in the record to suggest that the prosecution named Bravo as a witness in order to "manufacture a conflict" in order to disqualify Iredale.[201] Marshall also rejected the Court's deference to the trial court because "[t]he interest at stake in this kind of decision is nothing less than a criminal defendant's Sixth Amendment right to counsel of his choice."[202] Absent such deference, Marshall noted, "a decision upholding the District Court's ruling would be inconceivable."[203] Justice Stevens also dissented in an opinion joined by Justice Blackmun, arguing that the Court gave "inadequate weight to the informed and voluntary character of the clients' waiver of their right to conflict-free representation."[204]

2. The Proposed Test Applied to the *Wheat* Facts

Our first question is whether the proposed test should be applied to determine whether waivers of conflict of interest should be enforced in the criminal defense setting. The *Wheat* Court suggests that the attorney ethics rules and the Sixth Amendment analysis should align on this issue.[205] It would be troubling indeed if the Sixth

198. *Wheat*, 486 U.S. at 165 (Marshall, J., dissenting).

199. *Id*. at 169.

200. *Id*. at 170.

201. *Id*. at 170 n.3.

202. *Id*. at 168.

203. *Id*.

204. *Id*. at 172 (Stevens, J., dissenting).

205. *See id*. at 160 (noting that the American Bar Association's Model Code of Professional Responsibility and the California Bar Association's rules have limitations on the "multiple representation of clients"); *see also id*. at 162 ("[W]hen a trial court finds an actual conflict of interest which impairs the ability of a criminal defendant's

Amendment interest in retaining counsel of one's choice required or allowed counsel to violate the ethics standards and to handle a matter that violated the competency demand for waivers under Model Rule 1.7(b).

While one could envision abandoning the ethical standard in the criminal defense setting, the strong hope is that the two will coincide—especially since the ethics and constitutional standards for waiver are animated by the same concern. The *Model Rules* allow clients to waive a conflict of interest to preserve the client's "autonomy" or control over the representation.[206] Likewise, we allow criminal defendants to waive their right to conflict-free counsel to preserve the criminal defendant's freedom of choice.[207] Not coincidentally, the most persuasive rationale for *striking down* a criminal defendant's waiver of his Sixth Amendment right to conflict-free counsel is, as noted above, client protection[208]—the rationale that grounds the proposed test's approach to waivers under Model Rule 1.7(b).[209] In both contexts, the challenge is therefore the same: to understand when client control over the representation should give way to client-protection concerns. Thus, the client-objectives test should allow us to assess when a client waiver of a conflict of interest should be upheld under both the ethics rules and under the Sixth Amendment.[210]

Our next question is how a court might apply the proposed test in determining whether to uphold the client's conflict waiver under the facts of *Wheat*.[211] With respect to the first element of the proposed test, Wheat's goal for the representation was self evident—acquittal.[212] Turning to the second element, it is clear that Iredale

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chosen counsel to conform with the ABA Code of Professional Responsibility, the court should not be required to tolerate an inadequate representation of a defendant." (quoting United States v. Dolan, 570 F.2d 1177, 1184 (1978))).

206. *See supra* Part II. A-B.

207. *See Wheat*, 486 U.S. at 164 (creating a rebuttable presumption in favor of client's choice of counsel)*; see also* United States v. Curcio, 680 F.2d 881, 888 (2d Cir. 1982) (upholding defendant's informed conflict waiver, citing Sixth Amendment right to counsel of one's choosing).

208. *See supra* note 195 and accompanying text.

209. *See supra* Part II.C.3.

210. *See* U.S. v. Massimino, 832 F. Supp. 2d 510, 514-15 (E.D. Pa. 2011) (applying *Wheat* standard to determine whether court can reject criminal defendant's conflict waiver despite Sixth Amendment right to counsel of one's choice, and noting that the Pennsylvania Rules of Professional Conduct "provide a useful template against which to measure the conduct of lawyers subject to a disqualification motion").

211. When joint representation is proposed in federal criminal matters, the court must conduct a hearing to assess whether joint representation is appropriate. FED. R. CRIM. P. 44(c)(2) ("Unless there is good cause to believe that no conflict of interest is likely to arise, the court must take appropriate measures [to protect each defendant's right to counsel.").

212. Although acquittal (or a favorable plea bargain grounded on the prospect of

was subject to two limitations in representing Wheat as a result of the conflict of interest. If the trial court rejected Gomez-Barajas's tax plea, and if the government called Wheat to testify, then Iredale would not be able to cross-examine Wheat in his defense of Gomez-Barajas.[213] Moreover, if the government called Bravo as a witness in Wheat's case, then Iredale would not be able to cross-examine Bravo in his defense of Wheat.[214]

The third element of the test asks whether the limitations we have identified are likely to defeat either Gomez-Barajas' or Wheat's goal of acquittal.We might first ask what the likelihood is that the trial court in the Gomez-Barajas trial would reject the plea agreement struck by the parties.[215] As a statistical matter, it is beyond contention that trial courts accept the overwhelming majority of plea agreements in criminal matters.[216] Moreover, nothing in the *Wheat* opinion suggests that the plea agreement in the *Gomez-Barajas* case was unusual and therefore likely to be treated differently than the typical plea agreement presented to the trial court. In addition, even if the *Gomez-Barajas* case went to trial, the likelihood appears quite low that Wheat would have been called as a witness given that he was not involved in the crimes alleged.[217] With a less than 5% chance the trial would take place, multiplied by the modest prospect that Wheat would offer testimony of probative value, it seems fair to conclude that the waiver was not likely to defeat Gomez-Barajas's objectives of acquittal.

Turning to Wheat's case, Bravo appears not to have been privy to much that could incriminate Wheat. Bravo did not know of the existence of Wheat and had no dealings with him.[218] The value of Bravo's testimony to the government thus appears tenuous at best,

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acquittal) is the goal of nearly every criminal defendant at trial, one exception might be the defendant who believes that conviction is inevitable and who seeks only a "show trial" or a platform to proclaim his views. This limited goal presumably would expand the types of conflict limitations that we would allow under the proposed test. As we shall see in our discussion of the civil-practice setting, however, client objectives can vary considerably in other practice settings, and thus the first element of the test will require careful inquiry. *See infra* Parts IV.C , IV.D.

213. *See Wheat*, 486 U.S. at 164.

214. *See id.* at 155-56.

215. We will assume here, arguendo, that protection of Gomez-Barajas in a separate matter is reason to deny Wheat counsel of choice in his own matter.

216. Over 95% of criminal cases in the federal system are resolved by plea agreement. Jacqueline E. Ross, *The Entrenched Position of Plea Bargaining in United States Legal Practice*, 54 AM. J. COMP. L. 717, 717 (2006). It seems a safe bet, moreover, that a considerable portion of the 5% of cases remaining go to trial because the parties cannot agree on a plea rather than because the judge rejected a proffered settlement.

217. Wheat's lack of involvement is noted by Justice Marshall in his dissent. *Wheat,* 486 U.S. at 169-70 (Marshall, J., dissenting).

218. *Id.* at 156.

and counsel's inability to cross-examine Bravo would not be likely to defeat Wheat's goal of acquittal. Thus, under the proposed test, we would not reject Wheat's voluntary and knowing decision to retain Iredale as his attorney.

The proposed test provides a means by which to determine when a conflict of interest can be waived in the criminal defense setting, a critical question on which the *Wheat* holding provides little or no guidance to practitioners or courts. *Wheat*'s holding that an "actual . . . [or] potential" conflict is sufficient grounds to reject an informed waiver[219] does not tell us *which* conflict waivers should be rejected since a conflict waiver *presupposes* such a conflict of interest. The *Wheat* approach would either invalidate every waiver or leave the trial court to decide which waivers to invalidate by caprice rather than principle—a curious laxity given the interests at stake for the criminal defendant and the attorney-ethics system. The client-objectives test, by contrast, allows trial courts to identify not only the concerns posed by the conflict, but to determine *when* those concerns rise to a level that warrants rejection of the client's informed waiver under an analytical standard that allows for genuine appellate review rather than deference.

Notice what the proposed test does *not* do: it does not substitute the trial court's judgment for that of the defendant on the question of what is best for the defendant. The fact that the client could, in the court's eyes, fare better with different, conflict-free counsel is insufficient to strike down a waiver. Unless and until the client's decision about limitations is likely to defeat his own objective, the proposed test allows the defendant to engage in his own weighing of the benefits of retaining his choice of counsel against the costs of proceeding with such counsel despite material limitations. This latitude is what honors the client's autonomy and control over the representation under Model Rule 1.2(a) as well as the client's right to counsel of his choice under the Sixth Amendment. The *Wheat* Court has deprived the defendant of his chosen attorney without an adequate theory of why or when waivers should be invalidated. Wheat's chosen attorney had already demonstrated his prowess in gaining the acquittal of another defendant in the alleged scheme.[220] Given the stakes for criminal defendants, we must insist on a clear, reasoned justification for refusal to honor a client's choice of counsel.

In summary, a material limitation on the representation caused by a conflict of interest is not enough to invalidate a waiver. A client

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219. *See id.* at 163. In Marshall's dissent, he noted: "When a defendant's selection of counsel, under the particular facts and circumstances of a case, gravely imperils the prospect of a fair trial, a trial court may justifiably refuse to accede to the choice." *Id.* at 166 (Marshall, J., dissenting).

220. *See id.* at 170 n.3 (Marshall, J., dissenting).

may rightly determine that the advantage of proceeding jointly or with a particular attorney outweighs the loss from a material limitation caused by an attorney's conflict of interest. This is the range of freedom required to ensure that the competency requirement does not swallow up the client's right to enter into an informed conflict waiver in the first place. It is only when the client has accepted a waiver that is likely to undermine his own goal that courts can overturn the consent on competency grounds without undermining the client's autonomy.

C. Civil Litigation

In the civil litigation setting, we are confronted with many of the same types of competency concerns as in the criminal setting, albeit without the right-to-counsel concerns posed by the latter. Civil litigants may, however, have more varied objectives than criminal defendants. By examining some fact patterns from the civil litigation setting, we can explore how variations regarding objectives can affect the enforceability of a conflict waiver.[221]

Suppose A is a passenger in a car driven by B. A is injured when the car collides with a car driven by C. An attorney obtains consent to represent both A and B in a claim against C, disclosing to A—among other things—that he cannot bring a claim against B.[222] Assuming that the consent is fully informed,[223] the question is whether A's waiver should be upheld under what we have termed the competency element of Model Rule 1.7(b).[224] In looking at these facts, it is difficult without a clear, principled standard to know how to order and prioritize our various concerns about the representation: client autonomy, client protection, the significance of the limitations posed by the conflict, and so on.

The proposed test directs us first to client objectives. Let us

221. We will explore the driver-passenger setting because it will allow us to consider a range of variations without extended factual accounts. The proposed test would apply to joint representations in civil litigation generally regardless of the nature of the underlying claims, such as the representation of the company and an executive in defense of a wrongful-termination claim, co-plaintiffs in commercial litigation, joint claimants under a will, and so on.

222. MODEL RULES OF PROF'L CONDUCT R. 1.7(b)(3) (2012) categorically prohibits representation of adverse parties in the same litigation matter. *See*, *e.g.*, Walden v. Hoke, 429 S.E.2d 504, 509 (W. Va. 1993) (prohibiting dual representation of husband and wife in divorce proceeding even with informed consent).

223. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7(b)(4), 1.0(e) (2012). For examples of limitations that an attorney may need to disclose to gain informed consent, see *supra* note 4 and accompanying text. *See also supra* notes 130-35 and accompanying text.

224. We will limit our analysis here to whether A's waiver is valid. In practice, counsel would need to undertake a separate analysis under the proposed test to determine whether B's consent is valid. *See supra* note 168 and accompanying text.

assume that, after a discussion with A, it is clear that A wants what is hardly surprising—full and fair compensation for his injuries. Our next question is whether the limitation on means resulting from the conflict is likely to defeat A's goal. That question, in turn, directs us to an assessment of whether B had any fault in the accident.[225] If it is clear that the fault lies solely with C—if, for example, C were drunk and veered into B's lane—then A's recovery will likely not be diminished by the failure to bring a claim against B, and thus the consent should be upheld.

Suppose, however, that B's tires were tread worn, extending the distance required to slow or stop his vehicle on the wet road.[226] In adducing A's consent to the conflict, we will assume that the lawyer has adequately explained that B may have liability to A, that A will not be able to sue B because of the attorney's conflict, and that failure to sue A may reduce B's recovery. Under the proposed test, the fact that there is a material and even substantial—for example, a one-in-three—prospect that B will be found negligent is insufficient reason to overturn the waiver. This is the "decision space" that belongs to the client. Within this range, A should decide whether the risk that his recovery will be reduced by not suing B is outweighed by the benefit of proceeding with counsel of choice. If, however, it is more likely than not that B will be found negligent and therefore that A's recovery will be reduced, then we must reject A's waiver as self-defeating, i.e., likely to undermine his own professed goal.[227]

Notice that we do not characterize A's goal in terms of the probability of achieving a certain outcome. For example, we would *not* describe A's goal as "maximizing his prospects of achieving a full and fair recovery." We focus instead on what the client wants to achieve (a full and fair recovery), and bring probability to bear in

225. We will assume that the inability to bring a claim against co-client B is the only material limitation arising in our example, which may or may not be the case in practice. For example, C may have insurance coverage and assets insufficient to cover the entirety of A and B's claims, in which case the lawyer may face a new limitation on means, namely the inability to maximize A's recovery given his competing obligation to B. *See* Straubinger v. Schmitt, 792 A.2d 481, 487 (N.J. Super. Ct. App. Div. 2002) (finding a conflict of interest). Under the proposed test, a court could hold that a consent to this limitation, no matter how well informed, is invalid because it is likely to undermine A's objective of a full and fair recovery.

226. For an early case examining the liability of a driver for tread-worn tires, see DeLair v. McAdoo, 188 A. 181 (Pa. 1936). For background on how insufficient tire tread can extend stopping distance, see *How Safe Are Worn Tires?*, CONSUMERREPORTS.ORG, http://www.consumerreports.org/cro/2012/12/how-safe-are-worn-tires/index.htm (last updated Feb. 2013).

227. Under apportionment rules, A's recovery would be allocated between B and C by degree of fault. RESTATEMENT (THIRD) OF TORTS: APPORTIONMENT OF LIABILITY § 26 (2000); *see also* WIS. STAT. § 895.045 (2011) (providing for allocation based on fault except that defendant shall be jointly and severally liable for the damages if his fault is 51% or more).

determining when the limitations resulting from the conflict are "likely" to undermine the client's goal.

The proposed test also shapes our analysis of client objectives.[228] Suppose that A states that he does not wish to sue B because B is a friend. It is tempting to assume that this renders the waiver valid. A's goal might be understood as a full and fair recovery reduced by the amount he would have recovered if he had sued B. Thus, the fact that A cannot sue B due to his attorney's conflict will not undermine A's goal. The reasoning is correct provided that we can be confident that this is in fact A's goal.[229] There are reasons for concern, however. First, any waiver can be rendered valid if we simply recharacterize the troublesome procedural limitation (the attorney cannot sue B) into a new goal (the client only wants recovery minus proceeds he would received from B). If we treat means limitations as objectives when they are not, we allow clients to accept procedures that are likely to undermine their *genuine* objectives, eliminating the competency constraint on waivers imposed by Model Rule 1.7(b) and the proposed test. Second, there is cause for suspicion when client objectives mirror the limitations caused by a conflict of interest: is this a happy coincidence or a contrivance to insulate the waiver from competency review?

Thus, when we are confronted by a client goal that incorporates a procedural limitation, we need to confirm that it is in fact the client's goal. The question is whether the client would have wanted this limited goal even if he had independent counsel, i.e., counsel who was not subject to the conflict. This might be confirmed by client statements to this effect coupled with the identification of special client circumstances that explain why the client would want this limited goal.[230] Thus, if A and B were mere acquaintances, we would be reluctant to accept at face value A's supposed desire to recover less than a full amount. The close friendship of A and B may, however, be sufficient to conclude that A's goal is not a contrivance. And if A and B were married, we would accept the limited goal without question.

The client-objectives test also allows us to identify after-arising

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228. *See supra* Part III.B.

229. This example also highlights the importance of counsel providing sufficient explanation to the client to enable the latter to make an informed decision about her objectives for the representation. *See supra* note 126 and accompanying text. The client may not know, to cite one possibility, that the friend's insurer would be responsible for payment of any judgment against the friend within the policy limits. This information may well affect the client's decision about whether to institute suit against the friend.

230. If there is conflicting testimony or other factual barriers to a clear account of the client's objectives, a court may be required to reconstruct or infer the client's objectives from the circumstances. See *infra* Part IV.E., for a discussion of the procedures for determining and documenting client objectives to reduce ambiguity on this critical question.

conflicts, i.e., information learned after the representation is underway that warrants revisiting the original conflict-waiver decision.[231] Suppose that, in the original example, the parties first learn of the tread wear during discovery. At that time, the lawyer and his clients will need to revisit the waiver question. Limiting our analysis to A, the question, once again, is whether A's objectives are likely to be undermined by the decision not to sue B. If so, we will not allow A to consent to the continued dual representation, and the lawyer will be required to withdraw from the representation of A. Whether the lawyer should continue to represent B turns on factors outside the scope of our inquiry.[232]

D. The Transaction Setting

Suppose that an attorney obtains consent to represent Mary and Dave, who are shareholders in a closely held corporation, in connection with an agreement to set forth their rights and obligations by and between themselves and the corporation ("shareholder agreement"). Attorneys are often asked to serve multiple shareholders in drafting agreements of this kind,[233] in part because of a perception that the shareholders are generally aligned regarding the issues at stake and that separate attorneys will slow the deal and add to its expense.[234] Assuming that the attorney has gained informed consent to the transaction, the question is whether the conflict is waivable under Model Rule 1.7(b). We will focus solely on Mary's waiver, although the lawyer would have to analyze the

231. *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 122 cmt. d (2000) ("If a material change occurs in the reasonable expectations that formed the basis of a client's informed consent, the new conditions must be brought to the attention of the client and new informed consent obtained . . . .").

232. *See* § 121 & cmt. d.

233. We will assume that the attorney proposes to represent the shareholders rather than the corporation in this example. *Cf.* MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 28 (2012) ("[A] lawyer may seek to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs . . . ."). *See generally* Ze'-ev Eiger & Brandy Rutan, *Conflicts of Interest: Attorneys Representing Parties with Adverse Interests in the Same Commercial Transaction,* 14 GEO. J. LEGAL ETHICS 945 (2001) (discussing adverse representation in commercial transaction setting).

234. *See id.* at 949 n.25 (noting that separate counsel in transaction setting may result in additional costs); Zacharias, *supra* note 23, at 414-15 ("Even when clients are antagonists, the potential benefits that an aggressive, unconflicted lawyer might achieve on behalf of a client may be less than the expense of the additional representation."); Richard A. Epstein, *The Legal Regulation of Lawyers' Conflicts of Interest*, 60 FORDHAM L. REV. 579, 592 (1992) (discussing possible savings from multiple representation); Robert H. Aronson, *Conflict of Interest*, 52 WASH. L. REV. 807, 822-33 (1976) (noting cost savings and conflicts of interest arising from multiple representation in a variety of settings, including transactions).

situation from Dave's perspective as well before entering into the joint representation.[235]

Attorneys typically begin by identifying the limitations on the representation resulting from the dual representation.[236] The attorney might, for example, warn Mary that the attorney cannot: keep her confidences from Dave; provide individual counsel to Mary; negotiate on behalf of Mary against Dave; or assist Mary in advancing terms that may disadvantage Dave.[237] The attorney might next ask Mary whether she understands these limitations and wishes to go forward despite them, and if so, document Mary's informed consent.[238] The problem with this approach, as the proposed test makes clear, is that neither the attorney nor ultimately the court can evaluate the competency of a representation by considering only the limitations arising from the conflict.

The proposed test asks us first to consider the client's objectives or desired outcomes from the representation.[239] After discussion, the attorney may conclude that Mary seeks an agreement that reasonably protects her with respect to the central concerns relating to the business. The attorney's inquiry should run deeper, however. He could explore with Mary her various objectives for the agreement, listening intently for any goal that would require services that the attorney cannot provide because of the conflict. Suppose Mary and Dave will own equal interests and Mary harbors no objective that will place a premium on private counseling, confidentiality, or negotiation of terms with Dave. In these circumstances, we have not identified any client goal that, as a result of the limitations arising from the dual representation, is likely to prevent the attorney from developing an agreement that provides Mary with the reasonable protections she seeks. Thus, under the proposed test, Mary's informed conflict waiver would be valid.

Here, the proposed test sharpens and focuses the intuition that guides the *Model Rule* comments, which note that consent can cure a conflict in the transaction setting if "clients are generally aligned in interest even though there is some difference in interest among them."[240] The drafters' comments should not be read to imply that a waiver is acceptable if the issues on which the parties align preponderate over those on which they disagree—a calculation that ignores the nature and magnitude of the issues on which the parties'

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235. *See supra* note 168 and accompanying text.

236. *See supra* notes 133-37and accompanying text.

237. *See supra* notes 136-38 and accompanying text.

238. *See* MODEL RULES OF PROF'L CONDUCT R. 1.0(e) (2012) (defining informed consent); *id.* R. 1.7(b)(4) (requiring that informed consent be confirmed in writing).

239. In Part IV.E, we will discuss both the importance and means of documenting the client's desired outcomes as part of any conflict waiver.

240. MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 28 (2012).

interests diverge. As we shall see next, disagreement on *one* issue can—in certain circumstances—be sufficient to render a dual representation incompetent. By insisting that we determine each client's objectives, and then asking how the limits resulting from the conflict affect those objectives, the proposed test shows us how to identify client-specific concerns—regardless of quantity—that bear on the validity of a consent, moving us from intuition to a viable standard for measuring competence.

Suppose, to vary our hypothetical, that Mary plans to work for the company for two years and then move to another state with her fiancé. A critical concern is whether she will be allowed to continue as a shareholder if her employment ceases. Mary is unsure whether to tell Dave about her plans, and she hopes to forge an agreement that will allow her to continue to own her stock in the company regardless of whether she continues in the company's employ. [241] It is difficult to know how an attorney could address Mary's concern without conferring with her confidentially regarding this issue, exploring the question of whether to disclose Mary's planned move to Dave, and considering whether Mary has sufficient leverage to negotiate an agreement with Dave allowing Mary to continue as a shareholder after the move. Moreover, given Mary's lack of legal knowledge and understandable discomfort discussing the issues with Dave, there is no alternative path by which these terms could be reasonably addressed—for example, by direct discussion between Mary and Dave. Because the limitations on the representation are likely to defeat Mary's goal, a court could hold under the proposed test that Mary's consent to the dual representation—no matter how well informed—renders the waiver unenforceable.[242]

Consider still another factual variation. Suppose that Mary states that she has contributed more to the company through her services and is deserving of a greater stock percentage and salary. Mary explains to the attorney, however, that she has already discussed these issues with Dave and she plans to negotiate her ownership percentage on her own behalf. If Mary can reasonably advance her own interests on this issue, then there is no reason to invalidate the representation on competency grounds with respect to this client objective. Questions of ownership percentage and salary are terms that can be negotiated by business persons, and while individual counseling on these issues would be preferable, it does not appear that Mary's objectives are likely to be defeated by the limitations stemming from the dual representation. Thus, the

241. See *infra* Part IV.E for a discussion of how counsel might conduct an inquiry into the circumstances that inform the client's objectives.

242. The same reasoning should prompt counsel not to seek a waiver in the first place, eliminating the prospect of later court review under the competency standard. *See infra* Part IV.E.

proposed test explains the significance of the client's decision to undertake certain aspects of the representation on her own.[243] The test does not dismiss this desire as irrelevant in evaluating the competency of the joint representation. Nor does the test presume that the client's desire to handle certain aspects of the representation automatically validates the arrangement as competent. Instead, the test treats the client's desire to handle a portion of the matter as a decision about means, and asks whether that approach is likely to undermine the client's goal.

Thus, if the issues on which Mary had special concerns were suffused with legal aspects, we would be less willing to defer to a limitation based on Mary's assertion that she will handle such matters on her own. Suppose, for example, that in a separate transaction Dave proposed to sell commercial real estate to Mary, and in a conflict waiver precedent to representing both Mary and Dave, the attorney once again discloses all, explaining for example that he cannot individually counsel or negotiate for either party. Suppose, as is often the case, that the commercial real estate transaction contains an array of conditions, contingencies, title clearance, and other concerns that require legal analysis and counseling. Absent legal training or some other reason to believe that Mary can competently protect herself on these issues, we should be unwilling to accept a waiver that precludes counsel from performing these services, which are essential to Mary's presumptive goal of consummating the transaction with reasonable protections.[244] If the client wishes to proceed on her own, she certainly may, even incompetently. But under the proposed test, counsel cannot preside over a transaction that will fundamentally disserve the client's objectives—even with the client's informed consent.

E. The Law Office

The proposed test would not only fundamentally alter the method by which courts analyze the enforceability of conflict waivers, it would augur a sea change in the way that practitioners approach conflict-waiver problems. In many ways, the current approach of practitioners reflects the lack of clarity or coherence in the law governing whether consent can cure a concurrent conflict of interest.[245] Although attorneys understand that they must explain to

243. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 32 (2012) (noting in concurrent representation "the clients may be required to assume greater responsibility for decisions than when each client is separately represented").

244. *See* Baldasarre v. Butler, 625 A.2d 458, 467 (N.J. 1993) (holding that the buyer and seller in a complex commercial real estate transaction cannot consent to dual representation by an attorney).

245. *See id.* at 459-61 (attorney procured consent of buyer and seller, then attempted to execute transaction).

clients the risks and limitations posed by the conflict, they have no standard by which to determine whether consent should be sought in the first place.[246] As a result, client rights and interests are compromised: attorneys obtain waivers when they should not,[247] and, conversely, they may refuse to obtain a waiver when the clients strongly prefer to proceed jointly and there is no reason not to accommodate them.[248]

Counsel must begin with an inquiry into the prospective client's objectives for the representation.[249] In some instances, the prospective client's objectives will often be obvious: in the criminal setting, she seeks an acquittal or the most favorable plea agreement;[250] in the civil litigation context, the plaintiff typically wants a full and fair recovery, and the defendant hopes to minimize the plaintiff's recovery.[251] In some situations, however, the prospective client may have special circumstances that counsel must descry in order to have a full understanding of the client's goal.[252] For example, in the litigation setting, the prospective client may be unwilling to pursue a claim or sue a potentially responsible party.[253] In the transaction setting, the prospective client may have a particular protection in mind that flows from her unique circumstances.[254] The attorney need not be passive in seeking to uncover the client's objectives: she may need to counsel the client on the implications of various objectives that the client is considering. While the attorney may provide valuable advice on client objectives,

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246. *See supra* notes 129-30 and accompanying text.

247. *See, e.g.*, *Baldasarre*, 625 A.2d at 467 (representing buyer and seller of commercial real estate); *In re* Jans, 666 P.2d 830, 833 (Or. 1983) (representing employer and employee regarding employment agreement); Rice v. Baron, 456 F. Supp. 1361, 1374 (S.D.N.Y. 1978) (representing clients with cross claims against each other).

248. *See* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 122 cmt. (b) (2012) ("A lawyer might be unwilling to accept the risk that a consenting client will later become disappointed with the representation and contend that the consent was defective . . . .").

249. The term "prospective client" is used here because the attorney should inquire into objectives (and analyze whether the conflict is consentable under the proposed test) before eliciting consent to the conflict or entering into the representation.

250. *See supra* note 212 and accompanying text.

251. *See infra* Part IV.C, for a discussion of varied client objectives in the civil litigation setting. Of course, a client may have values that lead to objectives other than maximizing her legal interests. *See* Kruse, *supra* note 126, at 133-34 (suggesting that attorney "actively" listen and probe "beneath the client's expressed desires" to help the client clarify her values.).

252. For additional discussion of special circumstances, see *supra* notes 141-41, 228-30 and accompanying text.

253. *See supra* notes 228-30 and accompanying text.

254. *See supra* note 241 and accompanying text.

the decision belongs to the client.[255]

In a joint representation, the attorney's inquiry into a client's objectives must be conducted outside the presence of the other prospective client. A prospective client may be unwilling to disclose his special circumstance in the presence of the other client. Moreover, such disclosure may compromise prospective client interests that would have been protected in a confidential communication with separate counsel.[256] The lawyer cannot evaluate whether a matter is a good candidate for a client waiver without an uninhibited and confidential discussion with the prospective client about her objectives for the representation.

If, after the private discussion with the prospective clients,[257] the attorney concludes that a waiver is appropriate, then the attorney can establish with each client the treatment of confidential information under the dual representation.[258] If the conflict cannot be waived under the proposed test, however, and if the information learned in the private consultation could adversely harm a prospective client if withheld or disclosed from the other client, then the lawyer should not represent *either* prospective client in the same or related matter.[259]

Once the attorney has thoroughly considered the client's objectives, she must next identify the limitations on the representation resulting from the conflict of interest. The attorney must then determine whether the limitations on means resulting from the conflict of interest are likely to defeat those objectives. The examples of the proposed test in application provided earlier[260] should provide guidance for counsel in conducting this analysis even though the factual particulars will no doubt differ.

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255. *See supra* notes 126-27 and accompanying text.

256. *See* MODEL RULES OF PROF'L CONDUCT R. 1.18(b) (2012) ("Even when no client-lawyer relationship ensues, a lawyer who has had discussions with a prospective client shall not use or reveal information learned in the consultation . . . .").

257. The attorney should not disclose the contents of the objectives discussion with either prospective client to the other without consent. *Id.* R. 1.18(b).

258. Almost invariably, the correct practice is for counsel to condition the joint representation on a sharing of all information relating to the representation by and between the co-clients. This will avoid the danger that one client will provide information to counsel that the other client will deem material, and the attorney will be left with the unenviable choice of breaching his duty of confidentiality to one client under Model Rule 1.6(a) or breaching his duty of communication to the other client under Model Rule 1.4. *See id.* R. 1.7 cmt. 31.

259. *See id.* R. 1.18(b) (2012). See *infra* note 258 for an analysis of why the competing obligations of confidentiality and disclosure cannot be satisfied between co-clients. These concerns apply with equal force to a representation of one client who will benefit from disclosure of confidential information gained from a prospective but-not-retained co-client.

260. *See supra* Part IV.

If the attorney concludes that the circumstances allow for a conflict waiver under the proposed test, the attorney is well advised to document the facts and analysis upon which that finding is based. First, the client's objectives are best memorialized in writing.[261] Second, if the goal differs from the typical outcome that a client would want from a representation of this kind, then the attorney should also document the special client circumstances that warrant the unusual goal.[262] Third, the attorney should identify the limitations on the representation posed by the conflict, and explain why those limitations—even if material—are not likely to defeat the client's objectives. Finally, if alternate means will be used to further the client's objectives,[263] counsel should identify these alternate means and explain why this approach, even if less than optimal, is not likely to defeat the client's objectives.

By providing a written analysis of the facts and analysis mandated by the proposed test, the attorney can reduce the risk of a later challenge by a client who contends that he should never have been allowed to waive the conflict in the first place. While a court need not defer to the attorney's analysis of whether the limits on the representation are likely to defeat the client's objectives, the documentation—if countersigned by the client—will establish the lawyer's and client's understanding regarding the client's objectives, any special circumstances that informed them and any alternate means. This writing should create a strong (although defeasible) presumption that the factual elements that supported the attorney's decision to proceed with a waiver are correct.

V. CONCLUSION

The world would be simpler if lawyers were never asked to represent two or more clients in the same or related matters. In

261. The *Model Rules* apparently require only that the fact of the informed consent but not the underlying disclosures be confirmed in writing. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7(b)(4) (requiring that the informed consent of each client be "confirmed in writing."); *see id.* R. 1.0(b) (defining "confirmed in writing" as "informed consent that is given in writing by the person or a writing that a lawyer promptly transmits to the person confirming an oral informed consent"). Nonetheless, the detailed writing recommended herein will provide a measure of protection for counsel against a later client challenge of the waiver. *See supra* note 258 and accompanying text.

262. *See supra* note 225. By documenting why the client does not wish counsel to pursue a particular goal or objective, counsel can reduce the risk of a later claim that that failure to pursue this goal was the result of a conflict of interest that rendered the representation incompetent. Moreover, the understanding should qualify as a competent, enforceable limitation on the scope of the representation under Model Rule 1.2(c), protecting the attorney against a malpractice claim for not pursuing such goal. *See, e.g.*, Fitzgerald v. Linnus, 765 A.2d 251, 259 (N.J. Super. Ct. App. Div. 2001).

263. For a discussion of alternate means, see *supra* text accompanying notes 241-42.

practice, however, the request is surprisingly common, and it can place counsel in a difficult position. Clients may have good reasons for wanting to proceed with a joint representation, and—after explanation by counsel—they may fully understand the risks and disadvantages of doing so. As the *Model Rules* make clear, however, the informed consent of the clients is not enough to waive the conflict of interest posed by a joint representation. Informed conflict waivers are valid only if the representation of each client will nonetheless be competent. Thus, the attorney is left with the challenge of determining whether to accede to the client's request, knowing that proceeding jointly could lead to disciplinary and malpractice consequences if a tribunal later disagrees with her competence analysis. The need for a principled standard to guide lawyers and courts in determining when and whether a joint representation is competent could hardly be greater.

And yet we have anything but clarity. Courts have not found a way to integrate the twin elements of competence and consent, and—as a result—they have not developed a viable test by which to determine when a concurrent conflict can be waived under Model Rule 1.7(b). Our traditional understanding of competence asks what a reasonable lawyer would do for the client in the representation. Reasonable lawyers, one presumes, undertake material actions for the client during the course of a representation. When clients grant their informed consent to a joint representation, however, they understand that counsel *cannot* undertake certain material actions on their behalf as a result of the conflict of interest. These are the disadvantages of joint representation—the disadvantages the client accepts by waiving the conflict. Thus, if we measure competence without understanding its relation to client consent, nearly every informed conflict waiver presents a risk of invalidation due to the material limitations on counsel's role resulting from the conflict of interest.

Without a unified understanding of competence and consent, courts have been remitted to largely intuitive accounts of whether informed consents should be disregarded under the competence standard. In *Wheat*, the Supreme Court's five-four split was grounded in fundamental disagreement over whether to uphold the defendant's conflict waiver, but neither the majority nor minority opinions articulate the basis for the differing standards they applied in evaluating the competence of the representation. The confusion extends to other major practice areas, since lawyers regularly receive requests for joint representation in civil litigation and transaction settings and courts have likewise offered no principled basis by which to analyze competence in these matters. We need to find a way to honor client consent and competence without allowing either element to overtake the other.

The search for a principle that can unify these two seemingly disparate elements begins with an understanding of the interests served by each. We allow clients to consent to a conflict to preserve their autonomy or control over the representation. Although a variety of rationales have been proffered for our commitment to competence, the best account understands competence as a safeguard to protect clients from their own faulty decision making—a form of paternalism. Paternalism takes a variety of forms, however, and most forms of paternalistic intervention are simply incompatible with client autonomy. If we strike down consents because the client has not acted in her "best interest," we supplant the client's assessment of the joint representation with our own, undermining the commitment to client autonomy that grounds the client's right of consent in the first place.

However, one type of paternalism *is* consonant with client autonomy—that which we have termed "means" paternalism. Under this approach, we defer to the client's *objectives*, long understood as the sole province of the client; we intervene when the client makes decisions about *means* that are likely to undermine those objectives, and thereby defeat her own, more fundamental commitment. In an important sense, therefore, intervention to protect the client from undermining *her own objectives* enhances rather than restricts client autonomy. Thus understood, competence and consent are animated by the same deeper goal—client autonomy. This insight allows us to fashion a standard by which to determine when concurrent clients can waive a conflict of interest under Model Rule 1.7(b). *An informed conflict waiver must be rejected as incompetent if limitations on the means or procedures by which the attorney pursues the matter caused by the conflict of interest are likely to defeat the client's objectives for the representation (the "client-objectives" or "proposed" test).*

The proposed test solves the paradox of competency and consent posed by Model Rule 1.7(b). If the purpose of a conflict waiver is the client's acceptance of material limitations on the representation resulting from the conflict, and if representations with material deficiencies are incompetent, how could *any* waiver withstand scrutiny under the competence standard? In a standard representation, where there is no conflict of interest and the client has not accepted any limitations on the lawyer's performance, *any* material deficiency in the representation can render it incompetent under Model Rule 1.1. When the client accepts limitations on the lawyer's performance as a result of a conflict, however, those accepted deficiencies cannot render the representation incompetent simply because they are material, otherwise the client's consent will be given no force or effect. Under the proposed test, a limitation resulting from a conflict could prevent the attorney from taking certain, material steps to achieve the client's goal without being

likely to defeat the client's goal. The question is not whether the limitations are material. We presume as much: if the limitations were not material, they would not have been the subject of disclosure and consent under Model Rule 1.7(b) in the first place. The question instead is whether the limitations are likely to be goal defeating. In evaluating competency, the proposed test acknowledges that the client has *accepted* the limitations in question.

The proposed test integrates Model Rule 1.7(b) with the remainder of the *Model Rules* and the deeper commitments of the legal profession that ground the *Rules*. The *Model Rules* treat objectives and means as distinct elements of the representation, and provide that objectives are, within ethical limits, uniquely the client's to shape. Moreover, the "agency" or "client autonomy" vision of lawyering remains a core commitment of the legal profession. It is the *client's* case or transaction, after all, and the client—as principal—ought to retain control (within ethical limits) over what is pursued on her behalf. When courts reject waivers on competency grounds under the proposed test, they do not superimpose their objectives for the representation on the client. When the client accepts means limitations that are *inconsistent* with the client's objective, however, we have strong reason to believe that the objective and not the means represents the true and deepest commitment of the client. Incompetence, understood through this lens, is a failure of means—limitations that are likely to prevent the attorney from undertaking the steps necessary to fulfill the client's goal. Thus, in an important sense, we *preserve* client autonomy by refusing to accept client-approved lawyering means that undermine client objectives.

By integrating competency and consent into the test of conflict waivers, the client-objectives test restores both elements to their proper role in conflict-waiver analysis under Model Rule 1.7(b). We need no longer oscillate between the poles of (i) deference to informed consent—assuming that every informed decision of the client to waive a conflict is valid regardless of its effect on the representation, and (ii) an assessment of competency uninformed by consent—rejecting client waivers that do not comport with our view of the client's best interests without acknowledging that the client has accepted at least certain, material deficiencies in the representation through her informed consent.

By identifying what the client hopes to accomplish with the representation, the proposed test provides a baseline against which to measure the significance of the limitations caused by the joint representation. Not just any limits on means—even material ones—will invalidate a client's consent. When a client consents to limitations that are likely to undermine her own objectives for the representation, the representation is incompetent—by dint of the

client's own more fundamental commitment. The proposed test accommodates both elements of Model Rule 1.7(b): competency and consent in tandem determine when and whether a client's consent to a joint representation should be upheld or disregarded.

By way of summary of Parts III and IV, we can offer something of a decision guide for practitioners and courts in applying the proposed test to determine when clients can waive a concurrent conflict of interest.[264]

I. *Objectives*

A. The attorney should engage in a confidential discussion with each proposed client (henceforth "client") to identify the objectives of each for the representation.[265]

B. While the type of representation will often provide strong presumptions about a client's objectives, an inquiry into the client's "special circumstances" may reveal a different or more particularized client objective. While lawyers can offer valuable input on what the client might hope to achieve from the representation, decisions about what to accomplish in the representation lie ultimately with the client.

C. Practitioners and courts should be solicitous of any client objective that incorporates a procedural limitation, e.g., "the client wishes to maximize her recovery in the civil litigation without suing B." Absent careful inquiry, waivers can incorrectly be rendered valid by characterizing the troublesome procedural limitation (the attorney cannot sue B) as a new objective (the client seeks only the recovery she would obtain without suing B).

1. When client objectives reflect the same limitations caused by a conflict of interest, courts must determine whether: (a) the client genuinely desires only the limited objective, thereby satisfying the competency concern; or (b) the limited objective is a contrivance to insulate the waiver from competency review.

2. The question is whether the client would have sought this limited objective if she had pursued the representation with independent counsel.

3. The attorney should document the special circumstances

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264. The following assumes that the lawyer has or plans to disclose sufficient information to gain the informed consent of the client. Our question here, as in this Article generally, is whether this consent should be honored under the competence and diligence demands of Model Rule 1.7(b)(1) and not what must be disclosed in order to obtain informed consent to the conflict Model Rule 1.7(b)(4). Nonetheless, the proposed test also implies much about the latter question: in eliciting informed consent, the attorney must identify the limitations on means caused by the conflict and explain their implications, which are the effect of the limitations on the attorney's pursuit of the client's objectives.

265. The representation of *each* client that proposes to enter into the concurrent representation must satisfy the proposed test.

that explain why the client desired a limited objective. For example, the client and B may be close personal friends and the client may not wish to sue B; or a corporation may not wish to litigate a matter to avoid negative publicity.

D. The client's objective should not be characterized in terms of the probability of achieving a certain outcome. For example, we would *not* describe A's objective as "maximizing her prospects of achieving a full and fair recovery." We focus instead on what the client wants to achieve (e.g., a full and fair recovery), and bring probability to bear in determining whether the limitations resulting from the conflict are "likely" to undermine the client's objective.

II. *Limitations*.

A. The attorney or court must next identify the material limitations on the actions the lawyer can take as a result of the conflict of interest. For example:

1. In the litigation setting, the dual representation may preclude a lawyer from raising or counseling the clients about certain claims or defenses that affect the other client, one client's testimony may adversely affect the other, or the attorney may not be able to cross-examine a co-client who provides adverse testimony.

2. In the transaction setting, the conflict may preclude a lawyer from negotiating on behalf of one client against the other, or from suggesting alternatives to one client that could disadvantage another.

3. In concurrent representations, an overriding limitation is the lawyer's inability to preserve client confidences from the co-client.

B. To identify limitations that may affect the representation, the lawyer should ask herself what services will be necessary for the client over the predicted course of the representation, and which of these services cannot be undertaken because of the conflict of interest.

III. *Likely to Defeat the Client's Objectives*

A. A material limitation on the representation caused by a conflict of interest is not enough to invalidate an informed conflict waiver. The client may determine that the advantages of proceeding jointly or with a particular attorney outweigh the loss from a material limitation. This is client's "decision space," which keeps the competence requirement from overtaking the client's right to enter into an informed conflict waiver. When it is more likely than not that the limitations resulting from the conflict will defeat the client's goal, then the waiver should not be honored. For example:

1. In *Wheat*, the attorney's inability to cross-examine a witness whose testimony is not central to the case, although a disadvantage, should not defeat the client's informed waiver.

2. If there were, say, a one-in-three chance that the failure to

name a defendant as a result of a conflict will reduce the client's objective of a full recovery in a civil litigation (assuming that the client has no special circumstances that warrant a limited goal as described above), then the client's informed decision to take on that risk warrants deference. When the risk exceeds 50%, however, the conflict has rendered the representation incompetent and must not be honored.

3. In the transaction setting, when a client will require the attorney's confidential counseling and negotiation efforts to achieve the client's objectives, a dual representation that prevents the attorney from providing these services renders the waiver unenforceable.

B. If a client proposes to undertake certain aspects of the matter on her own (e.g., a sophisticated businessperson who wishes to negotiate certain terms with the co-client without assistance from counsel), the proposed test asks whether that approach is likely to undermine the client's objective. The test does not dismiss the client's desire as irrelevant in evaluating the competence of the representation. Nor does the test presume that the client's desire to handle certain aspects of the representation automatically validates the arrangement as competent.

C. If circumstances change materially during the course of the representation, the proposed test should be reapplied to determine whether the consent remains valid on competency grounds.

D. If the attorney concludes that the circumstances allow for a conflict waiver under the proposed test, she should document the facts and analysis upon which that finding is based. The attorney should document: the client's objectives and, if the objectives differ from those for a typical representation of this kind, the special client circumstances that warrant the limited objectives; the material limitations on the representation posed by the conflict; and why those limitations are not likely to defeat the client's objective.

E. Counsel should understand the risk posed by engaging in the preliminary inquiry to determine whether a concurrent representation waiver is appropriate. If the conflict cannot be waived under the proposed test, *and* if the information learned in the private consultation with each prospective client could adversely affect either client if disclosed or withheld from the other, then the lawyer should not thereafter represent *either* prospective client in the same or related matter.

Model Rule 1.7(b) offers a challenge and an opportunity in conditioning a valid conflict waiver on both competency and consent. The challenge is to avoid allowing either element to serve as the sole measure of whether a conflict waiver is valid. The opportunity lies in forging a deeper understanding that enables us to honor *both* elements. The client-objectives test proposed in this Article reconciles

the dual demands of competency and consent, and offers a principled standard by which to determine when conflict consents should be upheld or struck down by courts on competence grounds. Given the stakes for clients and attorneys, it is time we understood why and when a conflict can be waived.

ETHICAL CONSIDERATIONS OF REPRESENTING CURRENT AND FORMER CLIENTS IN BROKER-INITIATED EXPUNGEMENT-ONLY ARBITRATIONS

Jason R. Doss

I. Introduction

The Financial Industry Regulatory Authority (FINRA) works with state securities regulators to maintain a database, i.e. Central Registration Depository ("CRD"), of information on individuals working as current and former registered representatives of FINRA member firms. Complaints by investors, for example, are included in the CRD records, which can be accessed by the public through FINRA BrokerCheck tool on FINRA's website as well as from some state securities regulators. The information on the CRD provides an important investor protection function because it allows regulators to track problem brokers and trends across the industry. The database is also important to prospective employers as well as the public, who can use the information to evaluate whether they want to begin or continue working with a financial adviser. Since its inception, a competing and countervailing view to the investor protection function is that unwarranted and otherwise invalid customer complaints harm the reputation of individuals working in the securities industry.

To protect financial advisers from false customer complaints, FINRA provides registered representatives with a process to attempt to expunge investors complaints through its arbitration forum if the arbitrator(s) make an affirmative finding that:

> (A) the claim, allegation or information is factually impossible or clearly erroneous;
> (B) the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or
> (C) the claim, allegation or information is false

In May 2009, FINRA expanded its rules to require CRD reporting of customer complaints even if the financial adviser is not named as a party to the arbitration. That change resulted in a drastic increase in the number of complaints being reported, and in turn, a drastic increase in the number of expungements being sought. Since then, advocates for and against the expungement process have debated about the best way to effectively balance the competing interests of investor protection and preservation of brokers' reputations.

FINRA's expungement arbitration process is not as controversial in instances where an investor files an arbitration claim, names their broker as a named party, and appointed arbitrators issue an award recommending expungement after they have the opportunity to examine the merits of the claim based on evidence presented by the parties. FINRA's expungement arbitration process, however, is less effective and more controversial when a broker is not a named party and the brokerage firm settles the investors' claims pre-hearing, in part, because the panel has not reviewed or ruled on the merits.

This article raises awareness about a tactic that is being used more frequently in recent years called Broker-Initiated Expungement-Only Cases. According to FINRA's 2017 *Notice to Arbitrators and Parties on Expanded Expungement Guidance*, a Broker-Initiated Expungement-Only Case is an arbitration initiated by an associated person against their own member firm solely

for the purpose of seeking expungement, without naming the customer. These arbitrations are required by FINRA to be filed after the conclusion of the underlying arbitration proceedings brought by the investor.

Broker-Initiated Expungement-Only Cases are problematic for a number of reasons. After all, stockbrokers and their firms have a financial interest in erasing customer complaints from the brokers' records and as a result, are not truly adverse to each other in Broker Initiated Expungement-Only Cases. It is not difficult to come up with many ways in which the parties could collude with each other to secure a favorable expungement award (e.g. broker-dealers fail to answer or otherwise oppose the expungement requests in Statements of Claim filed by stockbrokers; broker-dealer fails to submit an arbitrator ranking form or otherwise coordinates with stockbroker resulting in hand-picked arbitrators.)

To make matters worse, in many cases, customers are not being notified that these expungement proceedings exist until just days before the hearing, which could be months if not a year after the conclusion of the original investor arbitration. Investors who have settled their case months may not want to participate in these proceedings because they may understandably not want to relitigate their dispute. Furthermore, investors who are notified of the new expungement proceedings and wish to oppose the request often have a difficult time retaining the attorney that represented them in the original arbitration, because the original representation has concluded and investors likely will not be willing to pay that attorney to oppose the new expungement proceeding on an hourly basis.

For those attorneys who are willing to represent the investor in these expungement proceedings, most likely *pro bono*, this article examines some of the ethical considerations that should be considered when agreeing to represent an investor in a Broker-Initiated Expungement-Only Case. This article does not purport to examine all ethical rules that may be applicable or render legal opinions on these subjects. The ethical rules discussed in this paper are the ABA Model Rules, not state ethical rules. As a result, you should consult the applicable state ethical rules. The rules discussed below are meant to provide a road map for further discussions at the breakout session at the upcoming PIABA Annual Meeting.

II. PIABA Has Long Been A Critic of FINRA's Expungement Process.

PIABA has long been a critic of FINRA's expungement process, which is supposed to be an extraordinary remedy. PIABA has gone to great lengths and devoted a lot of resources to document its flaws and explain how granting expungements of valid complaints harms the investing public. For example, in 2013, past-President Scott Ilgenfritz authored a report entitled, *Expungement Study of the Public Investors Arbitration Bar Association* ("2013 Expungement Study"), which studied expungement requests by FINRA members of customer complaints in securities arbitration proceedings filed between January 1, 2007 and December 31, 2011. According to the press release describing the results of the 2013 Expungement Study:

- An "alarmingly" high percentage of arbitration cases resolved by settlement or stipulated awards where expungement relief has been granted. For the time period January 1, 2007 through mid-May 2009, expungement was granted 89 percent of cases resolved by stipulated awards or settlement.

- For the most recent time period mid-May 2009 through the end of 2001, expungement relief was granted in nearly every instance- 96.9 percent of the cases resolved by settlement or stipulated awards.

The 2013 Expungement Study used the results to recommend changes. For example, the report noted that one possible reason that arbitrators grant expungement requests so frequently is that they do not appreciate the importance of the accuracy of disclosure information in the CRD system to investor protection. As a result, the 2013 Expungement Study recommended that FINRA improve its arbitrator training. In addition, PIABA recommended that FINRA propose a rule change with respect to respondents and their counsel "bargaining for in settlement negotiations or conditioning a settlement upon an investor's agreement to not oppose expungement or an agreement to expungement." See 2013 Expungement Study at pages 2-3. In addition, PIABA recommended that FINRA should play a more active role in arbitrators' rulings on motions for expungement relief. Id. PIABA stated that FINRA needed to review and critically assess all motions for expungement relief, particularly those made in cases resolved by settlement and to critically assess settlement agreements. According to PIABA, a proposed rule change should include the requirement that the hearing on any motion for expungement relief be scheduled no sooner than 60 days after service of the motion on the customer and FINRA. Id.

Importantly, the 2013 Expungement Study did not discuss or otherwise analyze the impact of instances where brokers filed brand new arbitrations against their broker-dealer(s) seeking expungement relief of investor complaints after the conclusion of arbitrations brought by those investors. In PIABA's 2015 expungement study entitled, *Update to the 2013 Expungement Study of the Public Investors Arbitration Bar Association*, the organization conducted a follow up analysis from the 2013 Expungement Study and analyzed expungement data from January 1, 2012-December 31, 2014 and found expungement results consistent with the 2013 Expungement Study. See 2015 Expungement Study.

In its 2015 expungement study, PIABA identified a trend in a relatively new type of expungement proceeding that is the subject of this article, i.e. Broker-Initiated Expungement-Only Cases.

The 2015 Expungement Study analyzed the results of expungement relief requested in Broker Initiated Expungement Cases and found that from January 1, 2007-May 17, 2009, there were a total of 20 cases filed and expungements were granted 90% of the time. From May 18, 2009 - December 31, 2011, there were a total of 61 cases filed and expungements were granted 90.2% of the time. In 2012, there were there were a total of 76 cases and expungements were granted 92.1% of the time. In 2013 and 2014, there were a total of 138 cases filed and expungements were granted 90.6% of the time.

PIABA flagged the growing problem in the 2015 Expungement Study and stated that "the analysis of the data regarding Broker Initiated Expungement Cases clearly reflects a dramatic increase in the filing of such proceedings by brokers." See 2015 Expungement Study at 9. PIABA also stated that it performed the analysis "because PIABA members have reported what appears to be an increase in stockbrokers seeking expungement relief in separately initiated arbitration proceedings naming the customer or the broker's broker-dealer." Id. at 8.[1] The 2015

[1]In Seth Lipner's 2013 expungement study entitled *Expungement of Customer Complaint CRD Information Following The Settlement of a FINRA Arbitration*, Lipner flagged 10 instances of Broker Initiated Expungement-Only Cases and he characterized it as "a clever device that deprived the investor of notice that the investors' complaint was subject to an expungement proceeding." See Lipner Expungement Study at 92-93. Like the 2015 Expungement Study though, Lipner did not go further and analyze why brokers

Expungement Study recommended that FINRA should prohibit Broker Initiated Expungement Cases altogether. Id.

This year, in an effort to study instances of Broker-Initiated Expungement-Only Cases, and how these types of expungement proceedings may harm the integrity of the FINRA arbitrations process as a whole, PIABA and The PIABA Foundation have created a work group to start a program that would encourage attorneys to represent their former customers in these Broker-Initiated Expungement-Only Cases *pro bono*. Part of the program will include offering to pay for a court reporter to document the proceedings and if the original attorney does not wish to represent the customer in the expungement proceeding, PIABA and The PIABA Foundation will provide the names of attorneys willing to take on such representation *pro bono*.

III. Brief Description of FINRA's Guidance on How Investors and Their Representatives May Participate in Broker-Initiated Expungement-Only Cases.

According to FINRA's Notice to Arbitrators and Parties on Expanded Expungement Guidance:

> It is important to allow customers and their counsel to participate in the expungement hearing in settled cases if they wish to. Specifically, arbitrators should:
>
> 1. Allow the customer and their counsel to appear at the expungement hearing;
>
> 2. Allow the customer to testify (telephonically, in person, or other method) at the expungement hearing;
>
> 3. Allow counsel for the customer or a pro se customer to introduce documents and evidence at the hearing;
>
> 4. Allow counsel for the customer or a pro se customer to cross-examine the broker and other witnesses called by the party seeking expungement;
>
> 5. Allow counsel for the customer or pro se customer to present opening and closing arguments if the panel the panel allows any party to present such arguments.

The Notice also states that "to ensure that customers know about the expungement request, arbitrators should order the associated persons to provide a copy of their Statement of Claim to the customer(s) involved in the customer(s)' arbitration case that gave rise to the customer dispute information. […] It is particularly important to note that without this directive from the arbitrators the customer may not even be aware that an expungement claim is pending regarding their prior dispute." Importantly, FINRA's guidance does not provide a date certain by which the arbitrators must issue such an order. Anecdotally, it has been my experience that the customer is not provided notice until days before the scheduled arbitration hearing. As a result, the investor customer is faced with dilemma of whether they want to participate pro se in a daunting hearing in which they would be expected to cross examine brokers who have counsel, ask their former lawyer to represent them for free, or to ignore the notice altogether. I suspect to that the vast

were using this clever device or how the broker vs. brokerage firm expungement may be a sham dispute resolution proceeding.

majority of customers who receive the notice will choose to ignore it rather than relitigate a settled dispute. And I suspect that the way in which Broker-Initiated Expungement Only cases are designed and operate is no coincidence and that it is FINRA's preferred outcome for investors not to oppose an expungement request.

In some cases, notice of the Broker-Initiated Expungement-Only Case is provided to the attorney who represented the investor. In other instances, the customer may want to oppose the expungement request. In still other instances, the investor client may be indifferent to participating in the expungement hearing but the attorney may wish to do so to protect their own reputation out of concern that arbitrators ruling on these expungement requests may over time generate a belief that the attorney files frivolous claims. This article will examine some of the ethical rules that may apply to these situations.

IV. Ethical Rules and Considerations

A. Ethical Duties to Current and Former Clients

Attorneys who are either contacted by their former client or receive notice directly from counsel for the broker in the subsequently filed Broker-Initiated Expungement-Only Case should consider any ethical obligations owed to the client.

An initial question that an attorney faced with this situation may ask is whether the person or entity is a current or former client and look to their original contract of representation with that individual. Rule 1.16 entitled *Declining or Terminating Representation,* suggests that the attorney may be required to provide them with notice of the pending expungement proceeding even if the individual is a former client and the attorney has provided informed consent that the prior representation is terminated.

> Rule 1.16: Declining or Terminating Representation
> (d) Upon termination of representation, a lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled and refunding any advance payment of fee or expense that has not been earned or incurred. The lawyer may retain papers relating to the client to the extent permitted by other law.

Another consideration is whether the attorney formally terminated their prior representation of the client. Rule 1.2 entitled Scope of Representation & Allocation of Authority Between Client & Lawyer, suggests that the scope of the lawyer's representation may not be limited to the express terms of the contract of representation because Rule 1.2(a) states that "[a] lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation." It logically follows that a client may consider opposition to the Broker-Initiated Expungement-Only Case as part of the original representation.

> Rule 1.2: Scope of Representation & Allocation of Authority Between Client & Lawyer
> (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.

As such, it may be a best practice for an attorney to include an express provision in their fee agreement stating that their representation does not include representing the client in any future expungement proceeding.

> Rule 1.2(c) states:
> (c) A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.
> Rule 1.0(e) "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.

Once again, even if an attorney incorporates an express limitation in the fee agreement that the representation does not include representing the investor in a subsequently filed expungement proceeding by the broker, Rule 1.4 entitled Communications, may still require the attorney to notify the investor about the existence of a Broker-Initiated Expungement-Only Case because the rule requires an attorney to "inform the client of any decision or circumstance with respect to which the client's informed consent."

> Rule 1.4: Communications states in pertinent part:
>
> (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;
> (3) keep the client reasonably informed about the status of the matter;
> (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. Use of Confidential Documents from Original Arbitration to Oppose Expungement Requests

Assuming that the investor wants to oppose the expungement request in the new arbitration initiated by the broker against his or her firm, any attorney agreeing to represent them should consider the impact of any ethical or contractual limitations to use information from the prior arbitration proceeding to oppose the newly filed Broker-Initiated Expungement-Only case.

It is common that certain documents produced in the underlying arbitration were deemed confidential and their future use is governed by a confidentiality agreement. In addition, if the investors' claims were settled, it is commonplace for settlement agreements to include confidentiality provisions that may impact the investors' ability to effectively oppose the expungement request by the broker, who may not have been a party to the underlying arbitration.

> Rule 1.6: Confidentiality of Information
> (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in

order to carry out the representation or the disclosure is permitted by paragraph (b).

(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.

Attorneys that agree to represent former clients in these Broker-Initiated Expungement-Only cases should think through these issues in connection with their representation.

C. Unlicensed Practice of Law Considerations for Representing Investors In Broker-Initiated Expungement-Only Cases.

As most practitioners are aware, the location of the arbitration proceeding in investor arbitrations is determined by the state of residency of the claimant. As such, for example, if an investor was a resident of Georgia at the time of the dispute, FINRA rules require that the hearing location be located in Atlanta, Georgia. Practitioners must therefore make sure in this example that they are authorized under Georgia's Rules of Professional Responsibility to represent the investor without running afoul of unlicensed practice of law issues.

In Broker-Initiated Expungement-Only Cases, since the broker is the claimant, presumably the arbitration site will be the state in which the broker resides, not the investor, whose complaint they are seeking to expunge.

Model Rule 5.5 (c)(3) entitled Unauthorized Practice of Law; Multi-Jurisdictional Practice of Law, states that:

(c) A lawyer admitted in another United States jurisdiction, and not disbarred or suspended from practice in any jurisdiction, may provide legal services on a temporary basis in this jurisdiction that:

…

(3) are in or reasonably related to a pending or potential arbitration, mediation, or other alternative dispute resolution proceeding in this or another jurisdiction, if the services arise out of or are reasonably relate to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice and not services for which the forum requires pro hac vice admission.

The majority of states have adopted the ABA's version of Rule 5.5 above and as a result, attorneys who may be members of the bar of that particular state can still participate in the arbitration proceeding so long as they comply with Rule 5.5(c)(3), including the provision that states the attorney may provide legal services on a temporary basis in that jurisdiction if the representation is reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted.

Importantly, there are many states that have not adopted Model Rule 5.5 and the instances in which an attorney may be able to participate in an arbitration proceeding may be much more limited or prohibit such representation altogether.

Attorneys representing investors in these expungement proceedings should confirm the location of the arbitration and make sure that they are in compliance with the particular states' rules on the unlicensed practice of law and multi-jurisdictional practice of law, even if the expungement proceeding will take place telephonically.

JUDGMENT ENFORCEMENT; COLLECTION REMEDIES

Scope: This article considers collection of judgments through Writ of Execution, Garnishment and Post Judgment Receivership, as well as domestication of foreign judgments and judgment-renewal.

I. WRIT OF EXECUTION

In Texas, this writ is issued and delivered to an officer, a Sheriff, Constable or Deputy. The officer may seize and sell non-exempt property.

Advantages - A uniformed officer makes demand, getting debtor's attention. This may be debtor's only interaction with an officer.

Disadvantages - The officer is a government employee, often with dozens of writs to execute. Substantial delay is common. Understandable, law enforcement is the priority of Sheriff's and Constable's Offices. Also, Texas has broad exemption laws. A debtor's homestead, vehicles, and wages are generally exempt. Writs of Execution rarely result in satisfaction of the judgment.

II. WRIT OF GARNISHMENT

A Writ of Garnishment is a lawsuit, often against a bank. It requires filing the petition; issuance and service of citation on the bank; service of the pleadings on debtor; review of bank records and negotiation with the bank; setting hearings, if necessary. The bank is entitled to recover its attorney's fees, as an innocent stakeholder. Fees are often paid from seized funds. If sufficient funds are not trapped, judgment creditor must often pay the bank's fees. If a dispute arises as to the garnishment or the answer, creditor may be required to pay extensive fees for both its lawyer and the bank's lawyer to litigate the matter.

III. POST-JUDGMENT RECEIVERSHIP

Receivership - Receiver is ordered by the Court to collect the judgment. The Receiver is not a public servant and is motivated to promptly collect the judgment. Receiver's fees are generally paid from the funds trapped or property seized. If judgment is collected, the Receiver's fees are paid by judgment debtor. If a portion of the judgment is collected, Receiver is generally authorized to deduct fees from funds recovered, remitting the balance to Plaintiff's counsel. Only the net amount paid by Receiver is a credit against the judgment. If the full judgment is collected, the full judgment balance is remitted from the Receiver to creditor. The Receiver additionally collects from debtor, the Receiver's fee. For a complete discussion of the remedy, see Mike Bernstein, Nuts and Bolts of Turnover Receivership, State Bar of Texas, Collections and Creditors' Rights, 2019. See also, Tex. Civ. Prac. & Rem. Code §31.002.

Help your Receiver Help You:
It is critical that all debtor-information be forwarded to Receiver. This includes: contact information, business associations, bank information, accounts receivable information, customer lists, credit applications, balance sheets, income statements; also email addresses, websites, social media activity; tangible and intangible assets; pending litigation. Supplying all available

information may determine whether the judgment is collected. Judgment creditor may be the best source of information on which the Receiver bases his levies.

Custodia Legis:
Receivership should end the debtor's opportunity to improperly convey assets to family and friends. The Receivership results in debtor's property being in custodia legis. Transfers after Receivership are generally void. *Pratt v. Amrex, Inc.*, 354 S.W.3d 502 (Tex.App. - - San Antonio 2011, pet. denied). All debtor's non-exempt property and financial information should be reachable by the Receiver. The Receiver can obtain documents and information from third parties, including bank records, credit applications, and tax returns. The debtor's accountant can be directed to provide the Receiver with financial records, including tax returns. The Receiver can demand bank records, account agreements, signature cards and seize funds held by the bank. Safe deposit boxes can be opened by Receiver's locksmith in the presence of a bank representative, and the non-exempt contents seized.

IV. **OTHER MATTERS**

A. Domestication of Judgment - Enforcing the Judgment in Another State.
Texas, and all states, give full faith and credit to judgments of other states. If a California judgment needs to be enforced in Texas, an exemplified copy of the judgment is forwarded to Texas. The judgment is filed in a Texas court as a new matter. Upon filing, the California judgment becomes a Texas judgment, subject to enforcement. Citation need not be served, but the notice of filing the judgment must be provided to Defendant pursuant to Tex.Civ. Prac. & Rem. Code, Chapter 35.

B. Locating Creditor's Counsel. Judgment creditors sometimes need to retain out-of-state counsel to assist in judgment domestication and judgment collection. When seeking such counsel, consider:

American Lawyers Quarterly (ALQ)
The American Lawyers Company
853 Westpoint Parkway, Suite 710
Cleveland, OH 44145-1546
Email: alq@alqlist.com
Website: www.alqlist.com

ALQ has published its list of counsel in all states since 1899. Creditors' counsel are listed for all major cities and many towns in the United States.

C. Judgment Renewal. A Texas judgment generally has a ten-year life before going dormant. A judgment can be revived for two years after dormancy. A timely Writ of Execution renews a Texas judgment for 10 years after date of issuance. Consider discussing in closing letters, the firm's practice and fee, for renewing unpaid judgments.

RECEIVERSHIP BASICS[1]

A receivership is an equitable remedy under state or federal law in which a court-appointed fiduciary takes charge of, preserves, and manages property that is the subject of an ongoing legal dispute. A receivership is unique in that it is the only alternative to bankruptcy that does not necessarily require cooperation between the creditor and debtor. A creditor or group of creditors seeks court approval for the appointment of a receiver in either federal district court or Texas state court. In some instances, the debtor only finds out about the receivership after initial court approval. It should not be thought, however, that all receiverships are the product of litigation. In some instances, a voluntary receivership may be used to facility a sale to a sophisticated purchaser that wants some supervision of a going-concern sale process without a bankruptcy.

A receivership has several advantages that may not be available in a bankruptcy proceeding. First, a single creditor or interest holder can seek the appointment of a receiver, as compared to the three unsecured creditors generally required to commence an involuntary bankruptcy proceeding pursuant to Bankruptcy Code section 303.[2] Second, a party seeking appointment of a receiver is able to quickly insert an experienced manager into the troubled company who can promptly stabilize the company, stem losses, and stop any decline in asset value. Third, because there are fewer procedural rules and statutory regulations, there is greater flexibility within a receivership than a proceeding under the Bankruptcy Code. Finally, because receiverships are not as widely understood as bankruptcy petitions, the negative connotations arising from appointment of a receiver may not be as great as the stigma of being a bankruptcy debtor.[3]

A drawback of receivership is that the appointment of a receiver may require the petitioning plaintiff to establish cause, in one form or another, to displace existing management. Court's uniformly state that appointment of a receiver is not an action to be taken lightly and any petition seeking such an appointment will be carefully scrutinized.[4] Additionally, a receiver selling assets will not have the same advantages as a trustee under Chapter 7 or Section 363 of the Code.

The next section of this article will cover the specifics of receivership under both state and federal law. The discussion will provide practitioners with the basic knowledge necessary to use a receivership as an alternative to a bankruptcy filing, and give practitioners a practical knowledge of the powers and workings of a receivership.

III. RECEIVERSHIPS UNDER TEXAS AND FEDERAL LAW

A. History and Equitable Powers of a Receiver

Modern receiverships can trace their roots to English law where receiverships were established to manage property that an owner was incapable of maintaining in the era of Queen Elizabeth I.[5] In England, receiverships were an equitable remedy and were administered by the courts of equity. Those same principals applied when receiverships came to the new world.

In the United States, courts of equity can trace their roots back to the U.S. Const. Art. III, § 2, where the judicial power of the federal government was established for all cases "at law and in equity."[6] A court of equity, established under the Constitution, has the power to fashion remedies and appoint persons that allow the court to perform of its judicial functions. Justice Brandeis summed up these powers when he stated:

> Courts have (at least in the absence of legislation to the contrary) inherent power to provide themselves with appropriate instruments required for the performance of their duties …. This power includes authority to appoint persons unconnected with the court to aid judges in the performance of specific judicial duties, as they may arise in the progress of a cause.[7]

From these powers and their state analog, courts appoint receivers. A court appointment of a receiver is an equitable procedure wherein a court believes that a party to an action is not in a position to comply, or refuses to comply with the court's procedure or orders. A receiver is generally tasked with preserving and maintaining assets, so that waste does not occur and the value of an asset in dispute can be preserved pending final adjudication.[8]

Federal courts in the 19th Century utilized equity receiverships from the common law of the Chancery Courts of England, the remedy that became the historical antecedent to modern chapter 11 bankruptcy.[9] The courts devised the model of equity receiverships as a way to reorganize insolvent railroads by adjusting the rights of all creditors under one unified proceeding, thus denying the robber-baron tycoons their opportunity for further inflating their already vast wealth.[10]

Texas law originally followed the federal common law model. As the Texas Supreme Court noted in a case dealing with the appointment of receivers:

> We have no statute regulating the subject of receivers. Though the authority of the courts to appoint them has been long recognized, yet the record in this case shows that the practice in making such appointments ... is unsettled and loose.[11]

The first Texas receivership statute was enacted shortly thereafter in 1879 and elaborated in its present form in 1887.[12] Despite the presence of statutory authority, Texas receivership law continues to develop to this day.

B. Federal and Texas Authority

1. Federal Authority

In federal courts, Fed. R. Civ. P. 66 authorizes the appointment of receivers by federal court judges with the somewhat backhanded language: "The practice in the administration of estates by receivers . . . appointed by the court shall be in accordance with the practice heretofore followed in the courts of the United States or as provided in rules promulgated by the district courts."

In federal court the appointment of a receiver is ancillary relief requiring a pending federal court action asserting other substantive claims. The underlying action is usually a collections action filed by a lender but can take other forms.[13] As with any other federal action, jurisdiction is the first hurdle. Because creditors' rights claims are not typically based upon a federal question, diversity of citizenship and the minimum amount in controversy under 28 U.S.C. §1332 must exist in order to invoke federal court jurisdiction.[14] Ancillary jurisdiction arises after initial jurisdiction is satisfied by the suit. This ancillary jurisdiction allows the federal court to appoint a receiver and ancillary subject matter jurisdiction provides a means to oversee actions commenced by the receiver in the carrying out of the receiver's duties.[15] The minimum contacts analysis of *International Shoe Co. v. Washington*, 326 U.S. 310 (1945), is inapplicable to ancillary actions and proceedings brought by a federal receiver to execute his duties in districts other than the district in which he was appointed.[16] Section 1692 allows nationwide service of process in a federal receivership proceeding, and the territorial jurisdiction of the appointing court extends to any judicial district in which receivership property is located.[17] While a federal receivership action requires that a creditor meet certain requirements, it has the distinct advantage of allowing a creditor to pursue a debtor's assets in multiple jurisdictions with one filing.

Along with individual creditors, several federal agencies commonly seek the appointment of a receiver to help meet their goals. The U.S. Securities & Exchange Commission, the Federal Trade Commission, the Commodities Futures Trading Board, and the Federal Deposit Insurance Corporation have all utilized receivers to aide in federal enforcement actions.

28 U.S.C. § 959 dictates a receivers rights powers and duties when appointed by a federal court.

> (a) Trustees, receivers or managers of any property, including debtors in possession, may be sued, without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property. Such actions shall be subject to the general equity power of such court so far as the same may be necessary to the ends of justice, but this shall not deprive a litigant of his right to trial by jury.
>
> (b) Except as provided in section 1166 of title 11, a trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

Despite their federal mandate, a receiver management of the estate is controlled by state law in the state where the property is located.

2. Texas Receivership Authority

In Texas, a court may appoint a receiver in actions where the statutory requirements have been met or when the common law principals of equity provide for the appointment of a receiver.[18]

The Texas receivership statute for property is found in the Texas Civil Practice and Remedies Code Chapter 64.[19] Texas Civil Practice & Rem. Code § 64.001(a)(1) to (4) provides for the imposition of a receiver when seeking to impose an interest on property. Subject to control by the court, a receiver may take charge and keep possession of the property at issue, may receive rents, may collect and compromise demands, may make transfers, and may perform other acts with regard to the property as authorized by the court.[20]

The Texas receivership statute for a domestic entity or for that domestic entities property can be found at Tex. Bus. Orgs. Code Ann. (TBOC), § 11.401 *et seq*. Once appointed by the court under the TBOC, the receiver has the powers and duties provided by the TBOC and by other laws applicable to receivers, and may sue and be sued in the receiver's name in any court. In addition, the receiver has the powers and duties stated in the order appointing the receiver or that the appointing court considers appropriate to accomplish the objectives for which the receiver is appointed. The court may increase or diminish those powers at any time during the proceedings.[21]

C. Appointment Requirements

Before a receiver is appointed by the court, he must meet certain criteria and perform specific tasks, such as posting a bond. The specific requirements that a receiver must meet can vary depending on whether he is appointed by a Texas court or a federal court.

Texas law sets forth clear prerequisites for a receiver. If the receiver is appointed under the TBOC, the receiver must meet four statutory requirements. First, the person must be a citizen of the United States or if the receiver is an entity be authorized to act as a receiver pursuant TBOC § 11.406(a)(1). Second, the receiver must post a bond in an amount set by the court with sureties recognized by the court where the receivership action is being filed.[22] Third, the person must have authority to sue or be sued in his or its own name.[23] Finally, the person or entity must be able to exercise the powers and duties provided by law relating to the receivers and specified by the court.[24] If appointed under Texas Civil Practice & Rem. Code, the receiver must meet all of the above requirements and be a qualified voter of Texas, not be interested in the action, and maintain actual residence in Texas during the receivership.[25]

Because federal receivership law is not statutory, the requirements are not spelled out. Generally, federal courts like their state counterparts require the receiver to be capable of discharging his duties and for the receiver to post a bond.

D. Basis for Appointment

Many different situations present an opportunity for the appointment of a receiver. However, the underlying principal that must guide a practitioner's decision to pursue a receivership is that "appointment of a receiver is an extraordinary remedy and is granted only in cases of clear necessity to protect a plaintiff's interest in property.[26]

In a federal court proceeding, the determination whether to appoint a receiver is made under federal law.[27] Further, the party seeking receivership must have a legal or equitable substantive right in the property he wishes to seize, which substantive right must amount to more

than a mere claim. A district court, therefore, will not appoint a receiver at the insistence of a simple contract creditor.[28] As the 5th Circuit has noted, receivers have been appointed in a number of contexts:

> Secured creditors, lienholders and mortgages may seek appointment of a receiver because they clearly have an interest in the property in which they have a security interest that may provide a basis for convincing the court to appoint a receiver ending a foreclosure suit or any other action to enforce one or more outstanding liens. Additionally, a receivership is a remedy for taking possession of a judgment debtor's property. A receivership also can be utilized when a judgment creditor seeks to set aside allegedly fraudulent conveyances by the judgment debtor, or who has had execution issued and returned unsatisfied or who otherwise is attempting to have the debtor's property preserved from dissipation until his claim can be satisfied.[29]

Factors that courts have considered relevant to establishing the requisite need for a receivership include the following: fraudulent conduct on the part of defendant; the imminent danger of the property being lost, concealed, injured, diminished in value, or squandered; the inadequacy of the available legal remedies; the probability that harm to plaintiff by denial of the appointment would be greater than the injury to the parties opposing appointment; and, in more general terms, plaintiff's probable success in the action and the possibility of irreparable injury to his interests in the property.[30]

Texas law sets forth a statutory list of instances where the appointment of a receiver is appropriate. When a Texas court has jurisdiction over specific property it may appoint a receiver pursuant to the TBOC in an action: (1) by a vendor to vacate a fraudulent purchase of the property; (2) by a creditor to subject the property or fund to the creditor's claim; (3) between partners or others jointly owning or interested in the property or fund; (4) by a mortgagee of the property for the foreclosure of the mortgage and sale of the property; and (5) in which receivers for specific property have been previously appointed by courts of equity. Likewise, when a court has jurisdiction pursuant to the Texas Civil Practice & Rem. Code it may appoint a receiver: (1) in an action by a vendor to vacate a fraudulent purchase of property; (2) in an action by a creditor to subject any property or fund to his claim; (3) in an action between partners or others jointly owning or interested in any property or fund; (4) in an action by a mortgagee for the foreclosure of the mortgage and sale of the mortgaged property; (5) for a corporation that is insolvent, is in imminent danger of insolvency, has been dissolved, or has forfeited its corporate rights; or (6) in any other case in which a receiver may be appointed under the rules of equity.[31]

The final provision is a wild card. Tex. Civ. Prac. & Rem. Code Ann. § 64.001(a)(6) allows a practitioner to seek appointment of a receiver in almost any instance where a court of equity previously appointed a receiver, provided that appointment is equitable and necessary to protect the moving parties interest. This could encompass hundreds of unique factual situations.

It should also be noted that Texas law prevents appointment of a receiver "for a corporation, partnership, or individual on the petition of the same corporation, partnership, or

individual."[32] Basically, a principal is prevented from seeking the appointment of a receiver for his own corporation or partnership. However, this provision does not prevent the appointment of a receiver for a partnership in action arising between partners or on the petition of one or more stockholders.[33]

Similar to the list of federal government entities who move for receiver appointments, many state agencies and officials also seek such appointments. This list includes the State Securities Board, the Department of Banking, Department of Insurance, Public Utility Commission, and TCEQ. These agencies use receivership as a means to control assets without using public authorities to do so.

E. Mechanics of Receivership

1. Moving for Appointment

To obtain the appointment of a receiver the creditor begins by filing an action in the appropriate federal or Texas court. Because the appointment of a receiver is an ancillary proceeding in both federal and Texas court, a receivership is generally not permissible if the applicant fails to assert a cause of action that is independent of the request for receivership.[34] For example, a creditor must also file a collection action, foreclosure action, or a complaint alleging conversion or unjust enrichment, etc., in order to be able to also file a petition to appoint a receiver.

Once the underlying cause of action is on file, the party seeking the appointment of a receiver can move for an appointment. In its receivership motion a party should establish several factors. At a minimum the party must show 1) appropriate jurisdiction and venue; 2) a probable right or interest in the property sought to be placed in receivership; 3) facts and circumstances, not mere opinions and conclusions, that would justify the appointment of a receiver.[35] Texas law also requires both the party applying for a receivership and the receiver to separately file bonds with the clerk of the court payable to defendant in an amount fixed by the court.[36] A moving party ordinarily states its ability to provide a bond in its motion.

2. Notice and Ex Parte Motions

The party seeking appointment of a receiver has certain notice obligations. Generally, the party seeking appointment will want to notify all interested parties, or any party that could be adversely affected by the appointment.[37] If a movant fails to notify all interested parties, the court may require additional notice before proceeding with appointment, or a hearing on the appointment of a receiver. Where the receivership involves property and the adverse party's whereabouts are unknown, the notice may be affixed to the property.[38]

In certain exceptional cases *ex parte* appointment is possible. However, the movant must show that there is "urgent and imperious necessity," and that the movant's property rights cannot be protect by other less drastic remedies.[39] The ex parte appointment of a receiver is not permitted for a receivership for fixed and immovable property because Rule 695 of the Texas Rules of Civil Procedure prohibits the appointment of a receiver for such property unless the court conducts a hearing, and the adverse party is given at least three days notice of the

hearing.[40]

3. Receiver's Oath and Bond

After a receiver is appointed but before he can begin his duties, the receiver must take an oath and post a bond.[41] In the oath, the receiver affirms his commitment to faithfully discharge his duties in accordance with the court's order. The receiver's bond is conditioned upon the faithful discharge of his duties as a receiver and his obedience to the orders of the court.[42]

4. The Receivership Order

The receivership order is the court's guidance to a receiver and will dictate the scope of the receiver's powers. Under Section 64.031 of the Texas Civil Practice and Remedies Code, a receiver may, subject to the control of the court, (1) take charge and keep possession of the property; (2) receive rents; (3) collect and compromise demands; (4) make transfers; and (5) perform other acts concerning the property as authorized by the court. The TBCO, like § 64.033 of the Texas Civil Practice & Rem. Code, grants the receiver the power to sue without seeking the permission of the appointing court. The TBCO further grants the receiver broad authority by providing that the receiver shall have: (1) the powers and duties provided by other laws applicable to receivers, (2) the powers and duties that are stated in the order appointing the receiver, or that the appointing court considers appropriate to accomplish the objectives for which the receiver was appointed.[43] The statutes give the court great flexibility in fashioning its order to protect the property or interest at issue in the case. The documents giving rise to a movant's interest may also set limits on a receiver's power. Generally, movants will want to ask the court to provide the receiver with broad powers. This allows the receiver to function efficiently without returning to the court for additional authority.

The purpose of the receivership order includes but is not limited to the following: 1) to confer authority upon the Receiver to take control over, protect, and temporarily ensure the status quo of the subject property; 2) to confer authority upon the Receiver as an officer of the court; 3) to direct the Receiver to file with the court an Oath and Acceptance of Receiver; 4) to set the amount of the Receiver's bond or to exempt Receiver from posting bond, if appropriate; 5) to specifically set forth duties, powers, and responsibilities of the Receiver; 6) to describe the nature of the property over which the Receiver has authority; 7) to direct the defendant – or those in possession of the property of the defendant – to deliver property to the Receiver; 8) to restrain or enjoin the defendant or others from interfering with the Receiver or the subject property; 9) to authorize the Receiver to employ counsel, accountants, agents, servants, or employees to assist the Receiver to carry out the terms of the Receivership orders of the court; 10) to permit the Receiver to rent facilities and equipment; to set procedures and deadlines for filing, allowing, and paying claims; 11) to direct the Receiver to file periodic reports with the court and establish the frequency and content of the reports; in some instances, to set the range of compensation for the Receiver; and 12) to establish single forum for filing suits against receivership estate, where appropriate.[44]

5. Receiver's Power

The extent of the receiver's powers is controlled by the receivership order. It is the receiver's duty to take charge and possession of the property of which he has been appointed receiver and hold it subject to order of the court. The appointing court has jurisdiction and authority to order surrender of property held by the defendant or any other person who is a party to the suit. Property in the possession of a receiver is in in the custody of the law. Any attempt to disturb the receiver's possession of the receivership property is punishable by contempt.[45]

Receivers should take careful note of their powers. Also, along with this, the receiver may be required to engage security services to monitor assets, maintain proper insurance, and pay for ongoing expenses and maintenance costs.

6. Reports

The receivership order generally mandates periodic reports from a receiver. These reports serve as the receiver's communication with the court during the period he is in control of the estate. Depending on specific factual circumstances, the court can require reports on a regular basis or at specific milestones. Reports should be accompanied by an accounting. The receiver's accounting should be of such particularity and detail as will give the interested parties sufficient information to enable them to determine whether to consent or object to the report. The receiver's periodic reports should also, in narrative form, describe the status of the receivership, matters of litigation, problems to be resolved, and whatever else the receiver believes may be important to the court and/or those parties claiming an interest in the property under the receivership estate.[46] Any interested party may file an objection to the receiver's reports. Although a receiver is not required to prove every item of his or her account, once a report is opposed, the receiver should file supporting vouchers, evidence, and/or affidavits to support each major item.[47]

Upon termination of the receivership, the receiver will be required to make a final report that will need to be approved by the court. The return of the receiver's bond is usually dependent on submittal and approval of the final report.[48] Also, upon approval, the receiver is discharged from his duties to the estate and the court.

7. Term of the Receivership

The term of a receivership can be broken down into three periods for purposes of understanding a receiver's activities: 1) the first 48 hours; 2) the first 30 days; 3) day 31 through discharge. A receiver's responsibilities in these three periods vary drastically.

During the first 48 hours, the receiver is primarily concerned with meeting his court mandated requirements and obtaining some control of the property. Upon appointment, the receiver should be prepared to execute his oath and pay his bond. These items, while perfunctory, are mandated by statute and will be part of the receivership order. A receiver cannot proceed with his duties until they have been completed.

The receiver is then tasked with gaining control of the property or business. This can be a difficult period, and the receiver will often need to determine what level of cooperation he will

receive from the opposing party. During this period the receiver will want to gain access to the property or business and do an initial inventory. Receivers way also want to take photographs and question third parties about activity on the property.

During the next 30 days that receiver will want to gain full control of the property or business, determine what resources he needs to preserve the property, complete a full inventory and/or accounting, and take any actions necessary to preserve and protect the property or business. Typically, a court will require a report within 30 days of appointment. Ahead of issuing this 30 day report, the receiver will want to ensure he has a firm understanding of the state of the property or business and be able to articulate what needs to happen to preserve the property or business going forward.

After the initial report is filed with the court, the receiver should be able to move towards a management role. Instead of crisis control, the receiver should be shifting his focus to efficient management of the business or property to ensure that the value is preserved or maximized. Generally, it is during this period that the receiver can exercise powers provided by the court. For instance, if the receiver is charged with liquidating the property or distributing assets to creditors, the receiver would undertake this effort in earnest at this point of the receivership. The receiver will also continue to submit his periodic reports to the court, continue his accounting, and use proceeds from the estate to pay his fees if so authorized. This period culminates when the receiver has completed his court appointed duties or an intervening process such as bankruptcy, foreclosure, or injunction terminates the receiver's duties. Regardless of how the receivership ends, the receiver is responsible for a final report and accounting.

8. Bankruptcy and Foreclosure

More often than not, receiverships are a prelude to either bankruptcy or foreclosure. Creditors pursue a receivership to get a property or a business's assets out of the hands of bad management. In some instances, this results in the business's management pursuing bankruptcy to regain control of the entity. In other instances, creditors may place a business in a receivership to evaluate whether bankruptcy is appropriate or to ensure waste does not occur while foreclosure proceedings are pending. Regardless of which scenario plays out, an understanding of the interplay between a receivership and bankruptcy or foreclosure is important.

Article 7.04(A)(2) of the TBCO authorizes appointment of a receiver to oversee foreclosure of property when the prerequisites covered above are met. The mortgaged property must also be in danger of being lost, removed, or materially injured, the condition of the mortgage has not been performed, and the property is probably insufficient to discharge the mortgage debt.[49] While this remedy may not be preferred by Texas courts, it is a viable alternative when property in in danger of waste by a borrower.

Alternatively, if, after the appointment of a receiver, a bankruptcy petition is filed by or against the debtor whose property is the subject of the receivership, the receiver is a "custodian" under the Bankruptcy Code, and must turn over the receivership property to the bankruptcy trustee. In most cases the bankruptcy trustee is the debtor's former management exercising control of the business as a debtor in possession.[50] In some instances, Section 543(d) of the

Bankruptcy Code may allow the receiver to continue to manage and possess the property, notwithstanding subsequent bankruptcy, if the interests of creditors would be better served by permitting a custodian to stay in possession.[51]

IV. CONCLUSION

Bankruptcy is the most widely used and familiar forum for addressing creditor-debtor issues. The benefits of the bankruptcy system are well known and include its predictability, its well-established rules and precedent, and the statutory protections it provides to both creditors and debtors. Additionally, most practitioners enjoy a level of comfort practicing in that system and maybe hesitant to explore other ways of dealing with a distressed business. On the other hand, bankruptcy filings are often expensive, highly exposed, and complicated judicial proceedings that can leave both debtors and creditors unhappy with the final outcome. This article looked at other options that are available and the advantages and disadvantages of those options. Finally, the article took a deeper look at the workings of receiverships.

Other means do exist. Practitioners need to be familiar with alternatives to bankruptcy so that they can properly counsel their clients about the options. One of the most widely used and effective non-bankruptcy alternative is a receivership. Receiverships are unique in that they can be initiated by a creditor and provide a creditor with near instantaneous protection for its collateral. Receiverships can also be complicated. The intent of the article was to give practitioners a better understanding of receiverships and other bankruptcy alternatives.

[1] This paper has been adapted from a prior presentation co-authored with Keith Miles Aurzada, Bryan Cave, LLP.
[2] Andrew C. Kassner & Howard A. Cohen, *Anything but Bankruptcy!: ABCs, Receiverships and Other Alternatives*, 080405 ABI-CLE 239 (2005).
[3] *Id*.
[4] *Id.*
[5] RALPH E. CLARK, A TREATISE ON THE LAW AND PRACTICE OF RECEIVERSHIPS, at 4 (1918).
[6] MATTHEW W. KAVANAUGH & RANDYE B. SOREF, BUSINESS WORKOUTS MANUAL § 34:4 (2015).
[7] *In re Peterson*, 253 U.S. 300, (1920).
[8] Clark, *supra* note 26.
[9] *Id.*
[10] *Id.*
[11] *Weems v. Lathrop*, 42 Tex. 207, 213 (1875).
[12] Lee A. Chagra & Charles W. Wolfram, *Liens and Equity Rules in A Creditor's Application for A Receiver in Texas*, 40 Tex. L. Rev. 649 (1962).
[13] Kassner & Cohen, *supra* note 23.
[14] *See Inland Empire Insurance Company v. Freed*, 239 F.2d 289, 290 (10th Cir. 1956).
[15] Kassner & Cohen, *supra* note 23.
[16] 28 U.S.C. § 1692.
[17] *Id.*
[18] JONATHAN P. FRIEDLAND, STRATEGIC ALTERNATIVES FOR AND AGAINST DISTRESSED BUSINESSES§ 70:2 (2016).
[19] JONATHAN P. FRIEDLAND, STRATEGIC ALTERNATIVES FOR AND AGAINST DISTRESSED BUSINESSES§ 70:1 (2016).
[20] *Id.*
[21] Texas Jurisprudence Pleading and Practice Forms, 9B Tex. Jur. Pl & Pr. Forms § 188:16 (2d ed. 2016)

(*citing* Tex. Bus. Orgs. Code Ann. § 11401).
[22] TEX. BUS. ORGS. CODE ANN. § 11.406(a)(2).
[23] TEX. BUS. ORGS. CODE ANN. § 11.406(a)(3).
[24] TEX. BUS. ORGS. CODE ANN. § 11.406(a)(4).
[25] TEX. CIV. PRAC. & REM. CODE ANN. § 64.021.
[26] *Commodity Futures Trading Comm'n v. Comvest Trading Corp*., 481 F. Supp. 438, 440, 441 (D. Mass. 1979).
[27] *Waag v. Hamm*, 10 F. Supp. 2d 1191, 1193 (D. Colo. 1998).
[28] 12 CHARLES ALAN WRIGHT ET AL., FEDERAL PRACTICE AND PROCEDURE § 2983 (2d ed. 2016).
[29] *Netsphere, Inc. v. Baron*, 703 F.3d 296, 306 (5th Cir. 2012).
[30] Wright, *supra* note 49.
[31] TEX. CIV. PRAC. & REM. CODE ANN. § 64.001(a)(1-6).
[32] TEX. CIV. PRAC. & REM. CODE ANN. § 64.002(a).
[33] TEX. CIV. PRAC. & REM. CODE ANN. § 64.002(b)--(c).
[34] *Pelton v. First Nat'l Bank of Angleton*, 400 S.W.2d 398, 401–02 (Tex. Civ. App. 1966); *Continental Trust Co. v. Brown*, 179 S.W. 939, 944 (Tex. Civ. App. 1915); *but see Sims v. Stegall*, 197 S.W.2d 514, 515 (Tex. Civ. App. 1946) (stating that receiverships brought pursuant to statutory authority, as opposed to receiverships brought under the rules of equity, are not required to be ancillary to an independent cause of action).
[35] JOEL W. REESE, 15 TEX. PRAC., TEXAS FORECLOSURE LAW & PRAC. § 12.16 (2015).
[36] *See Fite v. Emtel, Inc.*, No. 01-07-00273, 2008 WL 4427676, at *27 (Tex. App. 2008) (*citing Ahmad v. Ahmed*, 199 S.W.3d 573, 575 (Tex. App. 2006).); TEX. R. CIV. P. 695a; TEX. CIV. PRAC. & REM. CODE ANN. § 64.023 (Vernon 2008).
[37] *See, e.g., Best Inv. Co. v. Whirley*, 536 S.W.2d 578, 581 (Tex. Civ. App. 1976).
[38] TEX. R. CIV. P. 695.
[39] *Associated Bankers Credit Co. v. Meis*, 456 S.W.2d 744, 750 (Tex. Civ. App. 1970).
[40] JOEL W. REESE, 15 TEX. PRAC., TEXAS FORECLOSURE LAW & PRAC. § 12.18 (2015).
[41] TEX. CIV. PRAC. & REM. CODE ANN. §§ 64.022 to 64.023 (Vernon 1997); TEX. BUS. ORG. CODE ANN. § 11.406 (Vernon 2009).
[42] TEX. CIV. PRAC. & REM. CODE ANN. § 64.023 (Vernon 1997).
[43] TEX. BUS. ORG. CODE ANN. § 11.406 (Vernon 2009). The business Organizations Code further provides that the powers and duties "may increase or diminish at any time during the proceedings." *Id*.
[44] WAYNE KLEIN, LEWIS B. FREEMAN & ANNETTE W. JARVIS, RECEIVERSHIP MANUAL FOR THE UTAH JUDICIARY, Section VI (December 9, 2008).
[45] ROBIN RUSSELL & JAMES W. PAULSEN, TEXAS PRACTICE GUIDE § 6:422 (2015).
[46] James M. McGee & Ross H. Parker, Basic Receivership Law/Concepts, Section O. available at http://www.munsch.com/content/newsroom/documents/basic_receivership_law_concepts_article_presentation_pdf.pdf.
[47] *Id.*
[48] ROBIN RUSSELL & JAMES W. PAULSEN, 1 TEXAS PRACTICE GUIDE § 6:449 (2015).
[49] JOEL W. REESE, 15 TEX. PRAC., TEXAS FORECLOSURE LAW & PRAC. § 2.109 (2015).
[50] ROBIN RUSSELL & JAMES W. PAULSEN, 1 TEXAS PRACTICE GUIDE § 6:423 (2015).
[51] 11 U.S.C.A. § 543(d).

Filed in The District Court
of Travis County, Texas

LM AUG 13 2013

At 9:04A M.
Amalia Rodriguez-Mendoza, Clerk

NO. D-1-GV-13-000763

STATE OF TEXAS, Plaintiff, v. HOUSE SAVINGS INVESTMENT, LLC, AA HOUSE SAVING FINANCIAL, INC., d/b/a HOUSE SAVINGS FINANCIAL, and LUIS MARIACA, individually and as the sole director and owner of HOUSE SAVINGS INVESTMENT, LLC AND AA HOUSE SAVING FINANCIAL, INC. d/b/a HOUSE SAVINGS FINANCIAL, Defendants, and CAPITAL ONE BANK, AMEGY BANK and RODRIGO MUNOZ, Relief Defendants.	§ § § § § § § § § § § § § § § §	IN THE DISTRICT COURT TRAVIS COUNTY, TEXAS 353rd JUDICIAL DISTRICT

AGREED PERMANENT INJUNCTION
AND ORDER APPOINTING PERMANENT RECEIVER

On this day, the Court heard the Plaintiff's Original Verified Petition and Application for Temporary Restraining Order, Injunctive Relief, and Appointment of Receiver (the "Petition") filed by the State of Texas at the request of Charles Cooper, the Commissioner of Banking (the "Commissioner"). The Petition asks this Court to issue a Permanent Injunction against all named Defendants – House Savings Investment, LLC ("HSI"), AA House Saving Financial, Inc., d/b/a House Savings Financial ("HSF") and Luis Mariaca, individually and as owner and sole director of Defendant HSI and Defendant HSF – including any current or former officers, agents, employees, attorneys or other persons in active concert or participation with them who receive actual notice of this Order by personal service or otherwise, and to appoint Gregory S. Milligan of Harney Management Partners, LLC, as Permanent Receiver for Defendant HSI and Defendant HSF. The State of Texas appeared by and through its Attorney General, Greg Abbott, on behalf

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of the Texas Commissioner of Banking, Charles Cooper. Defendants appeared through Ojay M. Grace of the Grace Law Firm.

I. STIPULATIONS

Having considered the Petition, the Court makes the following findings:

1. The Court has jurisdiction over the parties and causes of action asserted in the Petition.

2. The law and facts are as the State of Texas has alleged and the State of Texas is entitled to a Permanent Restraining Order and Order Appointing Permanent Receiver.

3. Defendants HSI and HSF are currently operating from offices located in Houston, Texas at 6223 Richmond Avenue, Suite 300, Houston, TX 77057-6263. Defendant HSI operates at the internet address: hsmoney.com. Defendant HSF operates at the internet address: housesavingsfinancial.com.

4. This Agreed Permanent Injunction and Order Appointing Permanent Receiver complies with all statutory, jurisdictional, and procedural requisites for entry and enforcement.

5. All parties agree to the terms of this order, request the Court to approve it, and waive the right to appeal its validity. This order is entered into by the Defendants in order to avoid the costs and uncertainties of litigation.

6. The State of Texas does not waive its right to take future action against the Defendants to enforce the laws and regulations of the State of Texas or the United States.

7. The Parties agree to waive Texas Rules of Civil Procedure 63 and 683 through 689.

II. PERMANENT INJUNCTION

It is THEREFORE ORDERED, ADJUDGED, and DECREED that the Clerk of this Court shall issue a Permanent Injunction against the persons and entities named below, with the following force and effect.

TO: House Savings Investments, LLC, its current and former directors; stockholders, affiliates or subsidiaries, managers, employees, contractors, members, trustees, associates, representatives, servants, agents, third party administrators, adjusters, accountants, bookkeepers, attorneys and with, or on behalf of, any persons or entities described above;

AA House Saving Financial, Inc., d/b/a House Savings Financial, its current and former directors, stockholders, affiliates or subsidiaries, managers, employees, contractors, members, trustees, associates, representatives, servants, agents, third-party administrators, adjustors,

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accountants, bookkeepers, attorneys and with, or on behalf of, any persons or entities described above; and

Luis Mariaca, Individually and as Director and Manager of Defendant HSI and sole director of Defendant HSF, and any person or persons acting in concert or participation with him:

YOU ARE EACH hereby RESTRAINED and ENJOINED from:

1. Transacting the money services business or any other business of Defendants HSF and HSI, or exercising any direction, control, or influence over the business of Defendants HSI or HSF, except through the authority of the Permanent Receiver or its designees;

2. Doing anything, directly or indirectly, to prevent the Permanent Receiver or its designees from investigating, gaining access to, examining, or acquiring any and all books, records, Property (as defined herein), or other materials concerning Defendants HSI or HSF, under whatever name they may be found;

3. Disposing of, converting, dissipating, using, releasing, transferring, withdrawing, allowing to be withdrawn, selling, assigning, canceling, hypothecating, offsetting, or concealing, in any manner, any property belonging to, payable to, claimed by, in the possession, custody, or control, or held for the benefit of Defendant HSF or Defendant HSI, their affiliates, or any of their officers, directors, shareholders, representatives, employees, or agents, or any other person or entity, whether such property is real, personal, or mixed, of whatever nature and wherever located, including, but not limited to, the computer hardware and software (including computer programs, data bases, disks and all other media); websites; licenses, trademarks, patents, and all other intellectual property; assets, causes of action; accounts receivable; promissory notes; tax attributes; vehicles; money; financial accounts; trust assets and accounts; depository accounts; investment accounts; brokerage accounts; customer funds and/or accounts; retainers; refunds, deposits; contract rights; share accounts; stocks; bonds; securities; security instruments; funds; notes; deposits; letters of credit; safe deposit boxes; accounts maintained, held or managed for the benefit of the customers or clients of Defendants HSI and HSF; furniture; fixtures; equipment; books; records or documents, or other assets of Defendant HSI or Defendant HSF, whether real or personal, tangible, intangible, or mixed; wherever situated, belonging to, owned by, in the possession of or claimed by Defendant HSF or Defendant HSI or the Receiver, or any items into which such property has been transferred, deposited or placed, whether legally or beneficially owned or held individually, jointly or severally for Defendant HSF or Defendant HSI, regardless of the names in which such items are held (collectively "Property" or "the Property");

4. Disposing of, converting, dissipating, using, releasing, transferring, withdrawing, allowing to be withdrawn, selling, assigning, canceling, hypothecating, offsetting, or concealing, in any manner, any Property belonging to, payable to, claimed by, or held for the benefit of any of the customers of Defendant HSF or Defendant HSI; causes of action that the Permanent Receiver could assert, including, but not limited to, any claims or

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causes of action for accounts receivable, or debts;

5. Releasing, transferring, selling, assigning or asserting ownership of, in any manner, any claims or causes of action belonging to or asserted by Defendant HSI or Defendant HSF;

6. Removing from this Court's jurisdiction, or from the place of business of Defendant HSI or Defendant HSF, any office equipment, furniture, fixtures, books, records or other property, of any kind or nature, whether real or personal, including, but not limited to, those items that have been acquired, purchased or paid for by Defendant HSI or Defendant HSF, except through the authority of the Permanent Receiver or his designees;

7. Interfering with these proceedings or with the lawful acts of the Permanent Receiver of his representatives, or his designees; and

8. Making any claim, charge, or offset, commencing or prosecuting any action, appeal, or arbitration, including administrative proceedings, obtaining any preference, judgment, attachment, garnishment, or other lien, or making any levy on behalf of or against Defendants HSF or HSI or any Property belonging to either Defendant HSI or Defendant HSF, or both of them, or against the Permanent Receiver.

9. Communicating, in person, via telephone, e-mail or otherwise, directly or indirectly, themselves or through agents, with any customers or clients of Defendant HSI or Defendant HSF, without the prior express written consent of the Permanent Receiver.

YOU ARE EACH FURTHER SPECIFICALLY ORDERED, if you have not already done so, to make available and disclose to the Permanent Receiver, his representatives or his designees the nature, amount, and location of any and all property of Defendant HSI and Defendant HSF, including any of the property listed above, and to immediately surrender all such property to the Permanent Receiver or his designees.

YOU ARE EACH FURTHER SPECIFICALLY ORDERED to cooperate as reasonably necessary with the Permanent Receiver, his representatives, and his designees in the Receiver's administration of the receivership estate with such cooperation including, without limitation, providing information pertaining to HSI and HSF, assisting the Receiver in understanding and reconciling HSI and HSF's financial information and customer accounts, and providing instruction and information regarding the operation of HSI and HSF's computer system. Such requests for cooperation from the Permanent Receiver must be reasonable in regard to the time commitments and other constraints that any such requests impose on the parties.

III. ORDER APPOINTING PERMANENT RECEIVER

It is FURTHER ORDERED, ADJUDGED, and DECREED by this Court that Gregory S. Milligan of Harney Management Partners, LLC, a duly qualified person, is authorized to serve as Permanent Receiver for Defendant HSI and Defendant HSF and the affairs and Property of these Defendants.

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The primary obligations of the Receiver, which will guide him in using his discretion, continue to be and are:

1. To locate and preserve all Property of Defendant HSF and Defendant HSI;

2. To notify customers and clients of these proceedings after it has identified customers and clients;

3. To discover who has sent money to Defendants, in what amounts, when, and under what terms;

4. To cancel customer contracts;

5. To effect fair restitution from the Property, according to a plan to be approved by the Court after the Receiver has conducted a diligent investigation into the identity of customers and clients, the amounts each customer or client paid to Defendants, any amounts already paid by Defendants to or on behalf of customers and clients, and the circumstances under which their dealings with Defendants arose;

6. Other than for payments made in the ordinary course of business of Defendant HSI and Defendant HSF, to refrain from making any payments to customers, clients or creditors until an order approving such payments has been entered by this Court, PROVIDED HOWEVER, that the Receiver is authorized to continue processing mortgage payments on behalf of all customers of Defendants HSF and HSI in accordance with all current contractual obligations.

7. To assist the Department of Banking, the Attorney General and/or other law enforcement related entities in their investigation of Defendants' violations of the Texas Finance Code and other laws to the extent not inconsistent with the other terms of this order and/or the best interests of the receivership estate and the depositors; and

8. To keep receivership expenses as low as possible consistent with an accurate and efficient administration of the receivership estate.

Gregory S. Milligan of Harney Management Partners, LLC, is thus HEREBY APPOINTED Permanent Receiver of all Property of Defendant HSI and its affairs, and Defendant HSF and its affairs. He is DIRECTED AND EMPOWERED as Receiver to exercise the following powers in his sole discretion, in pursuit of the obligations set out above:

1. To take possession and full legal control of all Property of whatever nature and wherever located (within or without the State of Texas), specifically including BUT NOT LIMITED TO the following accounts and assets:

   (a) Capital One Bank, with corporate headquarters located in McLean, Virginia, accounts relating to Defendant HSF or Defendant HSI, including but not limited to the following account numbers:

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(a) Account No. _____828 (HSF customer account);
(b) Account No. _____836 (HSF expense account);
(c) Account No. _____469 (HSF program cost account);
(d) Account No. _____883 (HSF savings account);
(e) Account No. _____378 (HSI checking);
(f) Account No. _____440 (HSI expense account); and
(g) Account No. _____450 (HSI investment account).

(b) Amegy Bank N.A., located in Houston, Texas, accounts relating to Defendant HSI or Defendant HSF, including Account Number _____366 (certificate of deposit account).

2. To take possession and full legal control of all books, records, computers, computer disks and materials relating to Defendants HSI and HSF and all other Property of Defendants HSI and HSF which appear to the Receiver, including computers, computer passwords and access codes, financial and other records, books of accounts, checks, accounts receivable, passbooks, account numbers, and access codes for the accounts of deposit of Defendants HSI and HSF described in paragraph 1 above, wherever and by whomever these records or accounts may be held;

3. To hold exclusively and exercise full legal control over all evidentiary privileges of Defendants HSI and HSF, including any and all attorney-client privileges, work-product privileges and all other privileges recognized under Texas law.

4. To enter, occupy and take full legal control, including authority to change the locks, of any portion of the premises located at 6223 Richmond Avenue, Suite 300, Houston, TX 77057, that are or were occupied by Defendants HSI or HSF; to terminate any lease if it determines it is in the best interest of the receivership estate; and to remove any Property, including records, whether written or stored in computers, and including said computers, from the premises located at 6223 Richmond Avenue, Suite 300, Houston, TX 77057;

5. To conduct, manage, and take charge of all business affairs of, and on behalf of Defendants HSI and HSF with the goal of winding down the business, such authority to include the power and ability to continue collecting mortgage payments and associated fees from current customers of Defendants HSI and HSF, in accordance with applicable contractual agreements;

6. To receive, collect and open all mail directed to Defendants HSI or HSF or delivered to any address or post office box used by Defendants HSI or HSF, and to direct the post office and commercial delivery services to forward all such mail and deliveries to the Receiver's office;

7. To close accounts, transfer funds to any bank or brokerage firm that it may deem appropriate in his sole discretion, sign checks or other instruments withdrawing, depositing or transferring funds with respect to any account listed in paragraph 1 of this Order or otherwise identified by the Receiver as Property;

GRAYS COUNTY DISTRICT COURT STATE OF TEXAS

8. To sell, transfer, redeem, or otherwise negotiate any certificate, contract, instrument or security held by or in the name of Defendant HSI or HSF, to specifically include the certificate of deposit referenced in Section 1(b) above;

9. To dismiss employees, contractors, consultants, attorneys, agents or assistants of Defendants HSI or HSF or to change the terms of employment or engagement with any of them;

10. To take control and ownership of the Property belonging to Defendant HSI or HSF, including any Property located offshore;

11. To file any lawsuits the Receiver deems necessary to carry out his duties under this Order;

11. To prosecute, or defend any suit or suits by or against Defendant HSI or Defendant HSF which may be deemed necessary, in the sole discretion of the Receiver, to further the obligations of the Receiver as set out above, but not to serve as an arbiter of claims by creditors of Defendants, or other claimants who are not customers as determined in the sole discretion of the Receiver;

12. To dispose of, for the benefit of customers, clients, and creditors, the Property;

13. To open accounts and transfer money from one bank, brokerage firm, or other financial institution to another, or one account to another, as necessary in the Receiver's sole discretion, and under terms the Receiver considers appropriate, for orderly administration and restitution;

14. To enter into contracts as necessary for the orderly administration of the receivership estate and to pay reasonable and necessary expenses incurred in connection with the foregoing duties out of the funds of the receivership estate;

15. The Receiver is authorized to send and publish (including on the website of Defendants HSI or HSF) letters, notices and requests for information to Defendant HSI or Defendant HSF's customers, clients, depositors, creditors and other parties interested in the affairs of Defendant HSI or Defendant HSF; provided, the process for the filing of claims against Defendant HSI and/or Defendant HSF shall be established by further order of the Court;

16. The Receiver is authorized to employ such professionals, firms, attorneys, accountants and other assistants as he may deem necessary or proper to the administration, receivership and liquidation of Defendants HSI and HSF and to compensate such persons and firms from the Property. All such fees and expenses, including all amounts due the Receiver, shall be accorded priority to the maximum extent provided by applicable law;

17. To delegate to agents the authority to exercise any of the powers conferred on the Receiver by this Order;

TRAVIS COUNTY DISTRICT COURT TEXAS

18. The Receiver shall file monthly reports, including, but not limited to, financial reports with the Court as may be directed by order of the Court;

19. The Receiver may seek future orders from the Court regarding the standing, powers, and obligations of the Receiver, operations of Defendant HSI and Defendant HSF and administration of the Property as may be deemed necessary to conserve the assets of Defendants HSI and HSF, secure the best interests of creditors of Defendant HSI and Defendant HSF, and protect the interests of the Receiver;

20. The Receiver is authorized to use the Property to pay debts and expenses of Defendant HSI and Defendant HSF that have arisen and that are, in the sole discretion of the Receiver, essential or necessary to maintain the ongoing business of Defendant HSI and/or Defendant HSF; and

21. To exercise all equitable powers under the statutes and common law of this State authorizing the appointment of a Receiver.

It is further ORDERED that neither the Receiver, the Commissioner, the Texas Attorney General, nor their respective employees, designees, attorneys or agents shall have or incur any liability or responsibility for the prior actions or omissions of Defendant HSI or Defendant HSF; further, the Receiver (including its employees, designee, attorneys or agents) shall not be liable for any act or omission taken in connection with its duties, powers, and obligations as Receiver of Defendant HSI and Defendant HSF, unless it is shown that the Receiver (or its employees, designee, attorneys or agents) were grossly negligent; and further, the Receiver (including its employees, designees, attorneys or agents) shall not be liable for any act or omission taken in connection with its duties, powers, and obligations as Receiver for any act done or omitted in good faith.

It is further ORDERED that in operating Defendant HSI and Defendant HSF and administering the trust accounts of Defendants HSI and HSF, the Receiver may rely in good faith upon the established business procedures of Defendants HSI and HSF, information provided and statements made by Defendants HSI and HSF and their employees, information provided by the Commissioner, the Office of the Texas Attorney General, and their representatives, and the records located in the files of Defendant HSI or Defendant HSF or provided by third persons.

It is further ORDERED that the title to all assets belonging to or held by Defendant HSI or Defendant HSF, including, but not limited to, the Property, as defined herein, in this Agreed Permanent Injunction and Order Appointing Permanent Receiver, is vested in the Permanent Receiver.

It is further ORDERED that the Permanent Receiver shall be paid for his services from the Property and that the Receiver shall charge his reasonable and customary rate of $275.00 per hour, plus reasonable expenses, including, but not limited to, reasonable and necessary attorneys' fees, costs and expenses. The Receiver shall file a periodic application for reimbursement of his fees and expenses with the Court and serve it on all parties of record. If no party of record files an objection to Receiver's application with the Court within ten days of the filing of the

DISTRICT COURT OF TRAVIS COUNTY TEXAS

application, then the Receiver shall pay himself the application from the Property. If any party of record files an objection to any portion of the application within ten days, the Receiver shall not pay himself that portion of the application until the objection is resolved as between the Receiver and the objecting party or the Court rules on the objection. Such fees may be considered nunc pro tunc to July 15, 2013 when the Receiver first met with the Commissioner and Office of the Texas Attorney General. Between that date and the date of the initial order appointing the Receiver as Temporary Receiver, the Receiver expended the necessary time to prepare for this assignment and plan for the execution of the ordered duties immediately upon his appointment, which efforts inured to the benefit of the receivership estate and its beneficiaries.

It is further ORDERED, that this Court has exclusive jurisdiction over all claims and causes of action against Defendants arising from or related to the operation of Defendant HSI or Defendant HSF and over all matters involving the Receiver and the Receivership estate.

It is further ORDERED that the State of Texas and the Attorney General of Texas shall have a claim for reasonable attorneys' fees and court costs against the receivership estate, pursuant to TEX. CIV. PRAC. & REM. CODE ANN. §§ 64.051 and 66.003 and TEX. GOV'T CODE § 402.006.

It is further ORDERED that the Texas Department of Banking shall have a claim for ancillary relief, including a claim for civil penalties and costs against the Defendants pursuant to TEX. FIN. CODE, § 151.701.

It is further ORDERED that all future pleadings, notices, and requests made by any party in interest, account holder, creditor, or Defendant HSI or Defendant HSF to the Court shall be filed in this cause and contemporaneously with filing be served upon the Permanent Receiver (Gregory S. Milligan, Harney Management Partners, LLC, P. O. Box 90099, Austin, Texas 78709-0099, phone: (512) 892-0803, gmilligan@harneypartners.com), the Receiver's counsel (Lynn Butler, Husch Blackwell, LLP, 111 Congress Avenue, Suite 1400, Austin, Texas 78701, phone: (512) 479-9758; lynn.butler@huschblackwell.com) and the undersigned State's counsel.

IV. GENERAL PROVISIONS

1. This order may be executed in multiple parts, which together shall constitute a single original instrument. Any executed signature page to this order may be transmitted by electronic transmission to the other parties, which shall constitute an original signature for all purposes.

2. Each of the undersigned representatives of the parties to this order certifies that he or she is fully authorized to enter into the terms and conditions of the order and to legally execute and bind that party to this order.

No bond being required by the State of Texas, this *Agreed Permanent Injunction and Order Appointing Permanent Receiver* shall issue and become effective immediately.

All relief not expressly granted herein is hereby denied and this judgment constitutes a final judgment. All costs are taxed against the party incurring the same, for which no execution

DISTRICT COURT OF TRAVIS COUNTY TEXAS

shall issue, said costs having been paid.

SIGNED at Austin, Travis County, Texas this the 13 day of Aug., 2013, at 9 o'clock A .m.

DISTRICT JUDGE PRESIDING

AGREED AS TO SUBSTANCE AND FORM:

Joshua R. Godbey
Assistant Attorney General
State Bar No. 24049996
H. Melissa Mather
Assistant Attorney General
State Bar No. 24010216
Financial Litigation, Tax, and Charitable Trusts Div.
300 W. 15th Street, 6th Floor
Austin, Texas 78701
Attorneys for Plaintiff

Ojay M. Grace
Grace Law Firm, P.C.
State Bar No. 08245980
3778 S. Gessner Rd.
Houston, Texas 77063
Attorney for Defendants

Lynn H. Butler
Husch Blackwell

COUNTY OF TRAVIS DISTRICT COURT TEXAS

State Bar No. 03527350
111 Congress Avenue, Suite 1400
Austin, Texas 78701
Attorney for Receiver

DISTRICT COURT OF TRAVIS COUNTY TEXAS

shall issue, said costs having been paid.

SIGNED at Austin, Travis County, Texas this the ___ day of _____,

2013, at _____ o'clock ____.m.

_____
DISTRICT JUDGE PRESIDING

AGREED AS TO SUBSTANCE AND FORM:

_____
Joshua R. Godbey
Assistant Attorney General
State Bar No. 24049996
H. Melissa Mather
Assistant Attorney General
State Bar No. 24010216
Financial Litigation, Tax, and Charitable Trusts Div.
300 W. 15th Street, 6th Floor
Austin, Texas 78701
Attorneys for Plaintiff

_____
Ojay M. Grace
Grace Law Firm, P.C.
State Bar No. 08245980
3778 S. Gessner Rd.
Houston, Texas 77063
Attorney for Defendants

_____
Lynn H. Butler
Husch Blackwell

DISTRICT COURT OF TRAVIS COUNTY TEXAS

State Bar No. 03527350
111 Congress Avenue, Suite 1400
Austin, Texas 78701
Attorney for Receiver

I, AMALIA RODRIGUEZ-MENDOZA, District Clerk, Travis County, Texas, do hereby certify that this is a true and correct copy as same appears of record in my office. Witness my hand and seal of office on Aug. 13 2013

AMALIA RODRIGUEZ-MENDOZA
DISTRICT CLERK
By Deputy:

Filed in The District Court
of Travis County, Texas
ER MAY 20 2011
At 1:47 PM
Amalia Rodriguez-Mendoza, Clerk

CAUSE NO. D-1-GV-11-000006

STATE OF TEXAS,	§	IN THE 353rd
	§	
Plaintiff,	§	
	§	
v.	§	
	§	
WARR INVESTMENT GROUP, LLC, WARR INTERNATIONAL GROUP, LLC, JAMES ELTON "JIM" WARR,	§	
	§	
Defendants,	§	
	§	
AND	§	
	§	
ELTON JAMES, LLC 1501 AND 1505 MAIN STREET, ORANGE, TEXAS 77630 TRUST, 1205 LINK AVENUE, ORANGE, TEXAS 77630 TRUST, 4218 5TH STREET, ABILENE, TEXAS 79605 TRUST, 1006 E. TIMBERVIEW LANE, ARLINGTON, TEXAS 76014 TRUST, 980 VIVIAN STREET, BRIDGE CITY, TEXAS 77611 TRUST, 592 N. LYDIA STREET, STEPHENVILLE, TEXAS 76401 TRUST, 3725 YELLOWSTONE STREET, IRVING, TEXAS 75235 TRUST, 608 W. 8TH STREET, DALLAS, TEXAS 75208 TRUST, 4854 LOMA LOOP, SIERRA VISTA, ARIZONA 85635 TRUST, 16 JAY CIRCLE, CABOT, ARKANSAS 72023 TRUST, AND TFSBJW, LLC, d/b/a TEXAS FINANCIAL SOLUTIONS	§	DISTRICT COURT OF
	§	
Relief Defendants	§	TRAVIS COUNTY, TEXAS

AGREED PERMANENT INJUNCTION ORDER AGAINST DEFENDANTS WARR INVESTMENT GROUP, LLC, WARR INTERNATIONAL GROUP, LLC, AND JAMES ELTON "JIM" WARR, AND ORDER APPOINTING PERMANENT RECEIVER, AND FINAL JUDGMENT

On this day came to be considered *Plaintiff's Agreed Permanent Injunction Order Against Defendants Warr Investment Group, LLC, Warr International Group, LLC,*

DISTRICT COURT OF TRAVIS COUNTY TEXAS

James Elton "Jim" Warr, and Order Appointing Permanent Receiver, and Final Judgment, filed by the State of Texas ("State"), at the request of the Securities Commissioner of Texas, Benette L. Zivley, (the "Commissioner"). The Petition asked the Court to issue a Permanent Injunction against **Defendants Warr Investment Group, LLC, (referred to herein as "Warr Investment"), Warr International Group, LLC ("Warr International"), and James Elton "Jim" Warr ("Warr") (collectively "Defendants"),** their officers, directors, principals, partners, joint venturers, successors, shareholders, managers, employees, agents, representatives, attorneys, family members and any other party in active concert with or participating with them who receives actual notice of the order by personal service, facsimile transmission, or otherwise.

The Petition also asked the Court to issue a Permanent Injunction against 1501 and 1505 Main Street, Orange, Texas 77630 Trust, 1205 Link Avenue, Orange, Texas 77630 Trust, 4218 5TH Street, Abilene, Texas 79605 Trust, 1006 E. Timberview Lane, Arlington, Texas 76014 Trust, 980 Vivian Street, Bridge City, Texas 77611 Trust, 592 N. Lydia Street, Stephenville, Texas 76401 Trust, 3725 Yellowstone Street, Irving, Texas 75235 Trust, 608 W. 8TH Street, Dallas, Texas 75208 Trust, 4854 Loma Loop, Sierra Vista, Arizona 85635 Trust, and 16 Jay Circle, Cabot, Arkansas 72023 Trust (the "Relief Defendant Trusts"), Elton James, LLC, and TFSBJW, LLC d/b/a Texas Financial Solutions (collectively the "Relief Defendants") solely in their capacity as Relief Defendants.

The Petition further requested the Court maintain the appointment of Gregory S. Milligan, of Harney Management Partners, LLC, as Receiver for Defendants Warr Investment and Warr International.

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The Court issued its *Temporary Restraining Order and Order Appointing Temporary Receiver* on January 7, 2011 ("TRO"), which is still in full force and effect.

The Court issued an *Agreed Temporary Injunction Order Against Defendants Warr Investment Group, LLC, Warr International Group, LLC, and James Elton "Jim" Warr, and Relief Defendants, and Order Appointing Receiver* ("TI"), on January 21, 2011, which is still in full force and effect.

Plaintiff the State of Texas appeared by and through Joshua R. Godbey, Assistant Attorney General. Defendants Warr Investment and Warr International, each in receivership, appeared by and through C. Daniel Roberts of C. DANIEL ROBERTS & ASSOCIATES, P.C., who represents the Receiver, Gregory S. Milligan. Defendant Warr appeared by and through Mark Schwartz of MARK SCHWARTZ & ASSOCIATES, LLP.

The parties to this agreed order (as evidenced by their signatures below) agree that this order shall take effect and remain in effect, subject however to further Orders of this Court.

The Court finds that the Court has jurisdiction over the parties and the subject matter herein. The Court finds this *Agreed Permanent Injunction Order Against Defendants Warr Investment Group, LLC, Warr International Group, LLC, and James Elton "Jim" Warr, and Order Appointing Permanent Receiver, and Final Judgment* ("Agreed Order") to be proper, necessary, and in the best interest of justice.

I. Stipulations

The parties stipulate to the following:

1.1 The Court has jurisdiction over the Defendants and the subject matter of this action.

DISTRICT COURT OF TRAVIS COUNTY TEXAS

1.2 The State of Texas is duly authorized to bring this cause of action pursuant to state law.

1.3 The parties hereto waive the entry of Findings of Fact and Conclusions of Law under Rule 296 of the Texas Rules of Civil Procedure with respect to the entry of this Agreed Order.

1.4 This Agreed Order complies with all of the statutory, jurisdictional and procedural requisites for entry and enforcement.

1.5 Defendants hereby waive Texas Rules of Civil Procedure 63, and 683 through 689.

1.6 Defendant Warr hereby agrees to the continuation of the Appointment of Gregory S. Milligan as the Permanent Receiver of Defendants Warr Investment and Warr International pursuant to the Court's order dated January 6, 2011; and further permanently waives any motion or any other action to set the Receiver's appointment aside.

1.7 Defendant Warr hereby waives any right, title or interest in the accounts, money, and other assets the Receiver has seized in this case as well as any other property belonging to the receivership estate and agrees that the proceeds thereof may be distributed to investors as authorized by further orders of the Court.

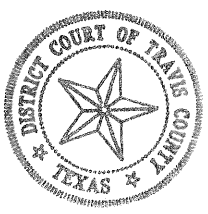
1.8 All parties agree to the terms of this Agreed Order, request the Court to approve it, and waive the right to appeal its validity.

1.9 The State of Texas does not waive its right to demand additional enforcement of the laws and regulations of the State of Texas or the United States.

1.10 Nothing in this Agreed Order shall be construed, in any manner, as limiting the Texas State Securities Board or any licensing authority from reviewing and taking appropriate action with respect to any registration application filed directly or indirectly by the Defendants, or relating to any notice filed with the Texas State Securities Board.

It appearing that no further notice of hearing for the entry of this Agreed Order need be given; the Court being fully advised in the premises, and no just reason for delay appearing:

II. Permanent Injunction Order



IT IS THEREFORE ORDERED, ADJUDGED, AND DECREED that the Clerk of this Court shall issue a Permanent Injunction against the persons and entities named below, with the following force and effect:

TO: Defendants Warr Investment, Warr International, Warr, their officers, directors, princpals, partners, joint venturers, successors, shareholders, managers, employees, agents, representatives, attorneys, family members and any other party in active concert with or participating with them who receive actual notice of the Court's order by personal service, facsimile transmission, or otherwise, are hereby COMMANDED and ORDERED as follows:

YOU ARE EACH hereby **RESTRAINED** and **ENJOINED** from:

2.1 **Dissipation of assets**. Disposing of, transferring, selling, assigning, negotiating, expending, encumbering, partitioning, canceling, concealing, secreting, disguising, hypothecating or removing money, assets, notes, equipment, fixtures, receivables, expectancies, funds or other property or objects of value, whether real, personal, or mixed and whether tangible or intangible, wherever situated, belonging to, owned by, in the possession of, acquired by, or claimed by Defendants, their affiliated companies, or their officers, directors, principals, partners, and attorneys, and others acting in concert with or in behalf of said entities where such property results from or is derived from the business or operations of Defendants;

2.2 **Destruction or removal of books and records**. Disposing of, transferring, selling, assigning, canceling, concealing, destroying, hiding, moving, secreting, disguising, or hypothecating the books, records, ledgers, journals, invoices, contracts, notes, leases, investor lists, investor files, investor subscription agreements, tax forms or advice, receipts, computer files, electronic information of any kind, materials, or any other documents or tangible items relating in any way to Defendants and their affiliated companies, or relating in any manner whatsoever to the services or contracts relating to the business or operations of the Defendants, which are now or which may come within or under the possession, custody, or control of the Defendants, their affiliated companies, and their agents, servants, officers, directors, principals, partners, joint venturers, successors, shareholders, employees, salesmen, representatives, attorneys, or any other entity acting in concert with or on behalf of Defendants;

2.3 **Selling securities**. Promoting, issuing, selling, offering for sale, negotiating for sale, advertising, soliciting, dealing in or distributing any securities, including investment contracts, in any way and by any manner or means, either directly or indirectly through agents, servants, officers,

DISTRICT COURT OF TRAVIS COUNTY TEXAS

directors, shareholders, employees, representatives, or any other entity acting for them or on their behalf without complying with the securities registration requirements found in the Texas Securities Act;

2.4 **Acting as an agent, dealer, or salesman**. Promoting, issuing, selling, offering for sale, negotiating for sale, advertising, soliciting, holding seminars, dealing in or distributing any securities, including investment contracts, to investors in any way and by any manner or means, either directly or indirectly through agents, servants, officers, directors, shareholders, employees, representatives, or any other entity acting for them or on their behalf, without complying with all dealer and salesman registration requirements of the Texas Securities Act;

2.5 **Engaging in fraud**. Engaging in any fraud or fraudulent practice in connection with the offer for sale or sale of securities, in violation of the Texas Securities Act or other laws of Texas, including any misrepresentation of relevant fact or omission of material facts;

2.6 **Interfering with investigation**. Obstructing, hampering, seeking to delay, or interfering in any manner with any investigation of Defendants' sale of securities, including notes, evidences of indebtedness, investment contracts, conducted pursuant to the lawful authority of the Texas State Securities Board, the Office of the Attorney General, the Receiver, or any other law enforcement or governmental authority;

2.7 **Making any claims**. Making any claim, charge, or offset, commencing or prosecuting any action, appeal, or arbitration, including administrative proceedings, obtaining any preference, judgment, attachment, garnishment, or other lien, or making any levy against Defendants Warr Investment and Warr International or their assets, or against the Receiver or the State;

2.8 **Interfering with operation of trusts**. Interfering in any manner with or taking any action as trustee over any trust related in any way to Defendants Warr Investment and Warr International, or related in any way to any securities issued, offered or sold by Defendants, without the express written consent of the Receiver; and

2.9 **Interfering with the Receiver or the Receivership Estate**. Interfering with, obstructing, or hampering the Receiver appointed under this Order, including accessing or using any web site, telephone, voice mail, or electronic mail account owned or used by Defendants Warr Investment and Warr International.

YOU ARE EACH FURTHER SPECIFICALLY ORDERED, TO THE EXTENT YOU HAVE NOT DONE SO IN COMPLIANCE WITH THE TEMPORARY

DISTRICT COURT OF TRAVIS COUNTY TEXAS

INJUNCTION ORDER AND ORDER APPOINTING RECEIVER, AND TO THE EXTENT ANY OF THE FOLLOWING ITEMS ARE WITHIN YOUR CUSTODY, CARE OR CONTROL, YOU AND EACH OF YOU ARE ORDERED TO PERFORM THE FOLLOWING ACTS:

2.10 Immediately place in the possession of the Receiver appointed herein, Gregory S. Milligan, or one or more of his designated agents for the purpose of this turnover, all of the books, records, documents and other records, whether written, graphic, photographed, magnetically recorded, electronically recorded, generated by computer, or stored in a computer or other device, including said computer or other device, pertaining to Defendants Warr Investment and Warr International;

2.11 Immediately place in the possession of the Receiver appointed herein, Gregory S. Milligan, or one or more of his designated agents for the purpose of this turnover, all cash, checks, money orders, notes receivables, or the like, of or pertaining to Defendants Warr Investment and Warr International;

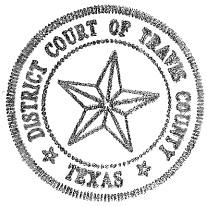
2.11 Immediately place in the possession of the Receiver appointed herein, Gregory S. Milligan, or one of more of her designated agents for the purpose of this turnover, all assets derived from the operation of Defendants Warr Investment and Warr International except for assets in the possession of third parties, of which you are to immediately report the exact location and name of the custodian of the assets to the Receiver or his designated agents;

2.12 Repatriate to an account under the sole control of the Receiver any of the property held either by any Defendant or his agents, for any Defendant's benefit, or held under any Defendant's direct or indirect control, individually or jointly, and immediately notify the Receiver of the institution and account in which any repatriated funds are located;

2.13 Provide to the Receiver a list of all investors in investment programs offered and sold by Defendants Warr Investment and Warr International, including addresses and phone numbers;

2.14 Upon request of the Receiver or his designated agents, provide the Receiver with a full accounting of all of the property held either by Defendants; for Defendants' benefit; or under Defendants' direct or indirect control, individually or jointly;

2.15 Prevent any transfer, disposition, or dissipation whatsoever of any of the property controlled by the Defendants, either directly or indirectly;



2.16 Provide the Receiver or his designated agents access to Defendants Warr Investment's and Warr International's records and documents held by financial institutions wherever located;

2.17 Immediately upon entry of this Agreed Order, provide to the Receiver a list of all vehicles purchased by the Defendants beginning November 1, 2009 through the date of this Agreed Order, including the make, model, year, Vehicle Identification Number, state of registration, owner named on the title to the vehicle, and the name and address of the insurance carrier on each vehicle; and

2.18 Immediately upon entry of this Agreed Order, provide to the Receiver a list of all mortgage notes or interests in mortgage notes or other forms of indebtedness owned by the Defendants Warr, Warr Investment and Warr International or any person or entity under the ownership or control of Defendants Warr, Warr Investment and Warr International.

III. Order Appointing Permanent Receiver

IT IS FURTHER ORDERED, ADJUDGED, AND DECREED by this Court that Gregory S. Milligan, a duly qualified person, appointed as Receiver pursuant to the TRO shall be appointed the Permanent Receiver for the company, assets, monies, securities, claims in action, and properties, real and personal, tangible and intangible, of whatever kind and description, wherever situated (within or without the State of Texas) of Defendants Warr Investment and Warr International, and for assets, monies, securities, claims in action, and properties, real and personal, tangible and intangible, of whatever kind and description, wherever situated, of Defendant Warr as appears to the Receiver to contain or be derived from proceeds of Defendants' sale of securities or used in furtherance thereof (collectively, the "Receivership Assets").

The primary obligations of the receiver, which will guide him in using his discretion, are:

3.1 To collect, preserve and maintain the Receivership Assets;

DISTRICT COURT OF TRAVIS COUNTY TEXAS

3.2. To notify investor-victims of these proceedings;

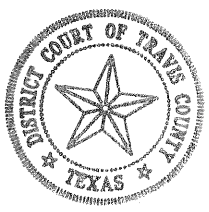
3.3 To discover who has sent money to Defendants, in what amounts, when, and under what terms;

3.4 To effect fair restitution if possible, from assets under control of the Receiver, according to a plan to be approved by the Court after a diligent investigation has been made into the identity of investor-victims, the amounts they paid to Defendants, any amounts already paid by Defendants to the investor-victims, and the circumstances under which their dealings with Defendants arose;

3.5 To assist the State Securities Board, the Attorney General, and/or law enforcement entities in their investigation of Defendants' violations of the Securities Act to the extent not inconsistent with the other terms of this order; and

3.6 To keep receivership expenses as low as possible consistent with an accurate and efficient administration of the receivership estate.

Gregory S. Milligan shall be APPOINTED Permanent Receiver of the records, property, assets, and affairs of Defendants Warr Investment and Warr International and for all money, property, and assets of Defendants Warr Investment and Warr International and Warr, as appears to the Receiver to contain or be derived from proceeds of Defendants' sale of securities or used in furtherance thereof. Except for an act of willful malfeasance or gross negligence, the Receiver shall not be liable for any loss or damage incurred by the Receivership Estate, or any of Defendants, the Defendants' clients, investors or associates, or their subsidiaries or affiliates, their officers, directors, agents, managers and employees, or by any of Defendants' creditors or equity holders because of any act performed or not performed by him or his agents or assigns in connection with the discharge of his duties and responsibilities hereunder.



IT IS FURTHER ORDERED, ADJUDGED, AND DECREED Gregory S. Milligan is DIRECTED AND EMPOWERED as Permanent Receiver to exercise the following powers in his sole discretion, in pursuit of the obligations set out above:

3.7 To take possession of and control, to the extent another law enforcement entity has not done so by court order, over all property, records, and assets of whatever nature and wherever located (within and without the State of Texas) as appears to the Receiver, in his sole discretion, to be derived from Defendants' fraudulent operations or used in furtherance thereof, whether directly or indirectly; belonging to, claimed by, or controlled by Defendants, including, but not limited to monies deposited by or on behalf of Defendants, in any capacity, including "trustee," with any bank, savings and loan, credit union, securities dealer, clearing agent, or other depository; and interest in real estate owned or controlled by Defendants in any capacity; any stock owned by Defendants and the voting and other rights attaching thereto; any accounts receivable owed to Defendants, and any interest or other return earned upon any of the foregoing, specifically including BUT NOT LIMITED TO the accounts and assets maintained at Chase Bank USA, N.A., IronStone Bank, BBVA/Compass Bank, and University Federal Credit Union;

3.8 To take possession of, full legal title to, and sole ownership and control of any and all rights, powers, and interests in, pursuant to, or in connection with any trust, beneficial interest, insurance policy, contract, assignment, or related instrument owned or held by Defendants Warr Investment and Warr International;

3.9 To take possession and full legal control of all books, records, computers, computer disks and materials relating to Defendants' fraudulent operations and all money, property and assets of Defendants which appear to the Receiver in his sole discretion to contain or be derived from proceeds of Defendants' sale of securities or used in furtherance thereof, including computers, financial and other records, books of accounts, checks, accounts receivable, passbooks, account numbers, and access codes for the accounts of Defendants described in paragraph 3.7 above, wherever and by whomever these records or accounts may be held;

3.10 To enter, occupy and take full legal control of the premises where Defendants' fraudulent business operations occur, including but not

DISTRICT COURT OF TRAVIS COUNTY TEXAS

limited to 11149 Research Blvd, Suite 320, Austin, Texas 78759, including changing locks and security codes; terminating any lease if he determines it is in the best interest of the receivership estate; and removing assets, property, materials and records, whether written or stored in computers, and including said computers, from the premises located at 11149 Research Blvd, Suite 320, Austin, Texas 78759;

3.11 To conduct, manage, and take charge of all business affairs of, and on behalf of Defendants Warr Investment and Warr International, including making such ordinary and necessary payments, distributions, and disbursements as he deems advisable or proper for the marshaling, maintenance, or preservation of the Receivership Assets;

3.12 To receive, collect, and open all mail directed to or delivered to any address or post office box used by Defendants, including but not limited to, 11149 Research Blvd, Suite 320, Austin, Texas 78759, and to direct the post office and commercial delivery services to forward all such mail and deliveries to the Receiver's office;

3.13 To sign checks or other instruments withdrawing, depositing or transferring funds with respect to any account listed in paragraph 3.7 under this subsection of this order or otherwise identified by the Receiver as property of the receivership estate;

3.14 To negotiate, transfer, or redeem any certificate, contract, instrument or security held by or in the name of Defendants;

3.15 To dismiss employees, contractors, consultants, attorneys, agents or assistants of Defendants Warr Investment and Warr International, or to change the terms of employment or engagement with any of them, or to hire employees, contractors, consultants, accountants, attorneys, legal assistants, or other assistants under terms to be determined by the Receiver, whose services, in the sole discretion of the Receiver, are necessary for an efficient and accurate administration of the receivership estate;

3.16 To recover by taking full legal control and ownership of assets or property acquired with funds derived from or obtained through Defendants' investment scheme, whether directly or indirectly, including any assets located offshore;

DISTRICT COURT OF TRAVIS COUNTY TEXAS

3.17 To file any lawsuits the Receiver deems necessary to carry out his duties herein;

3.18 To file, prosecute, or defend any suit or suits by or against Defendants which may be deemed necessary, in the sole discretion of the Receiver, to further the obligations of the Receiver as set out above, but not to serve as an arbiter of claims by creditors of Defendants, or other claimants who are not investor-victims, as determined in the sole discretion of the Receiver;

3.19 To dispose, for the benefit of investor-victims, of real and personal property of Defendants, if that property is determined by the Receiver to have been obtained or derived from the unlawful sale of securities;

3.20 To close and open accounts and transfer money from one institution to another, or one account to another, as necessary in the Receiver's sole discretion, and under terms the Receiver considers appropriate, for orderly administration and restitution;

3.21 To enter into contracts as necessary for the orderly administration of the receivership estate and to pay reasonable and necessary expenses incurred in connection with the foregoing duties out of the receivership estate;

3.22 To advance his own funds, if necessary in his sole discretion, to pay any expense incurred in carrying out his responsibilities under the Court's orders and to reimburse himself immediately for any funds advanced;

3.23 To delegate to agents the authority to exercise any of the powers conferred on the Receiver by this order;

3.24 To exercise all equitable powers under the statutes and common law of this State authorizing the appointment of a Receiver, and;

3.25 To engage attorneys, accountants, or other professionals to perform duties on behalf of the receivership estate.

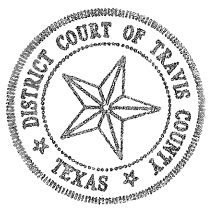
IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that the oath taken by Gregory S. Milligan on January 7, 2011, shall remain in force and that the $100 cash bond posted by Gregory S. Milligan of Harney Management Partners, LLC remains good.

DISTRICT COURT OF TRAVIS COUNTY TEXAS

and sufficient surety and conditioned upon faithful discharge by the Receiver of his duties and obedience to the orders of the Court, and that this appointment his appointment took effect upon the making of such oath and upon the Clerk's approval of the bond on January 7, 2011, at which time the Receiver became fully qualified and empowered to take charge of the assets and business affairs of Defendants Warr Investment and Warr International, and of all money, property, and assets of Defendant Warr that appears to the Receiver to contain or be derived from proceeds of Defendants' sale of securities or used in furtherance thereof, in the manner provided above, and to function as a receiver herein.

IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that the Receiver shall be paid for his services from the funds held by him, and that the Receiver shall charge his reasonable and customary rate of $275.00 per hour, plus reasonable expenses, and submit to the Court and all parties of record his request for payment. If no objections are filed with the Court within ten days of the filing of the request, then the Receiver shall pay himself the amount of the request, from funds he holds in receivership estate. If an objection is filed within ten days, the Receiver shall not pay himself until a hearing has been had on the objection and a ruling has been issued. In that case, the Receiver will pay himself in accordance with the ruling. Any professionals employed by the Receiver shall be paid in accordance with the procedures established by this paragraph.

IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that this Court has exclusive jurisdiction over all claims and causes of action against Defendants Warr Investment and Warr International and Warr arising from or related to the operation of Defendants Warr



Investment and Warr International and over all matters involving the Receiver and the Receivership Estate.

IV. Constructive Trust

IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that a constructive trust is imposed over the property in the Receiver's possession for the sole benefit of the individuals whom the Court determines at a later date are holders of allowed claims against Defendants.

V. Defendants' Waiver of Interest in Receivership Estate

IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that the Defendants waive and relinquish all claims to the property held in the Receivership estate.

VI. General Provisions

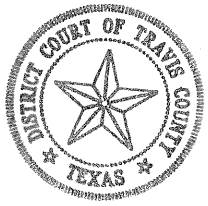
6.1 This Order may be executed in multiple parts, which together shall constitute a single original instrument. Any executed signature page to this order may be transmitted by facsimile transmission to the other parties, which shall constitute an original signature for all purposes.

6.2 Each of the undersigned representatives of the parties to this Order certifies that he or she is fully authorized to enter into the terms and conditions of the order and to legally execute and bind that party to this Order.

6.3 There being no just reason for delay, the Clerk of this Court is hereby directed to enter this Agreed Order pursuant to Rule 301 of the Texas Rules of Civil Procedure.

VII. Other Orders

IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that no bond is required of the State of Texas and this *Agreed Permanent Injunction Order Against Defendants Warr Investment Group, LLC, Warr International Group, LLC, and James Elton "Jim" Warr,*



and Relief Defendants, and Order Appointing Permanent Receiver, and Final Judgment shall issue and be effective immediately.

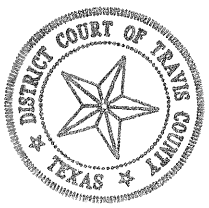
IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that this Court shall retain jurisdiction of this action for all purposes.

IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that this Agreed Order shall be binding on each Defendant and upon those persons in active concert or participation with such Defendant who receive actual notice of the Agreed Order, a copy of which may be served in person, by mail, or by any officer of the State.

IT IS FURTHER ORDERED, ADJUDGED, AND DECREED that the State have all writs of execution and other process necessary to enforce this Agreed Order.

All costs are taxed against the party incurring the same, for which no execution shall issue, said costs having been paid.

All of the foregoing is subject to further Orders of this Court.



SIGNED at Austin, Travis County, Texas this the ___ day of May, 2011 at _____ o'clock __.M.

_____
JUDGE PRESIDING

AGREED & ENTRY REQUESTED

OFFICE OF THE ATTORNEY GENERAL

_____
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State Bar No. 24049996
Assistant Attorney General
Financial and Tax Litigation Division
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Austin, Texas 78711-2548
TEL: (512) 475-4209
FAX: (512) 477-2348
Attorney for Plaintiff State of Texas

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1602 E. Cesar Chavez
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TEL: (512) 494-8448
FAX: (512) 494-8712
Attorney for Court-Appointed Receiver, Gregory S. Milligan

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Austin, Texas 78705
TEL: (512) 439-6930
FAX: (512) 519-2696
Attorneys for Defendants Warr Investment Group, LLC, Warr International Group, LLC

_____
JAMES ELTON ("JIM") WARR
210 Canyon Wren
Buda, Texas 78610
TEL: (512) 797-7869
Individually Pro Se

DISTRICT COURT OF TRAVIS COUNTY TEXAS

SIGNED at Austin, Travis County, Texas this the 20 day of May, 2011 at 1:45 o'clock P.M.

JUDGE PRESIDING

AGREED & ENTRY REQUESTED

OFFICE OF THE ATTORNEY GENERAL

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Attorneys for Defendants Warr Investment Group, LLC, Warr International Group, LLC, and James Elton "Jim" Warr

DISTRICT COURT OF TRAVIS COUNTY TEXAS

SIGNED at Austin, Travis County, Texas this the ___ day of May, 2011 at _____ o'clock __.M.

_____
JUDGE PRESIDING

AGREED & ENTRY REQUESTED

OFFICE OF THE ATTORNEY GENERAL

_____
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FAX: (512) 519-2696
Attorneys for Defendants Warr Investment Group, LLC, Warr International Group, LLC, and James Elton "Jim" Warr

DISTRICT COURT OF TRAVIS COUNTY TEXAS

SIGNED at Austin, Travis County, Texas this the ___ day of January, 2011 at _____ o'clock __.M.

JUDGE PRESIDING

AGREED & ENTRY REQUESTED

OFFICE OF THE ATTORNEY GENERAL

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FAX: (512) 519-2696
Attorneys for Defendants Warr Investment Group, LLC, Warr International Group, LLC, and James Elton "Jim" Warr

I, AMALIA RODRIGUEZ-MENDOZA, District Clerk, Travis County, Texas, do hereby certify that this is a true and correct copy as same appears of record in my office. Witness my hand and seal of office on 2-20-11
AMALIA RODRIGUEZ-MENDOZA
DISTRICT CLERK
By Deputy:

DISTRICT COURT OF TRAVIS COUNTY TEXAS

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MARYLAND

SECURITIES AND EXCHANGE COMMISSION, **Plaintiff,** **v.** **KEVIN B. MERRILL, et al.,** **Defendants**	Case No. 1:18-cv-02844-RDB

FIRST AMENDED ORDER APPOINTING TEMPORARY RECEIVER

WHEREAS this matter has come before this Court upon Plaintiff Securities and Exchange Commission's (the "SEC") Motion for a Temporary Restraining Order Freezing Assets, Appointing a Temporary Receiver, and Granting Other Emergency Relief (Doc. No. 3) and Receiver Gregory S. Milligan's Motion to Clarify and Modify Receivership Order (Doc. No. 53);

WHEREAS Defendants and their affiliate entities possess significant assets-the full nature and extent of which are not currently known to the Court-including but not limited to debt portfolios, automobiles, jewelry, real estate, and other assets, the value of which should be preserved during the pendency of this litigation;

WHEREAS the Court finds that, based on the record in these proceedings, the appointment of a receiver in this action is necessary and appropriate for the purposes of marshaling and preserving all assets of Defendants Kevin B. Merrill, Jay B. Ledford, Cameron R. Jezierski, Global Credit Recovery, LLC, Delmarva Capital, LLC, Rhino Capital Holdings, LLC, Rhino Capital Group, LLC, DeVille Asset Management LTD, Riverwalk Financial

Corporation ("Defendants"), and the affiliate entities of Defendants, as described below, including but not limited to funds fraudulently obtained from investors that are held by the Relief Defendants Amanda Merrill and Lalaine Ledford (collectively, the "Relief Defendants") and any and all assets acquired, either directly or indirectly, using such funds;

WHEREAS this Court has subject matter jurisdiction over this action and personal jurisdiction over Defendants, and venue properly lies in this district;

NOW THEREFORE, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED THAT:

1. This Court hereby takes exclusive jurisdiction and possession of the assets, of whatever kind and wherever situated, of the following Defendants, and the affiliate entities of Defendants, including but not limited to: Kevin B. Merrill ("Merrill"), Jay B. Ledford ("Ledford"); Cameron R. Jezierski ("Jezierski"); Global Credit Recovery, LLC; Delmarva Capital, LLC; Rhino Capital Holdings, LLC; Rhino Capital Group, LLC; DeVille Asset Management LTD; Riverwalk Financial Corporation; K.B. Merrill Associates; Financial Reclamation Group LLC; Halo Credit Solutions LLC; JBL Holdings LLC; Jay B. Ledford, P.C.; the Joseph Finance Company; Leddy Bear LTD; Ledford & Associates, PLLC; King Fischer LTD d/b/a LP Investments LTD; NLEX, Inc.; Receivables Portfolio Interchange, Inc.; Riverwalk Capital Investments, Inc.; Riverwalk Credit Solutions, Inc.; Riverwalk Debt Solutions, Inc.; Riverwalk Fixed Asset Group LLC; SCUSA Financial, Inc.; Vaquero Asset Management, Inc.; CRJ Holdings LLC; Centurion Capital Corporation; GCR CBL CP I, LLC; GCR CBL CP II, LLC; GCR CBL CP III, LLC; GCR CBL CP IV, LLC; GCR HCP Holdings 1, LLC; GCR Mercer Holdings, LLC; the J Trust; and the Kevin B. Merrill Revocable Trust (collectively, the "Receivership Parties").

2. Until further Order of this Court, Gregory S. Milligan, of the firm Harney Management Partners, LLC, is hereby appointed to serve without bond as receiver (the "Receiver") for the estates of the Receivership Parties.

I. Asset Freeze

3. Except as otherwise specified herein, all assets of Defendants and Receivership Parties (collectively, "Receivership Assets") are frozen until further order of this Court. "Receivership Assets" means assets of any and every kind whatsoever, including without limitation all assets described in this Order, that are: (a) owned, controlled, or held, in whole or in part, by or for the benefit of any of the Receivership Parties; (b) in the actual or constructive possession of any of the Receivership Parties, or other individual or entity acting in concert with any of the Receivership Parties; (c) held by an agent of any of the Receivership Parties, including as a retainer for the agent's provision of services; or (d) owned, controlled, or held, in whole or in part, by, or in the actual or constructive possession of, or otherwise held for the benefit of, any corporation, partnership, trust, or other entity directly or indirectly owned, controlled, or held, in whole or in part, by any of the Receivership Parties, including assets that have been transferred to other persons or entities but as to which assets such persons or entities do not have a legitimate claim. For the avoidance of doubt, the "Receivership Assets" include all assets owned, controlled, or held, in whole or in part by, or in the actual or constructive possession of, or otherwise held for the benefit of the J Trust and Kevin B. Merrill Revocable Trust, including the following real properties: (a) 1718 Greenspring Valley Road, Stevenson, MD 21153; (b) 9017 Grove Crest Lane, Las Vegas, NV 89134; and (c) 1650 Cedar Hill, Dallas, TX 75208. The "Receivership Assets" also include funds fraudulently obtained from investors that are held by the Relief Defendants and any and all assets acquired, either directly or indirectly, using such funds, including but not limited to: (i) 1055 Spyglass Lane, Naples, FL 34102; (ii) 27776 Sharp

Road, Easton, MD 21601; and (iii) 531 Hampton Lane, Baltimore, MD 21204. Accordingly, all persons, institutions, and entities with direct or indirect control over any Receivership Assets-other than the Receiver or law enforcement officials acting within the course and scope of their official duties are hereby restrained and enjoined from directly or indirectly transferring, setting off, receiving, changing, selling, pledging, assigning, liquidating or otherwise disposing of or withdrawing such Receivership Assets. This freeze shall include, but not be limited to, Receivership Assets that are on deposit with financial institutions such as banks, brokerage firms, and mutual funds, or other institutions, including but not limited to casinos.

II. General Powers and Duties of Receiver

4. Except as limited herein, the Receiver shall have all powers, authorities, rights, and privileges heretofore possessed by the officers, directors, managers, and general and limited partners of the Receivership Parties under applicable state and federal law, by the governing charters, by-laws, articles and/or agreements in addition to all powers and authority of a receiver at equity, and all powers conferred upon a receiver by the provisions of 28 U.S.C. §§ 754, 959 and 1692, Fed. R. Civ. P. 66, and this Order, including but not limited to paragraphs 49 and 50 of this Order.

5. The trustees, directors, officers, managers, investment advisors, accountants, attorneys, and other agents of the non-individual Receivership Parties are hereby dismissed and the powers of any partners, directors, and/or managers are hereby suspended. Such persons and entities shall have no authority with respect to the Receivership Parties' operations or assets, except to the extent as hereafter may be expressly granted by the Receiver. This Order, however, does not dismiss Defendants' attorneys, if any, who file an appearance in this action.

6. The Receiver shall assume and control the operation of the non-individual Receivership Parties and shall preserve all of their claims or interests using the powers set forth

in this Order. The Receiver shall not have the power to bring suits in law or in equity without further Order of this Court except as otherwise authorized in Paragraph 37 this Order. The Receiver may continue and conduct the business of the Receivership Parties in such manner, to such extent and for such duration as the Receiver may deem to be necessary or appropriate, if at all.

7. No person holding or claiming any position of any sort with any of the non-individual Receivership Parties shall possess any authority to act by or on behalf of any of the non-individual Receivership Parties, unless expressly authorized, in writing, by the Receiver.

8. Subject to the specific provisions in Sections III through XIV, below, the Receiver shall have the following general powers and duties:

A. To use reasonable efforts to determine the nature, location, and value of all property interests of the Receivership Parties, including, but not limited to, monies, funds, securities, credits, investments, savings, options, shares, cash, currencies, checks, accounts, vehicles, boats, equipment, fixtures, effects, goods, chattels, lands, premises, leases, claims, notes, membership interests in any limited liability company, partnership interests, contracts, certificates of title, instruments, inheritances, interests in any trust, art, collectibles, furnishings, jewelry, personal effects, digital currencies, virtual currencies, cryptocurrencies, digital or electronic property, casino accounts, deposits, or chips, rights, and other assets, together with all rents, profits, dividends, interest, or other income attributable thereto, of whatever kind, which the Receivership Parties own, possess, have a beneficial interest in, or control directly or indirectly (the foregoing,

together with all assets described in this Order collectively may be referred to as the "Receivership Assets" or the "Receivership Estate");

B. To take custody, control, and possession of all Receivership Assets and records relevant thereto from the Receivership Parties;

C. To manage, control, operate, and maintain the Receivership Estate and hold in his possession, custody, and control all Receivership Assets, pending further Order of this Court;

D. To use Receivership Assets for the benefit of the Receivership Estate, making payments and disbursements and incurring expenses as may be necessary or advisable in the ordinary course of business in discharging his duties as Receiver;

E. To take any action which, prior to the entry of this Order, could have been taken by the officers, directors, partners, managers, trustees, and agents of the Receivership Parties, except as limited by this Order;

F. To engage and employ persons in his discretion to assist him in carrying out his duties and responsibilities hereunder, including, but not limited to, accountants, attorneys, securities traders, registered representatives, financial or business advisers, liquidating agents, real estate agents, forensic experts, brokers, traders, or auctioneers;

G. To take such action as necessary and appropriate for the preservation of Receivership Assets or to prevent the dissipation or concealment of Receivership Assets;

H. To the extent necessary to locate and identify assets, the Receiver is authorized to issue subpoenas for documents and testimony consistent with the Federal Rules of Civil Procedure;

I. To resist and defend all suits, actions, claims and demands which may now be pending or which may be brought by or asserted against the Receivership Estate; and,

J. To take such other action as may be approved by this Court.

9. Unless otherwise limited by this Order, the Receiver is authorized to exercise all equitable powers under applicable law.

10. The Receiver may delegate to his agents any of the powers of the Receiver granted to him by this Order.

11. The Receiver may seek further Orders of this Court regarding standing powers of the Receiver, operations of Receivership Parties, and administration of Receivership Assets as may be deemed necessary to conserve the Receivership Assets, secure the best interests of creditors, investors, and other stakeholders of the Receivership Parties, and protect the interests of the Receiver.

III. Access to Information

12. The individual Receivership Parties and the past and/or present officers, directors, agents, managers, general and limited partners, trustees, attorneys, accountants, and employees of the non-individual Receivership Parties, as well as those acting in their place, including third party vendors storing financial and other business information, as well as email communications, are hereby ordered and directed to preserve and tum over to the Receiver forthwith all paper and electronic information of, and/or relating to, the Receivership Parties and/or all Receivership Assets; such information shall include but not be limited to books, records, documents, accounts,

all financial and accounting records, balance sheets, income statements, bank records (including monthly statements, canceled checks, records of wire transfers, details of items deposited, and check registers), client lists, title documents, writings, drawings, graphs, charts, photographs, audio and video recordings, computer records, computer files, databases and other data compilations, including but not limited to records relating to debt portfolios, including but not limited to all information stored using Debtmaster software, electronically stored records and information, including any information stored by third parties (including but not limited to Intuit, Inc.), including those utilizing using cloud-based services" access codes, security codes, passwords, safe deposit keys, combinations, and all other instruments, papers, and electronic data or records of any kind or nature. This does not, however, include any documents or files of Merrill's, Ledford's, or Jezierski's personal attorneys, if any, that are protected by the work-product doctrine and/or attorney-client privilege.

13. Within ten (10) days of the entry of this Order, the Receivership Parties shall file with the Court and serve upon the Receiver and the SEC a sworn statement, listing: (a) the identity, location, and estimated value of all Receivership Assets, including contact information for the party in possession of all assets of such Receivership Party, held jointly or singly, including without limitation all assets held outside the territory of the United States; (b) all employees (and job titles thereof), other personnel, attorneys, accountants, and any other agents or contractors of the Receivership Parties; and (c) the amount and nature of all liabilities of such Receivership Party, including without limitation the names, addresses, and amounts of claims of all known creditors of the Receivership Parties. Such sworn statement shall include the names, addresses, telephone numbers, facsimile numbers, and e-mail addresses of the holders of any legal, equitable, or beneficial interests in such assets and the names, addresses, telephone

numbers, facsimile numbers, and e-mail addresses of any financial institutions or other persons or entities holding such assets, along with the account numbers and balances. The sworn statements shall be accurate as of the date of this Order, shall be signed and verified as true and complete under penalty of perjury.

14. Within thirty (30) days of the entry of this Order, the Receivership Parties shall file with the Court and serve upon the Receiver and the SEC a sworn statement and accounting, with complete documentation, covering the period from January 1,2013 to the present:

A. Of all Receivership Assets, wherever located, held by or in the name of the Receivership Parties, or in which any of them, directly or indirectly, has or had any beneficial interest, or over which any of them maintained or maintains and/or exercised or exercises control, including, but not limited to: (a) all securities, investments, funds, real estate, automobiles, jewelry, digital assets, including but not limited to any assets contained in digital assets held at crypto-currency exchanges, and other assets, stating the location of each; and (b) any and all accounts, including all funds held in such accounts, with any bank, brokerage, or other financial institution, or any other institution, including but not limited to casinos, held by, in the name of, or for the benefit of any of them, directly or indirectly, or over which any of them maintained or maintains and/or exercised or exercises any direct or indirect control, or in which any of them had or has a direct or indirect beneficial interest, including the account statements from each bank, brokerage, or other financial institution;

B. Identifying every account at every bank, brokerage, or other financial institution, including but not limited to casinos: (a) over which Receivership Parties have signatory authority; and (b) opened by, in the name of, or for the benefit of, or used by, the Receivership Parties;

C. Identifying all credit, bank, charge, debit or other deferred payment card issued to or used by each Receivership Party, including but not limited to the issuing institution, the card or account number(s), all persons or entities to which a card was issued and/or with authority to use a card, the balance of each account and/or card as of the most recent billing statement, and all statements for the last twelve months;

D. Of all assets received by any of Receivership Parties from any person or entity, including the value, location, and disposition of any assets so received;

E. Of all funds received by the Receivership Parties, and each of them, in any way related, directly or indirectly, to the conduct alleged in the SEC's Complaint. The submission must clearly identify, among other things, all investors, the securities they purchased, the date and amount of their investments, and the current location of such funds;

F. Of all expenditures exceeding $1,000 made by any of Receivership Parties, including those made on their behalf by any person or entity; and

G. Of all transfers of assets made by any of Receivership Parties.

15. Within thirty (30) days of the entry of this Order, the Receivership Parties shall provide to the Receiver and the Commission copies of the Receivership Parties' federal income tax returns for 2013 through 2017 with all relevant and necessary underlying documentation.

16. The individual Receivership Parties and the non-individual Receivership Parties' past and/or present officers, directors, agents, attorneys, managers, shareholders, employees, accountants, debtors, creditors, managers and general and limited partners, and other appropriate persons or entities shall answer all questions which the Receiver may put to them and produce all documents as required by the Receiver regarding the business of the Receivership Parties, or any other matter relevant to the operation or administration of the receivership or the collection of funds due to the Receivership Parties. The Receiver maintains and controls the attorney-client privilege for all non-individual Receivership Parties. Nothing in this Order shall operate as or effectuate a waiver of the attorney-client privilege regarding communications between Defendants Merrill, Ledford, and Jezierski and their respective personal attorneys, if any, and such personal attorneys shall not be compelled by this Order to divulge information that would otherwise be protected by the attorney-client privilege.

17. The Receivership Parties are required to assist the Receiver in fulfilling his duties and obligations. As such, they must respond promptly and truthfully to all requests for information and documents from the Receiver. This cooperation and assistance shall include, but not be limited to: (a) providing any information or documents that the Receiver deems necessary or appropriate to the exercise of the Receiver's authority and the discharge of the Receiver's responsibilities under this Order; (b) providing any keys, including but not limited to physical, digital, and cryptographic keys, codes, device PINs, and passwords, including but not limited to account, encryption, email account, and computer passwords required to access any computer,

electronic file, or telephonic data in any medium; (c) immediately advising all persons who owe money or currency of any kind to the Receivership Parties that all debts should be paid directly to the Receiver; (d) providing full access to all Receivership Assets; and (e) maintaining and not wasting, damaging, disposing of, or transferring in any manner any Receivership Assets.

IV. Access to Books, Records, and Accounts

18. The Receiver is authorized to take immediate possession of all assets, bank accounts or other financial accounts, books, and records and all other documents or instruments relating to the Receivership Parties. All persons and entities having control, custody, or possession of any Receivership Assets are hereby directed to turn such property, including but not limited to all accounts, over to the Receiver.

19. The Receivership Parties, as well as their agents, servants, employees, attorneys, any persons acting for or on behalf of the Receivership Parties, including third party vendors of the Receivership Parties, and any persons receiving notice of this Order by personal service, facsimile transmission, or otherwise, having possession of the property, business, books, records, accounts, or assets of the Receivership Parties are hereby directed to deliver the same to the Receiver, his agents, and/or employees.

20. All banks, brokerage firms, financial institutions, and other persons or entities which have possession, custody, or control of any assets or funds held by, in the name of, or for the benefit of, directly or indirectly, the Receivership Parties that receive actual notice of this Order by personal service, facsimile transmission, or otherwise shall:

A. Not liquidate, transfer, sell, convey, or otherwise transfer any assets, securities, funds, or accounts in the name of or for the benefit of the Receivership Parties except upon instructions from the Receiver;

B. Not exercise any form of set-off, alleged set-off, lien, or any form of self-help whatsoever, or refuse to transfer any funds or assets to the Receiver's control without the permission of this Court;

C. Within five (5) business days of receipt of that notice, file with the Court and serve on the Receiver and counsel for the SEC a certified statement setting forth, with respect to each such account or other asset, the balance in the account or description of the assets as of the close of business on the date of receipt of the notice; and,

D. Cooperate expeditiously in providing information and transferring funds, assets, and accounts to the Receiver or at the direction of the Receiver.

V. Access to Real and Personal Property

21. The Receiver is authorized but not directed to take immediate possession of all personal property Receivership Assets, wherever located, including but not limited to electronically stored information, computers, laptops, hard drives, external storage drives, and any other such memory, media or electronic storage devices, books, papers, data processing records, evidence of indebtedness, bank records and accounts, savings records and accounts, brokerage records and accounts, certificates of deposit, stocks, bonds, debentures, and other securities and investments, contracts, mortgages, furniture, office supplies, and equipment.

22. The Receiver is authorized but not directed to take immediate possession of all real property Receivership Assets, wherever located, including but not limited to all ownership and leasehold interests and fixtures. Upon receiving actual notice of this Order by personal service, facsimile transmission, or otherwise, all persons other than law enforcement officials acting within the course and scope of their official duties, are (without the express written permission of the Receiver) prohibited from: (a) entering such premises; (b) removing anything

from such premises; or, (c) destroying, concealing, or erasing anything on such premises. Notwithstanding the foregoing, the individual Receivership Parties, or any of their respective family members, shall be permitted to continue residing in their respective primary places of residence, until further notice by the Receiver.

23. In order to execute the express and implied terms of this Order, the Receiver is authorized to change door locks to the premises described above. The Receivership Parties, all other persons in possession or control of Receivership Assets, or any other person acting or purporting to act on their behalf, are ordered not to change the locks in any manner, nor to have duplicate keys made, nor shall they have keys in their possession during the term of the receivership.

24. The Receiver is authorized to open all mail, other than mail directed to the spouses of individual Defendants, directed to or received by or at the offices or post office boxes of the Receivership Parties, and to inspect all mail opened prior to the entry of this Order, to determine whether items or information therein fall within the mandates of this Order.

25. Upon the request of the Receiver, the United States Marshal Service, in any judicial district, is hereby ordered to assist the Receiver in carrying out his duties to take possession, custody and control of, or identify the location of, any assets, records, or other materials belonging to the Receivership Estate. In addition, the Receiver is authorized to request similar assistance from any other federal, state, county, or civil law enforcement officer(s) or constable(s) of any jurisdiction.

VI. Notice to Third Parties

26. The Receiver shall promptly give notice of his appointment to all known officers, directors, agents, employees, shareholders, creditors, debtors, managers, and general and limited

partners of the Receivership Parties, as the Receiver deems necessary or advisable to effectuate the operation of the receivership.

27. All persons and entities owing any obligation, debt, or distribution with respect to an ownership interest to any Receivership Defendant shall, until further ordered by this Court, pay all such obligations in accordance with the terms thereof to the Receiver, and its receipt for such payments shall have the same force and effect as if the Receivership Defendant had received such payment.

28. In furtherance of his responsibilities in this matter, the Receiver is authorized to communicate with, and/or serve this Order upon, any person, entity, or government office that he deems appropriate to inform them of the status of this matter and/or the financial condition of the Receivership Estate. All government offices which maintain public files of security interests in real and personal property shall, consistent with such office's applicable procedures, record this Order upon the request of the Receiver or the SEC.

29. The Receiver is authorized to instruct the United States Postmaster to hold and/or reroute mail which is related, directly or indirectly, to the business, operations, or activities of any of the Receivership Parties (the "Receiver's Mail"), including all mail addressed to, or for the benefit of, the Receivership Parties. The Postmaster shall not comply with, and shall immediately report to the Receiver, any change of address or other instruction given by anyone other than the Receiver concerning the Receiver's Mail. The Receivership Parties shall not open any of the Receiver's Mail and shall immediately tum over such mail, regardless of when received, to the Receiver. All personal mail of any individual Receivership Parties, mail addressed to any individual Receivership Defendant's spouse, and/or any mail appearing to contain privileged information, and/or any mail not falling within the mandate of the Receiver,

shall be released to the named addressee or addressee's attorney by the Receiver. The foregoing instructions shall apply to any proprietor, whether individual or entity, of any private mail box, depository, business or service, or mail courier or delivery service, hired, rented, or used by the Receivership Parties. The Receivership Parties shall not open a new mailbox, or take any steps or make any arrangements to receive mail in contravention of this Order, whether through the U.S. mail, a private mail depository, or courier service.

30. Subject to payment for services provided, any entity furnishing water, electric, telephone, sewage, garbage, or trash removal services to the Receivership Parties shall maintain such service and transfer any such accounts to the Receiver unless instructed to the contrary by the Receiver.

VII. Injunction Against Interference with Receiver

31. The Receivership Parties, other persons in possession or control of Receivership Assets, and all persons, other than law enforcement officials acting within the course and scope of their official duties, receiving notice of this Order by personal service, facsimile, or otherwise, are hereby restrained and enjoined from directly or indirectly taking any action or causing any action to be taken, without the express written agreement of the Receiver, which would:

A. Interfere with the Receiver's efforts to take control, possession, or management of any Receivership Assets; such prohibited actions include but are not limited to, using self-help or executing or issuing or causing the execution or issuance of any court attachment, subpoena, replevin, execution, or other process for the purpose of impounding or taking possession of or interfering with or creating or enforcing a lien upon any Receivership Assets;

B. Hinder, obstruct or otherwise interfere with the Receiver in the performance of his duties; such prohibited actions include but are not limited to, concealing, destroying, or altering records or information;

C. Dissipate or otherwise diminish the value of any Receivership Assets; such prohibited actions include but are not limited to, releasing claims or disposing, transferring, exchanging, assigning or in any way conveying any Receivership Assets, enforcing judgments, assessments, or claims against any Receivership Assets or any Receivership Defendant, attempting to modify, cancel, terminate, call, extinguish, revoke or accelerate (the due date), of any lease, loan, mortgage, indebtedness, security agreement or other agreement executed by any Receivership Defendant or which otherwise affects any Receivership Assets; or,

D. Transact any of the business of the Receivership Parties or transfer any Receivership Assets to anyone other than the Receiver;

E. Destroy, secret, deface, transfer, delete, or otherwise alter or dispose of any documents of or pertaining to the Receivership Parties or the Receivership Assets and to the extent any such documents are no longer in existence, fail to disclose the nature and contents of such documents and how, when, and by whom such documents were caused to no longer be in existence;

F. Fail to notify the Receiver of any Receivership Assets, including accounts constituting Receivership Assets held in any name other than the name of a Receivership Defendant, or by any person other than the Receivership

Parties, or fail to provide any assistance or information requested by the Receiver in connection with obtaining possession, custody, or control of such Receivership Assets;

G. Refuse to cooperate with the Receiver or the Receiver's duly authorized agents in the exercise of their powers, duties, or authority under any order of this Court; or

H. Interfere with or harass the Receiver, or interfere in any manner with the exclusive jurisdiction of this Court over the Receivership Estate.

32. The Receivership Parties shall cooperate with and assist the Receiver in the performance of his duties.

33. The Receiver shall promptly notify the Court and SEC counsel of any failure or apparent failure of any person or entity to comply in any way with the terms of this Order.

VIII. Stay of Litigation

34. As set forth in detail below, the following proceedings, excluding the instant proceeding, all police or regulatory actions, and actions of the SEC related to the above-captioned enforcement action, are stayed upon entry of this Order and until further Order of this Court: All civil legal proceedings of any nature, including, but not limited to, bankruptcy proceedings, arbitration proceedings, foreclosure actions, default proceedings, or other actions of any nature involving: (a) the Receiver, in his capacity as Receiver; (b) any Receivership Assets, wherever located; (c) any of the Receivership Parties, including subsidiaries and partnerships; or, (d) any of the Receivership Parties' past or present officers, directors, managers, agents, or general or limited partners sued for, or in connection with, any action taken by them while acting in such capacity of any nature, whether as plaintiff, defendant, third-party plaintiff, third-party

defendant, or otherwise (such proceedings are hereinafter referred to as "Ancillary Proceedings").

35. The parties to any and all Ancillary Proceedings are enjoined from commencing or continuing any such legal proceeding, or from taking any action, in connection with any such proceeding, including, but not limited to, the issuance or employment of process. All counterparties to agreements and contracts entered into with the Receivership Parties are enjoined from unilaterally terminating such agreements or contracts without order of this Court.

36. All Ancillary Proceedings not subject to Paragraph 37 below are stayed in their entirety, and all Courts having any jurisdiction thereof are enjoined from taking or permitting any action until further Order of this Court. Further, as to a cause of action accrued or accruing in favor of one or more of the Receivership Parties against a third person or party, or as to any and all claims or causes of action under applicable law that have accrued or are accruing regarding transfers and transactions of fraudulently obtained investor funds (or proceeds thereof) to third parties, any applicable statute of limitation is tolled during the period in which this injunction against commencement of legal proceedings is in effect as to that cause of action.

37. The Court modifies the above-described stay in part and amends this Order to allow the Receiver to continue, in his discretion, the consumer debt collection business of the Receivership Parties under those contracts and agreements that existed on date of the entry of the Order Appointing Temporary Receiver. Specifically, the Court modifies the above-described stay in part and amends this Order to allow the Receiver to file, maintain, and prosecute consumer debt collection civil proceedings in the name of DeVille Asset Management Ltd. and any other Receivership Party pursuant to their service agreements with collection litigation firms, including AACANet, Inc. d/b/a American Alliance of Creditor Attorneys, DRB Financial

Solutions, LLC, Persolve, Series 2, d/b/a Account Resolution Associates, and such other similar entities. The stay is modified to cover all such agreements that the Receiver decides to continue as part of his duties under the Receivership Order.

IX. Managing Assets

38. The Receiver shall establish one or more custodial accounts at a federally insured bank to receive and hold all cash equivalent Receivership Assets (the "Receivership Funds").

39. The Receiver's deposit account shall be entitled "Receiver's Account, Estate of [Name of Receivership Defendant]" together with the name of the action, or a title to that effect.

40. Without further Order of this Court, the Receiver may not liquidate or otherwise dispose of Receivership Assets, including real estate, other than in the ordinary course of business.

41. The Receiver is authorized to use the Receivership Assets and proceeds thereof to pay debts and expenses of Receivership Parties that (i) have accrued prior to or during the receivership and (ii) in the sole discretion of the receiver are essential or necessary to the operations of the non-individual Receivership Parties.

42. The Receiver's duties shall include, using reasonable efforts, identifying, marshaling, taking custody of, and preserving the value of the Receivership Assets. Without further Order of this Court, the Receiver's duties shall not include a forensic investigation to identify claimants on or creditors of Receivership Assets or any determination of amounts owed to such parties. Defendants Merrill, Ledford, and Jezierski shall retain responsibility, and the Receiver shall assume no responsibility, for preparing and filing their respective personal income tax returns.

43. Upon further Order of this Court, pursuant to such procedures as may be required by this Court and additional authority such as 28 U.S.C. §§ 2001 and 2004, the Receiver will be authorized to sell, and transfer clear title to, all real property in the Receivership Estate.

44. The Receiver is authorized to take all actions to manage or maintain business operations of the Receivership Estate, including making payments to creditors, employees, and agents of the Receivership Estate and communicating with vendors, investors, governmental and regulatory authorities, and others, as appropriate.

45. The Receiver shall take all necessary steps to enable the Receivership Funds to obtain and maintain the status of a taxable "Settlement Fund," within the meaning of Section 468B of the Internal Revenue Code and of the regulations, when applicable.

X. Bankruptcy Filing

46. The Receiver may seek an Order of this Court authorizing the Receiver to file voluntary petitions for relief under Title 11 of the United States Code (the "Bankruptcy Code") for the Receivership Parties, or any of them. If a Receivership Defendant is placed in bankruptcy proceedings, the Receiver may become, and may be empowered to operate each of the Receivership Estate as, a debtor in possession. In such a situation, the Receiver shall have all of the powers and duties as provided a debtor in possession under the Bankruptcy Code to the exclusion of any other person or entity. Pursuant to Paragraph 4 above, the Receiver is vested with management authority for all non-individual Receivership Parties and may therefore file and manage a Chapter 11 petition.

47. The provisions of Section VIII above bar any person or entity, other than the Receiver, from placing any of the Receivership Parties in bankruptcy proceedings.

XI. Liability of Receiver

48. Until further Order of this Court, the Receiver shall not be required to post bond or give an undertaking of any type in connection with his fiduciary obligations in this matter.

49. The Receiver may choose, engage and employ attorneys, accountants, appraisers, and any other independent contractors and technical specialists, including, but not limited to, securities traders, registered representatives, financial or business advisers, liquidating agents, real estate agents, forensic experts, property managers, brokers, traders, and auctioneers (collectively, "Retained Personnel") as the Receiver deems advisable or necessary in the performance of the Receiver's duties and responsibilities under the authority granted by this Order. The Receiver and his Retained Personnel, acting within scope of such agency, are entitled to rely on all outstanding rules of law and Orders of this Court and shall not be liable to anyone for their own good faith compliance with any order, rule, law, judgment, or decree. In no event shall the Receiver or Retained Personnel be liable to anyone for their good faith compliance with their duties and responsibilities as Receiver or Retained Personnel, including compliance with applicable law governing the collection of debt, nor shall the Receiver or Retained Personnel be liable to anyone for any actions taken or omitted by them except upon a finding by this Court that they acted or failed to act as a result of malfeasance, bad faith, gross negligence, or in reckless disregard of their duties.

50. This Court shall retain exclusive jurisdiction over any action filed against the Receiver or Retained Personnel based upon acts or omissions alleged to have been committed in their representative capacities.

51. In the event the Receiver decides to resign, the Receiver shall first give written notice to the SEC's counsel of record and the Court of its intention, and the resignation shall not

be effective until the Court appoints a successor. The Receiver shall then follow such instructions as the Court may provide.

52. The Receiver shall not be personally liable for any liabilities that have accrued or will accrue to the Receivership Estate or the Receivership Parties.

XII. Insurance

53. Given the urgency to appoint a Receiver, the Court recognizes that the Receiver accepts this appointment without time for independent verification that appropriate insurance is in place on the property or that appropriate liability or other insurance is in place to protect the Receivership Assets and the Receivership Estate. Accordingly, the Court acknowledges that the Receiver has no responsibility or liability until such time as he can confirm that such insurance is in place or acquire the appropriate insurance. The Receiver shall make it a priority to verify or obtain insurance coverage immediately upon this Order Appointing Receiver being entered; however, the SEC, Receivership Parties, and Court acknowledge there may be a gap of time before such insurance may be in place to properly protect the assets of the estate and any employees of the estate, and that the Receiver has no responsibility or liability until such time as he/it has notified the Court by filing a notice that insurance is in place.

54. Defendants Merrill, Ledford, and Jezierski and Relief Defendants Amanda Merrill and Lalaine Ledford are ordered to immediately provide the Receiver with all available insurance information for both existing and prior insurance policies. This includes all applications, policies, riders, correspondence, endorsements, claims and other information. Merrill, Ledford, and Jezierski are ordered: (I) to advise the insurance agent(s) of this Order in writing, (2) designate all authority over the policies to the Receiver, and (3) take no action with regard to terminating or modifying existing insurance policies.

55. Any insurance broker, agent, carrier, or underwriter is specifically ordered by the Court to cooperate with the Receiver by timely furnishing the following: (I) copies of all insurance policies including any riders, endorsements and applications with respect to policies related to the Receivership Estate, (2) loss history for five consecutive years or for as long as insurance has been in force if less than five years, (3) premium payment history including current status, and (4) any correspondence with insurance agents, brokers and companies. Policies shall be endorsed by the Defendants naming the Receiver as Named Insured and Loss Payee effective the date of this Order as appropriate to the type of coverage, and evidence of this policy endorsement shall be promptly supplied to the Receiver.

56. The Receiver is hereby authorized to engage insurance brokers and consultants as necessary to properly insure the Receivership Assets.

XIII. Recommendations and Reports

57. The Receiver is authorized, empowered, and directed to develop a plan for the fair, reasonable, and efficient preservation of assets during the pendency of this litigation (the "Preservation Plan").

58. Within 60 days of the entry date of this Order the Receiver shall file the Preservation Plan in the above-captioned action, with service copies to counsel of record, to allow the Court to evaluate the best course of action for the preservation of assets.

59. Within thirty (30) days after the end of each calendar quarter, the Receiver shall file and serve a full report and accounting of each Receivership Estate (the "Quarterly Status Report"), reflecting (to the best of the Receiver's knowledge as of the period covered by the report) the existence, value, and location of all Receivership Assets, and of the extent of liabilities, both those claimed to exist by others and those the Receiver believes to be legal obligations of the Receivership Estate. The first Quarterly Status Report shall be filed and

served on or before January 30, 2019, to cover the period from September 13, 2018 through December 31, 2018.

60. The Quarterly Status Report shall contain the following:

A. A summary of the operations of the Receiver;

B. The amount of cash on hand, the amount and nature of accrued administrative expenses, and the amount of unencumbered funds in the estate;

C. A schedule of all the Receiver's receipts and disbursements (attached as Exhibit A to the Quarterly Status Report), with one column for the quarterly period covered and a second column for the entire duration of the receivership;

D. A description of all known Receivership Assets, including approximate or actual valuations, anticipated or proposed dispositions, and reasons for retaining assets where no disposition is intended;

E. A description of liquidated and unliquidated claims held by the Receivership Estate, including the need for forensic and/or investigatory resources; approximate valuations of claims; and anticipated or proposed methods of enforcing such claims (including likelihood of success in: (i) reducing the claims to judgment; and, (ii) collecting such judgments)

F. A list of all known creditors with their addresses and the amounts of their claims;

G. The status of Creditor Claims Proceedings, after such proceedings have been commenced; and,

H. The Receiver's recommendations for a continuation or discontinuation of the receivership and the reasons for the recommendations.

61. On the request of the SEC, the Receiver shall provide the SEC with any documentation that the SEC deems necessary to meet its reporting requirements, that is mandated by statute or Congress, or that is otherwise necessary to further the SEC's mission.

XIV. Fees, Expenses, and Accountings

62. Subject to Paragraphs 63-69 immediately below, the Receiver need not obtain Court approval prior to the disbursement of Receivership Funds for expenses in the ordinary course of the administration and operation of the receivership. Further, prior Court approval is not required for payments of applicable federal, state, or local taxes.

63. Subject to Paragraph 64 immediately below, the Receiver is authorized to solicit persons and entities ("Retained Personnel") to assist him in carrying out the duties and responsibilities described in this Order. With the exception of the retention of counsel to represent him in this matter, the Receiver shall not engage any Retained Personnel without first obtaining an Order of the Court authorizing such engagement.

64. The Receiver and Retained Personnel are entitled to reasonable compensation and expense reimbursement from the Receivership Estate as described in the "Billing Instructions for Receivers in Civil Actions Commenced by the U.S. Securities and Exchange Commission" (the "Billing Instructions") agreed to by the Receiver. Such compensation shall require the prior approval of the Court.

65. Throughout the pendency of the receivership, the Receiver and Retained Personnel shall apply to the Court for compensation and expense reimbursement from the Receivership Estates (the "Interim Fee Applications"). Interim Fee Applications are to be filed

by the Receiver and Retained Personnel no more frequently than every 60 days. At least thirty (30) days prior to filing each Interim Fee Application with the Court, the Receiver will serve upon counsel for the SEC a complete copy of the proposed Application, together with all exhibits and relevant billing information in a format to be provided by SEC staff.

66. All Interim Fee Applications will be interim and will be subject to cost benefit and final reviews at the close of the receivership. At the close of the receivership, the Receiver will file a final fee application, describing in detail the costs and benefits associated with all litigation and other actions pursued by the Receiver during the course of the receivership.

67. Interim Fee Applications may be subject to a holdback in the amount of 20% of the amount of fees and expenses for each application filed with the Court. The total amounts held back during the course of the receivership will be paid out at the discretion of the Court as part of the final fee application submitted at the close of the receivership.

68. Each Interim Fee Application shall:

A. Comply with the terms of the Billing Instructions agreed to by the Receiver; and,

B. Contain representations (in addition to the Certification required by the Billing Instructions) that: (i) the fees and expenses included therein were incurred in the best interests of the Receivership Estate; and, (ii) with the exception of the Billing Instructions, the Receiver has not entered into any agreement, written or oral, express or implied, with any person or entity concerning the amount of compensation paid or to be paid from the Receivership Estate, or any sharing thereof.

69. At the close of the Receivership, the Receiver shall submit a Final Accounting, in a format to be provided by SEC staff, as well as the Receiver's final application for compensation and expense reimbursement.

70. All such fees and expenses of the Receiver, including all amounts due to the Receiver or his counsel, shall be accorded priority to the maximum extent provided by applicable law.

IT IS SO ORDERED, this 27th **day of** November, **2018, at Baltimore, Maryland.**

Ellen D. Bennett
UNITED STATES DISTRICT JUDGE

DocID: 4842-8683-4554.3

DIVERSITY IN ARBITRATION: WHERE IS EVERYONE?

Jenice Malecki[1]

I. Introduction

Most legal practitioners will tell you that they know colleagues of every gender, race, and religion, but how often do we see a person of color in a securities arbitration on any side of the table, including the head of the table? Be honest, it is the exception and not the norm. We see in-house women more than women as claimant-side lawyers. How many experts have you come across that are women or people of color? You must admit, the numbers are low when we look for diversity in arbitration and sadly, we are used to it, so it is not shocking to us anymore. Women - although less in number - are active in associations like PIABA.

In "The Gender and Diversity in Arbitrator Selection," Debra Rothman posits that two possible contributing factors for the lack of diversity in arbitration are both on the supply and demand side. Supply-Side Problems: The "Pipeline" (the lack of diversity in the legal profession at the upper echelons); and (b) Demand-Side Problems: Implicit Bias and Gender Stereotyping (the failure to select female arbitrators is the result of implicit bias and wanting to choose an arbitrator whom the overwhelmingly male arbitration counsel believes "closely mirrors their own professional experience"). The purpose of this paper is to carefully examine these possible contributing factors to the shortage of women and people of color working in securities arbitration.

Moreover, knowledge is power, so knowing the truth of the struggles that women and people of color face can embolden as well as help them to push through the barriers. However, it is everyone's responsibility to level the playing field and recruit candidates from these pools. You can either be part of the problem or part of the solution.

II. Current Arbitration Landscape

Current FINRA statistics show that through October 2017, males still make up 72% of the overall FINRA roster.[2] Females make up only 25% of the overall roster, and 84% of the overall roster are Caucasians.[3] African-Americans show just a 6% sliver of the arbitrator pool, while Hispanic or Latinos make up only 4%, and Asian people make up only 2%, as do people identified as "multi-

[1]Abigail Becnel and Ashley Collis-Burgess assisted with the research and writing of this article. Abigail Becnel is a rising third-year law student at The George Washington University Law School. This summer, she worked at Malecki Law as a summer associate. Abigail graduated summa cum laude from Louisiana State University with a BA in political science and history and minor in business administration in 2016. Ashley Collis-Burgess is a Paralegal and Marketing Manager at Malecki Law. She graduated magna cum laude from Cornell University with degrees in English and Government and a minor in Inequality in 2016. In her senior year, Ashley wrote an honors thesis covering the representation of women in the entertainment industry.

[2]*Our Commitment to Achieving Arbitrator and Mediator Diversity at FINRA*, FINRA, https://www.finra.org/arbitration-and-mediation/diversity-and-finra-arbitrator-recruitment (last visited August 2, 2018).

[3]*Id.*

racial".[4] There are no American Indians or Alaskan Natives, and only 2% identify themselves as LGBT.[5]

FINRA has made a concerted effort to add arbitrators of different colors and genders. There is no question that FINRA is trying to create a more diverse pool of arbitrators, and that is certainly commendable. FINRA conducts outreach to more than 100 minority and women's organizations in an effort to increase diversity, and FINRA's diversity statistics have increased in the right direction over the past handful of years. In 2016, FINRA made efforts "to recruit more arbitrators, including hiring additional staff, enlisting consultant Aon Hewitt and using social media and direct marketing."[6] However look where we are – still in a white-male-dominated business, and it is not just at FINRA. Mediation statistics are about the same.

The American Arbitration Association states on its website that "[t]he AAA Roster is composed of 24% women **and** minorities, and this figure is increasing." [7]That is even less diversity than in FINRA. JAMS Endispute has the best numbers but boasts an overall composition of just 29% female and 9% persons of color. [8]In 2014, an ABA Dispute Resolution Section survey reported that cases with between one and ten million dollars at issue, 82% of neutrals and 89% of arbitrators were men. G.V. Brown and A.K. Schneider, *Gender Differences In Dispute Resolution Practice: Report On The ABA Section Of Dispute Resolution Practice Snapshot Survey,* Marquette Law School Legal Studies Paper No. 14-04 (January 31, 2014). Mark Smalls, on behalf of JAMS a major private commercial arbitration forum, identified the core issue:

> The most attractive recruits to major ADR providers are former judges with substantial civil court experience or attorneys that have ascended to the senior (i.e., partner) level at major law firms. Women and minorities are underrepresented in both of these talent pools. The same forces that keep many women from reaching the partner level at law firms or attaining the general counsel title at corporations naturally reduce the pool of candidates that transition to a career as a mediator or arbitrator.

Sexism in Law and the Securities Industry

The picture for women in the securities industry is at least as bad as we see in the "Me Too" movement and maybe even worse. The dominant male population and resulting sexism on Wall Street contribute to the lack of diversity in FINRA arbitrations. Naturally, with fewer women at the top, there are fewer opportunities for women to network with other women to advance their careers and business. Additionally, there are fewer role models to younger women being educated as interns and rising through the ranks. The statistics for women who make it to management positions in finance are discouraging, and the treatment that women face on Wall Street is even worse.

[4]*Id.*

[5]*Id.*

[6]Antoinette Gartrell, *FINRA Still Struggling to Diversify Arbitrator Pool*, BLOOMBERG (Oct. 19, 2016), https://www.bna.com/finra-struggling-diversify-n57982078833/.

[7]Roster Diversity & Inclusion, AMERICAN ARBITRATION ASSOCIATION, https://www.adr.org/RosterDiversity

[8]https://www.jamsadr.com/DIVERSITY/ (last visited August 2, 2018).

Women hold only 18% of jobs in finance, which is an even lower percentage than in STEM fields.[9] Women hold 9% of senior roles in venture capital, 6% of senior roles in private equity, and only 3% of senior management roles in hedge funds.[10] Brad Hooker from UC Davis' Graduate School of Management contributes this partially to the math gender gap in which boys tend to outperform girls in math because of deeply ingrained stereotypes against women in math.[11]

Maureen Sherry, who worked at Bear Stearns for 10 years, uses her book *Opening Belle* to describe the sexist horrors that go on in the securities industry.[12] Sherry experienced men mooing at her while lactating and others leaving condoms in her lunch.[13] However, Sherry explains that often women feel that they cannot make a fuss over the abuse. Sherry said, "Women filing complaints feel like it reflects poorly on them — that they are weak, non-team players. They don't want to be labeled as a troublemaker. It's a team environment, and they'll ostracize themselves if they do so."[14]

Susan Antilla writes about the treatment women faced in the 1980s on Wall Street in her book "Tales From the Boom-Boom Room."[15] The stories in the book may seem dated, but old habits and mindsets die hard. The book is titled after a notorious basement party room of Smith Barney's branch office known for lewd behavior and sexism. Antilla describes how male brokers would howl as strip-o-grams arrived at the office and how women were referred to by derogatory names such as "Slits and Tits." Although this crude behavior seems like an occurrence of just the past, women still experience similar mistreatment today.[16]

Sexual Harassment Claims

Senators Elizabeth Warren, Dianna Feinstein, and Catherine Cortez Masto requested more information on the prevalence of sexual harassment in the financial services industry from FINRA in a letter addressed to the agency's president, Robert W. Cook. [17] The letter references the

[9]Brad Hooker, *Why So Few Women in Finance?* UC DAVIS GRADUATE SCHOOL OF MANAGEMENT (Jan. 18, 2018), https://gsm.ucdavis.edu/news-release/why-so-few-women-finance.

[10]Sarah Chandler, *Why Are So Few Women in Finance? It's Complicated*, INVESTOPEDIA (Apr. 2, 2019), https://www.investopedia.com/articles/investing/092315/why-are-so-few-women-finance-its-complicated.asp.

[11]Brad Hooker, *Why So Few Women in Finance?* UC DAVIS GRADUATE SCHOOL OF MANAGEMENT (Jan. 18, 2018), https://gsm.ucdavis.edu/news-release/why-so-few-women-finance.

[12]Maureen Callahan, *Trader exposes sexist horrors of the Wall Street 'frat house*,' NEW YORK POST (Jan. 31, 2016), https://nypost.com/2016/01/31/trader-exposes-the-disgusting-sexism-plaguing-wall-street/.

[13]*Id.*

[14]*Id.*

[15]Susan Antilla, TALES FROM THE BOOM-BOOM ROOM: WOMEN VS. WALL STREET (Bloomberg 2002).

[16]Kaja Whitehouse, *Wolf of Wall Street has got nothing on this raunchy firm: suit*, N.Y POST (Aug. 10, 2017 8:39 pm), https://nypost.com/2017/08/10/wolf-of-wall-street-has-got-nothing-on-this-raunchy-firm-suit/.

[17]Letter from Elizabeth Warren, Senator, Dianne Feinstein, Senator, and Catherine Cortez Masto, Senator, to Robert W. Cook, Presiden/CEO, FINRA (Mar. 1, 2018),

"strong cultural and financial forces, that discourage speaking out, including the payout of large settlements with non-disclosure agreements to harassment victims, class-action prohibitions, and forced arbitration". [18] Sexual harassment within the financial securities industry is undoubtedly pervasive. Women who bravely come forward with any sexual discrimination allegations are often required to pursue their claims in FINRA arbitration panels, bounded by contract clauses. Software company, Microsoft not only removed forced arbitration agreements for employees alleging sexual harassment claims but also backed a Senate bill for other companies to do the same.[19] Furthermore, Microsoft's President and CEO Brad Smith, has publicly claimed that "The silencing of people's voices has clearly had an impact in perpetuating sexual harassment,". [20]

Compared to courtroom litigation, arbitration involving sexual harassment claims appears to be more likely to pose disadvantages for women such as lower success rates and concealment. As suggested by Brad Smith, sexual harassment cases handled in arbitration do not have the same public disclosure as court cases. [21] In effect, the privacy of the arbitration shields the respondents from social accountability. Besides silencing victims, forced arbitrations tend to not pan out well for women. The Intercept and Investigative Fund analyzed the outcome of 98 arbitration claims by women alleging sexual harassment as well as 14 filed by men. The numbers indicate that women who come forward with sexual harassment claims tend to not fair well. It is difficult to imagine that the low success rates for women claiming sexual harassment will not impact a woman's decision to come forward. With the higher risks females face in arbitrating sexual harassment claims, arbitrator diversity is even more essential.

Not only female claimants but also their attorneys in sexual harassment claims will face disadvantages because of their gender. Research suggests that female attorneys representing claimants are less likely to end up with a favorable outcome with discrimination arbitration claims. A group of Cornell researchers conducted a study[22]using regression experiments on over 3,000 FINRA employment arbitration disputes between 1986 and 2008 to analyze the effect of gender on awards. The results of the regression analysis reflect that the gender of the claimant and their attorney had an impact on the rendered award amount. Conversely, the research concludes that the gender of the respondent's attorney did not significantly impact the outcome. Therefore, female attorneys representing claimants in FINRA arbitration have even more obstacles in place impeding on their success.

https://www.warren.senate.gov/imo/media/doc/2018.03.01%20Letter%20to%20FINRA%20on%20Sexual%20Harassment.pdf.

[18] *Id.*

[19] Nick Wingfield and Jessica Silver-Greenberg, *Microsoft Moves to end Secrecy in Sexual Harassment Claims*, N.Y. TIMES (Dec. 19, 2017), https://www.nytimes.com/2017/12/19/technology/microsoft-sexual-harassment-arbitration.html.

[20] *Id.*

[21] *Id.*

[22] David Lipsky, J. Ryan Lamare, Abhishek Gupta, The Effect of Gender on Awards in Employment Arbitration Cases: The Experience in the Securities Industry, CORNELL UNIVERSITY ILR SCHOOL, https://digitalcommons.ilr.cornell.edu/articles/1266/.

Racism on Wall Street

African Americans comprise about 14% of the total U.S. population but only hold 2.8% of senior positions in financial services companies.[23] It was not until 1970 that a black man, Joseph Searless III, made a trade on the New York Stock Exchange's floor. Wall Street has a long-standing tradition of discrimination that has long barred African Americans and women.

In 2013, Merrill Lynch agreed to pay $160 million to settle racial discrimination claims brought by 700 black brokers based on a pattern of under-hiring black brokers and allocating customers that made it more difficult for those brokers to build business.[24] These practices are not unique to Merrill Lynch. Darek Sells, a lawyer who has filed a number of discrimination lawsuits against Wall Streets firms describes that "There's quite a bit of discrimination that takes place on Wall Street. I've been involved in cases where racial epithets have been used. I've been involved in cases where nooses have been used . . . racist jokes have been used, where individuals have been called racist names."

This year, Wayne Bland, a former Edward Jones broker, sued Edward Jones for "systemic, intentional race discrimination and policies that unlawfully segregate its workforce."[25] He is alleging that "Edward Jones employs company-wide policies and practices regarding training, compensation, partnerships and the assignment of territories, business opportunities and sales support that unlawfully segregate its workforce and deny African-Americans the income and advancement opportunities because of their race."[26] Bland argues that advisors are evaluated based on their commissions earned but that black advisors are often denied opportunities to grow their book of business, which results in a workforce that is 94% white. Bland also says that his request to prospect for clients in an affluent, white neighborhood was rejected. Instead, Bland was assigned a poorer, more predominantly African American neighborhood where Edward Jones had already closed an unsuccessful office.

Women as Expert Witnesses

How often have you seen a woman serving as an expert witness at a FINRA arbitration? Women are rarely expert witnesses in any type of litigation proceeding. An astounding 80% of expert witnesses in court are male, and on average, male experts get paid 60 percent more than females.[27] Tess Neal, of the University of Nebraska Public Policy Center, explains that "Attorneys seem to think jurors regard men as more credible experts than women and they may prefer to retain men as expert witnesses. Gender studies often show that men are more influential than women, partly because they are viewed as more credible sources of information."

[23]Dan Mangan, *Wall Street an elusive dream for black Americans*, NBC NEWS (Aug. 28, 2013), https://www.nbcnews.com/businessmain/wall-street-elusive-dream-black-americans-8C11022224.

[24]*Id.*

[25]Kenneth Corbin, *Former broker sues Edward Jones for 'systemic' racial discrimination*, FINANCIAL PLANNING OWS, (June 04, 2018, 11:09 am EDT), https://onwallstreet.financial-planning.com/news/former-broker-sues-edward-jones-for-systemic-racial-discrimination.

[26]*Id.*

[27]Bruce Kaufman, *Attorneys Faulted for Scarcity of Female Expert Witnesses*, BLOOMBERG, (Aug. 28, 2017), https://www.bna.com/attorneys-faulted-scarcity-n73014463810/.

FINRA arbitrations also likely see very few female expert witnesses because of their low numbers in the securities industry and finance. The scarcity of women can be attributed to barriers in succeeding within these fields including the gap in math knowledge.

Women and Minorities Practicing Law

A general understanding of the experiences of women and minority lawyers is crucial to make any sense out of their hurdles in arbitration. After all, arbitration recruiters often seek to recruit retired judges and attorneys with impressive credentials. In the "Gender in Diversity in Arbitrator Selection," article, Deborah Rothman posits that the pipeline issue is that attorneys should have a strong resume and career interest to join the alternative dispute resolution pool.[28]Be that as it may, female and minority attorneys frequently are shut out, not by choice, from the opportunity to even attain these desirable attributes. In fact, women and minority attorneys face significant obstacles in the unequal legal professional from unequal pay to racially insensitive treatment. Many of the barriers that impede an underrepresented group's opportunity to serve as arbitrators emerge in their previous work and life experiences.

The legal profession has historically been a white-male dominated business even with incremental increases in diversity in the past years. In 2017, the ABA Commission on Women released a report[29] with troubling statistics of women represented in the legal practice. As of 2017, female attorneys comprised just 36% of the legal profession, despite receiving around half of the awarded JDs for years. Women make up 24.8% of the Fortune 500 general counsel and 19.8% of Fortune 501-1000 General Counsel. In private practice, women were reported to be significantly underrepresented in positions of power encompassing 18% of equity partners as well as 18% of managing partners at 200 largest firms in contrast to 45% of associates.[30] In New York courtrooms, women hold just 25% of the lead counsel roles. As illustrated from the dismal statistics, women are significantly underrepresented in senior positions within the legal profession.

Once hired, female attorneys face a host of other disadvantages while working as an attorney including workforce harassment, lower pay and fewer career advancement opportunities. Female attorneys have expressed their feelings that legal culture might be to blame for the inequality. Full-time mediator Jill Switzer expressed her views just last year that the increasing number of diversity initiatives were "laudable," but not nearly as effective without a changing legal culture. [31] An admitted attorney since 1976, Swifter believes that the "you eat what you kill" business model is one of many legal cultural aspects excluding women from leading a trial or arbitration. In practice, male attorneys are "reluctant" to share billable hours, opportunities, credit and other career opportunities with women. [32] In doing so, women continue to be excluded from opportunities to develop their legal career further.

[28]Deborah Rothman, *Gender Diversity in Arbitrator Selection*, Dispute Resolution Magazine (Spring 2012), https://cdn.ymaws.com/www.wlala.org/resource/resmgr/imported/rothman.pdf.

[29]A Current Glance at Women in the Law, AMERICAN BAR ASSOCIATION, (Jan. 2018), https://www.americanbar.org/content/dam/aba/marketing/women/current_glance_statistics_january2017.authcheckdam.pdf.

[30]*Id.*

[31]Jill Switzer, *3 Reasons Women In Law Are Still Waiting On Equality,* ABOVE THE LAW (Aug. 9, 2017, 1:42 PM), https://abovethelaw.com/2017/08/3-reasons-women-in-law-are-still-waiting-on-equality/?rf=1.

[32]*Id.*

Salaries for female attorneys are still significantly lower than what is provided to males even with nearly identical experiences. A former hiring manager recently filed a suit against her former employer, international big law firm Dow Jones for the alleged "fraternity" culture and unequal pay between male and female attorneys. [33] Female attorneys are more likely to be selected for employment rather than commercial disputes. [34] Studies show that women get interrupted more frequently than men, even on the Supreme Court. [35] The two youngest female justices, Elena Kagan and Sonia Sotomayor were shown to get interrupted the most according to an analysis conducted by legal blogger Adam Feldman.[36]

Beyond gender, race serves as a significant barrier to attorneys. In general, all minorities represent 23.32% of associates, 32.33% of summer associates and 8.42% of partners. [37] Women lawyers of color face the most burdens in employment and practice. Data[38] reflects that law schools still have a low enrollment of students from African-American, Hispanic and other minority groups. Assistant Law Professor Aaron Taylor published an analysis purporting that African-American and Hispanic students were more likely to attend schools with lower median LSAT scores according to research findings.

The underrepresentation of female and minority attorneys can be partially attributed to systematic barriers impeding their ability even to get an interview. The percentage of women enrolled in law schools has been increasing with 2016 data[39] reflecting that women outnumbered men for the first time in history. In 2017, women still outnumbered men enrolled in juris doctor degrees, but not so much within the top law schools.[40] Out of the 2018 U.S News Best Law Schools ranking, men outnumbered women in enrollment for fourteen of the twenty. [41]

[33]Kathryn Rubino, *Jones Day Hit With Explosive Gender Discrimination Case*, ABOVE The Law, (June 19, 2018, 5:58 PM), https://abovethelaw.com/2018/06/jones-day-hit-with-explosive-gender-discrimination-case/?rf=1.

[34]Deborah Rothman, *Gender Diversity in Arbitrator Selection*, https://cdn.ymaws.com/www.wlala.org/resource/resmgr/imported/rothman.pdf.

[35]Adam Feldman, *Interruptions and References*, EMPIRICAL SCOTUS (May 26, 2016), https://empiricalscotus.com/2016/05/26/interruptions/.

[36]Stephanie Mencimer, *Even Female Supreme Court Justices Get Interrupted a Lot by Men*, Mother Jones (May 26, 2016), https://www.motherjones.com/politics/2016/05/even-female-supreme-court-justices-get-interrupted-lot-men/.

[37]https://www.nalp.org/uploads/2017NALPReportonDiversityinUSLawFirms.pdf

[38]*Law School Diversity Index*, U.S. NEWS, https://www.usnews.com/best-graduate-schools/top-law-schools/law-school-diversity-rankings/page+4 (Aug. 3, 2018).

[39]*Gender Enrollment by Law School*, ENJURIS, https://www.enjuris.com/students/male-female-law-enrollment-2016.html (last visited Aug. 3, 2018).

[40]*Law School Rankings by Female Enrollment*, Enjuris, https://www.enjuris.com/students/law-school-female-enrollment-2017.html (last visited Aug. 3, 2018).

[41]*Id.*

Women in the Courtroom

Women are also significantly underrepresented in the United States federal and state courts according to the ABA Commission on Women[42]. It is problematic that women hold only 27.1% of the coveted federal and state judgeships. The percentages of female judges by court type include 35.9% of Circuit Court of Appeals; 33% of Federal District Court Judges and 3 of the eight seats on the Supreme Court. In 2016, for the United States state court, female judges comprised 34.6% of States Final Appellate Jurisdiction Courts; 34.7% of State Intermediate Appellate Jurisdiction Courts; 29.7% of State General Jurisdiction Courts; 33.3% of State Limited and Special Jurisdiction Court. Overall, about 31.1% of all state court judges in the U.S are female. [43] Meanwhile, men claim 73.9% of the federal and state judgeships. Lawyers often seek run for politics to shape law, but females only comprise 17% of House of Representatives, 16% of U.S Senators, 16% of governors and 24% of state legislators.

Women as Business Lawyers: Not Reaching the Top

While women now make up a majority of law students, only a minor percentage of women make it to the highest paying positions in the legal field and few become equity partners at firms.[44] The International Bar Association's (IBA) study on women in commercial legal practice attributes this to the fact that traditional gender images are still working against women along with problems with work-life-family balance, which causes women to be less content with their work and inclined to leave the profession.[45] The study explains that anti-discrimination laws and policies have not been adequately effective. The IBA encourages more hospitable environments for women in law firms in an effort to remedy women's gap at the top.

Fewer Women at the Top - Contributing Factors

A recent study found that women are still paid 15 to 20 percent less than men, with children being the main reason for this pay gap.[46] In most societies, women are still expected to be the primary caregiver for the children and the home, despite having full-time jobs. The IBA study explains that:

> The ever-increasing demands of billable hours, the use of technology-enabling work to intrude on lawyers' time outside of work and the continued expectation that the 'ideal legal worker' must commit him or herself 'unconditionally' to work is used to call into question women's (among others) commitment to their careers. Diversity policies, introduced ostensibly to help women in the workplace, after 30 years have been found to be wanting. This is hardly surprising given that they were designed to address the problem of women, not the workplace.[47]

[43] *Id.*

[44] *Women in Commercial Legal Practice*, INTERNATIONAL BAR ASSOCIATION (Dec. 2017), file:///C:/Users/lawclerk/Downloads/IBA-LPRU-Women-in-Commerical-Legal-Practice-Report-2017%20(1).pdf.

[45] *Id.*

[46] Claire Cain Miller, *Children Hurt Women's Earnings, but Not Men's (Even in Scandinavia)*, N.Y. TIMES (Feb. 5, 2018), https://www.nytimes.com/2018/02/05/upshot/even-in-family-friendly-scandinavia-mothers-are-paid-less.html.

Traditional parenting roles are hurting women's careers, but not men's, largely because women spend more time on child rearing than men do.[48] Female executives are half as likely as men to be chief executives, and one-third less likely to be high earners — even when they were more qualified for these jobs than men. Most of these differences are explained by women working shorter hours and taking time off work in the five years after their first child was born. Despite increased efforts for longer paid maternity leave, women still face a lifetime of pay inequality due to the time away from the office. Long paid maternity leave increases the chances that women will return to the labor force, but it decreases their pay and chance at promotions. Researchers have found that for as long as mothers, and not fathers, are the ones using policies like paid leave and taking on the additional work at home after having children, women's lifetime pay inequity is unlikely to change.

In the legal profession, where billable hours and client interaction is vastly important to promotions and success, equal work at home is a necessary component for women to achieve top leadership positions and equal pay opportunities. Arguments have been made that women leave the workforce to rear children, but we need to ask ourselves whether they leave because they earn less than their spouse. Changes in family structure driven by income also die hard, but it does not have to be that way.

Unconscious Bias

One of the many things that people in the arbitration arena deal with as parties and counsel is the unconscious bias of arbitrators and how it thereby influences the decision-making of everyone in the room: counsel, parties and arbitrators alike, as it is not something that can be demonstrated in a vacatur motion. Following the Civil Rights Act, overt discrimination has almost become a publicly unacceptable practice in the workforce. Individuals are quick to deny holding discriminatory beliefs but fail to recognize their subliminal assumptions rooted in cultural norms. The reality is that unconscious gender stereotypes serve to place women and people of color at a disadvantage in the workplace.

Former American Arbitration Association President, Robert Coulson said, "It seems far more important to try to analyze how and why arbitrators make up their minds."[49] Robert Coulson's evident suggestion that discussions about arbitration should focus more on the decision-making process rather than specific laws is the truth. Incidentally, an analysis of how and why arbitrators make up their minds should include understanding the unconscious biases that influence individual thought processes. The unconscious or implicit bias, inherent within all individuals, is an important consideration to highlight the significance of diversity in the arbitration panel as well as within other decision-making groups. Implicit bias is "relatively unconscious and relatively automatic features of prejudiced judgement and social behavior" as defined by the Stanford

[47]*Women in Commercial Legal Practice*, INTERNATIONAL BAR ASSOCIATION (Dec. 2017), file:///C:/Users/lawclerk/Downloads/IBA-LPRU-Women-in-Commerical-Legal-Practice-Report-2017%20(1).pdf.

[48]Claire Cain Miller, *Children Hurt Women's Earnings, but Not Men's (Even in Scandinavia)*, N.Y. TIMES (Feb. 5, 2018), https://www.nytimes.com/2018/02/05/upshot/even-in-family-friendly-scandinavia-mothers-are-paid-less.html.

[49]Edna Sussman, *Arbitrator Decision Making: Unconscious Psychological Influences And What You Can Do About Them*, 24 AMERICAN REVIEW OF INTERNATIONAL 487, http://arbitragem.pt/conselhos/deontologia/doutrina/internacional/arbitrator-decision-making-unconscious-psychological-influences--edna-sussman.pdf.

Encyclopedia of Philosophy. Implicit bias is manifested in our unconscious beliefs, values and, perceptions that mold our thought processes.

Implicit bias is arguably the most significant hurdle that women who practice law have to face on their job. Female attorneys deal with the double standard of being perceived negatively as "aggressive or abrasive" when acting in the same behavior designated as "confident" in men.[50] As a result of social perceptions, women can also too easily be seen as too soft. Consequently, female attorneys end up having to be more conscious of their behavior to avoid confirming any unconscious biases that might affect their work. Female attorneys who are mothers suffer even more from the effects of implicit bias from being perceived as "second" class. [51]

A point overlooked is the way that implicit biases can be detrimental to rendering fair judicial decisions for members of marginalized groups. First, implicit biases impact the number of women and minorities able to ascend into positions of power within the legal industry and make decisions. Women are often the first to be eliminated from the list when selecting arbitrators for reasons that have little to do with their relative suitability.[52] Although not purposefully, law firms might perceive a woman with the same qualifications as a man as being less qualified. Minorities also experience the effects of explicit bias. Any cognitive biases judges hold towards a party's group membership should not, but sometimes do carry weight in adjudication.

How to Work towards Solving Inequality Issues

So how do we combat implicit bias and diversity issues in arbitration? It is a multi-prong problem. First, we must be cognizant of one's potential and privileges of certain demographic groups within spaces. Recognizing one's "privilege" is not easy but necessary for the sake of the ideal fair, efficient and effective forum. As Professor Michael Kimmel said in his talk about engaging men in the workplace, "Privilege is invisible to those who have it."[53]

For the betterment of all, men need to be more open to discussing female and minority experiences in the workplace. A discussion of these issues is necessary for the surprising number of individuals unaware of the statistics. Societal "black boxes" only hinder meaningful progress in resolving the underlying issues that contribute to the bigger problems. Companies can help foster a better workforce for females through prioritizing workplace policies to help end misconduct, just as done by Microsoft. [54] Above all, damaging implicit biases, sexual harassment and other inequity issues should not be silenced. All people need to have the courage to address issues right when they occur. This includes attorneys, arbitrators, administrators, and clients.

Additionally, male attorneys have a responsibility to actively foster gender equality by providing support, encouragement and mentorship to female and minority attorneys. [55] Men in the legal

[50]Kim Dougherty & Sofia Bruera, The Power of Gender Equity, https://ntlsummit.com/wp-content/uploads/2015/01/1-18-15-305-pm-kimberly-dougherty.pdf.

[51]https://lawrepository.ualr.edu/cgi/viewcontent.cgi?article=1045&context=faculty_scholarship.

[52]Rothman.

[53] https://www.theguardian.com/sustainable-business/2016/jun/08/workplace-gender-equality-invisible-privilege.

[54]https://www.nytimes.com/2017/12/19/technology/microsoft-sexual-harassment-arbitration.html id.

profession should also actively ask female attorneys for their input in cases to encourage diverse viewpoints. Moreover, male attorneys can select qualified female attorneys for lead or heavily communicative roles in courtroom cases. Law firms can only benefit from having their female attorneys active within the legal community.

For a diversified panel, the pools need to be significantly expanded in the areas of women and people of color, so that there is less of an option to strike them. FINRA and other alternative dispute resolutions forums must more aggressively recruit women and minority arbitrators but in an effective, targeted direction.[56] Additionally, law firms, schools and legal institutions also need to actively consider and accept qualified underrepresented groups. Efforts to increase diversity should not stop at recruitment but also through fostering a better work environment to retain marginalized groups. By this, law firms should offer mentoring, networking and other career development opportunities for underrepresented groups to feel included.

Arbitrators should have required diversity training so that they can recognize the importance of when and how to report indications of bias in fellow arbitrators. Perhaps the financial services industry, arbitration forums, and bar associations should become more proactive in facilitating diversity training to educate employees on issues. Big companies, like Starbucks, have implemented diversity training programs with success. Earlier this year, Starbucks[57] had to find an appropriate response to public outrage over a case of implicit bias when a white store manager called the police on two black men in Philadelphia. In response, Starbucks closed a thousand stores to host bias training. Individuals with decision-making authority must be cognizant of their implicit biases and prevent such external influences when rendering a decision. Diversity training can help with this.

At the very minimum, arbitration panels can work towards finding explicit instances of discrimination, perhaps by taking cues from the judicial system. In the judicial system, the government is prohibited from using peremptory challenges to exclude potential jury members solely based on race. That right comes from the constitution and serves to protect jurors as much as litigants. J.E.B., supra, at 127. Gender composition of a panel cannot alone support a finding of evident partiality (i.e., the all-white-male panel). Park v. First Union Brokerage Servs., Inc., 926 F. Supp. 1085, 1088-89 (M.D. Fla. 1996). There is no constitutional right to be an arbitrator, although forums fear and work to prevent exclusions of people from the arbitrator pool based on discrimination all the time.

The ABA has a rule against invidious discriminatory group membership by judges:

Rule 3.6: Affiliation with Discriminatory Organizations[58]

[55]https://ntlsummit.com/wp-content/uploads/2015/01/1-18-15-305-pm-kimberly-dougherty.pdf.

[56]*Id.*

[57]Madison Park, *What the Starbucks incident tells us about implicit bias*, CNN (Apr. 17, 2018 6:23 AM ET), https://www.cnn.com/2018/04/17/health/implicit-bias-philadelphia-starbucks/index.html.

[58]Rule 3.6: Affiliation with Discriminatory Organizations, ABA, https://www.americanbar.org/groups/professional_responsibility/publications/model_code_of_judicial_conduct/model_code_of_judicial_conduct_canon_3/rule3_6affiliationwithdiscriminatoryorganizations.html.

> (A) A judge shall not hold membership in any organization that practices invidious discrimination on the basis of race, sex, gender, religion, national origin, ethnicity, or sexual orientation.
>
> (B) A judge shall not use the benefits or facilities of an organization if the judge knows* or should know that the organization practices invidious discrimination on one or more of the bases identified in paragraph (A). A judge's attendance at an event in a facility of an organization that the judge is not permitted to join is not a violation of this Rule when the judge's attendance is an isolated event that could not reasonably be perceived as an endorsement of the organization's practices.

California's rule against evident partiality did not hold up in an NASD arbitration in Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119 (9th Cir. 2005), but such a rule could be helpful to arbitration parties in every state, prohibiting arbitrator membership in discriminatory organizations:

> (13) (Membership in organizations practicing discrimination) The arbitrator's membership in any organization that practices invidious discrimination on the basis of race, sex, religion, national origin, or sexual orientation. ….[59]

The parties in Grunwald, supra, involving the NASD, shows that parties have no right to an arbitration conducted in accordance with state ethics standards, despite the California legislature's intent that ethics standards apply to neutral arbitrators at the NASD. The court reasoned that the Securities and Exchange Act of 1934, as amended, preempted the application of California's ethics standards to NASD arbitrations. Grunwald, supra, at 1119.

It would be great to see dispute resolution forums adopting ethical standards against people that identify as and are members of groups of those that practice invidious discrimination; however, those forums would have to prepare for First Amendment challenges, which would be worth the fight for women and minorities, but perhaps not for the forum's balance sheet. That said, it certainly would increase their positive profile for those looking for fairness and strength in a forum.

Conclusion

Just as Thurgood Marshall concluded in Peters v. Kiff, "When any large and identifiable segment of the community is excluded from jury service, the effect is to remove from the jury room qualities of human nature and varieties of human experience the range of which is unknown, and perhaps unknowable" [60]

It is important to realize that any diversity within the legal field can foster a stronger justice system more reflective of society. Research shows that higher diversity within a decision-making group contributes to more efficient reasoning and outcomes. A greater increase in diversity within the securities industry can prevent decisions from a dominant group based on unconscious discriminatory beliefs. As arguably the most significant regulatory agency of the U.S securities industry, FINRA should exhaust all means to combat implicit bias and lead in diverse recruitment. Employment disputes should not be handled in arbitration until equal outcome opportunity exists

[59]Ethics Standards for Neutral Arbitrators in Contractual Arbitration, http://www.courts.ca.gov/documents/ethics_standards_neutral_arbitrators.pdf.

[60]Peters v. Kiff, 407 U.S. 493 (1972).

for all. Together, we must encourage underrepresented attorneys to have the opportunities to contribute towards a diverse, fair and efficient justice system.

ON ARBITRATOR SELECTION: THE EVOLUTION AND SOPHISTICATION OF TODAY'S ARBITRATOR RANKING AND SELECTION SERVICES

Richard P. Ryder, President
Securities Arbitration Commentator, Inc.

Summary: *This paper speaks to the subject and the history of arbitrator selection and examines the services that have arisen to assist arbitration practitioners in completing the arbitrator selection process in a thorough, efficient and timely manner. That our perspective derives from being one of those providers will not prevent us from supplying what information we have -- or have been given by others -- about the other available services, as well as SAC's own.*

Introduction

FINRA Rule 12403, "Cases with Three Arbitrators," is one of the longest and most intricate of the Rules in the forum's Arbitration Code. The Rule describes the "Generating of Lists", a process that produces 35 arbitrators selected on a rotational basis by the Neutral List Selection System, and then proceeds through the rest of the ranking process, including "Sending Lists to Parties, "Striking and Ranking Arbitrators," and "Combining Lists." These sections all pertain to the normal procedure for selection and ranking, and, from the parties' standpoint, these operations all have to be completed within a 20-day period.

From there, the Rule continues with the responsibilities FINRA staff members have for appointing and replacing arbitrator candidates, based upon the parties' submissions. So many times we have heard seminar speakers declare the vital importance of this vetting and selection process, some even opining that diligence in this area may contribute the most that counsel can provide toward impacting the outcome of the case. Others have called it "tantamount to malpractice" to fail in one's due diligence when attending to arbitrator evaluation.

At the same time, this complex process of gathering information, digesting the data and making one's choices all must be accomplished within "20 days after the date upon which the Director sent the lists to the parties." Since the gathering and vetting process is so open-ended and the resources warranted for vetting so subjective, one needs to work as efficiently as possible to crowd as maximal investigation and culling into this three-week period.

Investigation and vetting may mean scouring the Internet, tracking down those who know the arbitrator candidate *qua* arbitrator, running her name through BrokerCheck and other databases, reading anything the candidate has written, and a variety of other processes limited only by money, time and imagination. That an Arbitrator's Award history must be reviewed and dissected -- squeezed for the nectar of intelligence it can produce -- is on everyone's list that we have ever heard speak on the subject. They cannot be ignored and we have even heard experienced counsel remark that they will commonly strike candidates that have no Awards they can review.

For 30 years, the author has been supplying Award information to counsel engaged in checking their arbitrators. In the 90s, that process was less sophisticated and more attenuated at NASD and NYSE, because the staff *appointed* the arbitrators. One could challenge them for cause or ask the arbitrator to recuse herself, but that was the extent of control the parties had until the late 90s, when list selection was adopted by NASD Arbitration. SAC's effort in those early years was to gather the Awards that were publicly available, extract the pertinent data from the documents,

arrange that data in readable and easy-to-scan reports, and supply the Awards in paper form, as required by the client.

Experts & Arbitrator Selection

Since that time, parties have become ever more sophisticated and detailed in their arbitrator "due diligence" needs and, over time, other services have appeared, mainly out of the expert arena, that now compete with SAC to fulfill those needs. For the expert, providing arbitrator evaluation tools is just one further way in which s/he can assist arbitration counsel in case preparation. Experts are familiar with the investigative and research process; they are technologically oriented; and they have counsel's ear. One could argue that it's the expert's responsibility to inform counsel of tactical support resources that save time, yield greater benefits, enhance the value of their case, and generally make the litigation "life" easier.

As the age-old gripe of the expert is that s/he is called into the case too close to hearing and too late in the process, offering arbitrator selection services has the special advantage of involving the expert at a potentially earlier point in the case. The expert does not confer as an expert on selecting arbitrators; rather, s/he offers the technological tools one needs to distill the Award information, present it in drill-down fashion for the attorney to examine, and render the represented data -- just like an expert's chart -- in a manner that attracts the eye, facilitates quick understanding, and can be easily shared with the client or a group.

What Can the Awards Tell You?

These competitive services have only arisen within the most recent decade. In the first decade of arbitrator list selection, SAC had to up its game to meet the heightened demand that this new control over one's panel created for data to evaluate. At the turn of the new millennium, SAC converted its Award "stacks" -- our ceiling-high metal shelves of numerically-organized paper Awards -- to PDF format. That step was accomplished with a Colorado service that was acquired during the conversion by a major legal publisher and, together with that company, SAC launched its arbitrator search services online.

Since most of the Awards in this new Library were NASD Awards, SAC entered into a licensing arrangement with NASD that permitted NASD to offer these Award PDFs to parties online. For NASD, this new capability enabled it to phase out a laborious and expensive process of faxing Awards relating to the NLSS nominees to each party in a case and to do so a few years ahead of time. Online PDFs placed the choice in parties' hands whether to read the Awards online or to print them out. It also increased the demand for services that could supplant the necessity of reading and digesting Awards.

What practitioners can glean from Awards is both a subjective exercise and a skill that varies with the reader. If one plans to read all of the Awards, a spreadsheet that records like and differing features of the Award s/he reads is a must. One wants to know how often the Arbitrator sided with Claimant and how often dismissal was the result. Did the Arbitrator ever award punitive damages, attorney's fees, expert costs, and are any of her/his Awards outliers -- unusual, memorable, radical, or puzzling in some aspect?

We are always drawn to the accounting section of the Award, where the fees are assessed and allocated among the participating disputants. One can see here whether the Panel expressed

some pique or disapproval of a party's presentation, by a disproportionate allocation. Dissents are notable, and one must remember, in calculating "win" rates for the Arbitrator candidate (pro-Claimant, pro-Respondent) that, in the case of a favorable Award for one's side, the Arbitrator voted against it.

How often do the awards made by the Arbitrator fall into a moderate zone? Generally speaking, while *average* recovery rates (the amount a claimant wins relative to the amount s/he claimed) may fall in a moderate zone, the Awards themselves tend to be closer to zero or 100%, i.e., not in a moderate zone. To the extent an arbitrator's "grouping" differs from the norm, telling information may lie behind that grouping -- it may coincide with other subtle impressions that inform the picture one forms.

Highly important, in our view, especially when the candidate is a potential Chairperson, are his/her Explained Awards. Arbitrators are not obliged generally to explain their reasoning, so those that do reveal something in the decision to explain. The writing itself of the Explained Award opens a window to the Chairperson's belief framework, her communication abilities, her reasoning powers, knowledge of the law, of the business, and of human character. Is the Arbitrator more linear in her reasoning or intuitive? Does she emphasize the law or the facts, the human aspects or norms and rules? Explained Awards are rarely written as a result of party agreement, under Rule 12904(g), but they are far more common today, primarily as a result of
the requirement to provide reasoning when granting expungement relief.

Seemingly of prominent interest is the ability to seek evaluations from others who have appeared before the arbitrator candidate. The Awards provide information about the lawyers who represented the parties. Unfortunately, they do not usually disclose the names of the testifying experts. We say "unfortunately," because so many lawyers complain that counsel, when queried, may forget who the candidate was, may be coming from a subjective viewpoint, or may exhibit no particular interest in helping. Experts have an incentive to assist inquiring counsel, they are trained to recall and observe, and they are more likely, given their professional mien, to provide objective information. That's why SAC has an invitational arrangement with experts belonging to the Securities Experts Roundtable (SER) that permits them to record their participation in Awards on SAC's Award Database.

For those lawyers who are primarily interested in learning the names of counsel who have previously appeared before an arbitrator, SAC installed a feature on its ARBchek Lite platform that permits an inexpensive search of an Arbitrator's Awards that provides the names and affiliations of the involved professionals (representing counsel and experts) in the disclosed Awards.

Available Arbitrator Search Services

Having started the ball rolling with information about SAC's arbitrator selection services, we need to settle into a discussion of all the known services that are available to practitioners -- at least the ones that I know about. They are, of course, SAC's ARBchek online system, reports from Capital Forensics, Inc., an expert service for defense attorneys, Craig McCann's SLCG, an expert service well-known to claimant's counsel, and the Arbitrator Evaluator by Bates Group, LLC, which has its own Website.

Of course, the service we know the most about is ARBchek (and ARBchek LIte, for more streamlined arbitrator searches), the only one of the services that is available as an online product

24/7 . We know somewhat about Bates' Arbitrator Evaluator (AE), because the data that propels the AE Report comes from SAC. Bates accommodated our request for brochures and samples and we include them as part of this article. CFI, in response to our request, asked that we do not display their product and SLCG did not respond to our request at all.

Neither SLCG nor CFI provides information on their websites about their arbitrator search reports, to our knowledge. We, of course, have seen these reports and will provide some description below of their features as we know them, but without their assistance, we caution that the information may not be completely reliable. To be fair, then, we'll keep all of the product descriptions fairly brief and leave the reader to inquire further of any of the four outfits they may choose.

First, on price, we believe CFI to be the most pricey, although we understand there may be several levels of service at different prices. SAC's pricing provides full searches at prices between $600 and $1,500 and we believe Bates AE service falls somewhere between those two. Our sources say that the SLCG service is available for "free" -- how that works, we don't know. We know that we had a good claimant's client who was getting ARBchek searches at a fair discount, who told us SLCG would provide its reports to the client for free.

The SLCG Report

The Report format we have seen displays on a spreadsheet with workbooks that: (1) list the names of the Arbitrator, her classification, CRD number, if applicable, and a customer win rate that shows both overall and post-2007. For a recovery rate, SLCG calculates an average award percentage. Employment, education and biographical information appear in the cells that follow. Clicking on the candidate's name takes the reader to a Google search page pertaining to the Arbitrator; (2) a full breakdown of the Arbitrator's Awards and pending cases; (3) a book called "Cases Raw;" (4) Work history; and (5) Background - contains the Arbitrator's narrative. If it's free, this Report is a great bargain!

The CFI Product

WE have seen a full CFI package for a case that, besides the Award information and analyses, provided links to BrokerCheck and reports from a dozen perspectives. The main CFI Award analysis is color-coded, provides row tabs that are labeled "Compensatory (just customer cases)," "All Awards," "Other Exp" (lists other types of disputes and Award types), "Parties" (includes the attorneys), and "Other" categories. Each tab groups rows of data about each of the Arbitrators who are listed in columns at the top of the spreadsheet, along with their approximate age, FINRA roster number, and occupation. Summing up the data in the top rows of the Report, CFI calculates a "Score" for each Arbitrator, a preliminary ranking (which is CFI's ordering of the candidates, and a "Final Rank" column that the client is invited to use. The number of customer cases that provide the universe for the statistical analyses appears underneath these scoring row and some 35 rows of information of all varieties are contained in the five tab groupings. In this way, rather than working off a cluttered Excel sheet, all pertinent data is presented in summary form on one sheet and the user can drill down from there to greater detail about the Awards.

Bates Group's Arb Evaluator

The Bates Group report follows a summary sheet and drill-down approach as well. A portion of the main report is pictured on the HomePage of the AE Website. The summary sheet also color-codes, using red to highlight stand-out items and employs icons and images to good effect. The Report communicates in sections information about Award outcomes, about the favorability to claimant or respondent of the outcomes through bar-graphs and then dissects the Awards in the sections that follow. Otehr sections focus on background biographical information, previous appearances with other candidates, and drill-downs to further detail and the Awards themselves flow from these summary sheets. Bates' marketing materials emphasize the AE's ease of use, its linking features, an online portal for multi-user use, graphical views of critical data, and the integrity of the Award data (i.e., "powered by 30 years of [SAC] Award Data...").

SAC's ASR & ACR

SAC's online report, the Arbitrator Summary Report (ASR), is formed for each arbitrator, as that arbitrator's name is inputted online and matched with her Awards. ARBchek will search and present separate results for all 35 arbitrator candidates at once. Each ASR record provides data taken from the Award that record represents, for a quick picture of the Award's features and the outcome; each record also links to the PDF Award. Users can sort and print the ASR or the full Award and, if the user chooses, all or selected Awards may be automatically batched for printing. The ASR was originally designed to represent the Award. SAC has added to ARBchek an "Awards Plus" features that provides information -- most notably, whether the candidate has any AAA Consumer Award in her history. Finally, users may order a supplementary Arbitrator Comparison Report (ACR) , which is designed to highlight potential conflicts between counsel and panelists, data calculations (win rates, recovery rates), dissents, expungement grants, in spreadsheet format and these Award rows also link directly to the relevant PDF in SAC's Awards Library. SAC's reports are party-neutral in presentation and our pricing, too, has historically aimed at attracting serious users from both sides of the case.

Conclusion

One can see, just from this capsulized history and report on services, that the required focus on closely checking one's nominated arbitrators has become a small industry, one that remains in flux -- competitive and ever-improving. The sophistication of today's reports and the movement from simply distilling the Awards to cross-referencing, drill-downs, multi-user formatting, and utilizing the full powers of technology and marketing techniques aims at delivering greater quality, ease of use, and informed evaluation to lawyers who understand the case-vital importance of vetting one's arbitrators and selecting the "best" neutral for one's client.

HOW DO I FIND INFORMATION REGARDING ARBITRATORS ON MY STRIKE-LIST?

Most broker-dealers will do extensive research about potential arbitrators and may have even hired FINRA arbitrators to conduct “mock arbitrations” so that they can determine the qualities that they’re looking for in a potential arbitrator. At a minimum counsel should be doing basic research on potential arbitrators and look at their social media presence (yes, we know that many eighty-five-year old arbitrators don’t have Facebook); criminal history; and political/philanthropic donations.

The Google Basics

It doesn't matter how little you know about the person you're looking for; your search is going to start with Google. This is because Google is an extremely powerful tool if you know how to use it. But if you don't know anything particularly identifying about the person other than what’s on his/her arbitrator disclosure (such as his/her email address), it's better to skip the search hacks and go straight to plugging in keywords. Open up Google and type in some things you know about the person in keyword format; for example, "Bob Jones lawyer Chicago FINRA Arbitrator." Even if you only know the arbitrator’s name, keywords related to his/her job, location and former universities will likely bring up social networks or other identifiable results.

> **Tip.** It's best to complete these people finding search tips without being logged in to your Google account. Staying logged out helps ensure that the results aren't tailored to you specifically, but instead are raw results from the search engine.

Quotation marks let you search for a specific phrase on Google, so using them around a first and last name can help narrow down your person search. For example, looking up the name **John Smith** reveals over 2 billion results, but surrounding the name in quotes like **"John Smith"** shows a mere 32 million. Obviously, several million results aren’t ideal, but it's definitely better than *billions* of results.

The reason this works is because when looking for John Smith without quotes, Google finds all results that include both names. Using quotes make the search a single item, meaning that Google will only show results that have the name *John* next to *Smith*. In addition, if you know where the person lives or works, or what clubs/organizations, etc., that he or she is associated with, you can try a variety of different combinations:

- For younger arbitrators Googling their name and employer will often give you information regarding their practice (e.g., firm web page which will also yield an email address).
- Once you have an address on your arbitrator that will help narrow results.
- Once you find a phone number your results will dramatically narrow.
- An email address is the key as that will help unlock the arbitrator’s social media presence and give you access to their social media (LinkedIn, Facebook, Twitter, Instagram).

Once you have some basic information you can now move to social media.

Using Facebook's People Search and Other Social Media

If no social networks pop up in your initial Google search, you may need to go into the social networks themselves. Facebook is the most popular social network, and it has the most robust search engine. Facebook's *People Search* lets you search for people by filling in one or more search boxes: Name, hometown, current city, high school, mutual friend, college or university, employer, and graduate school. You should have most of this information on your search subject from their Arbitrator Bio. You can now narrow down your search and then browse through the photo results. Always look at your arbitrator phots; a male arbitrator with a ponytail, Birkenstocks and a Fuck Trump T-shirt might be just what you're looking for.

If your subject has no social media presence, try to find their friends and family members; it's possible they're hiding their account behind a fake name (you can also get great information on your eighty-five-year-old arbitrator from his spouse's Facebook page). If you have no idea who their friends and family members are, and you know their full name, use a free people search like Intelius to look up relatives.

The follow brief article gives you the basics on how to search Facebook:

How to Find Someone on Facebook If You Are Not on Facebook

BY FILONIA LECHATUPDATED SEPTEMBER 13, 2017

You don't need a Facebook account to access much of its content. You can see company and celebrity pages, as well as photos and personal profiles of friends and family – provided they have not put privacy restrictions on what they have shared. In 2017, there are two ways to search for people in Facebook. One way is to use its mobile search page. The other is to use a search engine like Google or Bing.

Using Facebook Search

Open any web browser and go to *m.facebook.com/search/* in the address bar. The website m.facebook.com is optimized for mobile devices, but it can be used on computers too. Facebook doesn't have a publicly-available search page on its main website.

Type your friend's name in the search field and press Enter. A list of people matching the name you entered is displayed as well as any publicly-available profile images. Select your friend from the list and enter the CAPTCHA text that appears to access your friend's profile.

Using a Search Engine

Go to your favorite search engine and type the name of the person you want to find. To specify you want to find information only on Facebook, type "site: facebook.com" after the name, such as: *John Doe site:facebook.com*.

If you don't see the results you want, narrow down the search by adding the person's city after his name. If you know your friend uses a specific variation of his name, put that name in quotation marks to eliminate similar names. For example, if your friend always goes by "Johnny Doe" without a middle name or initial and has always lived in Detroit, you could search for: *"Johnny Doe" Detroit site: Facebook.com*.

If you get too many results, you might want to try an image search engine, like images.google.com. Using the same search criteria, you may be able to more quickly pick out your friend's photo from the crowd.

Disadvantages

Searching Facebook without a Facebook account is not the ideal way to look up someone you know.

One problem is that you won't be able to contact your friend. You need an account to send someone a Facebook message or to write on her profile wall.

Secondly, if your friend has chosen to make her information private, the most you will see is a picture and her name. If your friend has opted to remove her profile from being accessed by web browsers like Google, you won't get any information at all. On the other hand, if you were friends on Facebook, or even if you had one mutual friend on the service, you would most probably be able to see more posts, videos, photos and other content.

A third disadvantage is that as you scroll through your friend's profile, you will be habitually prompted to create an account. This won't stop you from seeing what's publicly-available, but you will have to close the pop-up every time you attempt to scroll down the page, which can become a nuisance if you do a lot of scrolling.

Tip

- After you've found the person on Facebook, accessibility to his information is limited depending on his site's privacy settings. On Facebook, a person can opt to be public or private. Public means that you'd be able to see the page and all of its information from an external website, though you won't be able to use any of Facebook's contacting features. If the setting is private, you'll see just the person's site photo and name.

TIPS

- To do a Facebook lookup or search and narrow it by city, first type the name of the person you are looking for into the search box on the Facebook website or smart phone app. Then, click the "**People**" tab to indicate you're trying to search for a person.

- Under the "**Filter Results**" options, choose the city you want to limit the Facebook lookup to. If the city you're interested in isn't listed as an option at first, click or tap "**Choose a City**" and enter the city's name.

- This should limit your search to people associated with that city. You can also limit your search to people who have worked at a certain business or attended a particular school by using the other search filter options.

LinkedIn

Individual data points don't mean anything unless they can be connected to other data points to make up a person's online presence. Once you have several facts about your subject, you'll need to make connections and fill in the blanks. For example, if you know your subject's name, job title, and location, you can easily find their LinkedIn profile. On their LinkedIn profile, they've probably listed their undergraduate degree and *the real date* when they graduated from college, which means you can work backward to figure out approximately how old they are. LinkedIn also gives you the opportunity to compare the arbitrators work history to what they have placed on their Arbitrator Bio; it's not uncommon to see vast discrepancies between an Arbitrator Bio and LinkedIn.

Twitter

It's difficult to find an email address from a Twitter account alone; however, seeing a person's Tweets and who they follow can be quite helpful (would you rather have an arbitrator who follows @therealdonaldtrump or @senwarren?).

Twitter First Steps

The first and most obvious thing you can do is just check their user bio on Twitter. You'll have a pretty low success rate, because the bio is very limited in space, so most people choose to put another more relevant link in place. The only ones that list their email address in their bio are people who really want to be contacted via email, and generally have a business or ideology that they're promoting. However, once you have a user's Twitter handle it is simple to search for their tweets and determine who they follow.

Remember, people are not very creative

If you can find someone's username, Twitter account, personal email address or YouTube profile, you have hit gold. People, for the most part, aren't very creative when it comes to mixing up usernames (or passwords), so they've likely recycled that username many times over. Start by plugging their username into Google, but also look through social networks, forums such as Reddit, and blogs for old comments or posts. Email addresses and phone numbers almost always lead to highly targeted searches.

Arrest Records

Arrests are usually a matter of public record, which means that unless the records have been sealed or expunged, the general public has access to them. Although there are a variety of online services that charge individuals to complete such actions, there are ways to look up people's arrest records at no cost.

State and County Websites

Some states and local counties' websites have search features on them that allow people to search for a person's arrest record within that state or county. Such services are usually free to use and merely require that the searcher input the subject's name, date of birth and sometimes ethnicity. Obviously, the more information that a searcher has on a subject, the more likely that the search results will return the right individual. Some states' corrections websites will contain everything that an individual has been charged with in all states. However, for this type of information, some states require a fee.

PACER

Want to know if your arbitrator ever committed a federal crime? While PACER isn't going to find many arbitrators with a criminal history, it will show you their federal litigation and representation history. PACER will also identify bankruptcies and even the occasional case in which the arbitrator was a party.

POLITICAL CONTRIBUTION RESOURCES

Political contribution history can be an extremely accurate indicator of an arbitrator's social outlook, but the search tools to find them are often underutilized by attorney's researching arbitrator history. Among all the metrics that you might use to guide your strike plan, this data can be the most useful mainly because it indicates demonstrated commitment and an interest in continual engagement with personally meaningful causes. It also shows that an arbitrator was actually willing to spend money to support a cause.

Political contribution search tools make a great addition to your other researching techniques; having the full picture of your arbitrator as an individual is the key to an effective strike plan. Individuals who make political contributions of *any* size can become highly ranked prospects since they're clearly willing to stand by their beliefs and are motivated by a desire to see their support in action.

The top three political contribution search tools:

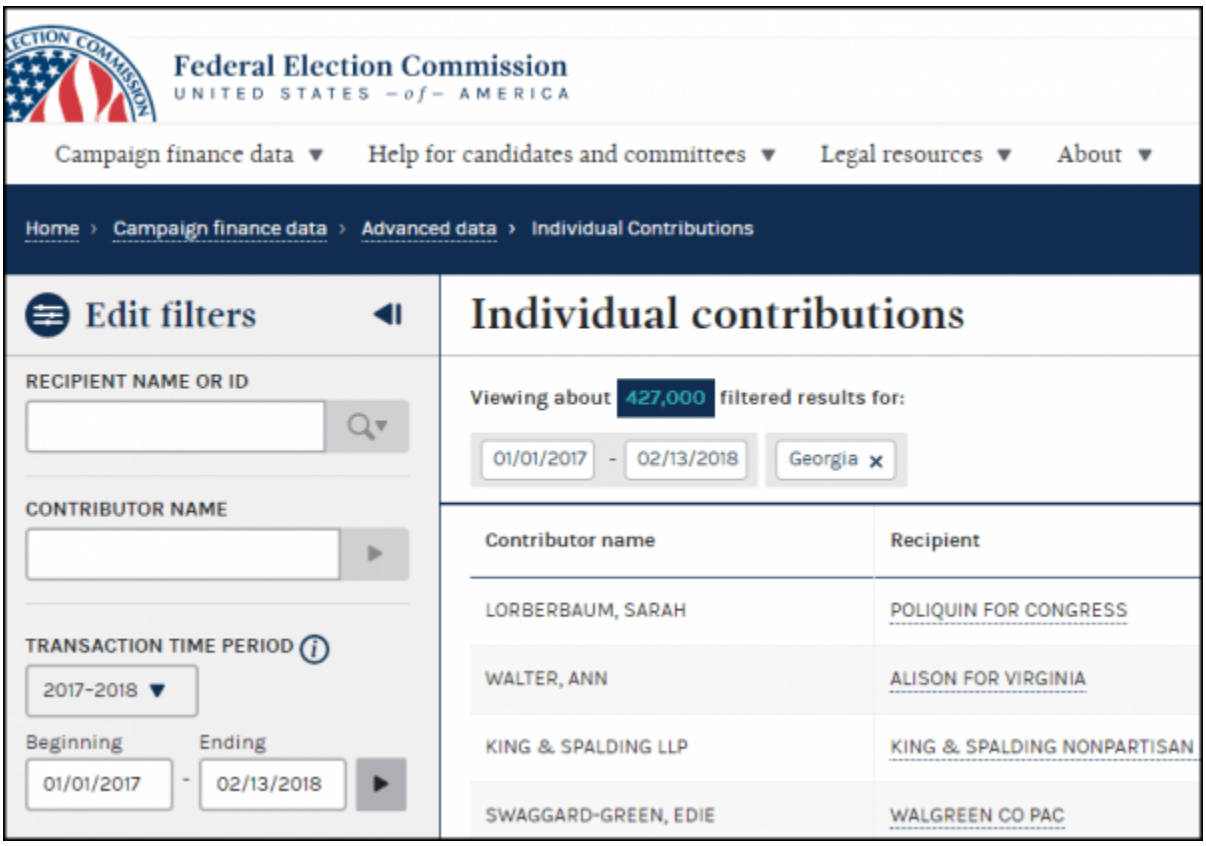
1. FEC.gov
2. Local Political Contribution Search Resources
3. DonorSearch

FEC.gov

The United States Federal Election Commission provides a very simple search tool for its database of political contributions made by individuals found at:

https://www.fec.gov/data/receipts/individual-contributions/

In this federal database you can filter your searches with several fields, allowing you to identify potential arbitrators by location, employer, contribution date, and amount. filtering the database by state and quickly browsing will probably yield results. The database will provide you with the donor's name and location, then by cross referencing other resources you can find more detailed information on the people of causes that this arbitrator supports. A quick Google search will tell you if the arbitrator supported a member of "the squad" for Congress or if the arbitrator was donating money to a religious conservative.



You might consider this tool even for arbitrators you are familiar with. The FEC search tool can refine your searches to easily find individuals with a proven commitment to financially supporting their beliefs and values, giving you insight to your arbitrator's beliefs and values. This is information that an arbitrator simply can't manipulate on their bio!

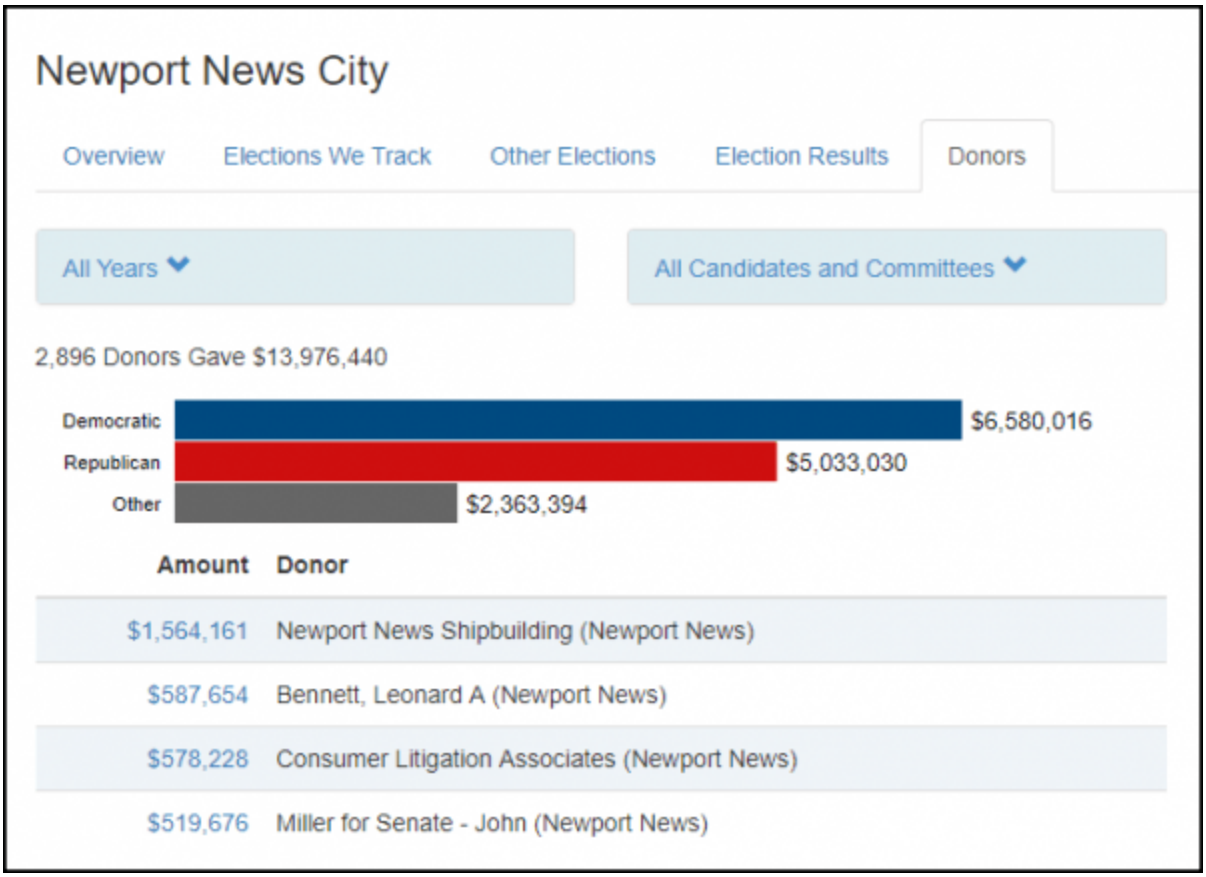
Best of all, as a federal database, this tool is free to use. It can provide an excellent starting point for your research, saving you time and effort in the early stages by identifying arbitrators that won't require further research.

How Do Local Political Contribution Search Tools Work?

Do a little online research to see which political contribution resources might exist to report specifically on contribution data in your local area. Here's an example from The Virginia Public Access Project:

This Virginia political contributions database is a great example of the general features you'll find in similar resources. You can search donors by name, city, and zip code.

Let's say your arbitrator is based in Newport News, Virginia. A quick search reveals the largest donors in the city, both individuals and other organizations, like the local shipbuilding consortium:



This search allows you to easily identify those in your search area who regularly donate to political causes and candidates, indicating a proven commitment to financially supporting certain ideals; ideals you may either like or dislike.

Donorsearch

How Does This Political Contribution Search Tool Work?

You've very generally identified one arbitrator, a guy named Bill Gates, to do a quick search on . This will cost you money, but will help you identify information about causes that Mr. Gates and his wife care about. A quick search reveal:

Bill Gates

Gates in 2015

Born	William Henry Gates III (1955-10-28) October 28, 1955 (age 62) Seattle, Washington , U.S.
Residence	, U.S.
Years active	1968–present
Net worth	US$ [1] .1 billion
Title	• Co-Founder and Technology Advisor of Microsoft

Team Graham Inc

Gates, William H Iii
Gift Amount Range:
$5,000 - $5,000

Gift Type	State	Gift Year
Political	SC	2012

Obama Victory Fund 2012

Gates, William
Gift Amount Range:
$17,900 - $17,900

Gift Type	State	Gift Year
Political	IL	2012

Women On The Road To The Senate: 12 And Counting-seattle

Gates, William
Gift Amount Range:
$10,000 - $10,000

Gift Type	State	Gift Year
Political	DC	2012

Democratic Senatorial Campaign Committee

Gates, William H Iii
Gift Amount Range:
$10,000 - $10,000

Gift Type	State	Gift Year
Political	DC	2011

Does anything stand out? Gates' major contribution to support women candidates for Senate might be an excellent indicator that he'd also be willing to support your client. In this case, Gates could be an arbitrator with potential.

Now imagine extending this concept to your entire arbitrator strike strategy. With access to detailed political contribution data, you could more sharply focus your strategy because such data gives you the biggest picture possible of your own data *and* theirs, including invaluable political and social contribution information; this allows you to make faster and smarter arbitrator strike decisions.

CLEAR Risk Inform (Thomson Reuters) WestLaw

On March 12, 2019, Thomson Reuters (owner of Westlaw) launched "CLEAR Risk Inform," "the first risk-scoring solution to bring together analysis and public records with customizable definitions." According to the press release, industry experts in banking, finance, insurance, healthcare, provider enrollment and vendor management collaborated on the development of CLEAR Risk Inform, which allows organizations and individuals to create an institutionalized risk assessment from public data.

As an example, through CLEAR Risk Inform, one can access business records, such as company name, address, telephone number of employees, comprehensive phone records, related professional licenses reported from various state agencies, assets your subject may own, including vehicles, aircraft, homes, businesses, and more, court records, intellectual property, as well as web analytics. The web analytics allow access to both surface and deep Web data, including social networks, blogs, chat rooms, news references and much more.

Given this relatively new service, however, it does appear that CLEAR Risk Reform is another resource that allows you to use cutting-edge tools to reveal data that other resources may miss.

ARBCHEK WEBSITE BENEFITS AND FEATURES

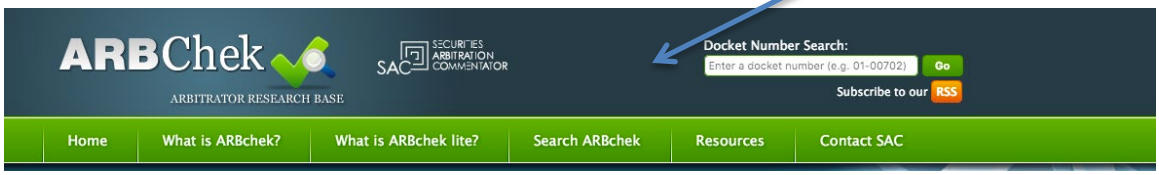
Before we get into the different features that our Arbchek website offers, let's give you some background on what our Arbchek website is and how it can help you in your Arbitrator selection process.

Started in 2007, our Arbchek website is a collection of Arbitrator Award Histories issued by different forums (FINRA, AAA, JAMS, NYSE, etc.) dating back to 1988. With over 58,000 awards and counting, our Arbchek website provides the customer with a comprehensive look into each Arbitrator's award history and breaks it down into a concise, yet detailed and easy to read summary.

If you look at the below screen shot, you will see what our Arbchek homepage looks like.

As you can see, our homepage has many different features in getting you started in your Arbitrator Selection process.

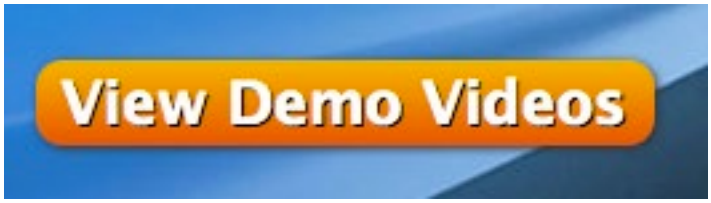
If you are new to Arbchek and are viewing it for the first time, we recommend that you direct your attention to the below green tool bar.



Here you will see buttons that say what is Arbchek? What is Arbchek Lite? If you click on these buttons, it will give you a description of what each service is about and how it can be beneficial to you when selecting Arbitrators.

Now some of you might say, well, I don't have time to read this or I'm busy preparing for an upcoming arbitration, that's not a problem.

On our homepage you will see a button that says video demos.

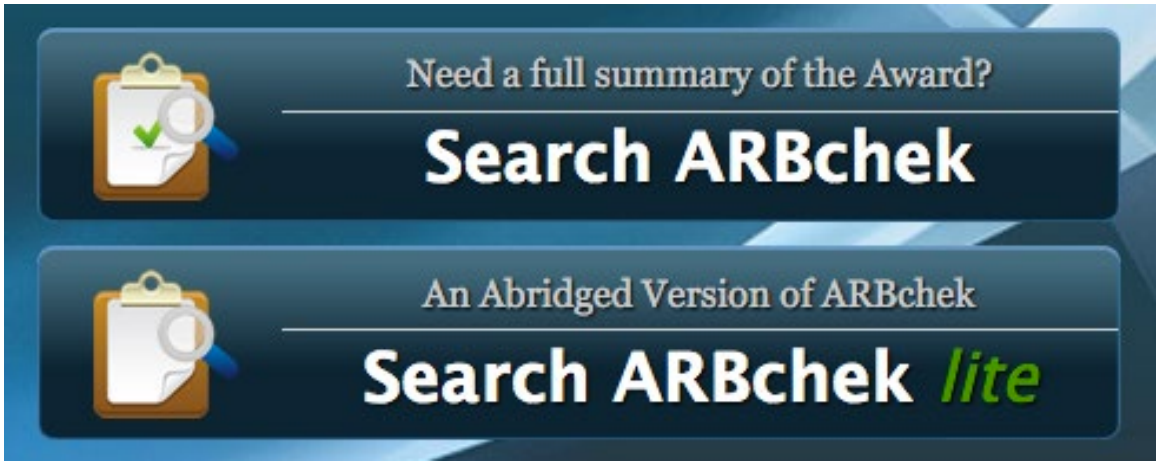


When you click on this button, it will show you how our Arbchek website works and how to use it.

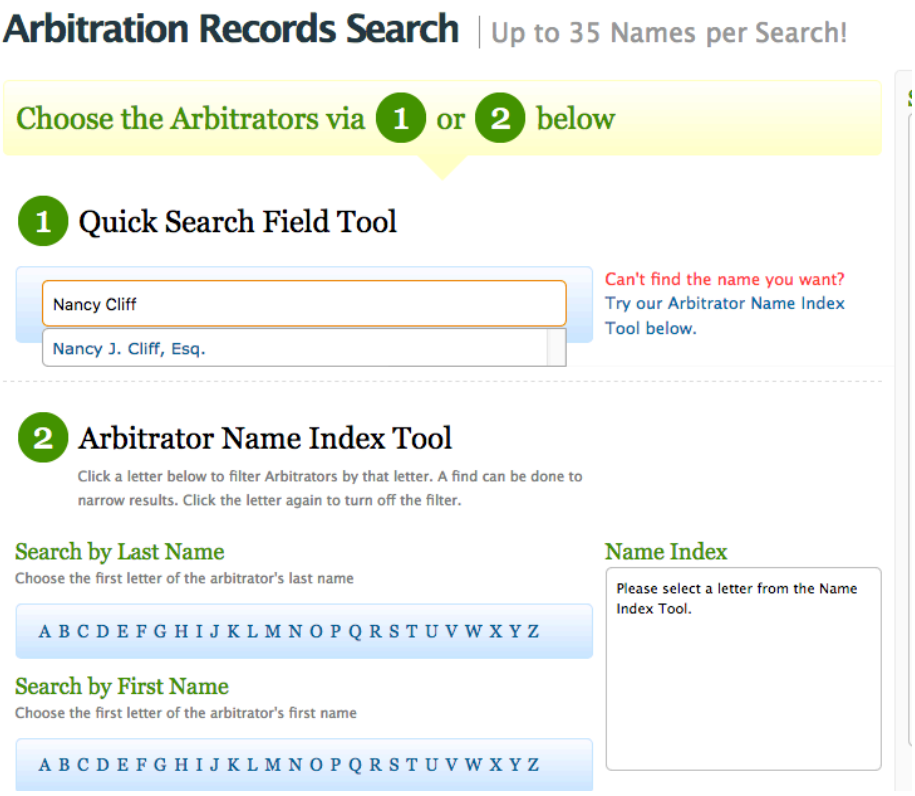
Once you've read and/or viewed what our Arbchek website has to offer, let's get you started with your Arbitrator selection process.

After signing up for our service, which can be done by clicking on this button

You need to log in under the account credentials you created. Once you log in, you would proceed to the following one of two buttons.



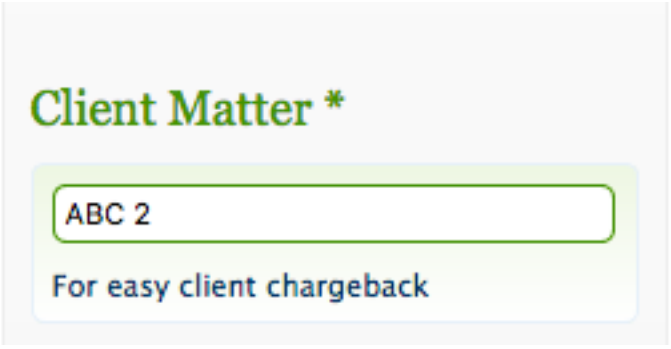
Then you will be taken to a page that looks like this:



The above is how you would start searching for your potential Arbitrators. You would begin by typing the name of the first Arbitrator into the Quick Search Field Tool or if you are not sure of the spelling of your Arbitrator name, you can use the Arbitrator Name Index Tool. This feature is broken down into two categories. You can either search by the Arbitrator's first or last name, which ever you prefer.

Once you've selected your Arbitrator name, that name will appear in the Selected Arbitrator field.

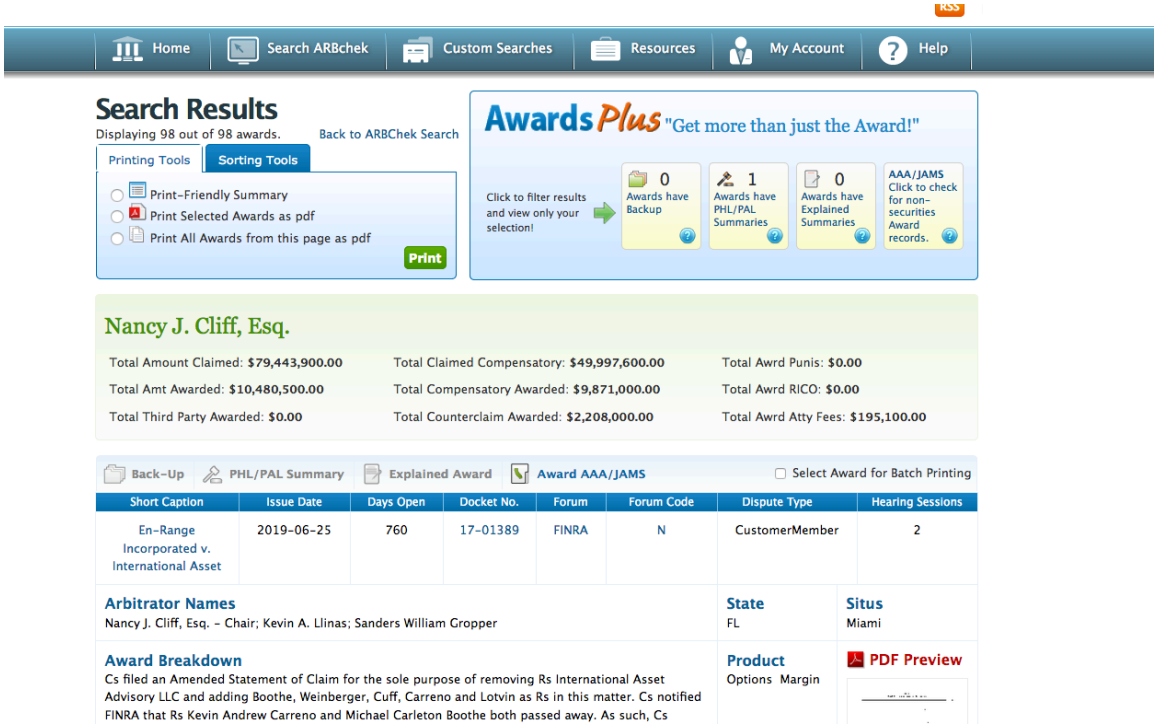
Just below that, you will see something that says Client Matter. Here you would type in the name of your search.



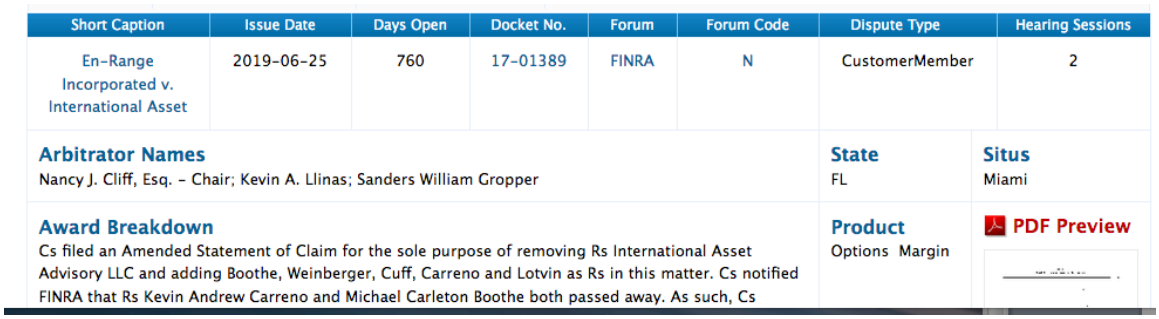
Then hit the search button.

After you've been taken to the payment page and selected your preferred payment, either bill my account or pay by credit card.

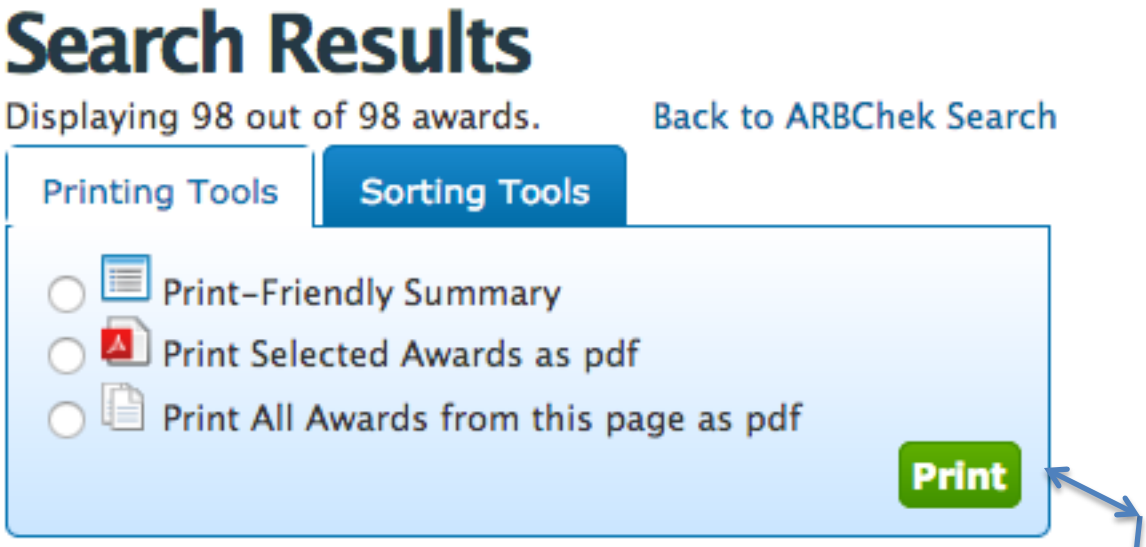
The next page you will be taken to is the results page. Please refer to the below screen shot.



On this page you will find a number of different features pertaining to your selected Arbitrator, most importantly a review of the first docket number appearing in your search. Giving you such details as the short caption, issue date, name of other Arbitrators appearing on that award, etc.



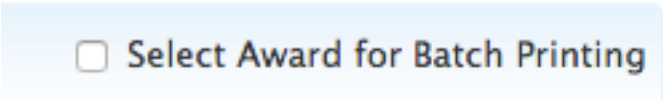
Another popular feature that many of our clients like to use is our Printing and Sorting Tools Feature



If you look at the above, you will see a number of different print options.

Our print-friendly summary will take all the information pertaining to your Arbitrator on this page and download the information into one large readable and summarized document.

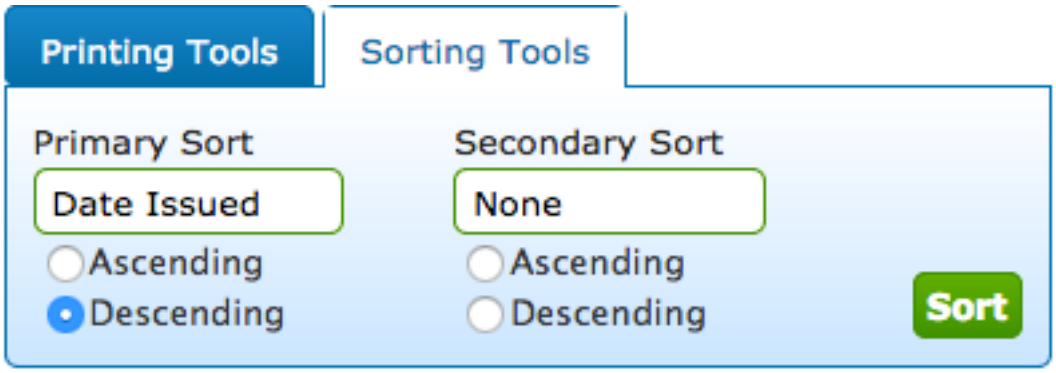
Print Selected Awards as a pdf. This button is useful if you don't want to print all the Award pdfs into one large document. For example, let's say you are only interested in the most recent awards from your selected Arbitrator well this feature allows you to do that. Simply select the following button next to each award pdf you are interested in:



Print all awards from this page as a pdf means that all the awards for this Arbitrator will download into one big pdf with each award appearing consecutively based on how you sorted your search.

Once you have chosen one of the above option, hit the green print button

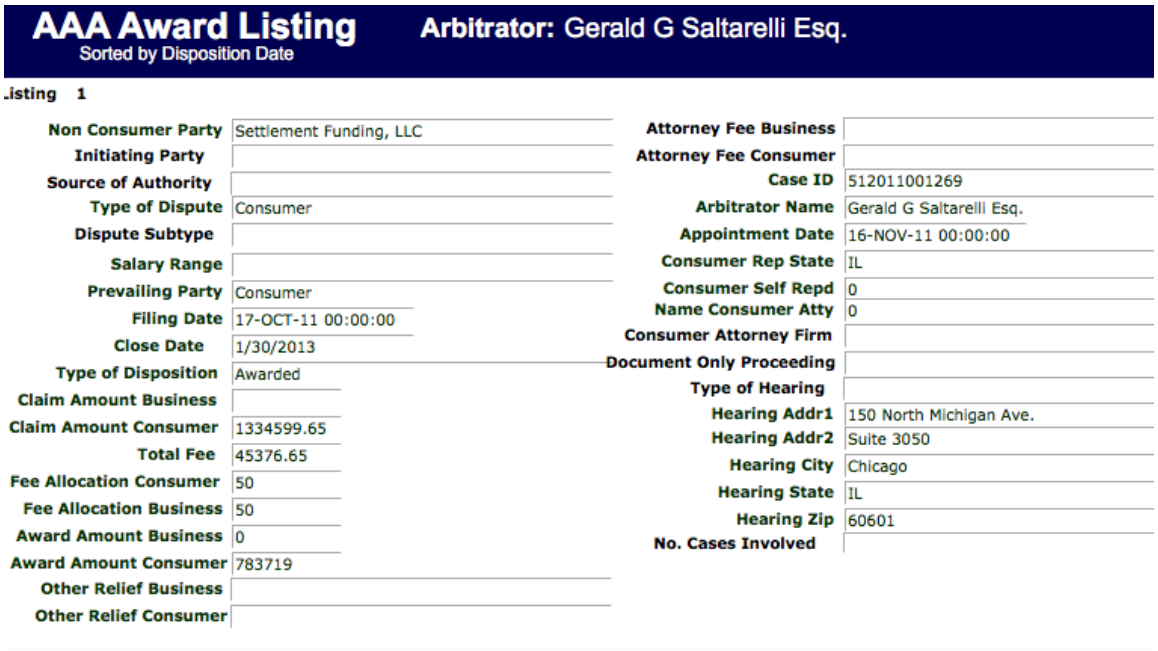
Our sorting feature allows you to customize how you want the results to appear on the Arbitrator's page.



One really unique feature that we offer that you can't find anywhere else is our AwardsPlus Feature.

When using this feature, it allows you to search for Arbitrators who have also appeared on Awards issued by the AAA or JAMS forum.

Once you click, you will receive the following report:



AAA Award Listing
Sorted by Disposition Date

Arbitrator: Gerald G Saltarelli Esq.

Listing 1

Non Consumer Party	Settlement Funding, LLC
Initiating Party	
Source of Authority	
Type of Dispute	Consumer
Dispute Subtype	
Salary Range	
Prevailing Party	Consumer
Filing Date	17-OCT-11 00:00:00
Close Date	1/30/2013
Type of Disposition	Awarded
Claim Amount Business	
Claim Amount Consumer	1334599.65
Total Fee	45376.65
Fee Allocation Consumer	50
Fee Allocation Business	50
Award Amount Business	0
Award Amount Consumer	783719
Other Relief Business	
Other Relief Consumer	

Attorney Fee Business	
Attorney Fee Consumer	
Case ID	512011001269
Arbitrator Name	Gerald G Saltarelli Esq.
Appointment Date	16-NOV-11 00:00:00
Consumer Rep State	IL
Consumer Self Repd	0
Name Consumer Atty	0
Consumer Attorney Firm	
Document Only Proceeding	
Type of Hearing	
Hearing Addr1	150 North Michigan Ave.
Hearing Addr2	Suite 3050
Hearing City	Chicago
Hearing State	IL
Hearing Zip	60601
No. Cases Involved	

That some of the fields in this example are not completed does not mean that they will not be filled in, when one views another AAA record. For example, the consumer attorney often is named. While these Consumer Awards are not often securities-related, these Awards are part of an Arbitrator's full Award history and can often point to helpful information regarding potential conflicts or leads to additional intelligence about the candidate.

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Jennifer Stout, CEO, Bates Group

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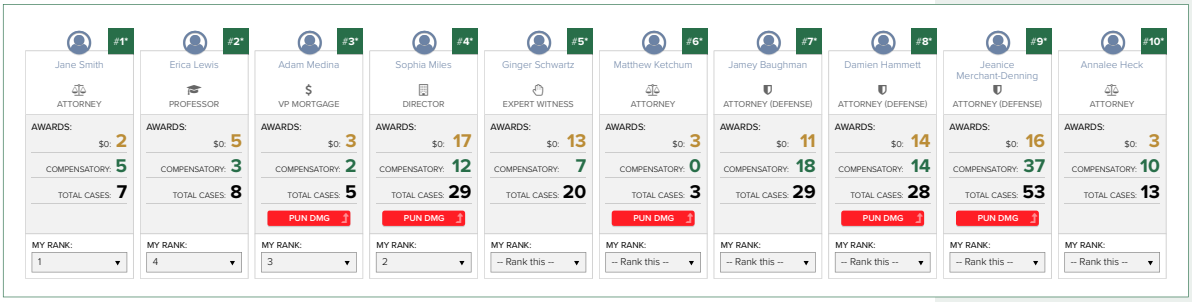
- Fast turnaround time!

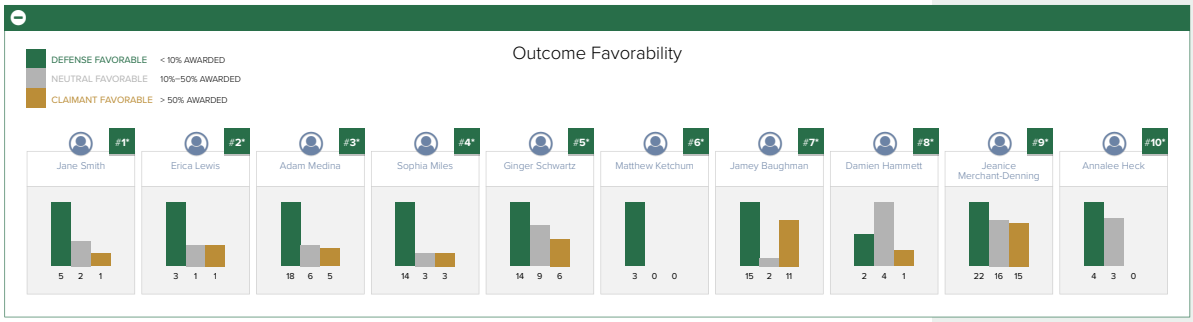
Candidate Evaluation Ranking:

Quantitative ranking of arbitrators based on previous award history and damages awarded



Outcome Favorability:

Prior awards ranked by outcome favorability for each arbitrator



Total Awards:

Easy-to-understand graphics that reveal total awards, claimed damages, and punitive damages granted

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Arbitrator Cross Reference Results
Client Matter: (ACR) 1772/1952

Securities Arbitration Commentator, Inc.
searches@sacarbitration.com
www.sacarbitration.com
973.761.5880

If an Award on this cross-reference chart was issued prior to 2000, it does not appear in the spreadsheet for that Arbitrator. To view a summary of an Award issued prior to 2000 go to that Arbitrator's results page where all results are displayed. To get to the results page click any Docket link below.

Arbitrator	Served on Panel with Arbitrator(s)	Docket #
Michael J. Ahlstrom, Esq.	Brock Bingham Gordon, Sr.	18-00623
	Jeannie B. Wright	09-07024
	John D. Mattingly, JD	09-04516
	John F. O'Neill, Jr., Esq.	04-03671
	Robert H. Putnam, Jr., Esq.	07-02790
	Robert H. Putnam, Jr., Esq.	18-00376
	Robert H. Putnam, Jr., Esq.	18-00623
John D. Mattingly, JD	David E. Morris, Sr.	04-06678
	Michael J. Ahlstrom, Esq.	09-04516
John F. Allgood, Esq.	Brock Bingham Gordon, Sr.	11-01226
	John F. O'Neill, Jr., Esq.	10-02653
	Robert H. Putnam, Jr., Esq.	13-00911
Sabrina Raquel Scott, Esq.	David E. Morris, Sr.	14-01409
Robert H. Putnam, Jr., Esq.	Brock Bingham Gordon, Sr.	18-00623
	John F. Allgood, Esq.	13-00911
	Michael J. Ahlstrom, Esq.	07-02790
	Michael J. Ahlstrom, Esq.	18-00376
	Michael J. Ahlstrom, Esq.	18-00623
Brock Bingham Gordon, Sr.	John F. Allgood, Esq.	11-01226
	Michael J. Ahlstrom, Esq.	18-00623
	Robert H. Putnam, Jr., Esq.	18-00623
	Samuel Appel, JD	15-03338
Samuel Appel, JD	Brock Bingham Gordon, Sr.	15-03338
David E. Morris, Sr.	John D. Mattingly, JD	04-06678
	Sabrina Raquel Scott, Esq.	14-01409
John F. O'Neill, Jr., Esq.	John F. Allgood, Esq.	10-02653
	Michael J. Ahlstrom, Esq.	04-03671
Jeannie B. Wright	Michael J. Ahlstrom, Esq.	09-07024

Arbitrator appeared as Professional	Appeared before Arbitrator(s)	Docket #	Who Won
Robert H. Putnam, Jr., Esq.	Michael J. Ahlstrom, Esq.	01-03864	Cs Win

AAA Award Listing

Sorted by Disposition Date

Arbitrator: Gerald G Saltarelli Esq.

Listing 1

Non Consumer Party	Settlement Funding, LLC	**Attorney Fee Business**	
Initiating Party		**Attorney Fee Consumer**	
Source of Authority		**Case ID**	512011001269
Type of Dispute	Consumer	**Arbitrator Name**	Gerald G Saltarelli Esq.
Dispute Subtype		**Appointment Date**	16-NOV-11 00:00:00
Salary Range		**Consumer Rep State**	IL
Prevailing Party	Consumer	**Consumer Self Repd**	0
Filing Date	17-OCT-11 00:00:00	**Name Consumer Atty**	0
Close Date	1/30/2013	**Consumer Attorney Firm**	
Type of Disposition	Awarded	**Document Only Proceeding**	
Claim Amount Business		**Type of Hearing**	
Claim Amount Consumer	1334599.65	**Hearing Addr1**	150 North Michigan Ave.
Total Fee	45376.65	**Hearing Addr2**	Suite 3050
Fee Allocation Consumer	50	**Hearing City**	Chicago
Fee Allocation Business	50	**Hearing State**	IL
Award Amount Business	0	**Hearing Zip**	60601
Award Amount Consumer	783719	**No. Cases Involved**	
Other Relief Business			
Other Relief Consumer			

Listing 2

Non Consumer Party	Settlement Funding, LLC	**Attorney Fee Business**	
Initiating Party		**Attorney Fee Consumer**	
Source of Authority		**Case ID**	512011001111
Type of Dispute	Consumer	**Arbitrator Name**	Gerald G Saltarelli Esq.
Dispute Subtype		**Appointment Date**	07-NOV-11 00:00:00
Salary Range		**Consumer Rep State**	IL
Prevailing Party	---	**Consumer Self Repd**	
Filing Date	12-SEP-11 00:00:00	**Name Consumer Atty**	
Close Date	5/7/2014	**Consumer Attorney Firm**	
Type of Disposition	Dismissed	**Document Only Proceeding**	
Claim Amount Business		**Type of Hearing**	
Claim Amount Consumer	2187555.43	**Hearing Addr1**	
Total Fee	59336.1	**Hearing Addr2**	
Fee Allocation Consumer	50	**Hearing City**	
Fee Allocation Business	50	**Hearing State**	
Award Amount Business		**Hearing Zip**	
Award Amount Consumer		**No. Cases Involved**	
Other Relief Business			
Other Relief Consumer			

SAC
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www.sacarbitration.com www.ARBchek.com

Arbitrator Comparison Report

Arbitrator: William Gilbert Faulk, Jr.

Client Matter: TEST - DO NOT CHARGE Pat
Primary Sort: Type of Dispute (Ascending)
Secondary Sort: Total Awarded (Descending)

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Notes:

Caption	Docket	Type Disp	Days Open	Issued	Allegations	Product	Explained	Wins	Dissent	Total Amt Clmd	Clmd Comp	Total Amt Awd	Recv Rate	Comp Awd	Atty Fees	A Punis	CC Awd	Expung
Hankins v. Brister	11-00932	CustomerMember	845	06/24/13	Suitability; Misreprestn; Negligence	Equity		Cs Win		2720.1	2697.6	287.8	10.7%	265.3	0	0	-1	Y
Foret v. Legg Mason	09-04067	CustomerMember	252	03/02/10	Suitability; Misreprestn; BreachFiducDty	Equity; VariableAnnuities		Rs Win		200	200	0	0	0	0	0	0	
Louisiana Citizens v. Bear Stearns	09-07085	CustomerMember	645	09/27/11	Misreprestn; Suitability; BreachFiducDty	ARS; MuniSecs		Rs Win	Y	111326.6	109548.1	0	0	0	0	0	0	
Jones v. Curtis	15-00187	CustomerMember	574	08/19/16	UnauthTdg; Suitability; Misreprestn	Equity; MutualFunds; Annuities; Margin		Stipulated		0	0	-1		-1	0	0	-1	Y
Charles Schwab v. Newton	16-01039	MemberEmployee	674	02/16/18	Raiding; TakingRecords; InjunctiveRelief	NP		Cs Win	Y	0	0	-1	0	0	0	0	0	

Arbitrator Award History
# of Awards Since 2000: 5
Total # of Awards in History: 5

Cross Reference Results for Ranking Form:
This Arbitrator has not previously served with the Arbitrators on the Ranking Form.

Name	Case #	Type
Chair		
Ms. Alexandra Smith	16-xxxxx	breach of fiduciary duty and aiding and abetting
aka Sandy Smith	16-xxxxx	unsuitability; unauthorized trading, failure to supervise; and breach of fiduciary duty
	15-xxxxx	suitability, violation of FINRA Rules 2210 and 2010, and failure to supervise
	14-xxxxx	signature forgery; unethical behavior in the roles of solicitor and financial advisor; dishonesty during investigation
	11-xxxxx	breach of contract; breach of fiduciary duty; fraud; negligent misrepresentation; failure to supervise; respondeat superior
	10-xxxxx	breach of fiduciary duty; breach of contract; unsuitability; failure to supervise; intentional and negligent misrepresentation; gross negligence
	10-xxxxx	breach of fiduciary duty; breach of contract; unsuitability
	11-xxxxx	misrepresentations
	09-xxxxx	breach of fiduciary duty; unsuitability; control person liability; respondeat superior
	08-xxxxx	misrepresentation of material facts and/or omission of material facts; breach of fiduciary duty; negligence; unsuitable investments; financial abuse
		democrat
		property value aprox $800k
		"Over the past 45 years I've provided professional services as an attorney, CEO, and arbitrator/mediator"
		formerly: Of Counsel at Davis & Davis; Partner at Anderson & Smith; before 1985 was General Counsel at Energy Company; and Counsel at Bank of the South
		also former CEO of a company and as executive director of a non-profit
		her legal practice is divided between litigation and transactional work
		Representative work includes litigation involving breach of fiduciary duty, accounting, and investment advisor malpractice; defense of the CFO with respect to the failure of a significant financial conglomerate; RICO claims, real estate fraud matters including broker liability; contract matters; and employment issues including sexual harassment and wrongful termination.
		Licensed to Practice Law in California

		aprox 70 years old Is a member of: Hays Trial Lawyers Association; Trial Lawyers College Was a member of: San Diego County Planning Council; State Bar Committee Previously on Board of Directors: San Diego County Food Bank; Association of Health Service Agencies; EEC arb failed to disclose that she is plaintiff / cross - defendant in an ongoing case filed in San Diego Court, Smith vs Def (Other Contract; General Civil) arb has 18 "5 star" reviews on yelp praising how much of a wonderful attorney and person she is("heart of gold", "a joy to work with and a great help solving the problem ", "patient and responsive", "no nonsense approach", "This lady really rocks!", "this attorney was on TOP of the game", "pure, unadulterated competence", "best advocate, warmest person and all round superb legal mind", "simply awesome!") PIABA comment: "I had Alexandra Smith once as the panel chair on a selling away case pending in NV. I would rank her very highly"

Mr. Mark Johnson, J.D.	14-xxxxx	breach of fiduciary duty; fraud; negligent misrepresentation; violation of Michigan Uniform Securities Act; and breach of MSRB and NASD Rules
	09-xxxxx	breach of contract; negligence; misrepresentation; vicarious liability; breach of fiduciary duty; and common law fraud republican property value aprox $353k labor attorney with Reese LLP (fka Reese Jones Carter & Smith LLP - full service law firm) disclosure: "My practice is focused on representing employers in disputes with unions and individuals." AB from Marketon College; JD from Minnesota School of Law Licensed to Practice Law in Minnesota 82 years old (Born: February 27, 1937, Little Falls., Minn.) Is a member of: Childhood Services Commission; The Rotary Club of Saint Paul Was a member of: Attorney Discipline Board - State of Minnesota; Saint Paul Chamber of Commerce; Minnesota Chamber of Commerce Currently on Board of Directors: Health Net of West Minnesota

		Previously on Board of Directors: Saint Paul Bar Foundation; Hennepin Health Plan Corporation; Nursing Home Administrators; Retirement Home; Kindness House and Lazarus Christian Services; Minnesota Hospice Johnson chaired the MN State Bar Committee on Character and Fitness for ten years; during his tenure, decisions included turning down candidates for relatively minor infractions such as plagiarizing, while recommending for admission people who had committed serious offenses, including murder -"An attorney has to be honest. If you tell the truth people will forgive you and work with you if you're really sorry about what you've done, but for Pete's sake, tell the truth." Adverse to in legal action: Wealth Advisors was one of the plaintiffs in securities case no. 1:89cv640, Stone, et al v. Ethel, et al (case dismissed) was named dft in his capacity as member of State Bar of Minnesota Standing Committee in case no. 2:94cv53458, Wilson v. Trim, et al - judgment entered for defendants disclosure: " I manage my own investments and monitor the investment of my retirement fund. " former president of Lazarus Christian Services 1972-79; member executive committee Gen. Synod, 1977-86; bd. dirs.of two Retirement & Assisted Living Facilities, 1987-93 Received Honors: State Bar of Minnesota - Distinguished Service Award; Peer Review Rating: AV the speaker who gave him the Bennet Adams Award, said as he called Johnson up to the stage, "So considerate has he been that his colleagues find themselves asking, 'What would Mark do?' in their own professional lives." Who's Who in American Law, 3rd Edition; Who's Who in America, 47th Edition in 2017 was moderator at an annual Medical Colloquy focused on "The Ethics of Health Care Access" PIABA comment: "bad on eligibility.
Mr. Donald R. Stein	17-xxxxx	failure to disclose; failure to file timely audited financials; negligence; and failure to conduct proper accounting
	16-xxxxx	breach of fiduciary duty; omission of facts; breach of contract.

15-xxxxx	negligence; breach of fiduciary duty and other duties; failure to supervise; and respondeat superior liability
13-xxxxx	illegal sales of unregistered securities; misrepresentations and omissions; and suitability
14-xxxxx	breach of contract; common law fraud; breach of fiduciary duty; and negligence and gross negligence
14-xxxxx	unauthorized wire transfer in violation of New York wire transfer laws, breach of contract, aiding and abetting fraud
09-xxxxx	sale of unregistered securities; suitability and fraud; and breach of fiduciary duty
07-xxxxx	unsuitability, negligence, breach of fiduciary duty, common law fraud, negligent misrepresentation
06-xxxxx	unsuitability, breach of contract, and breach of fiduciary duties
04-xxxxx	negligent misrepresentation, constructive fraud, fraudulent concealment, common law fraud/misrepresentation, breach of fiduciary duty
03-xxxxx	failure to supervise and breach of fiduciary duty
03-xxxxx	respondeat superior, negligence, breach of fiduciary duty, misrepresentations, and fraudulent concealment

politically unafiliated

property value aprox $1,3 m

Sole Practitioner - Attorney/Arbitrator/Mediator - "Since 1989, I have served on a full time basis as a professional neutral"; former attorney with a non profit organization

prior that served as a Deputy District Attorney (1975-1978) and as a litigation attorney in private practice focusing on commercial and interpersonal disputes for twelve years before joining Arbitration Org, an internationally recognized training firm in mediation and dispute resolution processes in 1989

Licensed to Practice Law in: Colorado #123456

Licensed to Practice: Colorado Real Estate Commission Independent Broker

67 years old (Born: April 30, 1952, NJ)

Is a member of: Academy of Family Mediators; Colorado Academy of Mediators & Arbitrators; Colorado Counsel of Mediators & Mediation Org; Society of Professionals in Dispute Resolution

Currently on Board of Directors: Water Utility Company; Non Profit Corp

not disclosed: is Board Member of Boulder Community Hospital, and Member of Office Evolution Corporation

Was a member of Colorado State Bar - Board of Governors

was dft in case no. 1987CV789, Felix Inc Vs. House Finance Et Al, Boulder Co Court

		not disclosed: starting 2002 is the owner of a bar in Aurora Martindale-Hubbell rating: AV is listed in Best Lawyers in America, Colorado Superlawyers and is a Fellow of the College of Commercial Arbitrators in 2006 was very close to become a Distrcit Court Judge (he was one of the three nominees that were selected and certified by the Governor) PIABA comment: "Stein is good. I usually rank high" PIABA comment: "I usually rank Stein high. He's fair-minded and sympathetic to investors" PIABA comment: "Probably my number 1 on this list. " PIABA comment: "I rank Stein well"

Mr. Peter Steven Miller	16-xxxxx	breach of contract; common law fraud; breach of fiduciary duty; negligence; and gross negligence
	15-xxxxx	suitability; financial abuse of an elder or dependent adult; breach of fiduciary duty; breach of contract; breach of the implied covenant of good faith and fair dealing
	11-xxxxx	breach of fiduciary duty; manipulations; misrepresentations/non-disclosures; and omission of facts.
	08-xxxxx	breach of contract; common law fraud; breech of fiductory duty; and negligence and gross negligence
	08-xxxxx	negligence, failure of supervision, breach of contract, fraudulent misrepresentation, and vicarious liability.
	06-xxxxx	breach of fiduciary duty, unsuitable investments, switching, fraud, churning and failure to supervise.
	06-xxxxx	Just and Equitable Principles of Trade; Suitability; Omissions and Misrepresentations of Material Fact; Negligent Supervision and Failure to Supervise;Negligence; Breach of Contract
	05-xxxxx	breach of fiduciary duty, breach of contract
	04-xxxxx	Material Misrepresentation in Securities Transaction; Fraud and Misrepresentation; Negligent Misrepresentation; Breach of Fiduciary Duty; and Failure to Supervise

	05-xxxxx	Breach of Fiduciary Duty; Fraud; Constructive Fraud; Negligent Misrepresentation; Negligence; Failure to Supervise democrat; in late '90s he was fined $5k for campaing violations while participating in his wife's campaign (she was running for city council) property value aprox $1,5 m President at Miller Arbitration/Mediation Services; managing partner of his family's farm formerly President at Thomas & Miller A Law Corp (prior 1997, for almost 30 years) as an attorney sued several insurance companies on behalf of his clients Licensed to Practice Law in California #98765 78 years old (1941) Was a member of California Trial Lawyers he is currently Vice President at SF Youth Alternatives; also he is Board Member for Tenants Association his brother is a Marriage and Family Therapist, and together they offer Family Mediation Services PIABA comment: "usually 5-6+"

Mr. Robert White	17-xxxxx	bait and switch, common law negligence, negligent misrepresentation, failure to supervise, breach of covenants of good faith and fair dealing
	17-xxxxx	breach of fiduciary duty, unauthorized trading, suitability, churning, misrepresentation, omission of facts, common law negligence, fraud, failure to supervise
	16-xxxxx	churning; unsuitable investment recommendations; breach of fiduciary duty; negligent supervision; and liability under agency law, respondeat superior, and/or as statutory control persons
	16-xxxxx	unsuitability and unauthorized transactions, failure to supervise, and breach of fiduciary duty
	16-xxxxx	breach of contract and breach of fiduciary duty
	15-xxxxx	breach of contract, negligence, and breach of fiduciary duty
	16-xxxxx	fraud, unsuitability, deceptive practices, breach of fiduciary duty, breach of contract, negligence, negligent misrepresentation
	12-xxxxx	breach of fiduciary duty, negligence and gross negligence, malpractice, promissory estoppel, unsuitability, common law fraud
	14-xxxxx	common law fraud; breach of contract; breach of fiduciary duty; negligence; and respondeat superior

13-xxxxx	breach of fiduciary duty; negligence and gross negligence; churning; breach of contract; malpractice; unsuitability
13-xxxxx	breach of fiduciary duty; negligence; malpractice; promissory estoppel; suitability; common law fraud
14-xxxxx	breach of fiduciary duty; negligence/unsuitability; negligent supervision; negligent misrepresentation; promissory estoppel; and punitive damages.
12-xxxxx	malpractice; negligence/recklessness; innocent misrepresentation; breach of fiduciary duty; respondeat superior liability; breach of supervisory rules
	democrat
	property value aprox $400k
	Full time arbitrator and mediator since1992; Adjunct Faculty with Michigan State University
	according to an interview he didn't really care for law school and this is why he became arbitrator
	formerly: Contract Admin Law Judge; Secretary with Grand Rapids Human Rights Dept; Assistant with Grand Rapids Accounting Dept
	Licensed to Practice Law in Michigan # P00001
	70 years old (01/11/1949)
	Is a member of: Labor Employment Relations Assn; National Academy of Arbitrators
	Has made a disclosure about The Institute of Continuing Legal Education - Volunteer
	Member of permanent labor arbitration panels involving numerous private and public sector employers
	in 2000 was repondent in case in his capacity as arbitrator
	was co defendant in a 2012 local case
	in 1992 was named dft in his capacity as Secretary in a case against Grand Rapids
	arb is the author of articles on negotiation and mediation as well as a best selling book on settlements
	member of Kehillat Israel Congregation
	read ancient texts on taoism
	Named to Michigan Super Lawyers for four consecutive years back in 2010 - 2013
	arb and his wife live in Lansing, enjoys gardening and smoking cigars
	PIABA comments: "strike him"
	PIABA comments: "usually strike"
	PIABA comment: "mixed reviews rank low or strike"
	PIABA comment: "White is pretty good. Rank in middle."
	PIABA comment: "rank mid ot high, generally like"
	PIABA comment: "might have a cozy relationship with BDs. rank him middle. Not high. I used to rank him high."

Mr. Gary Michael Stevenson	17-xxxxx	breach of fiduciary duty, negligence, and negligence supervision
	18-xxxxx	penny stock regulation; breach of fiduciary duty; and failure to supervise
	15-xxxxx	breach of fiduciary duty, failure to execute, negligence, and negligent misrepresentation.
	15-xxxxx	breach of fiduciary duty; aiding and abetting breach of fiduciary duty; fraud – intentional misrepresentation; fraud – fraudulent concealment; and promissory estoppel
	15-xxxxx	failure to execute a sell order.
	15-xxxxx	breach of contract, breach of fiduciary duty, negligent misrepresentation, conversion, common law fraud, suitability
	14-xxxxx	breach of fiduciary duty, misrepresentations, and omissions.
	11-xxxxx	breach of fiduciary duty; suitable recommendations; failure to conduct proper due diligence; failure to supervise and respondeat superior principles; negligence; misrepresentation; negligent misrepresentation; constructive fraud; breach of contract; control person liability; and ERISA violations
	09-xxxxx	securities fraud; negligent supervision; respondeat superior; breach of fiduciary duty; negligence; common law fraud; negligent misrepresentation
		democrat
		property value aprox $500k
		Principal at Stevenson Law Offices since 2011 formerly: Adjunct Professor (University of Minnesota Law School; University of St. Thomas Law School); Litigator at Smith & Jones, PA (over 200 attorneys); Partner at Brown, Gray & Green (predecessor firm to Smith & Jones); Partner at Lee, Bell & Stevenson Licensed to Practice Law in: California # 010101 (inactive); Iowa # 0101010; Minnesota
		72 years old (1947) Was a member of: AAA - Minneapolis Advisory Committee (2007) and Subcommittee on Class Actions of AAA Practice Committee (2010); MSBA Civil Juries; MSBA Dispute Resolution; MSBA Litigation Section; MSBA Natural Resources & Environmental Law; Minnesota Law Review Lectured for: AAA; ABA; Simon Property Group; Conflict Resolution Center; MILE; MN Defense Lawyers Association; MSBA; Minnesota CLE; Minnesota RIMS Conference; National Business Institute

	Adverse to in legal action: Credit Suisse - As attorney formerly represented parties against Credit Suisse Adverse to in legal action: Merrill Lynch- As attorney formerly represented parties against Merrill Lynch his firm / employer represented: Ameriprise; Wealth Enhancement Advisory Services, LLC; Securian Financial Services Inc (BD); Greene Holcomb & Fisher, LLC (Investment bank); Madeira Partners (investment banking firm); Bayview Capital Group (investment advisor) disclosure: "trained well over 600 practitioners in the practice of arbitration and mediation" Visiting Professorships at law schools in France and Greece worked with non-profits in capacity as advisor, board member, officer, and attorney: Autism Society of Minnesota, Autism Society of Minnesota, Simpson Housing (dedicated to housing, supporting and advocating for people experiencing homelessness) Best Lawyer (2008-present) not dislcosed: owns a real estate firm in Bloomington, together with his wife is a member of Wayzata Yacht Club PIABA comment: "Strike Stevenson" PIABA comment: "Of the Minnesota arbs, Stevenson should be ranked higher. He does mostly arb work and does a nice job."
Mr. Brian Young	democrat property value aprox $500k Attorney engaged primarily in Bankruptcy, Commercial, Real Estate, General Practice matters former accountant at Metal Factory.; former Auditor CPA with Hall Reed & Price Licensed to practice law in Ohio (#0011223) is Certified Public Accountant, Ohio Registration - Not Practicing Public Accounting - #12345 65 years old (7/12/1953) former member of National Association of Consumer Bankruptcy Attorneys was attorney in over 45 bankruptcy cases - in the most recent ten cases he represented inviduals-debtors; in all civil cases on pacer he represneted defendant-companies in trademark and labor cases. ten years ago represented a lender that sued several individuals for slander and libel asking over $500k in damages before 2000 represented sevreral defendants in criminal cases that were charged with mail fraud has three local lawsuits (undisclosed, small claims), arb was plaintiff in all of them in 2013 he contested a tax lien

		before 1995 represented a couple of small business owners against real estate companies was attorney for the respondent in arbitration case no. 02-xxxxx - claimants alleged violation of NASD rules, tortious inference, defamation of character and slander, respondeat superior; the panel decided in favor of respondents. has one (five stars) review on Martindale left by a former client in a bankruptcy case: "Great attorney". sometime discusses his potential cases on social media (without being too specific) big football fan

Judge Jennifer B Thompson	14-xxxxx	fraud and/or aiding and abetting fraud; breach of fiduciary duties; respondeat superior; and failure to supervise
	16-xxxxx	negligence, breach of contract, breach of fiduciary duty, conversion, and respondeat superior
	13-xxxxx	unsuitable investments and negligent account management; misrepresentations,breach of contract; breach of fiduciary duty and constructive fraud; respondeat superior; and negligence and negligent supervision
	12-xxxxx	breach of fiduciary duty, negligence and gross negligence, malpractice, promissory estoppel, unsuitability, common law fraud
		democrat
		property value aprox $268k
		Mediator/Arb
		formerly: Judge for Lake County Circuit Court; Public Defender with Lake County Public Defender's Office (representing indigent criminal defendants); General Practice Attorney (negligence, domestic relations, business, contracts and property disputes)
		Licensed to Practice Law in Michigan #Pxxxxx
		80 years old (1939)
		Is a member of: Michigan Judicial Alternative Dispute Resolution;
		is Member of the Michigan retired judges Association
		Was a member of Michigan Judges Association
		in her capacity as judge was dft in four cases: no. 1:xxcvxxxxx, Smith, et al v. Thompson (NOS: 440 - Other Civil Rights); case no. 4:xxcvxxx, Collins v. Lake County Circuit, et al (NOS: 550 - Prisoner - Other); case no. 1:xxcvxxx, Romano, et al v. Thompson, et al (NOS: 550 - Prisoner - Other); case no. 1:xxcvxxx, Carter, et al v. Thompson, et al (NOS: 440 - Other Civil Rights)
		was plaintiff in a professional malpraxis case
		wrote an article on Empathy at the Mediation table

	comments about her: ""I found her when I practiced in front of her, and I believe this is true today, to be a very caring and compassionate judge," said District Judge John B Smith. "She does really look inside people and tries to find the good, because people do make mistakes and do make bad decisions. It was always a person in front of her … not just another case. I really admired that and tried to do the same."" comments about her: ""I've seen her from all these different perspectives, as a defense attorney, as a prosecutor and as a fellow judge," he said. "I've never once seen her lose sight of the fundamental goal of being fair and kind to everyone in front her." PIABA comment: "I like judge thompson. Rank high." PIABA comment: "no" PIABA comment: "Bad. Strike." PIABA comment: "Had her on a case, gave a good discovery ruling."
Mrs. Susan G Whitney	democrat property value aprox $173k Managing Member of Law Office of Whitney & Associates, LLC (Estate Tax, Criminal Defense, and Personal Injury); according to social media arb is mostly known for being a really great tax attorney formerly: Montgomery County Public Defender and Business Controller with Federal Business Service; Senior Defense Counsel for U.S. Army JAG Corps - represented Army Reserve Soldiers facing adverse actions and separation for misconduct. BS in Business Administration from Widener University; JD from Widener University School of Law Licensed to Practice Law in: PA #xxxxx; NJ #xxxxxxxxx is a Pennsylvania Notary Public. Was a Licensed: PA Certified Public Account (inactive); New Jersey Title Insurance Producer (Inactive) 53 years old (1966) Is Shareholder of: Fidelity; Baron Funds; Oppenheimer; Pimco; USAA is a Judge Advocate in the US Army Reserves holding the rank of Major Non-investment related lawsuit/charge: Plaintiff in personal injury suit, settled (2005) according to her strategic profile she represented both plaitiffs and defendants, but arb is mainly a defendant attorney, has various banks as former firm clients

		she is a member of St. Rose of Lima Church PIABA comment: "not greatest" Struck in previous cases
Mr. Leonard G McDonnall	17-xxxxx 16-xxxxx	fraud; breach of duty of fair dealing, fraudulent misrepresentations; breach of fiduciary duty; breach of contract; failure to supervise; respondeat superior/vicarious liability; and unfair trade practices negligence, negligent misrepresentation, fraud by misrepresentation, fraudulent concealment, respondeat superior, breach of fiduciary duty democrat property value aprox $245k Sole Practitioner since 2001; he advertises that "His clientele includes red carpet movie stars and regular people" Independant contractor providing services for Ohio Title Insurance Company disclosure: "Beginning in the summer of 2018, I became affiliated with Vuitton and Suchardine in the area of class action litigation." formerly General Counsel at US General Mortgage Company; Counsel at Ohio Title Insurance Company; Real Estate Department at Michaels & Smith; Law Clerk at BAX, Inc. (defense contract litigation); Volunteer Attorney at Consumer Protection Legislation Project, Inc. and legal clinic.; Contract Assistant at ING Bank and Chase Bank BA from City College of New York (CCNY); JD from North Carolina Central University School of Law Licensed to Practice Law in: New York #xxxxxx; Ohio #xxxxx Was a Licensed Real Estate Broker (New York & Ohio)C31 aprox 55 years old In early 2012 worked on a temporary contract assignment in Washington, D.C. with the DOJ on a real estate finance fraud case. disclosure: filed bankruptcy in 2007, filed lawsuit on behalf of family member for assault charges according to corporationwiki he is the current owner of a business "Belle Associates" and a principal at "Brick Property Investors, LLC" has two five star reviews on avvo somebody left a comment to an article on ohiotrib.com entitled "Local attorney in conflict of interest" and claims, among other unrelated things, that he "hired a black attorney Leonard McDonnall who took my two thousand dollar retainer fee and never showed up in court because knew the judge was not going to allow me to win my criminal case or civil case"

	PIABA comment: "very limited intellectual capacity" 2017; "not very smart" 2019 Ranked 6th in previous case

Damages	Awards	Comments
$263,006.37	$181,930.91	Presiding Chair
$287,350.63	$270,452.34	Presiding Chair, All Public Panel (respondent filed a motion to vacate this case, motion pending)
$40,333.81	$31,156.99	Sole Public Arb
$3,680.00	$0.00	Sole Public Arb
$150,000.00	$100,000.00	Panelist, All Public Panel
unspecified	$50,000.00	Presiding Chair
unspecified	$10,366.14	Sole Public Arb
$11,000.00 comp; $5,000.00 punit	$12,617.00	Sole Public Arb
$1,000,000.00	$202,300.00	Presiding Chair
$606,400.00	$990,000.00	Public Arbitrator

Unspecified	$0.00	Panelist, All Public Panel; the Panel granted R's MTD for ineligibility under FINRA Rule 12206
$459,398.13	$0.00	Public Arbitrator; the Panel granted R's MTD

$150,000.00	$125,000.00	Presiding Chair, All Public Panel; signature page missing for him and another panelist
$440,158.00	$440,158.00	Panelist, All public panel

$300,000.00	$155,935.45	Presiding Chair, All Public Panel
unspecified	$1,559,139.00	Public Arbitrator, Presiding Chair
$475,000.00	$653,795.79	Presiding Chair, All Public Panel
$1,220,000.00	$0.00	Presiding Chair, All Public Panel
$106,024.68	$106,024.68	Public Arbitrator, Presiding Chair
$392,749.49	$377,068.00	Public Arbitrator, Presiding Chair
$100,000.00	$36,272.57	Public Arbitrator, Presiding Chair
$3,000,000.00	$369,850.00	Public Arbitrator, Presiding Chair
$565,772.00	$0.00	Public Arbitrator; signature page missing
$750,000.00	$748,680.00	Public Arbitrator, Presiding Chair

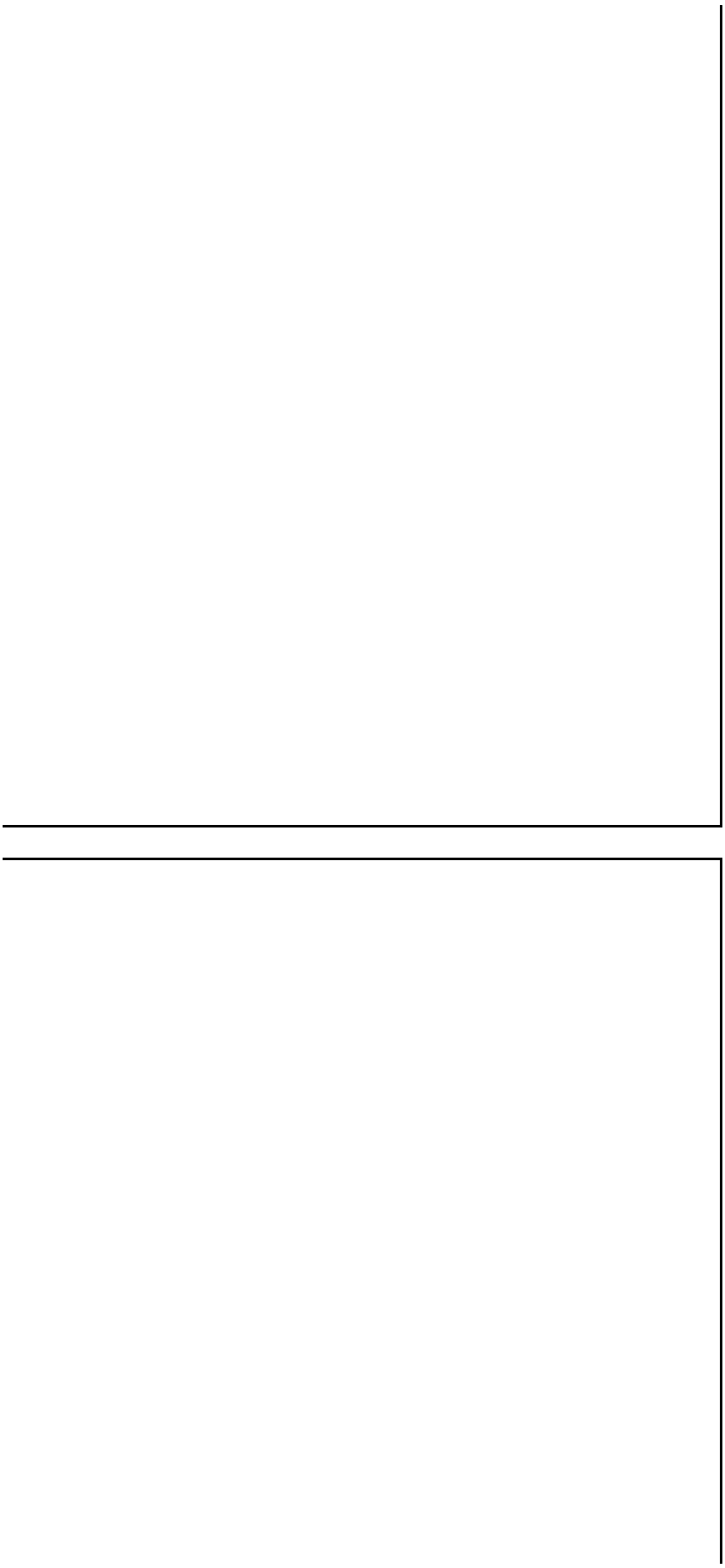
$155,699.49	$75,383.75	Panelist, All Public Panel
$250,000.00	$160,000.00	Panelist, All Public Panel; claim partially settled
$30,000 00 comp; $60,000.00 punit	$17,000.00	Sole Public Arbitrator
unspecified	$83,000.00	Presiding Chair
$429,622.00	$267,711.00	Presiding Chair
$680,000.00	$99,963.00	Presiding Chair
unspecified	$0.00	Public Arbitrator; The Panel concluded that the R failed to properly advise C of all the risks at the time C switched from fixed to variable annuities. However, the Panel also concluded that these investments generated a reasonable return and thus C suffered no damages.
$624,771.00	$295,822.00	Presiding Chair
$1,500,000.00 comp; $500,000.00 punit	$0.00	Presiding Chair; Claimant failed to produce documents

$400,000.00	$140,000.00	Public Arbitrator

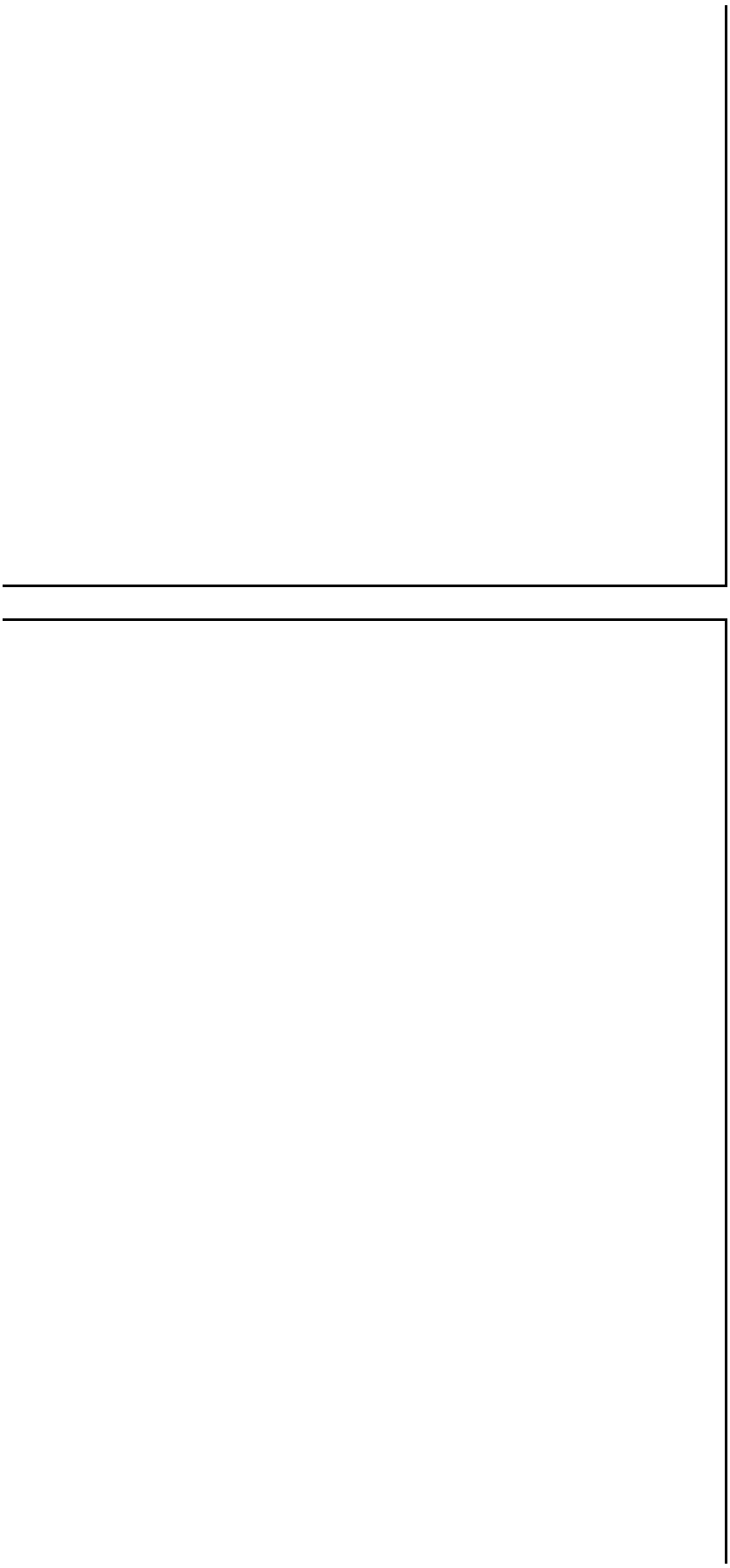
$31,129.25	$0.00	Sole Public Arbitrator
$900,000.00	$445,000.00	Presiding Chair
$2,000,000.00	$540,000.00	Public Arbitrator, Chair; claim partially settled
$38,084.00	$0.00	Sole Public Arbitrator
$5,027.56 comp; $25,135.00 punit	$0.00	Sole Public Arbitrator
$79,465.00 comp; $79,465.00 punit	$0.00	Chair, All Public Panel; a motion to vacate was filed. Motion denied
$70,000.00	$0.00	Sole Public Arbitrator; arb granted R's MTD pursuant to FINRA Rule 12206(a)
$585,940.00	$80,000.00	Chair, All Public Panel
$8,850.01	$0.00	Sole Public Arbitrator

$117,352.00	$0.00	Panelist, All Public Panel
$60,000.00	$0.00	Sole Public Arbitrator
$100,000.00	$0.00	Sole Public Arbitrator
$650,000.00	$378,000.00	Public Arbitrator, Chair

		arb granted R's MTD pursuant to Rule 12206 of the Code;
$75,000.00	$0	sole public arbitrator
$3,928.00	$0	Sole Public Arbitrator
$405,896.73	$0	Presiding Chair, All Public Panel
$126,924.73 comp; $255,905.46 treble	$126,924.73	Panelist, All Public Panel
$10,958.03	$0	Sole Public Arbitrator
$273,592.00	$0	Presiding Chair, All Public Panel
$135,156.85 comp; $200,000.00 punit; $50,000.00 RICO	$0	Presiding Chair
$2,028,000.00	$0	Panelist, All Public Panel
$300,000.00 comp; $300,000.00 punit	$0	Public Arbitrator



$3,471,847.73	$0	the panel denied R's MTD for Lack of Eligibility; Presiding Chair
$436,926.00	$0	Panelist, All Public Panel
$170,000.00	$159,623	Panelist, All Public Panel
$585,940.00	$80,000.00	Panelist, All Public Panel



		the panel granted R's Motion to Dismiss pursuant to Rule 12206; Public Arbitrator
$1,132,800.00 comp; $3,398,400.00 treble	$0.00	
$1,181,034.00 comp; $3,543,102.00 punit	$805,120.00	Panelist, All Public Panel

Arbitrator Disclosure Report

Arbitrator last affirmed the accuracy of this Disclosure Report on 07/24/2019

ARBITRATOR

Name: Ms. Alexandra Smith
Arbitrator ID: A654321
CRD #:
City/State/Country: San Marcos / CA / United States

Classification: Public
FINRA Mediator:
Chair Status: Qualified
DR Portal Registered: Yes

Injunctive Qualified - This arbitrator is an attorney and has reported experience litigating cases involving injunctive relief.

EMPLOYMENT

Start Date	End Date	Firm	Position
01/1996	Present	Law Office of Alexandra Smith	Arbitrator/Mediator
01/1995	01/1996	Everything Company	President/Gen. Counsel
01/1993	01/1995	Davis & Davis	Of Counsel
01/1985	01/1993	Anderson & Smith	Partner
01/1983	01/1985	Energy Company	General Counsel
01/1979	01/1981	Bank of the South	Counsel
01/1974	01/1978	Hokit & Barnes	Associate
01/1972	01/1974	Federal District Court	Clerk

EDUCATION

Start Date	End Date	School	Degree
01/1981	01/1984	Stanford	MBA
01/1971	01/1974	UCLA	JD
01/1968	01/1971	Stanford	BA (Honors)

TRAINING

Completed	Description	Details	Firm/School	Hours	Location
10/2009	Expungement - 2008 Refresher	Read FAQ	FINRA	1	
01/2009	Revised Code of Arbitration		FINRA	2	online
03/2007	New Chairperson Training [NASD]		NASD	9	online
03/2005	Additional Securities Training		AAA	4	
10/2004	Expungement online mini-course		NASD	1.5	online
02/1999	Non-Securities Related Training		AAA Commercial Arbitration Training	8	
12/1998	Non-Securities Related Training		AAA Med/Arb Insurance Training	24	
03/1998	Mediation Training		US District Court	16	

03/1998	Mediation Training	US District Court	16	
12/1997	New Panel Member Training [NASD]	NASD	11	San Francisco, CA
12/1996	Mediation Training	SCMA-Work Place & Commerce	16	Los Angeles, CA
12/1996	Mediation Training	SCMA	8	
12/1995	Participatory Arbitrator Skills Program	AAA Arbitrator Training	8	San Francisco, CA
10/1994	Mediation Training	Govt Inst-Advanced Mediation	24	Washington, DC

DISCLOSURE/CONFLICT INFORMATION

Type	Firm Name	Details
Previously on Board of Directors	San Diego County Food Bank	2006 - 2008
Was a member of	San Diego County Planning Council	1999 - 2001
Arbitrator for	American Arbitration Association	Since 1989
Previously on Board of Directors	Association of Health Service Agencies	2005 - 2009
Previously on Board of Directors	EEC	Advisory Board (2000 - 2002)
Is a Member of Bar Association	California	
Has made a disclosure about	FINRA Case #16-XXXX	Neutral in case where motion to vacate filed. Motion pending.
Was Arbitrator for	Kaiser	2006
Disclosed Online Activities	Law Office of Alexandra Smith	http://www.alexsmith.com/
Has an account with	Basic Financial Advisors	Investment account
Disclosed Online Activities	LinkedIn	https://www.linkedin.com/in/alex-sandy-smith-1100b1b
Was Arbitrator for	NYSE	
Was Arbitrator for	Pacific Stock Exchange	2000 - 2005
Is a Member of Bar Association	Hays	
Is a member of	Hays Trial Lawyers Association	Since 2006
Was a member of	State Bar Committee	Business Law Section
Is a member of	Trial Lawyers College	Since 2006
Was Mediator for	US District Court	1998 - 2009
Lectured on		"Entity Registration." CLE Education
for		the Bar
Received Honors		American Jurisprudence Award
Received Honors		Corporation Award

PUBLICLY AVAILABLE AWARDS FOR CASES INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases Involving Public Customers Section, Current as of 07/24/2019

Case ID	Case Name	Close Date	Role
16-[redacted]	[redacted]		Chair
16-[redacted]			Chair

15·	[redacted]	Panelist
15·		Chair
14·		Chair
12·		Panelist
11·		Panelist
10·		Chair
10·		Chair
11·		Chair
09·		Panelist
09·		Chair
08·		Panelist
08·		Panelist
03·		Chair
04·		Panelist
03·		Chair
04·		Chair
99·		Chair
00·		Panelist
99·		Panelist
99·		Chair
96·		Panelist
97·		Panelist

PUBLICLY AVAILABLE AWARDS FOR CASES NOT INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases NOT Involving Public Customers Section, Current as of 07/24/2019

Case ID	Case Name	Close Date	Role
18·	[redacted]		Chair
18·			Chair
17·			Chair
16·			Chair
12·			Chair

13-	[redacted]	Chair
14-		Chair
12-		Chair
12-		Chair
11-		Chair
10-		Chair
10-		Chair
10-		Chair
10-		Chair
10-		Chair
09-		Chair
09-		Chair
05-		Chair
06-		Chair
01-		Chair
01-		Panelist
98-		Panelist

CASES CURRENTLY ASSIGNED INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18	[redacted]		Chair
18			Panelist
18			Panelist
18			Chair
17			Chair
17			Chair
16			Chair

CASES CURRENTLY ASSIGNED NOT INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18 [redacted]	[redacted]		Chair

ARBITRATOR BACKGROUND INFORMATION

Over the past 45 years I've provided professional services as an attorney, CEO, and arbitrator/mediator. I have a MBA degree in addition to my law degree.

My legal practice has been entirely in the civil field, divided almost equally between litigation and transactional work. My primary focus is in the areas of finance, business entity formation and business practices, and employment. Representative work includes litigation involving breach of fiduciary duty, accounting, and investment advisor malpractice; defense of the CFO with respect to the failure of a significant financial conglomerate; RICO claims, real estate fraud matters including broker liability; contract matters; and employment issues including sexual harassment and wrongful termination.

My business background arises from my experience as CEO of a company and as executive director of a non-profit. In those capacities I've been responsible ultimately for the financial, administrative, personnel, and legal affairs of these businesses.

The dispute resolution portion of my professional life includes work as an arbitration panelist for the American Arbitration Association and the NASD as well as work as a mediation panelist for the United States District Court. These appointments have included a range of matters including various complaints against brokers, employment issues, financial claims, and regulatory complaints.

My background in the securities area arises primarily from my general civil practice including basic securities filings, issuance of securities as part of entity formation, and litigation concerning misrepresentation in offerings.

CHAIRPERSON QUALIFICATIONS FOR STATUTORY EMPLOYMENT DISCRIMINATION CASES

With respect to the Chairperson requirements, I have substantial familiarity with employment law due to clients I have counseled in my law practice and cases I heard as an arbitrator for the American Arbitration Association and the NASD. I have represented both employees and employers. I have 39 years experience practicing law and have been general counsel for two corporations during my legal career. In that capacity, I have drafted employee manuals, implemented personnel policies, advised the Board of Directors, down-sized corporations, and defended clients before the Labor Board.

Law Office of Alexandra Smith

The Well-Being of Your Business Is Our Business

When you need protection for your business assets, Sandy Smith delivers thoughtful and caring counsel. Whether you are in the initial stages of setting up your business, creating legal business relationships, protecting your business assets or transitioning out of your business, Sandy Smith brings first-hand knowledge of the business world to each situation. She knows from personal experience how difficult it can be to open and operate a business.

Whether you are forming your business entity, creating commercial agreements, faced with real estate issues, or responding to a violation of your rights, anticipating potential legal pitfalls of owning your business can save a lot of legal hassle and expense down the road.

Sandy will treat your business scenario with care and attention to every possible detail – regardless of the size of your business or scope of your need for counsel.

"I love this attorney! First, she talks in a way real people can understand. Then, she translates that into contracts that you can understand but that keep you legally protected. I recently hired Ms. Smith to look over my existing contracts for my business. She showed me how I wasn't protecting myself or my clients properly. It was straight talk and that's what I like most about her. I will definitely use her in the future and recommend her to everyone."
– former Client

Experience. Passion. Results.

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Arbitrator Disclosure Report

Arbitrator last affirmed the accuracy of this Disclosure Report on 07/24/2019

ARBITRATOR

Name: Mr. M□r□Johnson, J.D.
Classification: Public
Arbitrator ID: A223344
FINRA Mediator:
CRD #:
Chair Status: Qualified
City/State/Country: Saint Paul / MN / United States
DR Portal Registered: Yes

Statutory Discrimination Qualified - This arbitrator meets the conditions set forth in FINRA's Code of Arbitration Procedure to serve as the chairperson or sole arbitrator on a case involving a statutory discrimination claim.

EMPLOYMENT

Start Date	End Date	Firm	Position
12/2012	Present	Reese LLP	Partner
02/2002	06/2005	University of Minnesota	Adjunct Professor
05/1964	12/2012	Reese Jones Carter & Smith LLP	Associate / Partner

EDUCATION

Start Date	End Date	School	Degree
09/1955	06/1961	Minnesota School of Law	JD
09/1954	06/1958	Carlton College	AB

TRAINING

Completed	Description	Details	Firm/School	Hours	Location
06/2015	New Chairperson Training [FINRA]		FINRA	6	Online
11/2011	Suspicious Act Rpt & Anti-Money Laundrg		FINRA		online
02/2009	Motion to Dismiss Training		FINRA	1	
07/2009	Expungement - 2008 Refresher		FINRA	1	
05/2008	Non-Securities Related Training	Securities Arbitration	Grand Rapids Bar Association		
06/2007	Revised Code of Arbitration		NASD	2	online
08/2006	Non-Securities Related Training	Binding Arbitration and Fact Finding	Michigan Employment Relations Commission		
01/2006	Expungement online mini-course		NASD	1.5	online
08/2006	New Panel Member Training [NASD]		NASD	11	Las Vegas, NV
05/2006	Civility Training		NASD	1.5	Las Vegas, NV
03/2006	Non-Securities Related Training		TCLE	8	

04/2004	Mediation Training	Advanced Mediation	Institute of Continuing Legal Education	
03/2004	Non-Securities Related Training		American Bar Association	100
09/2001	Non-Securities Related Training		Dispute Resolution Center	40

DISCLOSURE/CONFLICT INFORMATION

Type	Firm Name	Details
Has an account with	Fidelity	Investment Account/Retirement Account
Related Conflict With	Fidelity Distributors Corporation	Conflict due to a merger/acquisition
Related Conflict With	Fidelity Investments Institutional Services Company, Inc.	Conflict due to a merger/acquisition
Related Conflict With	National Financial Services Llc	Conflict due to clearing relationship
Had an account with	A.G. Edwards & Sons, Inc.	
Was Arbitrator for	American Arbitration Association	
Is a Member of Bar Association	American Bar Association	
Lectured for	American Bar Association	
Previously on Board of Directors	American Bar Association	Labor and Employment Section & Dispute Resolution Section
Has made a disclosure about	College of Labor and Employment Lawyers	Fellow
Has made a disclosure about	University of St. Thomas	Previously served on advisory committee
Mediator for	Dispute Resolution Center of Minnesota	
Previously on Board of Directors	Minnesota Hospice	
Disclosed Online Activities	Firm website	(http://www.reesellp.com/people/mark-johnson/[reesellp.com])
Is a member of	Childhood Services Commission	Commission member
Previously on Board of Directors	Saint Paul Bar Foundation	Board member
Was a member of	Saint Paul Chamber of Commerce	
Is a member of	Saint Paul Rotary Club	
Investor complaint/arbitration/suit	Wealth Advisors	Plaintiff 1991 suit to reclaim margin accounts after bankruptcy claim filed by Wealth Advisors, concluded
Currently on Board of Directors	Health Net of West Minnesota	
Had an account with	Hilliard Lyons	
Previously on Board of Directors	Retirement Home	
Lectured for	ICLE	
Has made a disclosure about	Minnesota School of Law	Fellow of the Academy of Law Alumni Fellows
Previously on Board of Directors	Hennepin Health Plan Corporation	
Disclosed Online Activities	Linkedin	
Is a Member of Bar Association	Minnesota	
Licensed to Practice Law in	Minnesota	#038795

Was a member of	Minnesota Chamber of Commerce	
Was Arbitrator for	Minnesota Employment Relations Commission	
Arbitrator for	National Arbitration Forum	
Was Arbitrator for	National Center for Dispute Settlement	
Previously on Board of Directors	Nursing Home Administrators	Michigan Board
Received Honors	State Bar of Minnesota	Distinguished Service Award
Has made a disclosure about	Reese LLP	Formerly known as Reese Jones Carter & Smith
Had an account with	Wells Fargo Advisors, LLC	

PUBLICLY AVAILABLE AWARDS FOR CASES INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases Involving Public Customers Section, Current as of 07/24/2019

Case ID	Case Name	Close Date	Role
14-	[redacted]		Panelist
14-			Panelist
14-			Panelist
09-			Panelist

PUBLICLY AVAILABLE AWARDS FOR CASES NOT INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases NOT Involving Public Customers Section, Current as of 07/24/2019

Case ID	Case Name	Close Date	Role
17	[redacted]		Chair
17			Chair
16			Chair

CASES CURRENTLY ASSIGNED INVOLVING PUBLIC CUSTOMERS

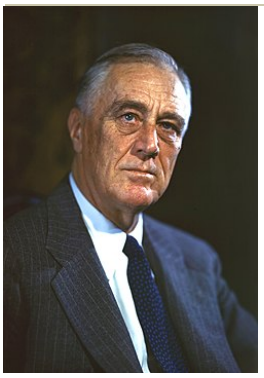
Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18-	[redacted]		Panelist
18-			Chair
18-			Chair

CASES CURRENTLY ASSIGNED NOT INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18	[redacted]		Panelist

ARBITRATOR BACKGROUND INFORMATION

Since 1964, I have practiced law with Reese Jones Carter & Smith, LLP, in Saint Paul. My practice focused primarily on representing employers in disputes with unions and individuals. Arbitration and mediation have been a continuous part of my practice as an advocate and neutral. My law firm has grown from twelve lawyers to more than one hundred seventy during my career. I served on its Management Committee and Recruiting Committee and chaired the Labor Practice Group. I have been active in the American Bar Association serving in leadership roles in the Dispute Resolution Section and the Labor and Employment Section. I served on both Section Councils and various committees. I am a Fellow in the College of Labor and Employment Lawyers. I chaired the Minnesota State Bar Character and Fitness Committee and the Attorney Grievance Commission of Minnesota. I also served on the Attorney Discipline Board of Minnesota. In 2007, I was awarded The Distinguished Service Award by the Labor & Employment Section of the State Bar of Minnesota, its highest award. In 2013 I was awarded the Bennet Adams Award, which is the highest honor given by the State Bar of Minnesota I have served in leadership positions on several non-profit and religious organization boards with responsibility for investment of retirement and endowment funds. I manage my own investments and monitor the investment of my retirement fund. I was named Trustee of the Year by Leading Age of Minnesota, which is an advocacy organization for senior care organizations I am a Distinguished Alumni Award recipient from Carleton College, having served on its Board of Trustees. I received a Special Recognition award from the Minnesota Health and Hospital Association. I was made a Fellow in the Academy of Law Alumni Fellows by the Minnesota School of Law, its highest honor. I have conducted hundreds of mediations at the Dispute Resolution Center of West Minnesota and received its Peacemaker of the Year award.



OFFICE	Saint Paul
PHONE	626/366-6632
FAX	626/366-7050
EMAIL	mjohnson@reesellp.com
DOWNLOAD	V-Card, Resume
ASSISTANT	Daniel Reed, 616/336-6688

Services

Labor and Employment Relations

Health Care

Labor and Employment Experience

Mark's practice focuses on various aspects of **labor and employment** relations and dispute resolution. He has mediated and/orarbitrated hundreds of cases for the National Center for Dispute Settlement, Minnesota Employment Relations Commission, Financial Industry Regulatory Authority (FINRA), The Dispute Resource Center of West Minnesota, and the National Arbitration Forum. Mark is afrequent speaker at the Institute for Continuing Legal Education (ICLE) and American and State Bar meetings on Alternative DisputeResolution (ADR) and at Labor Arbitration Institute forums. He serves on many non-profit, professional and business boards.

Recognitions

- Minnesota State Bennet Adams Award (2014, highest State Bar award)
- Trustee of the Year by Leading Age of Minnesota (2013)
- Carlton College Distinguished Alumni Award (2007)
- Minnesota Health and Hospital Association - Special Recognition (2007)
- Labor and Employment Law Section of the State Bar of Minnesota Distinguished Service Award Carlton College Second
- Century Club Annual Outstanding Services Award (2001)
- The College of Labor and Employment® Lawyers, Fellow (1997)
- Listed in Best Lawyers in America® since 1988
- Martindale-Hubbell Rated AV Preeminent™

Professional Affiliations

- American Employment Law Council
- American Bar Association: Dispute Resolution Section Council, Labor and Employment Section Council
- State Bar of Minnesota: Labor and Employment Section; Character and Fitness Committee, Chair Modernizing the Practice
- Committee, 2015
- State of Minnesota: Attorney Grievance Commission, Chair; Attorney Discipline Board Member
- Saint Paul Bar Association: Labor and Employment Section, Personnel Committee

Community Involvement

- Saint Paul Area Chamber of Commerce (Foundation Board Chair)
- Minnesota Chamber of Commerce (Board of Directors)
- Reformed Church in America (Executive Committee)
- Retirement Home (Board Chair)
- Saint Paul Downtown Rotary Club
- Lazarus Christian Services (Board Chair)
- Hennepin Health Plan Corporation (Board Chair)
- Minnesota Hospice (Board Chair)

- Health Net of West Minn□□o□a (Board Chair)

Education

- Minn□□o□a **School of Law**
  J.D., *with honors*, 196□
  Member, Editorial Board, *Law Journal*

- □ar□□on **College**
  A.B., *with honors*, 1958
  Order of the Coif

Arbitrator Disclosure Report

Arbitrator last affirmed the accuracy of this Disclosure Report on 08/08/2019

ARBITRATOR

Name: Mr. Donlald Stein
Arbitrator ID: A123456
CRD #:
City/State/Country: Aurora / CO / United States

Classification: Public
FINRA Mediator: Yes
Chair Status: Qualified
DR Portal Registered: Yes

Injunctive Qualified - This arbitrator is an attorney and has reported experience litigating cases involving injunctive relief.

EMPLOYMENT

Start Date	End Date	Firm	Position
01/1990	Present	Sole Practitioner	Attorney/Arbitrator/Mediator
01/1989	01/1990	Arbitration Org	Attorney
01/1986	01/1989	Evans Goodman Smith	Attorney
01/1985	01/1989	Evans Goodman & Stein	Attorney
01/1985	01/1986	Cooper Young & Gilman	Attorney
01/1981	01/1985	Private Practice	Attorney
01/1979	01/1981	Myers Fox & Larson	Attorney
05/1976	01/1977	Unemployed	N/A
01/1975	01/1978	County District Attorney	Deputy District Attorney

EDUCATION

Start Date	End Date	School	Degree
09/1972	05/1975	University of Colorado	JD
09/1968	05/1972	University of Rochester	BA

TRAINING

Completed	Description	Details	Firm/School	Hours	Location
05/2011	Discovery Guide Workshop (2011)		FINRA	0.5	online
05/2010	Non-Securities Related Training	Arbitration Ethics	AAA		
03/2009	Motion to Dismiss Training		FINRA		
01/2009	Expungement - 2008 Refresher		FINRA	1	
04/2007	Revised Code of Arbitration		NASD	2	online
08/2004	Expungement online mini-course		NASD	1.5	online
10/2000	New Chairperson Training [NASD]		NASD	11	Denver, CO
12/1997	Mediation Training		AAA	16	
09/1997	Mediation Training		not provided		

10/1993	Intro Securities Arbitrator Training		NASD	4	Denver, CO
10/1992	Non-Securities Related Training		University of Denver Faculty	8	Denver, CO
10/1992	Mediation Training	Mediation Skills	AAA		
10/1992	Mediation Training	Mediation Skills	AAA		
09/1992	Non-Securities Related Training		University of Denver Faculty	16	Denver, CO
06/1992	Mediation Training	Mediation Skills	AAA		
06/1992	Mediation Training	Mediation Skills	AAA		
05/1992	Mediation Training	Mediation Skills	AAA		
04/1992	Non-Securities Related Training		Settlement Negotiation Seminar	3	
03/1992	Mediation Training	Mediation Skills	AAA		
03/1992	Mediation Training	Mediation Skills	AAA		

DISCLOSURE/CONFLICT INFORMATION

Type	Firm Name	Details
Related Conflict With	Advest, Inc.	Conflict due to a merger/acquisition
Related Conflict With	BoA Investment Services, Inc.	Conflict due to a merger/acquisition
Related Conflict With	BoA Securities Llc	Conflict due to a merger/acquisition
Has an account with	Citigroup Global Markets, Inc.	
Related Conflict With	Fidelity Brokerage Services LLC	Conflict due to a merger/acquisition
Has an account with	Fidelity Investments Institutional Srvcs	
Has an account with	Merrill Lynch Pierce Fenner & Smith	
Related Conflict With	Merrill Lynch Professional Clearing Corp.	Conflict due to a merger/acquisition
Related Conflict With	Morgan Stanley & Co. Incorporated	Conflict due to a merger/acquisition
Related Conflict With	Morgan Stanley DW Inc.	Conflict due to a merger/acquisition
Related Conflict With	Morgan Stanley Smith Barney	Conflict due to a merger/acquisition
Has an account with	Salomon Smith Barney	
Has an account with	Valic	
Has an account with	Vanguard Investments	
Mediator for	ACR	
Has an account with	AIM Funds	
Is a member of	Academy of Family Mediators	
Mediator for	American Arbitration Association	
Is a member of	Association for Conflict Resolution	
Received Honors	Best Lawyers 2014 Denver Area	Alternative Dispute Resolution Lawyer of the Year
Received Honors	Best Lawyers 2015	Mediation Lawyer of the Year
Received Honors	Best Lawyers 2015 through 2016	Arbitration Lawyer of the Year
Received Honors	Best Lawyers in America	Mediation, Arbitration, and Family Law Mediation; 2007 through 2019
Was a Member of Bar Association	County Bar Association	Former Board member; former Professional Panel member

Has made a disclosure about	District Court	Master & arbitrator
Mediator for	Council of Mediators in Colorado	
Was Mediator for	College of Commercial Arbitrators	
Received Honors	College of Commercial Arbitrators	Fellow
Is a member of	Colorado Academy of Mediators & Arbitrators	
Disclosed Online Activities	Colorado Academy of Mediators & Arbitrators Bio	https://colmediators.org/donald
Is a Member of Bar Association	State Bar Association	Former Member of the Board of Governors; ADR Committee
Is a member of	Colorado Counsel of Mediators & Mediation Org.	
Licensed to Practice	Colorado Real Estate Commission	Independent Broker
Was a member of	Colorado State Bar	Board of Governors
Received Honors	Colorado Super Lawyer	2011 through 2019
Mediator for	Colorado Supreme Court	
Currently on Board of Directors	Water Utility Company	
Disclosed Online Activities	LinkedIn	https://www.linkedin.com/in/donald-stein-cc2c0726/
Was Arbitrator for	NYSE	
Is a member of	NADN	
Currently on Board of Directors	Non Profit Corp	President
Has an account with	Nicholas Income Funds	Mutual Fund
Had an account with	Piper Jaffray & Co.	
Was Mediator for	SPIDR	
Is a member of	DRS	
Had an account with	Wall Street Discount Corporation	
Has an account with	Wells Fargo Bank	Savings/checking account

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PUBLICLY AVAILABLE AWARDS FOR CASES INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases Involving Public Customers Section, Current as of 08/08/2019

Case ID	Case Name	Close Date	Role
16-	[redacted]	2018	Panelist
17-		2018	Chair
16-		2018	Panelist
16-		2017	Panelist
15-		2016	Chair
13-		2015	Chair
14-		2015	Chair
12-		2015	Chair
14-		2015	Chair

11-	[redacted]	2013	Chair
09-	[redacted]	2012	Chair
11-	[redacted]	2012	Chair
09-	[redacted]	2011	Chair
07-	[redacted]	2008	Chair
06-	[redacted]	2007	Chair
05-	[redacted]	2006	Chair
04-	[redacted]	2005	Chair
03-	[redacted]	2005	Panelist
03-	[redacted]	2004	Chair
02-	[redacted]	2003	Chair
02-	[redacted]	2003	Panelist
98-	[redacted]	1999	Chair
97-	[redacted]	1998	Chair
97-	[redacted]	1998	Chair
96-	[redacted]	1998	Chair
95-	[redacted]	1996	Chair
95-	[redacted]	1996	Chair
95-	[redacted]	1996	Panelist
95-	[redacted]	1995	Panelist
94-	[redacted]	1995	Panelist
93-	[redacted]	1994	Chair
93-	[redacted]	1994	Chair
92-	[redacted]	1993	Chair
91-	[redacted]	1993	Chair
91-	[redacted]	1992	Chair
90-	[redacted]	1992	Chair
91-	[redacted]	1992	Chair
90-	[redacted]	1991	Chair
88-	[redacted]	1991	Panelist
89-	[redacted]	1991	Panelist
88-	[redacted]	1991	Panelist

88	[redacted]	990	Panelist

PUBLICLY AVAILABLE AWARDS FOR CASES NOT INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases NOT Involving Public Customers Section, Current as of 08/08/2019

Case ID	Case Name	Close Date	Role
17-	[redacted]	2018	Chair
16-		2017	Panelist
16-		2017	Chair
15-		2016	Panelist
13-		2014	Chair
13-		2014	Panelist
12-		2012	Chair
12-		2012	Chair
10-		2011	Chair
08-		2010	Chair
07-		2009	Panelist
07-		2008	Panelist
99-		1999	Panelist
97-		1999	Chair

CASES CURRENTLY ASSIGNED INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18-	[redacted]	2019	Chair
18-		2019	Panelist
18-		2019	Chair
18-		2018	Panelist
18-		2018	Panelist
18-		2018	Chair
18-		2018	Chair

18-	[redacted]	2018	Chair

CASES CURRENTLY ASSIGNED NOT INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18-	[redacted]	019	Chair

ARBITRATOR BACKGROUND INFORMATION

Since 1989 I have served on a full time basis as a professional neutral conducting arbitration and mediation work on behalf of a variety of government and private agencies and private parties. I have served as a mediator in approximately 1500 cases and as an arbitrator in approximately 900 cases.

I serve on panels for the American Arbitration Association, the NASD, the New York Stock Exchange and the United States Government and the State of Colorado. I have been involved as neutral in a wide range of disputes encompassing many subject areas including securities, employment, commercial, real estate, and partnership matters. In addition to my work as a mediator and arbitrator, I am a frequent lecturer and teacher in the area of Alternative Dispute Resolution for government agencies, and other private industry groups.

My professional activities include: member of the Board of Governors of the Colorado Bar Association, member of the Board of Trustees of the County Bar Association, member of the national panels of the American Arbitration Association and the NASD; member of the mediation panel of the Colorado Supreme Court Grievance Committee.

I am a 1972 graduate of the University of Rochester, and received my Juris Doctor degree in 1975 from the University of Colorado, School of Law. I served from 1975 to 1978 as a Deputy District Attorney and was a member of two trial law firms until 1989. My responsibilities prior to my full time work as a neutral included a wide range of litigation in the areas of commercial, personal injury, and criminal matters.

Martindale-Hubbell rating: AV

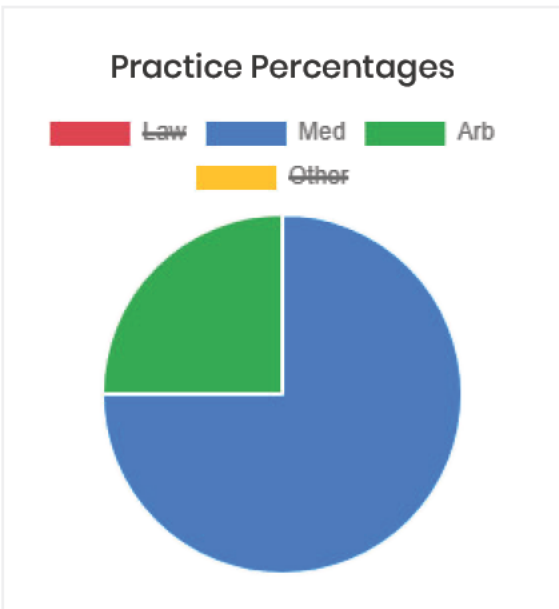
Donald Stein

Arbitration & Mediation Services
4548 Diamond West Square, Suite 107
Aurora, CO, 80010

Tel: (303) 440-2848
Fax: (303) 440-5657
Website: www.donaldstein.com
SEND EMAIL

Recognized to Colorado Chapter for Mediation & Arbitration
Other ADR Services: ADR Training/CME, Fact Finding, Insurance Umpire, Med-Arb, Special Master

Practice Commenced: 1990
Total Mediations (as of Apr 2019): 3500
Total Arbitrations (as of Apr 2019): 600



Local Regions Served

BOULDER
COLORADO SPRINGS
DENVER-AURORA
EDWARDS/GLENWOOD SPRINGS
FORT COLLINS
GRAND JUNCTION
PUEBLO

Business Dissolution
Commercial/Business
Condominiums
Construction
Contract Disputes
Debt Collections
Discrimination
Divorce (High Asset)
Education
EEOC
Elder Abuse
Employment
Franchise
Health Care
Insurance
Labor/Unions
Landlord/Tenant
Legal Malpractice
Local Govt./Municipalities
Partnerships
Personal Injury
Premises Liability
Probate
Professional Fees
Professional Malpractice
Professional Negligence
Real Estate
Securities
Sexual Harassment
Shareholder Disputes
Title Disputes
Torts
Trusts / Estates
Wage & Hour/FMLA

Education

- B.A. University of Rochester, 1972
- J.D. University of Colorado, 1975

ADR TRAINING:

- Mediator Training Arbitration Org 1985, 1987, served as lead trainer for CDR
- Associates 1989-1990 for programs for state and federal agencies
- AAA arbitrator training 1988
- AAA arbitrator and mediator trainings 1988-2007 and training mediators for AAA since 1990
- AAA Arbitrator I and II, Advanced Construction Mediator Training
- AAA Commercial Arbitration Training
- FINRA / NASD Chairperson Training
- NYSE Arbitrator Training

Memberships & Affiliations

- Mediation and arbitration panels of American Arbitration Association & Financial Industry Regulatory Authority New York Stock Exchange.
- Colorado Super Lawyer 2011-19
- Best Lawyers in America in 2006-2014 Mediation, Arbitration, and Family Law Mediation
- Best Lawyers 2012 Denver Area Alternative Dispute Resolution Lawyer of the Year
- Best Lawyers 2015 Mediation Lawyer of the Year
- Best Lawyers 2015-6 Arbitration Lawyer of the Year
- Fellow, College of Commercial Arbitrators
- Alternative Dispute Resolution Committee of the Colorado Bar AssociationB
- Board of Directors of the Adams County Bar Association (1988-1991)
- Member of the Board of Governors of the Colorado Bar Association (1989-93)
- Association for Conflict Resolution
- Member of Adams County Bar Association Professionalism Panel
- Colorado Real Estate Broker

Arbitrator Disclosure Report

Arbitrator last affirmed the accuracy of this Disclosure Report on 7/24/2019

ARBITRATOR

Name:	Mr. P□□□r □□□□□n Mi□□r	Classification:	Public
Arbitrator ID:		FINRA Mediator:	
CRD #:		Chair Status:	Qualified
City/State/Country:	□an □ran□i□□o / CA / United States	DR Portal Registered:	Yes

Injunctive Qualified - This arbitrator is an attorney and has reported experience litigating cases involving injunctive relief.

EMPLOYMENT

Start Date	End Date	Firm	Position
01/1998	Present	Miller Arbitration/Mediation Services	President
01/1967	12/1998	Thomas & Miller A Law Corp.	President/Shareholder

EDUCATION

Start Date	End Date	School	Degree
09/1962	06/1965	University of California	JD
09/1958	06/1962	University of California	BA

TRAINING

Completed	Description	Details	Firm/School	Hours	Location
03/2009	Motion to Dismiss Training		FINRA	1	
01/2009	Expungement - 2008 Refresher		FINRA	1	
02/2007	Revised Code of Arbitration		NASD	2	Online
01/2007	New Chairperson Training [NASD]		NASD	9	online
08/2004	Expungement online mini-course		NASD	1.5	online
01/2001	Mediation Training		NCMA Community Mediation	35	
01/2000	NASD Mediation Skills Conference		NASD Advanced Mediation	12	
10/1998	New Panel Member Training [NASD]		NASD	11	San Francisco, CA
01/1997	Mediation Training		JFK Divorce Mediation	18	
10/1981	Participatory Arbitrator Skills Program		CEB/Alameda Cty Bar-Personal Injury	12	
10/1975	Participatory Arbitrator Skills Program		Alameda Cty Bar - Atty Fee Arbitration	12	

DISCLOSURE/CONFLICT INFORMATION

Type	Firm Name	Details

Family Member has relationship with	Merrill Lynch	Spouse has cash and some funds in an index fund.
Related Conflict With	Charles Schwab	Conflict due to a merger/acquisition
Mediator for	San Francisco County Superior Court	Certified
Mediator for	San Francisco Dispute Resolution Service	
Is a Member of Bar Association	California	
Was a member of	California Trial Lawyers	
Had an account with	Smith Barney	
Has an account with	E*Trade Financial	
Family Member has relationship	E*Trade Financial	Spouse has account
Mediator for	NCMA	
Had an account with	PaineWebber, Inc	
Had an account with	UBS Securities	

PUBLICLY AVAILABLE AWARDS FOR CASES INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases Involving Public Customers Section, Current as of 07/24/2019

Case ID	Case Name	Close Date	Role
16-	[redacted]	2018	Panelist
17-		2018	Chair
16-		2017	Chair
15-		2017	Panelist
16-		2017	Chair
11-		2012	Chair
08-		2010	Chair
08-		2009	Chair
06-		2008	Chair
07-		2008	Chair
06-		2007	Panelist
05-		2007	Chair
04-		2006	Chair
04-		2006	Chair
02-		2006	Chair
05-		2005	Panelist
05-		2005	Chair
03-		2004	Chair

03-	[redacted]	2004	Chair
01-		2003	Chair
00-		2001	Panelist
99-		2000	Chair

PUBLICLY AVAILABLE AWARDS FOR CASES NOT INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases NOT Involving Public Customers Section, Current as of 07/24/2019

Case ID	Case Name	Close Date	Role
17-	[redacted]	/2018	Chair
18-		/2018	Chair
17-		/2017	Chair
15-		/2016	Chair
12-		/2013	Panelist
11-		/2012	Panelist
10-		/2011	Chair
09-		/2011	Chair
00-		/2001	Panelist

CASES CURRENTLY ASSIGNED INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18-	[redacted]	/2018	Panelist
18-		/2018	Chair
18-		/2018	Chair
18-		/2018	Panelist
17-		/2017	Panelist

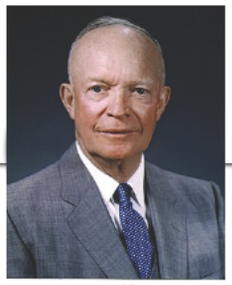
CASES CURRENTLY ASSIGNED NOT INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18-	[redacted]	2018	Panelist

ARBITRATOR BACKGROUND INFORMATION

Actively practiced law for over thirty years in which I was engaged primarily in commercial and civil litigation. For many years I was the managing partner of my firm and played an active role in managing the firm's pension plan.

I am now the managing partner of my family's farm. I have been the manager since 2001.



Pete Miller

Jd at Miller Arbitration and Mediation

San Francisco Bay Area

Connect ...

Miller Arbitration and Mediation

University of California, Berkeley - School of Law

Experience

Jd

Miller Arbitration and Mediation

May 1998 – Present 20 yrs

Education

University of California, Berkeley - School of Law

Doctor of Law (JD)

1962 – 1965

Skills & Endorsements

Legal Research 5

5 connections have given endorsements for this skill

Civil Litigation 4

4 connections have given endorsements for this skill

Criminal Law 3

3 connections have given endorsements for this skill

Show more

Interests

University of California, Berkeley - ...

18,088 followers

Arbitrator Disclosure Report

Arbitrator last affirmed the accuracy of this Disclosure Report on 07/30/2019

ARBITRATOR

Name: Mr. Ro□□r□□ □i□□

Arbitrator ID: A1□345

CRD #:

City/State/Country: □an□ing / MI / United States

Classification: Public

FINRA Mediator: Yes

Chair Status: Qualified

DR Portal Registered: Yes

Statutory Discrimination Qualified - This arbitrator meets the conditions set forth in FINRA's Code of Arbitration Procedure to serve as the chairperson or sole arbitrator on a case involving a statutory discrimination claim.

EMPLOYMENT

Start Date	End Date	Firm	Position
01/1992	03/1995	Contract Admin Law Judge	Appeal Court
01/1992	Present	Robert White	Owner/Arb/Mediator
01/1984	12/1991	Grand Rapids Human Rights Dept	Secretary
01/1979	01/1984	Grand Rapids Accounting Dept	Assistant
01/1976	Present	Michigan State University	Adjunct Faculty

EDUCATION

Start Date	End Date	School	Degree
01/1974	01/1977	Wayne State University	JD
01/1973	01/1974	University of Hawaii	MA Philosophy
01/1966	01/1970	Wayne State University	BA

TRAINING

Completed	Description	Details	Firm/School	Hours	Location
03/2014	Expungement online revised - 3/2009		FINRA	1.5	online
09/2009	Expungement - 2008 Refresher	Read FAQ	FINRA	1	
09/2007	Revised Code of Arbitration		FINRA	2	online
10/2004	Expungement online mini-course		NASD	1.5	online
05/1996	Additional Securities Training		NASD Train the Trainer	32	Denver, CO
11/1995	Intro Securities Arbitrator Training		NASD	4	Detroit, MI
11/1995	Chairperson Securities Training		NASD	4	Detroit, MI
10/1994	Employment Law Training		NASD	2	Detroit, MI
02/1994	Non-Securities Related Training		Failure to Superevise	2	Detroit, MI

11/1993	Non-Securities Related Training	Discovery in Arb./Mo	2	Detroit, MI
10/1993	Additional Securities Training	Arb. Ed. Approaches	2	Detroit, MI
06/1991	Mediation Training	AAA	16	Detroit, MI
04/1991	Non-Securities Related Training	AAA Commercial Arbitration Training		Detroit, MI
09/1990	Intro Securities Arbitrator Training	AAA Securities Arbitration Training		
01/1990	Mediation Training	Divorce Mediation Institute	40	
08/1988	Non-Securities Related Training	BBB Senior Arb. Training		
12/1986	Additional Securities Training	Neighborhod Justice	40	Detroit, MI

DISCLOSURE/CONFLICT INFORMATION

Type	Firm Name	Details
Related Conflict With	Advest, Inc.	Conflict due to a merger/acquisition
Related Conflict With	Banc Of America Investment Services, Inc.	Conflict due to a merger/acquisition
Related Conflict With	Banc Of America Securities Llc	Conflict due to a merger/acquisition
Has an account with	Fidelity	
Related Conflict With	Fidelity Distributors Corporation	Conflict due to a merger/acquisition
Related Conflict With	Fidelity Investments Institutional Services Company, Inc.	Conflict due to a merger/acquisition
Has made a disclosure about	Wells Fargo	Named as Trustee of an account with Wells Fargo
Related Conflict With	COR Professional Clearing Corp.	Conflict due to a merger/acquisition
Related Conflict With	National Financial Services Llc	Conflict due to clearing relationship
Was Mediator for	54th District Court	
Arbitrator for	AAA	
Has made a disclosure about	ACR	
Was Arbitrator for	AMEX	
Mediator for	American Arbitration Association	
Was Arbitrator for	BBB	
Had an account with	Charles Schwab	
Has an account with	Chase Bank	Checking Account
Is a member of	College of Labor and Employment Lawyers	
Mediator for	EEOC	
Mediator for	FINRA	
Has made a disclosure about	FINRA Case #15-xxxxx	Served as Neutral in FINRA Case #15-xxxxx. Where a motion to vacate was filed. Motion denied
Arbitrator for	FMCS	
Disclosed	Industrial and Labor Relations School	

Has published	NY Times	Op-Eds
Is a member of	LERA	Formerly IRRA
Disclosed Online Activities	Linkedin	https://www.linkedin.com/in/robert-white-a2a82a8/
Arbitrator for	MERC Michigan	
Disclosed Online Activities	Mediate.com	https://www.mediate.com/author/Robert-White/123
Arbitrator for	Mediation Tribunal Association	
Is a Member of Bar Association	Michigan	
Licensed to Practice Law in	Michigan	# P00001
Arbitrator for	Michigan Attorney Discipline Board	
Was Arbitrator for	Michigan Attorney Grievance Commission	
Has made a disclosure about	Michigan Civil Service Commission	Hearing Officer
Has made a disclosure about	Michigan Dept. of Civil Rights	Hearing Officer
Arbitrator for	NFA	
Was Arbitrator for	NYSE	
Is a member of	National Academy of Arbitrators	
Mediator for	Pennsylvania Department of Labor and Industry	
Disclosed Online Activities	Personal website	http://www.arbitratorbobwhite.com/
Arbitrator for	Private Labor Arbitrations	
Has published	State Bar of Michigan Labor & Employment Section	
Has made a disclosure about	The Institute of Continuing Legal Education	Volunteer
Mediator for	US Postal Service	
Disclosed Online Activities	Michigan State University Profile	https://law.michigan.edu/profile/ae0000
Has published		Litigation and Arbitration (2018)
Has published		Author of The Negociator (2006)
Has published		In New York Times

PUBLICLY AVAILABLE AWARDS FOR CASES INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases Involving Public Customers Section, Current as of 08/08/2019

Case ID	Case Name	Close Date	Role
17-	[redacted]	03/23/2018	Chair
17-		02/16/2018	Chair
16-		08/28/2017	Chair
16-		05/18/2017	Chair
16-		05/16/2017	Chair
15-		01/18/2017	Chair
16-		07/25/2016	Chair

13-	[redacted]	08/25/2015	Chair
12-		06/19/2015	Chair
14-		05/29/2015	Chair
13-		04/24/2015	Panelist
13-		04/15/2015	Chair
14-		03/17/2015	Chair
12-		03/06/2015	Chair
12-		08/25/2014	Chair
09-		03/21/2014	Chair
12-		01/27/2014	Chair
12-		10/04/2013	Chair
11-		05/21/2013	Chair
11-		03/11/2013	Chair
10-		07/30/2012	Panelist
11-		04/25/2012	Chair
09-		04/02/2012	Chair
10-		02/28/2012	Chair
10-		10/12/2010	Chair
09-		09/17/2010	Chair
09-		07/01/2010	Panelist
09-		05/24/2010	Chair
09-		01/25/2010	Chair
08-		02/27/2009	Chair
06-		07/10/2008	Panelist
07-		10/25/2007	Chair
06-		09/05/2007	Panelist
05-		05/10/2007	Chair
05-		08/30/2006	Panelist
02-		08/22/2006	Panelist
05-		06/19/2006	Chair

04	[redacted]	12/01/2005	Panelist
03		02/16/2005	Panelist
03		01/27/2005	Chair
01		11/04/2004	Chair
03		10/11/2004	Panelist
04		09/15/2004	Panelist
03		08/13/2004	Chair
03		05/26/2004	Chair
02		10/10/2003	Chair
01		11/15/2002	Chair
00		04/03/2002	Panelist
00		03/05/2002	Chair
99		12/20/2000	Panelist
99		11/01/2000	Chair
99		07/14/2000	Chair
98		03/02/2000	Chair
96		11/01/1999	Panelist
98		07/16/1999	Panelist
96		06/08/1999	Panelist
97		03/18/1999	Chair
98		02/04/1999	Chair
98		01/21/1999	Chair
97		01/13/1999	Chair
96		11/19/1998	Chair
98		11/08/1998	Chair
93		09/24/1998	Chair
97		08/20/1998	Chair
97		07/15/1998	Chair
97		05/15/1998	Chair
96		05/12/1998	Panelist

97-	[redacted]	05/10/1998	Chair
96-		10/27/1997	Chair
96-		10/14/1997	Chair
95-		08/25/1997	Panelist
95-		07/25/1997	Chair
93-		07/01/1997	Chair
95-		04/09/1997	Chair
96-		03/06/1997	Panelist
96-		01/22/1997	Chair
96-		01/02/1997	Chair
95-		12/31/1996	Chair
96-		11/26/1996	Chair
95-		11/15/1996	Chair
95-		09/03/1996	Panelist
94-		08/12/1996	Chair
95-		07/18/1996	Chair
95-		04/26/1996	Chair
95-		12/22/1995	Chair
93-		12/22/1995	Chair
95-		11/30/1995	Chair
94-		11/27/1995	Chair
93-		05/31/1995	Chair
92-		02/14/1995	Chair
93-		10/27/1994	Chair
93-		10/03/1994	Panelist
93-		08/12/1994	Chair
93-		06/21/1994	Chair
92-		05/20/1994	Chair
93-		12/02/1993	Chair
92-		10/19/1993	Chair
92-		06/10/1993	Chair
91-		03/26/1993	Chair
91-		01/30/1992	Chair

91-	[redacted]	01/10/1992	Chair
89-		03/21/1991	Chair

PUBLICLY AVAILABLE AWARDS FOR CASES NOT INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases NOT Involving Public Customers Section, Current as of 08/08/2019

Case ID	Case Name	Close Date	Role
18-	[redacted]	08/15/2018	Chair
16-		05/21/2018	Chair
18-		05/15/2018	Chair
16-		12/08/2016	Chair
16-		11/04/2016	Chair
16-		06/23/2016	Chair
13-		04/09/2015	Panelist
13-		11/12/2013	Chair
10-		09/20/2012	Chair
10-		05/24/2012	Chair
10-		08/31/2011	Chair
10-		06/17/2011	Chair
08-		10/20/2009	Chair
06-		01/17/2008	Panelist
03-		10/11/2005	Chair
00-		10/10/2001	Chair
95-		09/05/1997	Chair
95-		03/17/1997	Panelist
95-		07/18/1996	Chair
94-		06/13/1995	Chair

CASES CURRENTLY ASSIGNED INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18-	[redacted]	02/15/2019	Chair
18-		02/08/2019	Chair
18-		03/04/2019	Chair

18-	[redacted]	01/02/2019	Chair
18-		01/02/2019	Chair
18-		12/14/2018	Panelist
18-		01/08/2019	Chair
18-		11/30/2018	Chair
18-		12/14/2018	Panelist
18-		11/13/2018	Chair
18-		11/21/2018	Chair
18-		03/06/2019	Panelist
18-		03/11/2019	Chair
18-		09/18/2018	Chair
18-		08/23/2018	Chair
18-		06/27/2018	Chair
17-		01/04/2018	Chair
17-		05/01/2017	Panelist

CASES CURRENTLY ASSIGNED NOT INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
19-	[redacted]	04/03/2019	Chair
19-		03/20/2019	Chair
18-		03/05/2019	Chair
18-		03/08/2019	Panelist
18-		02/12/2019	Chair

18-	[redacted]	08/30/2018	Chair
18-		10/01/2018	Chair
17-		04/25/2017	Chair

ARBITRATOR BACKGROUND INFORMATION

Full time arbitrator and mediator since 1993. Primarily serve as a labor arbitrator, primarily in the public sector. Arbitrator for FMCS, AAA, MERC and other panels. Also, Hearing Officer for the Michigan Department of Civil Rights, Hearing Officer for the Michigan Attorney Discipline Board. Mediator for the EEOC and the USPS. Adjunct Faculty, Michigan State University and Michigan State University Law School.

Employment

Arbitrator and Mediator, private practice 1992 -

Part-time faculty, Michigan State University Law School 2002 -

Arbitration and Mediation Experience

Member of the Labor, Employment, Mediation, and Labor Mediation Panels of the American Arbitration Association.

Hearing Officer for the New York City Department of Education and members of the New York State United Teachers.

Member of permanent labor arbitration panels involving numerous private and public sector employers

Neutral third party in over 1,500 cases in more than 25 forums Federal Mediation and Conciliation Service, Financial Industry Regulatory Authority, Forum, Michigan Employment Relations Commission, National Arbitration and Mediation, National Futures Association, National Mediation Board, United Mine Workers of America and Bituminous Coal Operators' Association, and Central Michigan University.

Served as:
- Administrative Law Judge,
- Hearing Officer in two state departments
- Mediator

Member, National Academy of Arbitrators

Fellow, College of Labor and Employment Lawyers

Named to Michigan Super Lawyers 2010, 2011, 2012 and 2013.

Frequent speaker on negotiation and dispute resolution topics.

Education

Juris Doctor Wayne State University Law School 1977

Master of Arts (Philosophy) University of Hawaii 1974

Bachelor of Arts Wayne State University 1970

Arbitrator Disclosure Report

Arbitrator last affirmed the accuracy of this Disclosure Report on 08/02/2019

ARBITRATOR

Name:	Mr. Gar M n on	Classification:	Public
Arbitrator ID:	A 3456	FINRA Mediator:	Yes
CRD #:		Chair Status:	Qualified
City/State/Country:	B ooming on / MN / United States	DR Portal Registered:	Yes

Statutory Discrimination Qualified - This arbitrator meets the conditions set forth in FINRA's Code of Arbitration Procedure to serve as the chairperson or sole arbitrator on a case involving a statutory discrimination claim.

Injunctive Qualified - This arbitrator is an attorney and has reported experience litigating cases involving injunctive relief.

EMPLOYMENT

Start Date	End Date	Firm	Position
10/2011	Present	Ste enson Law Offices	Principal
01/2003	06/2009	University of Minnesota Law School	Adjunct Professor
01/2001	06/2010	ni ersity of St homas Law School	Adjunct Professor
01/1986	09/2011	Smith & Jones, PA	Litigator
01/1979	01/1986	rown, Gray & Green	Partner
01/1972	01/1979	Lee, ell & Ste enson	Partner

EDUCATION

Start Date	End Date	School	Degree
01/1969	01/1972	University of Minnesota Law School	JD cum laude
01/1965	01/1969	University of California	BA Philosophy

TRAINING

Completed	Description	Details	Firm/School	Hours	Location
04/2009	Motion to Dismiss Training		FINRA		
12/2008	Expungement - 2008 Refresher		FINRA	1	
09/2007	Non-Securities Related Training	Ethical Considerations	MN Continuing Legal Education		
03/2007	Revised Code of Arbitration		NASD	2	online
12/2004	Expungement online mini-course		NASD	1.5	online
06/2004	New Chairperson Training [NASD]		NASD	11	online
04/2003	New Panel Member Training [NASD]		NASD	11	Minneapolis, MN
03/2001	Mediation Training	Mediator Conference	AAA	7.5	
12/2000	Non-Securities Related Training	Arbitration II Workshop	AAA	10	

09/2000	Mediation Training	Mediator Conference	AAA	7.5
01/1999	Non-Securities Related Training		Negotiation Strategy Institute	9
11/1998	Non-Securities Related Training	Commercial Arbitrator Training	AAA	8
09/1995	Non-Securities Related Training		Fredrikson & Byron-ADR	1.75
05/1994	Mediation Training	Advanced	AAA	14.75
04/1994	Mediation Training	Commercial Mediation	AAA	21.75
01/1994	Non-Securities Related Training	Arbitrator Training	Fourth Judicial District	3

DISCLOSURE/CONFLICT INFORMATION

Type	Firm Name	Details
Related Conflict With	R C Wealth Management	Conflict due to a merger/acquisition
Has an account with	R C Wealth Management	
Related Conflict With	Merrill Lynch	Conflict due to a merger/acquisition
Has an account with	Merrill Lynch	Reopened
Has an account with	Ally In est	
Related Conflict With	Ally In est	Conflict due to a merger/acquisition
Related Conflict With	Charles Schwab	Conflict due to a merger/acquisition
Arbitrator for	AAA	
Mediator for	AAA	
Lectured for	AAA	2004 Arbitration rocess
Lectured for	AAA	2008
Lectured for	AAA	2003 - 2005 Arbitration s Mediation
Lectured for	AAA	2015 Cost efficient arbitration
Lectured for	AAA	Mediation 2004 - 2006
Lectured for	AAA	2001 - 2007 Arbitration Awards
Lectured for	AAA	Advanced Mediator Training, 2012
Lectured for	AAA	2010 ow to lead an Arbitration
Lectured for	AAA	2016 Arbitration and legal research
Was a member of	AAA	Advisory Committee (2007)
Lectured for	AAA	2016 rinciples of Arbitration

Lectured for	ABA	2005 The power of negotiation
Lectured for	ABA	2004 Arbitration awards
My firm/employer had a client of	Ameriprise	
Has published		“Another book on arbitration process" -contributor
Received Honors	Best Lawyers in America	Best Lawyer (2008-present)
Disclosed Online Activities	Business website	http://www.gslaw.com/index.html
Was Arbitrator for	Institute for Dispute Resolution	
Was Mediator for	Institute for Dispute Resolution	
Licensed to Practice Law in	California	#010101 inactive
Lectured for	Simon Property Group	1999
Lectured for	Conflict Resolution Center	2014
Lectured for	Conflict Resolution Center	2012
Mediator for	Conflict Resolution Center (CRC)	
Arbitrator for	Conflict Resolution Center (CRC)	
My firm/employer had a client of	Wealth Enhancement Advisory Services LLC	
Has made a disclosure about		Visiting Law Professor in several countries 08 -11 Licensed to
Practice Law in	Eighth Circuit Court of Appeals	
Has published		Various articles on ADR
My firm/employer had a client of	Securian Financial Services	
My firm/employer had a client of	Madeira Partners	
Was Arbitrator for	Fillmore County	
Was Mediator for	Fillmore County	
Lectured for	Fillmore Bar Association	1995
Arbitrator for	ICDR	
Mediator for	ICDR	
Disclosed Online Activities	Linkedin	https://www.linkedin.com/in/garry-stevenson-bb22342
Lectured for	MILE	1992
Lectured for	MILE	1995

Lectured for	MN Defense Lawyers Association	1995
Lectured for	MSBA	Litigation 1997
Lectured for	MSBA	Winning 1998
Lectured for	MSBA	ADR 1999
Lectured for	MSBA	Litigation 1999
Lectured for	MSBA	Arbitration 2011
Lectured for	MSBA	Litigation 1993
Lectured for	MSBA Conference	2001
Was a member of	MSBA Civil Juries	2001 - 2003
Was a member of	MSBA Dispute Resolution	ADR Section
Was a member of	MSBA Dispute Resolution	RUAA
Has published	MSBA Environmental and Natural Resources Law Secti	1995
Was a member of	MSBA Litigation Section	Governing Council (1997-1999)
Was a member of	MSBA Natural Resources & Environmental Law	Governing Council (1991-1997)
Has published	MSBA; Environmental & Natural Resources Law News	1993
Has published	MSBA; Environmental & Natural Resources Law News	1995
My firm/employer had a client of	Cornerstone Wealth Management	
My firm/employer had a client of	ay iew Capital Group	
Had an account with	ay iew Capital Group	
Mediator for	Minneapolis Mediation Program	
Is a Member of Bar Association	Minnesota	
Licensed to Practice Law in	Minnesota	
Lectured for	Minnesota CLE	
Mediator for	Minnesota (certified)	
Lectured for	Minnesota CLE	2015 Arbitration
Lectured for	Minnesota CLE	2013 Mediation
Lectured for	Minnesota CLE	2009 Arbitration
Lectured for	Minnesota CLE	2011 Costs of mediation

Lectured for	Minnesota CLE	2013 Arbitration
Lectured for	Minnesota CLE	2018 Arbitration
Lectured for	Minnesota CLE	2016 Mediation
Lectured for	Minnesota CLE	2016 Arbitration
Lectured for	Minnesota Defense Lawyers Association	1992
Was a member of	Minnesota Law Review	
Lectured for	Minnesota RIMS Conference	1994
Adverse to in legal action	dward Jones	As attorney formerly represented parties against dward Jones
Lectured for	National Business Institute	1995
Licensed to Practice Law in	Seventh Circuit Court of Appeals	
Licensed to Practice Law in	Sixth Circuit Court of Appeals	
Had an account with	Credit Suisse	
Licensed to Practice Law in	US District	Court of Appeals
Licensed to Practice Law in	US District Court	California
Licensed to Practice Law in	US District Court	tah
Licensed to Practice Law in	US District Court	Ohio
Licensed to Practice Law in	US District Court	North Dakota
Licensed to Practice Law in	US District Court	Minnesota
Licensed to Practice Law in	US District Court	Alabama
Licensed to Practice Law in	US District Court	entucky
Licensed to Practice Law in	US District Court	Iowa
Licensed to Practice Law in	US Supreme Court	
Had an account with	USAA Investment Management Company	
Licensed to Practice Law in	Upper Sioux Tribal Court	
Arbitrator for	ValueSolve ADR	
Mediator for	ValueSolve ADR	
Adverse to in legal action	Merrill Lynch	As attorney formerly represented parties against Merrill Lynch
Is a Member of Bar Association	Iowa	
Licensed to Practice Law in	Iowa	#0101010

PUBLICLY AVAILABLE AWARDS FOR CASES INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases Involving Public Customers Section, Current as of 08/08/2019

Case ID	Case Name	Close Date	Role
17-	[redacted]	03/05/2019	Chair

18-	[redacted]	08/22/2018	Chair
15-		12/06/2016	Chair
15-		08/08/2016	Panelist
15-		06/15/2016	Chair
15-		05/31/2016	Chair
14-		05/13/2015	Chair
13-		10/17/2014	Chair
14-		08/20/2014	Chair
13-		05/23/2014	Chair
10-		04/01/2013	Chair
11-		03/07/2013	Panelist
09-		06/29/2011	Panelist
09-		05/19/2010	Chair
09-		04/20/2010	Chair
07-		02/02/2009	Panelist
08-		11/20/2008	Chair
05-		02/20/2007	Panelist
05-		11/20/2006	Chair
03-		02/17/2005	Chair
03-		04/06/2004	Panelist

PUBLICLY AVAILABLE AWARDS FOR CASES NOT INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases NOT Involving Public Customers Section, Current as of 08/08/2019

Case ID	Case Name	Close Date	Role
16-	[redacted]	12/29/2017	Chair
12-		01/25/2016	Chair
14-		07/16/2015	Chair
14-		04/02/2015	Chair
13-		08/07/2013	Chair
12-		05/13/2013	Chair
11-		01/25/2013	Chair
10-		08/08/2012	Chair
11-		09/29/2011	Chair

CASES CURRENTLY ASSIGNED INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18-	[redacted]	03/20/2019	Chair
18-		02/14/2019	Chair
18-		12/12/2018	Panelist
18-		11/12/2018	Chair
18-		10/29/2018	Chair
18-		10/01/2018	Chair
18-		07/02/2018	Panelist

CASES CURRENTLY ASSIGNED NOT INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18-	[redacted]	10/25/2018	Chair

ARBITRATOR BACKGROUND INFORMATION

Alternative Dispute Resolution

Alternative Dispute Resolution – Over 35 years' alternative dispute resolution experience, including selection by litigants as a mediator and arbitrator in more than 1,500 cases. Qualified neutral under Rule 114 of the Minnesota General Rules of Practice (1996 -). Membership on arbitration and mediation panels of the American Arbitration Association (AAA), International Centre for Dispute Resolution (ICDR) and the National Association of Securities Dealers (NASD) n.k.a. The Financial Industry Regulatory Authority. Mediator for States of Minnesota and Wisconsin Education ADR programs. Hearing officer for Minneapolis Public Housing Authority. Instructor for the AAA's continuing training program for mediators and arbitrators, having served in this capacity since the program's inception.

Chosen by peers as "Best Lawyer" in the practice of ADR in Best Lawyers in America (Woodward/White, Inc. 2008-present). Ranked within the First Tier of Law Firms by U.S. News & World Report (2015-2019) in "Best Law Firms" and "Best Lawyers."

I regularly serve on FINRA panels and chair FINRA arbitrations. I have an excellent working knowledge of securities law. I have handled FINRA consumer disputes involving claims of churning, fraud, suitability, unauthorized trading, breach of fiduciary relationship, breach of contract, negligent supervision, inadequacies in prospectus and private placement memoranda etc. involving a multitude of securities, e.g., preferred issues, options, variable and fixed annuities, derivatives, and auction rate securities. I have served on various FINRA employment disputes, such as ones involving claims of wrongful termination, breach of restrictive covenants, and defamation. I have arbitrated inter-brokerage disputes involving claims such as raiding and unfair competition. My experience, coupled with the fact that I have trained well over 600 practitioners in the practice of arbitration and mediation, enables me to be a successful professional in this field with a personality and skill set that gets claims handled efficiently and effectively.

I have over 30 years experience as a trial attorney emphasizing in business, environmental, and professional negligence disputes, e.g., ones involving shareholder and partnership problems, valuations of interests, director's and officer's liability, intellectual property, fraud, contract, employment, unfair competition, securities fraud, environmental cases, insurance coverage disputes, construction disputes, and defense of malpractice claims. These matters were tried to juries and the bench. I served as lead counsel, supervising associates and legal assistants.

I have lectured and published in the area of alternative dispute resolution and trial practice. I have also lectured and published in various substantive areas, including environmental law, business law, and director and officer liability.

I received my juris doctorate degree cum laude from the University of Minnesota in 1972. I have been in private practice since then. From 1972 through 1979, I was in general practice with Lee, ell, & Ste enson. In 1979, I joined a predecessor firm to Smith & Jones. I am admitted to the Bar in Minnesota, 1972; California, 1973 (presently inactive status); and Iowa,2001; and to the following courts: U.S. Supreme Court, 1995; Fifth Circuit Court of Appeals, 1988; Sixth Circuit Court of Appeals, 1987; Eighth Circuit Court of Appeals, 1982, U.S. District Courts in Minnesota, California, tah, Ohio, North Dakota, Alabama, entucky, and Iowa

Welcome to Stern Law Office:

- Arbitration
- Mediation
- Creative Dispute Resolution Mechanisms
- Minnesota Rule 114 Qualified Neutral
- Consultation
- Litigation

Gar□has been an effective commercial litigator who has tried many cases to verdict or judgment. Even so, he recognized early in his career that the default of suing as a mechanism for resolving differences lacked efficiency, while generating uncertainty, upheaval, and strain. What's more, in addition to being time-consuming and costly, he realized that suing does not lend itself to the far more difficult tasks of mending differences and moving on. Gar□had clients within the litigation process contend that they would rather have a root canal.

With that in mind, more than thirty i□□ years ago, Gar□sought training and became deeply committed to facilitating satisfying outcomes through alternative dispute resolution. Since then, he has handled well over 1,500 cases as a neutral, using varied ADR procedures. His practice is geared toward providing fast, successful, and affordable solutions for parties in conflict.

Gar□has taught ADR as an adjunct and visiting professor; is a frequent lecturer on the subject; and serves on several administered ADR panels, such as AAA, ICDR, and FINRA. For the past thirteen years, he has been recognized by his peers as one of the top practitioners of ADR in Minnesota, as well as being listed as one of the top ADR practitioners in the national publication □□□ B□□□□a□ □□r□in □m□ri□a□

GARY STEVENSON
Attorney-at-Law
Mediator, Arbitrator

Mobile: 505-□□□-743□

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B□oom□i□□d. MN 55975

Gary is willing to travel statewide, nationally, or internationally. You can contact him at 505-222-7432 or email gary@gslaw.com

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Arbitrator Disclosure Report

Arbitrator last affirmed the accuracy of this Disclosure Report on 08/08/2019

ARBITRATOR

Name:	Mr. Brian Young	Classification:	Public
Arbitrator ID:	A34567	FINRA Mediator:	
CRD #:		Chair Status:	Qualified
City/State/Country:	Parma / OH / United States	DR Portal Registered:	Yes

EMPLOYMENT

Start Date	End Date	Firm	Position
10/1980	Present	Brian Young	Attorney
01/1980	10/1980	Metal Factory	Accounting
06/1976	01/1980	Hall Reed & Price	Auditor CPA

EDUCATION

Start Date	End Date	School	Degree
09/1976	06/1980	Cleveland Marshall College of Law	JD
09/1972	06/1976	Cleveland State University	BBA Accounting

TRAINING

Completed	Description	Details	Firm/School	Hours	Location
03/2016	New Chairperson Training [FINRA]	Paper exam	FINRA	6	
03/2009	Motion to Dismiss Training		FINRA	1	
01/2009	Expungement - 2008 Refresher		FINRA	1	
06/2008	Discovery/Abuse online course		FINRA	1	online
06/2008	Direct Communication Rule		FINRA	1	online
11/2007	Expungement online mini-course		FINRA	1.5	online
11/2007	Revised Code of Arbitration		FINRA	2	online
11/2007	Onsite Basic Panel Training		FINRA	4	Columbus, OH
08/2007	Online Basic Panel Training		FINRA	11	online

DISCLOSURE/CONFLICT INFORMATION

Type	Firm Name	Details
Related Conflict With	COR Clearing LLC	Conflict due to a merger/acquisition
Family Member has relationship with	Fidelity Investments	Son has brokerage account

Has an account with	UBS	
Family Member has relationship with	UBS	Wife has account
Related Conflict With	Td Ameritrade, Inc.	Conflict due to a merger/acquisition
Arbitrator for	Cuyahoga County Common Pleas Court	
Had an account with	Merrill Lynch	Closed
Family member had relationship with	Merrill Lynch	Wife had a brokerage account
Is a Member of Bar Association	Ohio	
Licensed to Practice Law in	Ohio	#0011223
Disclosed Online Activities	Twitter	@brianyoung
Licensed to Practice Law in	United States District Court	
Licensed to Practice Law in	United States Tax Court	
Is a Licensed		CPA (#12345)
Has made a disclosure about		Represented respondents in NASD case

PUBLICLY AVAILABLE AWARDS FOR CASES INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases Involving Public Customers Section, Current as of 08/08/2019

Case ID	Case Name	Close Date	Role

There is no award information.

PUBLICLY AVAILABLE AWARDS FOR CASES NOT INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases NOT Involving Public Customers Section, Current as of 08/08/2019

Case ID	Case Name	Close Date	Role
13-	[redacted]	03/10/2015	Panelist
09-		11/30/2010	Panelist

CASES CURRENTLY ASSIGNED INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18-	[redacted]	12/19/2018	Panelist
18-		06/07/2018	Panelist

CASES CURRENTLY ASSIGNED NOT INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role

There are no currently assigned cases.

ARBITRATOR BACKGROUND INFORMATION

Since 1980, I have been involved in commercial litigation, arbitration, and mediation of client disputes.

As an attorney in my own firm, I have the responsibility of investigating client representations, determination as to justifiability, calculation of probable outcomes, prosecuting, defending and conducting commercial litigation encompassing contract, UCC, NASD, employment discrimination, and other business related disputes. Legal experience includes serving as an arbitrator with the Cuyahoga County Common Pleas Court.

From 1976 to 1980, I was a senior auditor (CPA) with Hall Reed & Price involved in audits of client companies.

I have extensive personal knowledge of trading accounts, long and short sales, call and put options, option strategies, margins and calls, and types of market executions.

I received a BBA in Accounting from Cleveland State University in 1976 and obtained my CPA certification (Ohio) in 1978. In 1980 I graduated from Cleveland-Marshall College of Law and was admitted to practice as an attorney in the State of Ohio, United States District Court, and United States Tax Court.

Law Office of Brian Young

Mr. Brian Young

Contact Details

14805 Detroit Ave
Parma, OH 44129

Work: (216) 222-1200

Profile

Education

Cleveland - Marshall College of Law
Cleveland, Ohio, United States
J.D., 1980
1976 To 1980

Cleveland State University
Cleveland, Ohio, United States
B.B.A., 1976
Accounting - Economics
1972 To 1976

Job History

Brian Young, Attorney
Attorney

January 1980 - present

Hall, Reed & Price
Certified Public Accountant - Senior Auditor
Cleveland, OH
July 1976 - January 1980

Arbitrator Disclosure Report

Arbitrator last affirmed the accuracy of this Disclosure Report on 07/12/2019

ARBITRATOR

Name:	Judge Jennifer B Thompson	Classification:	Public
Arbitrator ID:	□□□□□3	FINRA Mediator:	
CRD #:		Chair Status:	Qualified
City/State/Country:	Baldwin / MI / United States	DR Portal Registered:	Yes

Statutory Discrimination Qualified - This arbitrator meets the conditions set forth in FINRA's Code of Arbitration Procedure to serve as the chairperson or sole arbitrator on a case involving a statutory discrimination claim.

Injunctive Qualified - This arbitrator is an attorney and has reported experience litigating cases involving injunctive relief.

EMPLOYMENT

Start Date	End Date	Firm	Position
05/2010	Present	Self-employed	Arbitrator/Mediator
07/1980	11/2009	Lake County Circuit Court	Judge
11/1975	06/1980	Lake County Public Defender's	Public Defender
01/1965	11/1975	Office Jennifer B Thompson, Private Practice	Solo Practitioner

EDUCATION

Start Date	End Date	School	Degree
09/1962	06/1965	Detroit College of Law	JD
09/1958	06/1962	Michigan State University	BA Business

TRAINING

Completed	Description	Details	Firm/School	Hours	Location
01/2016	New Chairperson Training [FINRA]	Paper exam	FINRA	6	
09/2011	Online Basic Panel Training		FINRA	11	online
09/2011	Expungement online revised - 3/2009		FINRA	1.5	online
09/2011	Live Video Basic Panel Training		FINRA	4	live WebEx
10/2010	Non-Securities Related Training	ADR	National Judicial College	40	Detroit, MI
09/2010	Mediation Training	Use of Caucus in Mediation	American Bar Association	1.5	
06/2010	Mediation Training	Sixth Annual Mediation Forum	-	6.5	Reno, NV
03/2010	Non-Securities Related Training	Ninth Annual Advanced Negotiation	DR Institute of Nevada ICLE	6.25	Reno, NV
11/2009	Mediation Training	Third Annual Master's Class Advanced Mediation		7.5	Reno, NV

11/2009	Mediation Training	Psychology of Impasse in Negotiation and Mediation	American Bar Association	1.8	
06/2009	Mediation Training	Civil Mediation	National Judicial College	40	Detroit, MI
03/2009	Non-Securities Related Training	Eighth Annual Advanced Negotiation and Resolution	Institute of Continuing Legal Education	6.5	Reno, NV

DISCLOSURE/CONFLICT INFORMATION

Type	Firm Name	Details
Has an account with	Nationwide Investment Services Corporation	401(k) Lake County Nationwide Retirement Consultants
Has published	ABA Judges Journal	Jury Reform, 2009
Has published	ABA Judges' Journal	Jury Pool, 2016
Has published	ABA Judicial Division Record	Jury System, 2012
Has published	ABA Judicial Division Record	Case study, 2003
Has published	ABA Judicial Division Record	Case study, 2003
Has published	ABA Judicial Division Record	US Supreme Court, 2014
Has published	ABA Judicial Division Record	Settlement, 2013
Was Arbitrator for	American Arbitration Association	
Is a Member of Bar Association	American Bar Association	
Has published	Behavioral Sciences and the Law	
Has published	Colleague	Child Witness, 1988
Has an account with	Merrill Lynch	
Licensed to Practice Law in	Michigan	#012345
Is a Member of Bar Association	Michigan Bar Association	

Was a member of	Michigan Judges Association	Member
Mediator for	Michigan Judicial Alternative Dispute Resolution	
Mediator for	Michigan Judicial Alternative Dispute Resolution	
Arbitrator for	Michigan Judicial Alternative Dispute Resolution	
Is a member of	Michigan Judicial Alternative Dispute Resolution	
Lectured for	Michigan Judicial Institute	
Has published	Michigan State Bar Journal	
Has published	Michigan Supreme Court	Personal Protection Orders, 1998
Has made a disclosure about	Michigan's Alternative Dispute Resolution Council	
Was a Member of Bar Association	Michigan's Judicial Conference State Bar	Member
Has published	Lake County Legal News	

lawsuit/charge	Appellee 2004 appeal re transfer of public defender credits to judges' retirement, judgmnt Appellant
on-investment related	
Lectured on	New Judges Civil Pre Trials

PUBLICLY AVAILABLE AWARDS FOR CASES INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases Involving Public Customers Section, Current as of 07/12/2019

Case ID	Case Name	Close Date	Role
18-	[redacted]		Chair
14-			Chair
17-			Panelist
16-			Panelist
13-			Panelist
12-			Panelist
12-			Panelist
12-			Panelist

PUBLICLY AVAILABLE AWARDS FOR CASES NOT INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases NOT Involving Public Customers Section, Current as of 07/12/2019

Case ID	Case Name	Close Date	Role
18-	[redacted]		Chair
16-			Chair
16-			Chair

CASES CURRENTLY ASSIGNED INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
19-	[redacted]		Chair
18-			Chair
18-			Chair
18-			Panelist
18-			Panelist
18-			Panelist
18-			Panelist
18-			Panelist
18-			Chair
18-			Panelist
18-			Chair
18-			Chair
18-			Chair
18-			Panelist
18-			Panelist
18-			Panelist
18-			Panelist
17-			Panelist

17-	[redacted]	Chair
17-		Panelist
17-		Chair

CASES CURRENTLY ASSIGNED NOT INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18-	[redacted]		Panelist
18-			Chair
16-			Chair

ARBITRATOR BACKGROUND INFORMATION

I was in a general private practice of law from 1965 through 1975 and represented parties in criminal and civil cases. The civil cases included negligence, domestic relations, business, contracts and property disputes.

From 1975 through 1980, I was with the Lake County Public Defender's Office representing indigent criminal defendants. This position implied plea negotiations and trails. From 1980 through 2009, I was an elected Circuit Court Trial Judge in Lake County, Michigan. I handled civil cases over $25,000, criminal felony cases, and domestic relations cases. Included were business cases of all varieties, partnerships, corporations, employment, stock, and contracts to name a few.

I have held judicial leadership positions on statewide and national levels. I was Member of the Michigan Judges Association that represents Michigan's Circuit and Court of Appeals Judges. I am currently a member of the ABA's section of Dispute Resolution's Membership Committee.

I have taken different courses related to Alternative Dispute Resolution, including a 40-hour course at the National Judicial College in Detroit, Michigan, where we performed as mediators.

I am on the State Bar of Michigan's Alternative Dispute Resolution Council.

Hon. Jennifer B Thompson (Retired)

Judge Jennifer B Thompson (Retired)

1610 S. Michigan Ave, Baldwin, MI 48558

123-456-7890

jthompson@gmail.net

Judge Jennifer B Thompson has the experience and ability to efficiently conduct all types of Alternative Dispute Resolution procedures and is available to mediate in both the Midland and Baldwin offices.

Judge Thompson spent 15 years as a successful trial attorney prior to being elected to the Lake County Circuit Court in 1980, where she served as chief judge from 1984 through 1997. From 2013 through 2016 she was a member of the Michigan Retried Judges Association.

She is a member of the State Bar of Michigan's Alternative Dispute Resolution Section and the section's Governance Council. She has also been the chair of the section's Judicial Access Team. Judge Thompson is also a member of the American Bar Association and its Judicial Division. She is a member of the ABA's Dispute Resolution Section, and is the Judicial Division's Liaison to that section.

Judge Thompson is a certified FINRA Arbitrator, certified Community Resolution Center mediator, certified as a Civil Mediator by the National Judicial College; and is a graduate of the Michigan State Administrative Office's trainings in Domestic Relations, Domestic Violence Screening, and Child Protection Mediation.

After serving 30 years on the bench, Judge Thompson retired at the end 2009. Since then, she continues to sit on assignment, and she conducts mediations and arbitrations. Her experience covers all the types of cases that come before Michigan Courts and includes conducting many settlement conferences and trials both Jury and non-jury. Judge Thompson's experience and training provides her the ability to help litigants understand the strengths and weaknesses of each other's cases, and work together to find solutions that best satisfy their interests.

She focuses her mediation and arbitration services on: torts, product liability, personal injury, malpractice, contracts, securities, employment, estates and domestic relation disputes. However, she is willing to help parties resolve any type of dispute and travel to where the need exists.

Arbitrator Disclosure Report

Arbitrator last affirmed the accuracy of this Disclosure Report on 07/09/2019

ARBITRATOR

Name:	Mrs. Susan G. Whitney	Classification:	Public
Arbitrator ID:	□98765	FINRA Mediator:	
CRD #:		Chair Status:	Qualified
City/State/Country:	Conshohocken / PA / United States	DR Portal Registered:	Yes

EMPLOYMENT

Start Date	End Date	Firm	Position
06/2000	Present	Law Office of Whitney & Associates, LLC	Managing Member
08/1989	05/2000	Federal Business Service	Business Controller

EDUCATION

Start Date	End Date	School	Degree
09/1995	05/1999	Widener University School of Law	JD
01/1985	05/1988	Widener University	BS Business Administration

TRAINING

Completed	Description	Details	Firm/School	Hours	Location
01/2019	New Chairperson Training [FINRA]	Paper exam	FINRA	6	
08/2012	Live Video Basic Panel Training		FINRA	4	live WebEx
07/2012	Online Basic Panel Training		FINRA	11	online
07/2012	Expungement online revised - 3/2009		FINRA	1.5	online
02/2009	Mediation Training	New Jersey Foreclosure Mediation	State of New Jersey	24	NJ
08/2002	Non-Securities Related Training	Montgomery County Arb Panel	Montgomery County Bar Internal Revenue Service	4	Conshohocken, PA
09/1997	Mediation Training	Mediation of Employer Employee Disputes		24	Philadelphia, PA

DISCLOSURE/CONFLICT INFORMATION

Type	Firm Name	Details
Is Shareholder of	TD Ameritrade	
Related Conflict With	Energy Distributors Corporation	Conflict due to a merger/acquisition
Related Conflict With	Camden Investments Institutional Services Company, Inc.	Conflict due to a merger/acquisition
Related Conflict With	Pershing	Conflict due to clearing relationship
Related Conflict With	Scottrade, Inc.	Conflict due to a merger/acquisition

Has an account with	Fidelity	Brokerage
Related Conflict With	Fidelity Clearing	Conflict due to clearing relationship
Related Conflict With	Mex Private Client Wealth Llc	Conflict due to a merger/acquisition
Related Conflict With	ING Securities (Usa) Llc	Conflict due to a merger/acquisition
Is Shareholder of	USAA	
Was a Member of Bar Association	American Bar Association	
Is Shareholder of	Amex Funds	
Was a Member of Bar Association	Burlington County	
Is a Member of Bar Association	Montgomery County	
Was a Licensed	Common Wealth of Pennsylvania	Certified Public Account (inactive)
Is a Member of Bar Association	Delaware County	
Arbitrator for	Montgomery County Pennsylvania	Chairman
Is a Member of Bar Association	Camden County	
Licensed to Practice Law in	New York	
Is Shareholder of	Morgan Stanley	
Family Member has relationship with	Morgan Stanley	Spouse is shareholder
Lectured for	Our Town Philadelphia	Estate planning in Pennsylvania
Licensed to Practice Law in	Pennsylvania	
Is a Member of Bar Association	Pennsylvania	
Lectured for	PA SPA Philadelphia	
Is Shareholder of	National Bank	
Has an account with	ING Bank N.A.	
Has made a disclosure about		Have an attorney interest in lawyer trust account (IOLTA)
Was a Member of Bar Association	State of New York	
Has an account with	ING Bank	
Has an account with	Scottstrade	
Has published		Articles about criminal defense, tax estate administration, estate planning, and real estate at website
Lectured on		Comfort Letters and Subpoenas
Lectured on		Limited Liability Companies
Non-investment related lawsuit/charge		Plaintiff in personal injury suit, settled (2005)
Disclosed Online Activities		Twitter account: @WhitneyLawFirm
Disclosed Online Activities		Website: http://www.whitneylawfirm.com/

Case ID	Case Name	Close Date	Role

There is no award information.

PUBLICLY AVAILABLE AWARDS FOR CASES NOT INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases NOT Involving Public Customers Section, Current as of 07/09/2019

Case ID	Case Name	Close Date	Role
13	[redacted]		Panelist

CASES CURRENTLY ASSIGNED INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
19	[redacted]		Chair
18			Chair
18			Panelist
18			Panelist
17			Panelist

CASES CURRENTLY ASSIGNED NOT INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role

There are no currently assigned cases.

ARBITRATOR BACKGROUND INFORMATION

I formed my own law firm in 2000, after spending 11 years auditing corporations for the Federal Business Service. I have had mediation training by the State of New York, Montgomery County and the Federal Business Service. I currently serve in five arbitration panels per year for Montgomery County Pennsylvania. I have served as an arbitrator since 2001 in over 40 cases. I am a Judge Advocate in the US Army Reserves holding the rank of Major. I write blogs for my website, Google, Facebook and Twitter accounts on legal and business issues.

I have skills in Criminal Defense, Corporate Governance and Entity Foundation and Estate and Tax Planning.

Mrs. Susan G. WHitney is a former FBS Controller and Pennsylvania Certified Public Accountant. Mrs. Whitney has over 25 years of tax and estate planning experience. Mrs. Whitney graduated from Widener University School of Law in May 1999. Mrs. Whitney started the Firm Whitney & Associates, LLC in June 2000 and has offices in Conshohocken, Pennsylvania, and Beachwood, New Jersey. Mrs. Whitney is also a Pennsylvania Notary Public.

Whitney & Associates, LLC focuses on estate and tax planning, estate administration. Mrs. Whitney probates estates and drafts wills, trusts, powers of attorney and health care directives. The firm also helps clients with Medicaid planning and other elder law issues.

The Firm also advises clients on selecting the appropriate type of entity to conduct business in Pennsylvania and timely making the appropriate tax elec ions. The Firm educates clients on proper corporate governance and limiting their liability. The firm prepares contracts, commercial leases and shareholder agreements. The Firm also represents corporate, small business and individual clients before the Internal Revenue Service, the United States Tax Court, as well as state and local taxing authorities.

Whitney & Associates, LLC drafts residen ial rental agreements and handles landlord tenant matters. The firm also helps clients sell their real estate without a realtor for a fraction of the cost.

Whitney & Associates, LLC prepares corporate and individual Federal and State and local tax returns year round.

Mrs. Whitney was a Montgomery County Public Defender in 2002. The Firm provides criminal defense for drug possession, DUI, retail theft and traffic violations.

Whitney & Associates, LLC represents clients in civil litigation in Philadelphia, Montgomery and Camden County Courts.

Mrs. Whitney is a retired JAG officer and senior defense counsel in the US Army Reserves.

Areas of Practice

- Estate and Tax Planning, Estate Administration, Elder Law
- Business Law, Contracts, Entity Formation and Corporate Governance
- Criminal Defense, White Collar Crime, DUI and Traffic Violations
- Tax Return Preparation
- Real Estate Transactions, Commercial and Residential Leases and Evictions
- Civil Litigation

Bar Admissions

- Commonwealth of Pennsylvania, 1999
- State of New York, 1999
- United States District Court for the District Of New Jersey, 1999
- United States Tax Court, 2002
- United States District Court for the Eastern District Of Pennsylvania, 2003
- United States Court Of Appeals for Veterans Claims, 2004
- United States Army Court of Criminal Appeals, 2011
- United States Court Of Appeals for the Armed Forces, 2011

Susan G. Whitney

Conshohocken, Pennsylvania
Managing Member
Phone: **610-599-8226** Email: **Contact Me**

10 BEST 2016 CLIENT SATISFACTION ESTATE PLANNING DIVISION American Institute of Legal Counsel™

BBB

WHO'S WHO TOP ATTORNEYS OF NORTH AMERICA CERTIFIED

Professional Certifications

- Pennsylvania Notary Public
- Financial Industry Regulatory Authority Arbitrator
- Employer Support of the Guard & Reserve Mediator
- New Jersey Foreclosure Mediator
- Pennsylvania Certified Public Accountant (Inactive)
- New York Title Insurance Producer (Inac ive)

Education

- Widener University School of Law, Wilmington, Delaware, 1998 J.D. *Honors*: Phi Delta Phi Fraternity *Honors*: Harrington Inn – Honor Chapter *Honors*: Pennsylvania Certified Public Accountant

Professional Associations and Memberships

- Montgomery County Attorney CPA Forum, 2007 – 2008 *Vice*
- *President* Montgomery County PRO, 2008 – Present *President*
- Montgomery County Bar Association
- Pennsylvania Bar Association
- Philadelphia Bar Association
- Philadelphia Estate Planning Council
- Camden County Bar Association

Past Employment Positions

- Federal Business Service, Federal Controller, 1988 – 2001
- Montgomery County, Public Defender, 2001 – 2002
- Philadelphia VIP, 2007 – 2008
- Pennsylvania LAMP Program, 2006 – 2008

Ancillary Businesses

- Tax Preparation Available Year Round
- Pennsylvania Notary Public

The Law Offices of Whitney & Associates, LLC

204 E. Chester Pike, Suite 3
Conshohocken PA 19428
Phone: (610) 599-8226

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Arbitrator Disclosure Report

Arbitrator last affirmed the accuracy of this Disclosure Report on 07/18/2019

ARBITRATOR

Name: Mr Leonard G McDonnall
Classification: Public
Arbitrator ID: □44556
FINRA Mediator:
CRD #:
Chair Status: Qualified
City/State/Country: Erie / OH / United States
DR Portal Registered: Yes

Statutory Discrimination Qualified - This arbitrator meets the conditions set forth in FINRA's Code of Arbitration Procedure to serve as the chairperson or sole arbitrator on a case involving a statutory discrimination claim.

Injunctive Qualified - This arbitrator is an attorney and has reported experience litigating cases involving injunctive relief.

EMPLOYMENT

Start Date	End Date	Firm	Position
01/2001	Present	Law Offices of Leonard McDonnall	Attorney
01/2001	01/2002	US General Mortgage Company	General Counsel
12/1998	01/2001	Ohio Title Insurance Company	Counsel
01/1996	12/1998	Michaels & Smith	Real Estate Department
01/1994	12/1995	BAX, Inc.	Law Clerk
01/1993	12/1993	Consumer Protection Legislation Project, Inc.	Volunteer Attorney
01/1993	12/1993	Legal Clinic	Volunteer Attorney
02/1992	10/1994	ING Bank	Contract Assistant
01/1990	01/1992	Chase Bank	Contract Assistant
05/1989	01/1991	Unemployed	Studied for bar exam

EDUCATION

Start Date	End Date	School	Degree
08/1986	05/1989	North Carolina Central University School of Law	JD
09/1982	05/1986	City College of New York (CCNY)	BA

TRAINING

Completed	Description	Details	Firm/School	Hours	Location
08/2018	Additional Securities Training	Securities Arbitration & Mediation Hot Topics 2018	Ohio Bar	3.5	Columbus, OH
09/2016	Arbitration Training	FINRA - Conflicts of Interest	Quest Continuing Education Solutions		online
09/2016	Additional Securities Training	FINRA - Private Securities Transactions	Quest Continuing Education Solutions		

09/2016	Arbitration Training	FINRA - Electronic Communications...	Quest Continuing Education Solutions		online
09/2016	Arbitration Training	FINRA - Retail Supervision: Sales to Senior...	Quest Continuing Education Solutions		
02/2016	Mediation Training	Utilizing Mediation to Navigate the Perils...	American Bar Association		Webinar
01/2016	Discovery Training (2011)		FINRA	1	online
01/2016	Revised Code of Arbitration		FINRA	1	online
01/2016	Understanding the Prehearing Stage		FINRA	1	online
01/2016	Duty to Disclose online mini-course		FINRA	1	online
01/2016	New Chairperson Training [FINRA]		FINRA	6	online
01/2016	Explained Decision Training		FINRA		
01/2016	Motion to Dismiss Training		FINRA		
01/2016	Suspicious Act Rpt & Anti-Money Laundrg		FINRA		
03/2014	Additional Securities Training	Securities Arbitration & Mediation	Ohio Bar Association	7	online
09/2013	New Online Civility Training		FINRA	1	online
09/2013	Direct Communication Rule		FINRA	1	online
09/2013	Live Video Basic Panel Training		FINRA	4	live WebEx
08/2013	Online Basic Panel Training		FINRA	8	online
08/2013	Expungement online revised - 3/2009		FINRA	1.5	online
11/2011	Mediation Training		United States District Court	6.5	Columbus, OH

DISCLOSURE/CONFLICT INFORMATION

Type	Firm Name	Details
Is a Member of Bar Association	American Bar Association	
Is a Member of Bar Association	Ohio	
Has made a disclosure about	FINRA Case □□8□□□□□	Neutral in case where motion to vacate filed. Motion granted (administrative error)
Has made a disclosure about	First Bank	Independant contractor providing services undr the Law Office of Leonard G McDonnall
Disclosed Online Activities	Linkedin	https://www.linkedin.com/in/mcdonnalllaw/
Is a Member of Bar Association	Erie County	
Licensed to Practice Law in	Ohio	
Is a Member of Bar Association	Ohio	
Licensed to Practice Law in	New York	

Was a Licensed	Real Estate Broker	Ohio & New York
Disclosed Online Activities	Twitter	@leonardmcdonnall
Had an account with	Chase Bank	Business checking and joint personal checking account
Non-investment related lawsuit/charge		File bankruptcy in 2010 (discharged)
Is a member of		Regional Review panel pertaining to policies affecting children in the child welfare system
Non-investment related lawsuit/charge		US Ct. App. assault charges on behalf of family member

PUBLICLY AVAILABLE AWARDS FOR CASES INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases Involving Public Customers Section, Current as of 05/16/2019

Case ID	Case Name	Close Date	Role
17	[redacted]		Panelist
16			Panelist

PUBLICLY AVAILABLE AWARDS FOR CASES NOT INVOLVING PUBLIC CUSTOMERS

Publicly Available Awards for Cases NOT Involving Public Customers Section, Current as of 07/18/2019

Case ID	Case Name	Close Date	Role
17	[redacted]		Panelist
18			Chair
18			Chair
15			Panelist

CASES CURRENTLY ASSIGNED INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
18	[redacted]		Chair
18			Panelist
17			Panelist

CASES CURRENTLY ASSIGNED NOT INVOLVING PUBLIC CUSTOMERS

Case ID	Parties and Current Representatives of Record	Date Assigned	Role
19	[redacted]		Chair
17			Panelist

ARBITRATOR BACKGROUND INFORMATION

From 1991 to 1992, I worked as a contract assistant for Chase Bank. In 1993, I started practicing law where I worked as a Volunteer Attorney for a legal clinic, and Consumer Protection Legislation Project, Inc., in Erie, Ohio. At the same time, I was working as a contract employee for ING Bank, in New York City, in the Real Estate Finance and Corporate Mortgage Finance Depts.

In 1994 to 1995, I worked as a Law Clerk for BAX, Inc., a defense contractor, in Pennsylvania, on defense contract litigation for the Department of Defense and Department of Justice. From 1996 to1998, I worked for Michaels & Smith law firm, in New York City, in their Real Estate Department on securitizations, real estate finance and reits. From 1998 to 2001, I worked for Ohio Title Insurance Company as Counsel on national franchise transactions, securitzations, reits, commercial closings and recording issues.

Since 2001 until present, I formed and operated my own law firm practicing in New York and Ohio, in the areas of contracts, real estate, complex estate administration, trusts and wills, employment law, corporate transactions and civil litigation. During the time that I was practicing law full time, in 2001 and 2008, respectively, I taught business and contract law at Erie Community College and Case Western University.

In early 2012, I worked on a temporary contract assignment in NY with the DOJ on a real estate finance fraud case. I formerly sat on two non-profit boards, which advocates for children's rights.

Beginning in the summer of 2018, I became affiliated with Vuitton and Suchardine in the area of class action litigation.

Leonard G McDonnall / Attorney

- Overview
- Contact

Leonard McDonnall founded the law firm in 2001, and has published various articles on the firm's website on various subjects of the law. He is a sought-after speaker and frequently appears at law firm retreats and legal industry conferences in the United States and around the world.

Leonard has dedicated his law career to doing good, in areas ranging from contracts, real estate, complex estate administration, trusts and wills, employment law, corporate transactions and civil litigation.

Before founding his own law firm, Leonard:

- Worked for a defense contractor, practising defense contract litigation
- Worked for an insurance company, on national franchise transactions, securitzations, reits, commercial closings and recording
  issues

BEHAVIORAL FINANCE: USE IN INVESTOR DISPUTES

Celiza (Lisa) Bragança, Kathy Adams, Patricia Vannoy

For many years brokers and registered investment advisers have used the tools of behavioral finance in marketing and advertising to investors. More recently, they began using behavioral finance in a different way to market their practices -- touting their training and expertise in identifying the biases that frequently occur in investing, and presenting themselves as experts in saving investors from these biases.

For example, Morgan Stanley says its financial advisors are "trained in identifying the heuristics and cognitive biases that frequently occur in investing" and that helps them " mitigate behavioral finance pitfalls and execute plans more deliberately and objectively, avoiding costly mistakes":

Morgan Stanley

Conclusion

In our role as financial advisors, we are trained in identifying the heuristics and cognitive biases that frequently occur in investing.

Our ability to observe these concepts combined with an established process for creating thoughtful investment plans customized to each client helps us mitigate behavioral finance pitfalls and execute plans more deliberately and objectively, avoiding costly mistakes.

https://advisor.morganstanley.com/puget-sound-wealth-management/documents/field/p/pu/puget-sound-wealth-management/An%20Introduction%20to%20Behavioral%20Finance.pdf.

Brinker Capital offers webinars on how financial advisors can use behavioral finance to help their customers:

JP Morgan Chase also pithes behavioral finance to its customers. JP Morgan Chase has a doctor of cognitive psychology, Michael Liersch, as its Global Head of Wealth Planning & Advice. https://privatebank.jpmorgan.com/gl/en/people/michael-liersch. Before that, Liersch worked for Merrill Lynch as Head of Behavioral Finance and Goals-Based Consulting and for Barclays Wealth. https://www.linkedin.com/in/michael-liersch-1882382/

J.P.Morgan
Asset Management

Here is a video for investors in which Dr. Liersch talks about managing behavior in volatile markets: https://chaseprivateclient.chase.com/our-thinking/5-smart-behaviors/

So, this begs the question: what is behavioral finance and why are BDs and RIAs interested in it?

What is Behavioral Finance?

Behavioral finance (often referred to as behavioral economics or behavioral decision-making) has come to the fore in recent decades with Nobel Prize awards for the ground-breaking research of Daniel Kahneman (with the late Amos Tversky) and Richard Thaler. At a high level, behavioral finance looks at how real investors make real decisions. Traditional finance is based upon models that assume perfectly rational profit maximizing behavior – efficient capital markets. Behavioral finance focuses on the heuristics and cognitive biases that real people have and use to make decisions in the real world.

In an interview with UBS, Daniel Kahneman explains how this research applies to financial decisions:

UBS

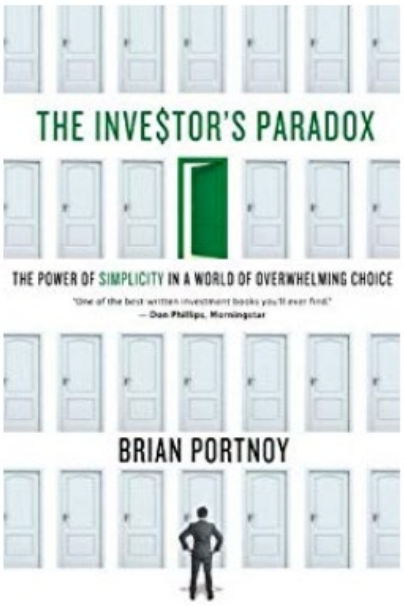
The assumption of rational investors can be dangerous

Kahneman points to the fact that one has to be extremely cautious in financial decisions. He calls it risky, if not dangerous, when people who have little knowledge of the financial system need to make decisions about which stocks to buy for their retirement, for example. "That becomes silly," he quips. "The assumption that individual investors are rational. That leads to serious mistakes."

With Prospect Theory, the work for which Kahneman won the Nobel Prize, he proposed a change to the way we think about decisions when facing risk, especially in finance. Along with Amos Tversky, he found out that people aren't first and foremost foresighted utility maximiziers, but react to changes in terms of gains and losses. "And gains and losses are short-term," Kahneman states. "They're immediate, emotional reactions. This makes an enormous difference to the quality of decisions." He demonstrates that when people think of the future, they think of the near future far more than the distant future. Changing the perspective from people acting to obtain long-term wealth, to people not wanting to lose tomorrow, significantly alters our understanding of behavior. "People put much more weight on losses than gains. People hate losing."

https://www.ubs.com/microsites/nobel-perspectives/en/laureates/daniel-kahneman.html

A number of financial professionals have written books addressing how financial advisors and investors can overcome heuristics and biases that affect financial decisions:



Brian Portnoy is Director of Education for Magnetar Capital.
https://www.magnetar.com/insights/magnetar-hires-brian-portnoy-as-director-of-education

Daniel Crosby is Chief Behavioral Officer for Brinker Capital (where he leads webinars, see above). https://blog.brinkercapital.com/tag/dr-daniel-crosby/.

Here are some books and articles by and about the Nobel Laureates in behavioral finance:

Daniel Kahneman – *Thinking Fast and Slow*

Michael Lewis – *The Undoing Project* (about the collaboration of Daniel Kahneman and the late Amos Tversky that led to Kahneman being awarded the Nobel Prize)

Several shorter articles on Kahneman's research:

https://www.theatlantic.com/business/archive/2017/01/undoing-project/511958/

https://www.newyorker.com/books/page-turner/the-two-friends-who-changed-how-we-think-about-how-we-think

YouTube interview of Michael Lewis, author of the Undoing Project (about Daniel Kahneman and Amos Tversky)
https://www.youtube.com/watch?v=nbblhD8K4WA

Richard Thaler – *Nudge* and *Misbehaving*

Thaler's Nobel Prize acceptance speech:
https://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2017/advanced-economicsciences2017.pdf

Several short articles on Thaler's research:

http://www.chicagotribune.com/business/ct-nobel-prize-economics-richard-thaler-20171009-story.html

https://www.theatlantic.com/business/archive/2017/10/richard-thaler-nobel-economics/542400/

http://review.chicagobooth.edu/behavioral-science/2018/article/behavioral-economics-nuts-nudges

BDs and RIAs Embrace Behavioral Finance

Broker-dealers and registered investment advisers are taking up the cause of behavioral finance as a way to market their services. Some, like this Ameriprise practice, offer programs to potential customers like this one entitled "Behavioral Finance in Today's Market." https://www.ameripriseadvisors.com/team/the-flynn-group/events Others tout their expertise as a differentiator. https://advisorhub.com/resources/advisor-sales-through-behavioral-finance/

FINRA's website identifies "certified behavioral financial advisor" as a designation that some financial advisors have. https://www.finra.org/investors/professional-designations/bfa. A financial advisor can become a certified behavioral financial advisor through Kaplan Financial Education. https://www.kaplanfinancial.com/bfa

Firms have identified a number of ways that a financial advisor could help a customer to overcome common biases in investing. Some of the biggest biases they identify are:

Choice Overload

Overconfidence (the illusion of validity)

Status Quo Bias (prospect theory)

Loss Aversion

Confirmation Bias

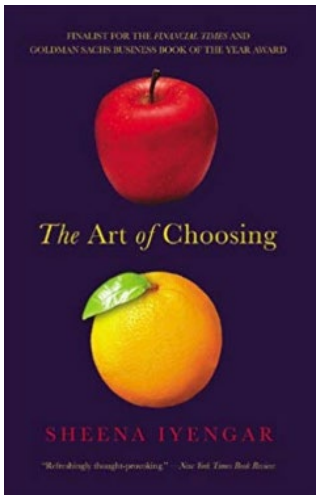
Choice Overload

Americans love having lots of choices – the more choices the better! But while we think that having more choices will lead to a better result, that is simply not the case. In many cases, the result is significantly worse. Choice overload can result in an investor being so overwhelmed she makes no choice at all. Too many choices can also lead to an investor believing that investing in a lot of different investments means she has diversified her portfolio. Benartzi & Thaler, Naïve Diversification Strategies in Defined Contribution Savings Plans (Chapter 16) of *Advances in Behavioral Finance*, Vol. 2 (Princeton Univ. Press 2005).

What is choice overload? Choice overload occurs when an individual is so overwhelmed with the choices presented that she makes no choice at all.

This is not uncommon in the investing arena. Investors are often overloaded (overwhelmed) by the dizzying array of investment options. As a result, they may put off making investment decisions or even beginning to contribute to a 401(k) plan.

Professor Sheena Iyengar of Columbia University has done substantial research on how much choice is too much. Her "jam experiment" addressed how people responded to different numbers of choices. Professor Iyengar's team tested how consumers responded to two different scenarios – a table offering six different jams for tasting versus a table offering 24 different jams. Brian Portnoy, *The Investor's Paradox* at 13-15. The experiment showed that more consumers stopped at the table offering 24 jams for tasting, but the consumers who stopped at the table offering six jams purchased more often. Sheena Iyengar TedTalk, available at https://www.ted.com/talks/sheena_iyengar_choosing_what_to_choose?utm_campaign=tedspread&utm_medium=referral&utm_source=tedcomshare. Iyengar & Lepper, When Choice is Demotivating: Can One Desire Too Much of a Good Thing? available at http://psy2.ucsd.edu/~nchristenfeld/DoG_Readings_files/Class%209%20-%20Iyengar%202000.pdf.



Professor Iyengar has also researched choice overload in retirement plans. She looked at 401(k) participation rates among clients of Vanguard Group to see whether more investment options led to greater participation. She found that the opposite was true. Iyengar & Jiang, How Much Choice is Too Much? Contributions to 401(K) Retirement Plans, available at https://www.researchgate.net/publication/237792043_How_Much_Choice_Is_Too_Much_Contributions_to_401K_Retirement_Plans.

Working with a financial advisor is a good way to overcome choice overload. https://www.morningstar.com/blog/2017/12/15/choice-overload.html An investor can rely upon the financial advisor to narrow down the investment choices to a manageable number or create a "default" investment plan for the investor. As one small New Jersey RIA puts it:

> Let's assume for a moment that your current investment portfolio was all in cash and you had to start from scratch. How would you invest it? What would be your asset allocation (stocks vs. bonds)? Where would you begin to look for help? If you did a simple web search for "How to invest in the stock market" you would be thrown down a rabbit hole of information and an overwhelming amount of choices.
>
> * * *
>
> The scenario above is meant to convey those feelings of apprehension and uneasiness you have when there are so many choices and so many questions with no answers, or even worse, conflicting answers. It is very easy to become overloaded and simply shut down. In which case you have **no** investment strategy at all.

https://www.weingartenassociates.com/blog-01/information-overload-decision-paralysis-and-herding. This is precisely why many people need a financial advisor -- assuming the narrowed list of choices is not filled with nontraded REITs, oil & gas limited partnerships, and equity indexed annuities!

Overconfidence

Behavioral research shows that people are overconfident – that includes investors and financial advisors. This is also sometimes referred to as the illusion of validity.

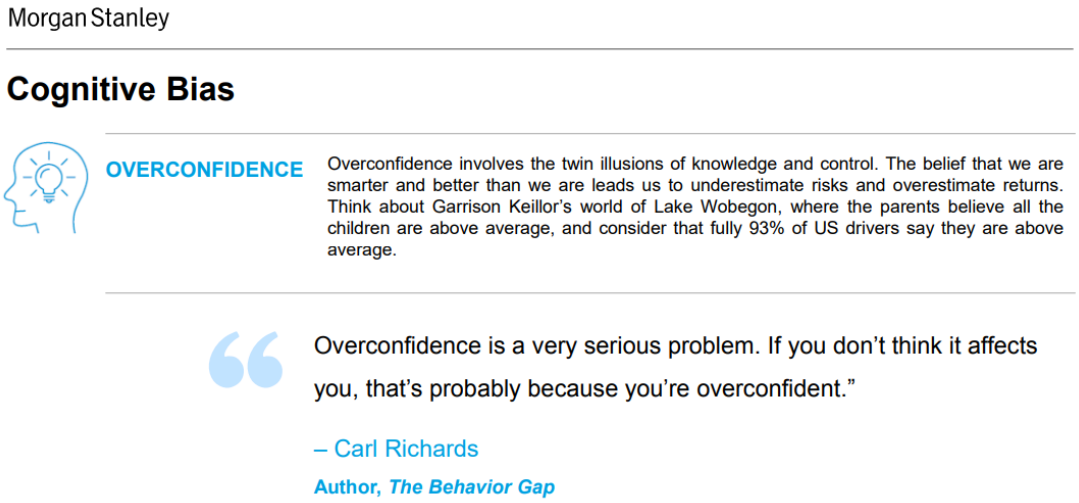
One survey found that 100% of the men surveyed felt they were better than average interpersonally and 94% felt they were athletically better than average. *The Behavioral Investor*

at 47. Just like in Garrison Keillor's Lake Wobegon, where "all the women are strong, all the men are good looking, and all the children are above average."

We would expect that financial advisors – who are experts in investing – would not be overconfident. Not so! Studies of predictions of earnings by stock analysts show that they are not accurate. Even consensus forecasts are more often off by more than 15%. *The Behavioral Investor* at 113. Another study found that there was only a 1 in 170 chance of being within 5% of the actual number. *Id.* Even those "experts" working for BDs and RIAs are subject to the overconfidence bias. Who can forget the fate of the overconfident folks at Long Term Capital Management? Lowenstein, *When Genius Failed*.

Does that mean that less competent financial advisors might be less biased than "expert" financial advisors? No! The Dunning-Kruger Effect teaches us that people who are not competent are unable to recognize their incompetence. *The Behavioral Investor* at 61. All financial advisors, just like all investors, are likely to be affected by overconfidence.

BDs and RIAs like Morgan Stanley and Madison Avenue Securities address the overconfidence bias in their marketing materials.



https://advisor.morganstanley.com/puget-sound-wealth-management/documents/field/p/pu/puget-sound-wealth-management/An%20Introduction%20to%20Behavioral%20Finance.pdf

http://www.mas-bd.com/resource-center/investment/dont-be-your-own-worst-enemy.

Financial advisors who are trained and aware of these biases and heuristics can help customers to avoid these biases. But, it is not only customers who are subject to these biases. Financial advisors are too. This is something Charles Schwab acknowledges:

IN: What about an adviser's own biases? How can those be countered?

OA: That's a question we get all the time, and I always offer the following analogy. Imagine you're on a plane and it suddenly hits turbulence. No matter who you are — a passenger, the pilot or a crew member — a reaction is expected because we are human. If you're the pilot or a flight attendant, the cognitive part of your brain kicks in almost immediately and calms you down. But if you don't travel that often or if you hate flying, it will take a while for the rational part of your human brain to override the emotional part. Both the trained and the untrained flyers have the same emotional reactions, it's just that trained professionals can switch mental gears more smoothly.

In the same way, financial advisers have the training and experience to help them overcome their own biases. But don't be mistaken; advisers have biases just like anyone else, and those biases don't go away. Advisers need to understand their own biases and how to manage them.

https://www.schwab.com/public/file/P-10392577.

Who is helping the financial advisors to avoid these biases? What training and supervisory policies and procedures to firms have to identify and mitigate overconfidence, choice overload, and other biases? Do they create model portfolios? Do they conduct substantive training to ensure individual financial advisors and supervisory personnel are on the "lookout" for evidence of overconfidence and are not overwhelmed with investment options? Do branch audits look for evidence of financial advisor "overconfidence" or other biases?

Or are these firms promising something that they are in no position to deliver?

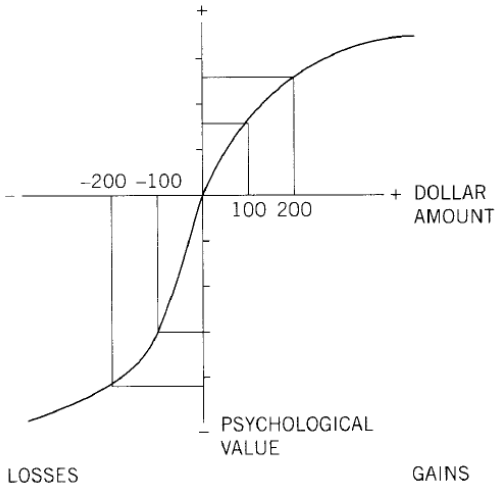
Loss Aversion and Prospect Theory

Another bias is loss aversion, which is part of prospect theory. Here is an illustration:

> What if you were offered the following gamble on the toss of a coin:
>
> - If the coin comes up tails, you lose $100
> - If the coin comes up heads, you win $150

Would you take the gamble? Objectively you stand to win more than you stand to lose. But, most people would decline to take the bet because the prospect of losing $100 is more painful than the prospect of gaining $150. That is loss aversion. It is worth something to us to avoid loss.

This graph illustrates Daniel Kahneman's prospect theory – we value gains and losses differently:

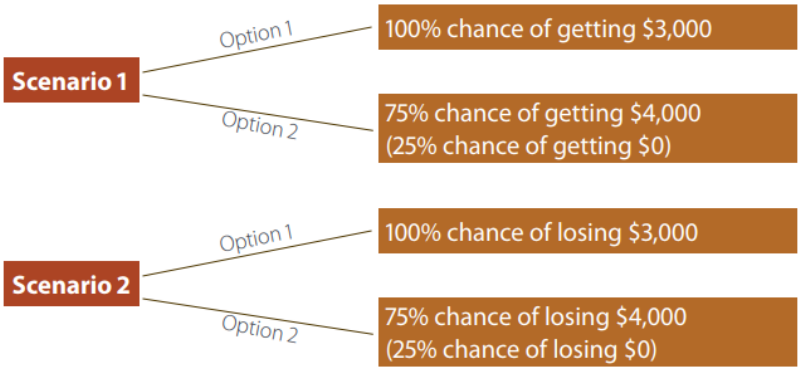


Wells Fargo Advisors explains prospect theory and loss aversion in its marketing materials:

Behavioral finance, an increasingly popular financial discipline, aims to understand investor behavior and identify the factors that cause observed behavior to diverge from purely rational principles. These factors can affect asset valuations, create short-term price distortions, and influence an investor's choice between reward and risk.

For example, a key concept in behavioral finance is prospect theory, which describes how investors make decisions that involve risk and gain. People frequently consider losses far more undesirable than they find comparable gains desirable, as discussed below.

Take the following choices:



Studies have shown that given the first scenario, most people will avoid the risk and take the first option (the sure $3,000 gain). On the other hand, when presented the second scenario, most favor the second option (the 75% chance of losing $4,000) because it offers the possibility of avoiding the pain of a loss. Keep in mind, all the choices are mathematically equivalent.

WELLS FARGO ADVISORS

https://www.wellsfargoadvisors.com/research-analysis/ask-the-institute/understand-behavorial-finance.htm

Morgan Stanley describes loss aversion in its marketing materials:

Morgan Stanley

Cognitive Bias

LOSS AVERSION

Kahneman and Tversky had discovered that individuals feel the pain of losses more than twice as deeply than they feel the pleasure from gains. The usual pattern for investors is to increase equity holdings when prices are high, and then reduce holdings in equities when prices are low – the opposite of what is required to be a successful investor.

Also, those who receive the most feedback about their portfolios take the least amount of risk and ended up earning the least amount of money. This is because the more people look at their portfolio, the greater the likelihood they will witness drops in value, since in the shortterm markets tend to be far more volatile. And seeing those drops triggers a greater feeling of loss aversion.

Example: In four distinct periods including the great October 1987 crash, the first Gulf War, the tech wreck, and the spring after the Great Recession, investors continued to reduce equity exposure while the market was reaching its lows. That is the pain of losses persevered in people well into the time when more rational individuals would have turned to buying equities.

Both Morgan Stanley and Wells Fargo recognize that customers do not like losses. That means customers are likely to resist selling losing investments – they will hold them, hoping to recover their losses, rather than realize those losses and move on to something else. Holding losing investments allows investors to avoid the pain of loss, even when it is objectively beneficial. Barber & Odean, Individual Investors (Chapter 15) of *Advances in Behavioral Finance*, Vol. 2 (Princeton Univ. Press 2005). This explains why a customer's failure to sell an investment might not be ratification or a failure to mitigate.

Confirmation Bias

We human beings do not like to be wrong. As a result, we tend to seek evidence that confirms our beliefs – rather than evidence that undermines those beliefs. LPL Financial recognizes this in materials for financial advisors entitled, Improving Investor Behavior – Five Common Mistakes. LPL introduces this topic as follows: "From anchoring to overreaction, why behavioral finance mistakes matter – and how you can help your clients address them."

4. Confirmation bias

What is it? When you have a strongly held belief, it's easy to see validation everywhere. This habit of noticing information that affirms your beliefs and opinions while also ignoring or denying contradictory information is known as confirmation bias. It's powerful in part because it's reassuring: "Once you're comfortable with an idea, you feel better when you hear information that tells you you're right," Shefrin explained.

While confirmation bias plays a role in everything from politics to medical diagnosis, it can be especially damaging when it comes to making financial decisions. That's because people in the grips of confirmation bias truly believe that they're making an informed decision—and they don't realize the information they're basing their choices on has been skewed by their own preconceptions. For example, a client who's

particularly convinced that a certain investment is a good buy will pay attention to the facts that support such a belief (such as strong recent performance) while glossing over other information (such as a high price-to-earnings ratio).

http://assets.penton.com/customs/lpl/WP_Improving%20Investor%20Behavior.pdf. LPL recognizes that the confirmation bias exists, but what does LPL do to address the confirmation bias of its financial advisors who pay attention to the facts that support their investment recommendations while glossing over contrary information?

As the Bernie Madoff fraud revealed, even the Securities & Exchange Commission can fall victim to confirmation bias. The SEC failed to follow up on over thirty red flags that Harry Markopolous provided indicating that Madoff was likely to be running a Ponzi scheme. That failure and many others demonstrates that it is important not just to follow up on known red flags, but to even see red flags. LPL recognizes this problem. What does LPL do to monitor its financial advisors for

confirmation bias? What policies and procedures does it have? What does it look for in branch audits? What kinds of supervisory reports does it generate?

Conclusion

Be aware of how BDs and RIA respondents in your cases are using behavioral finance. Their knowledge of heuristics and biases that could potentially affect the behavior of financial advisors means this should be part of their supervisory process. You don't have to let respondents get away with touting their expertise in investor heuristics and biases to attract customers while ignoring how those same heuristics and biases can be harmful to customers.

THE APPROPRIATE AND EFFICIENT USE OF EXPERTS IN SECURITIES ARBITRATION

Hugh D. Berkson

Introduction

Hiring experts, maximizing their value at hearing, and minimizing the associated expense, are critical components for any counsel regarding any arbitration hearing. We'll cover three major topics herein:

1. Ensuring your expert can testify;

2. Promoting efficient use of your expert before the hearing; and,

3. Maximizing the impact of the expert's testimony at the hearing.

Knowing the audience, we'll jump right to the summary conclusions for each of the three topics:

1. Presuming your expert is qualified, an arbitrator's refusal to allow them to testify is reversible error;

2. Involve your expert early in the process – even before the case is filed – to ensure that expert supports your theories of the case;

3. Use graphics during the expert's direct to help explain difficult concepts or summarize massive quantities of data.

Experts Are Allowed To Testify In Arbitration

My office has the somewhat dubious distinction of being involved in the oft-cited decision finding that experts are, in fact, allowed to testify in arbitration and the refusal to permit them to testify is reversible error. The decision is published: *Bordonaro v. Merrill Lynch, Pierce, Fenner & Smith*, 156 Ohio App.3d 358, 805 N.E.3d 1138 (8th Dist. Ct. App. 2004). The court case arose after we sought to offer the testimony of Ross Tulman concerning two topics during the course of our case in chief in arbitration: the standard of care applicable to Respondents, and damages. The Panel declined to allow Mr. Tulman to testify regarding the standard of care, instead proclaiming themselves to be the experts in that field. Adding insult to injury, the Panel allowed the broker and his managers to testify again and again that the manner in which they did things was simply how things were done in the industry (thereby back-dooring testimony concerning the standard of care). We were careful to tell the arbitrators, before the case was closed, that we did *not* believe we had been given a full and fair hearing. Unsurprisingly, the arbitrators ruled against Claimant and we sought to overturn the decision. The trial court rubber-stamped the arbitrators' decision(s), but the court of appeals took a different view.

The court of appeals saw the central issue as one concerning whether it was appropriate to allow the expert to offer an opinion regarding an issue to be decided by the trier of fact. The court started by confirming that "'Testimony in the form of an opinion or inference otherwise admissible is not objectionable solely because it embraces an ultimate issue to be decided by the trier of

fact.'" *Id.* at 361 (citations omitted). Continuing, the court found that many federal courts actually *required* testimony concerning the standard of care in securities cases.

> Whether a person professionally trained and licensed has exercised the degree of skill, care, and diligence required of his profession is a matter which can only be established by expert testimony. A layman, like the bricklayer or the general contractor here, may prefer to do things in a different way from that prescribed by the architect. This is not the same as stating that the architect failed to meet professional standards. Even an individual architect may have different personal preferences. Again this does not establish that an architect with different preferences is failing to come up to the standards of his profession.
>
> *Phillips v. I.W. Colburn & Assocs., Inc.*, (November 21, 1979), Montgomery App. No. 6148, 1979 Ohio App. LEXIS 10542, at *29.
>
> It is well settled that a securities broker is a licensed professional. It follows, therefore, that expert testimony is useful in establishing the proper standard of care applicable in a securities matter. We find support for this position not only in cases decided in the courts of Ohio and elsewhere but, most persuasively, in arbitrations conducted before and decided by the National Association of Securities Dealers. *See Ferritto v. Olde & Co.,* (1989), 62 Ohio App.3d 582, 577 N.E.2d 101, (plaintiff's expert testified as to the standard of care owed by a professional stockbroker).

Id. at 362.

After exploring the arbitration transcript in which the arbitrators declared themselves the liability experts and declined to allow either party to provide testimony on the subject, the court described the disparity in what actually happened during the course of the hearing:

> In the case at bar, the arbitration panel decided that Tulman could not testify about liability and excluded his testimony. The rules of evidence, however, do not support exclusion of Tulman's testimony, even if it were focused solely on liability, which we do not believe would have been the focus. On the contrary, the record is clear that Tulman was supposed to testify about standard of care and industry customs and practices. Such testimony would not have been dispositive of defendants' liability or an invasion of the arbitrators' ability to decide that issue.
>
> Moreover, the record shows that virtually all defendants' witnesses, including Telerico himself, were experienced securities professionals with more than 80 years experience between them in the industry. The hearing transcript shows that each of the witnesses' testimony touched on practices at Merrill Lynch and within the securities industry, generally. Though not expressly designated as experts, each of defendants' witnesses testified about the very issues plaintiff wanted Tulman to talk about. Once Tulman was excluded, however, plaintiff could not and did not present any evidence about such matters.

Id. at 366.

The court of appeals agreed that the arbitrators overstepped their bounds and prevented our client from a full and fair hearing. It therefore reversed the trial court's decision.

The *Bordonaro* decision does not stand alone in a vacuum. Other courts facing the same issues have cited it in support of the propriety of expert testimony in FINRA arbitrations. "Particularly, expert testimony on the applicable standard of care with respect to Plaintiffs' claim for the sale of unregistered securities will aid the jury in understanding this complex issue." *Mosley v. Ameriprise Fin. Advisors, Inc.*, 2008 Mont. Dist. LEXIS 874 *6 (Nov 5, 2008). *See also Wilde v. O'Leary*, 374 N.J.Super. 582, 866 A.2d 205 (Super.App.Div.2005)(addressing the propriety of expert testimony in a mortgage brokerage dispute). Indeed, the opinion has gone as far as an Ohio treatise on the subject: 1 Ohio Securities Law and Practice § 23.04 (2019).

Accordingly, there can be no meaningful debate on the issue of whether a claimant is entitled to call a liability expert to testify at hearing – presuming the expert is qualified. The panel may not claim it is the true expert and thereby decline to allow the liability expert to testify.

Promoting The Efficient Use Of Your Expert Before Hearing

You're allowed to have your expert testify if the matter gets as far as a hearing. The question then becomes *when* you involve the expert, and *how* the expert is involved. Polling a number of expert witnesses, a number of themes become clear. First and foremost, the question arises: do you actually want an expert? Most experts (properly) chafe at the concept of serving in a role that offers little more than parroting whatever counsel wants them to say. Instead, determine whether you're dealing with a particularly complicated product, or whether establishing and applying a standard of care will be at issue. In short, bring an expert to do what experts are meant to do: explain things not in the common purview of the average person (or arbitrator).

Second, experts polled agree that they prefer to be retained early in the process. Involving an expert early – even before the statement of claim is prepared – ensures that the case is developed with a theory that expert supports. The expert can also offer keen insights to ensure the pleading does not inadvertently make unsupportable or simply erroneous claims. If the expert has been involved in, or at least reviewed, the statement of claim, he or she can properly answer the question "Have you read the Statement of Claim?" And better yet, can respond to the follow-up "Is there anything in there with which you disagree?" without destroying your case.

A particular pet peeve of experts is being sandbagged at hearing with a document he or she hadn't seen before. Sometimes counsel made an economic decision not to dump everything on the expert, and sometimes counsel (for reasons that will forever remain a mystery) decided to hide the "bad documents" from the expert. Putting aside the obvious instruction to ensure that your expert is aware of all the good – and bad - facts of the case, the experts agreed that a good practice for a particularly document-heavy case is for counsel to provide the expert with well-organized copies of the key documents, as well as an inventory of *all* the documents in the case. The expert will then have the opportunity to review the index and select the documents he or she believes will be necessary to establish their opining concerning the case. To a person, the experts expressed frustration with the simple dump of boxes of unorganized records. The time and cost associated with the expert's organization and review of the documents is invariably far in excess of the cost it would have taken for a paralegal to make a first pass and organize the materials being delivered.

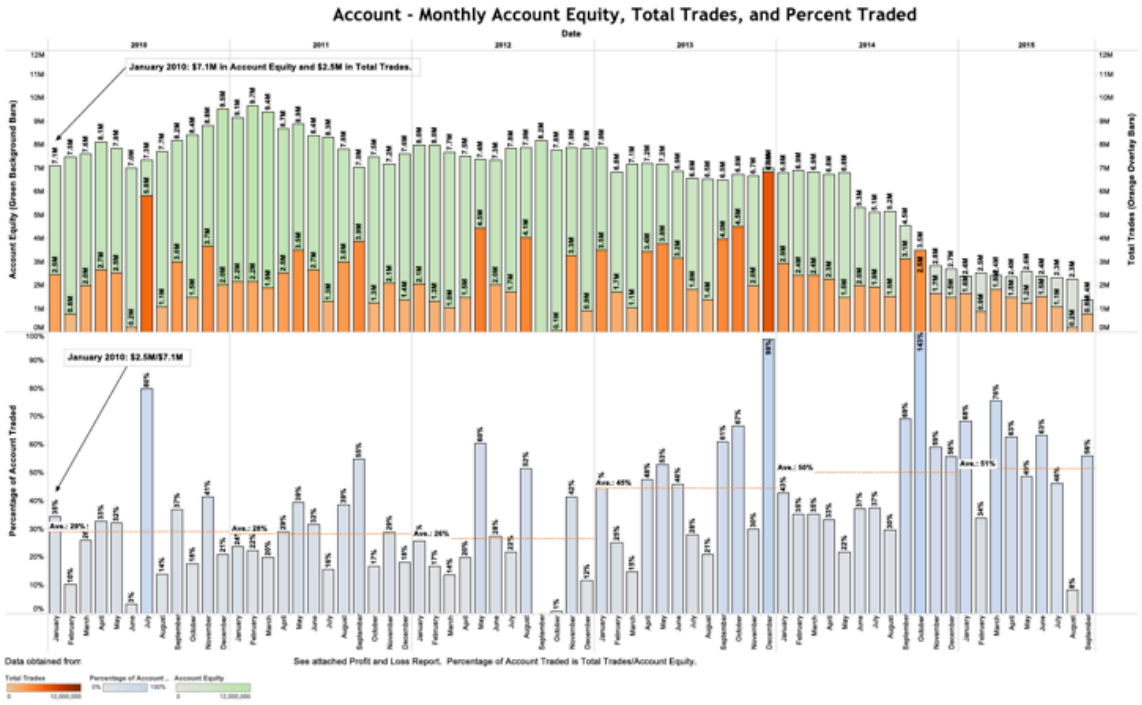
In short, the key to minimizing cost and maximizing value is to be efficient in dealings with the expert. Remember that they're professionals who have put their reputation on the line for your case. They can't possibly digest thousands of pages in a week's time as they rush to make travel arrangements to testify in your case on the other side of the country. Allowing the expert sufficient time to digest whatever materials they believe necessary to perform their job properly, and ensuring that their time is spent reviewing the key materials rather than organizing the mess of records you sent them, will ensure that they stand up to a withering cross examination much better than they would absent proper preparation.

Maximizing the Impact Of Your Expert's Testimony At Hearing

Experts are often (and properly) called in to explain to the arbitration panel (or jury) exceptionally complicated products or theories. The most skilled orator may still run a significant risk of losing the audience as he or she plows through a half-hour of testimony explaining a product. The testimony will be more likely understood if the expert accompanies the testimony with simple graphic images to explain the otherwise indecipherable product. Consider, for example, the slides attached as Exhibit A, taken from a presentation developed by Dr. Edward O'Neal, of Securities Litigation Consulting Group to explain a collateralized debt obligation product structure.

Note how a series of six slides provide a solid foundation to understand a collateralized debt obligation product whose prospectus typically carries on for well in excess of one hundred pages. That's not to say that the slides should supplant the expert's oral explanation. Rather, the slides supplement and reinforce the message for visual learners.

Charts and graphs are also particularly useful when the expert is addressing themes or patters that arise from mounds of data. Take, for example, the following single-page chart Jack Duval prepared for a single account that experienced thousands of trades over the course of a ten year period. While he could testify that between a quarter and half of the account turned over *every month*, and he could testify that millions of dollars of trades took place nearly every month, the following chart serves to illustrate those issues by itself, and nearly immediately. In a single page, thousands of data points are summarized into an easily understood picture of the account's average equity, trading volume, and percentage of assets being traded:



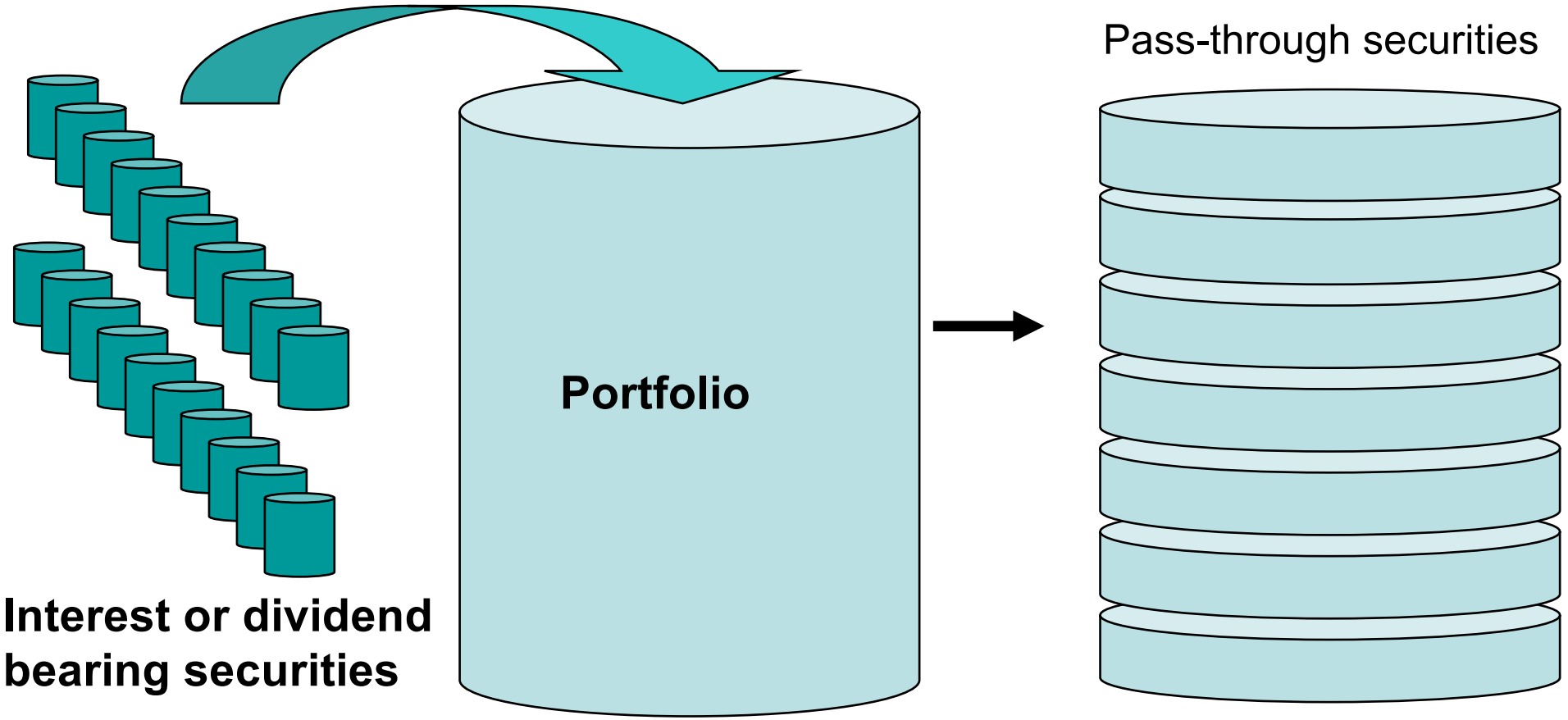
That same case involved dozens of accounts for the family matriarch and her two adult children. There was a question of who was in control of the account: the broker or the client. The broker was expected to testify that of course he called the family before each trade took place. The family was expected to testify that of course they rarely heard from him. And, naturally, there were thousands upon thousands of pages of trading data, and a few pages of phone records regarding the nine or ten phone numbers for the clients. It was unreasonable to line up phone records against trades during the hearing. There was no way the arbitrators would do that work on their own. And simply having the oral testimony from the witnesses didn't seem terribly compelling (since it would mirror the "he said/she said" dynamic present in nearly every arbitration proceeding). Mr. Duval therefore plotted the trades and the calls, coding the calls to show duration and the number called. The chart took thirty-six pages (and is attached hereto as Exhibit B), but those thirty-six pages summarize countless thousands of data points into an easy to digest message. The message was clear: even if a call matched a trade, the call was invariably of a duration insufficient to explain to an investor the propriety of a particular recommended trade or series of trades.

Conclusion

The job for any lawyer is to maximize client value. Avoiding easy mistakes with one of the biggest ticket items – experts – is easy. A little forethought will bring the expert into your case early. Providing that expert with the information necessary to support their opinion is also relatively easy. Supply well-organized documents and an index of *all* documents and the expert won't be caught flat footed with the dreaded "Well, would *this* document change your opinion?" It becomes awfully difficult to explain to the client she should pay that expert whose value was decimated by a document withheld from them. It's much easier to explain that the expert should be paid in full once the examination finishes and they escape unharmed.

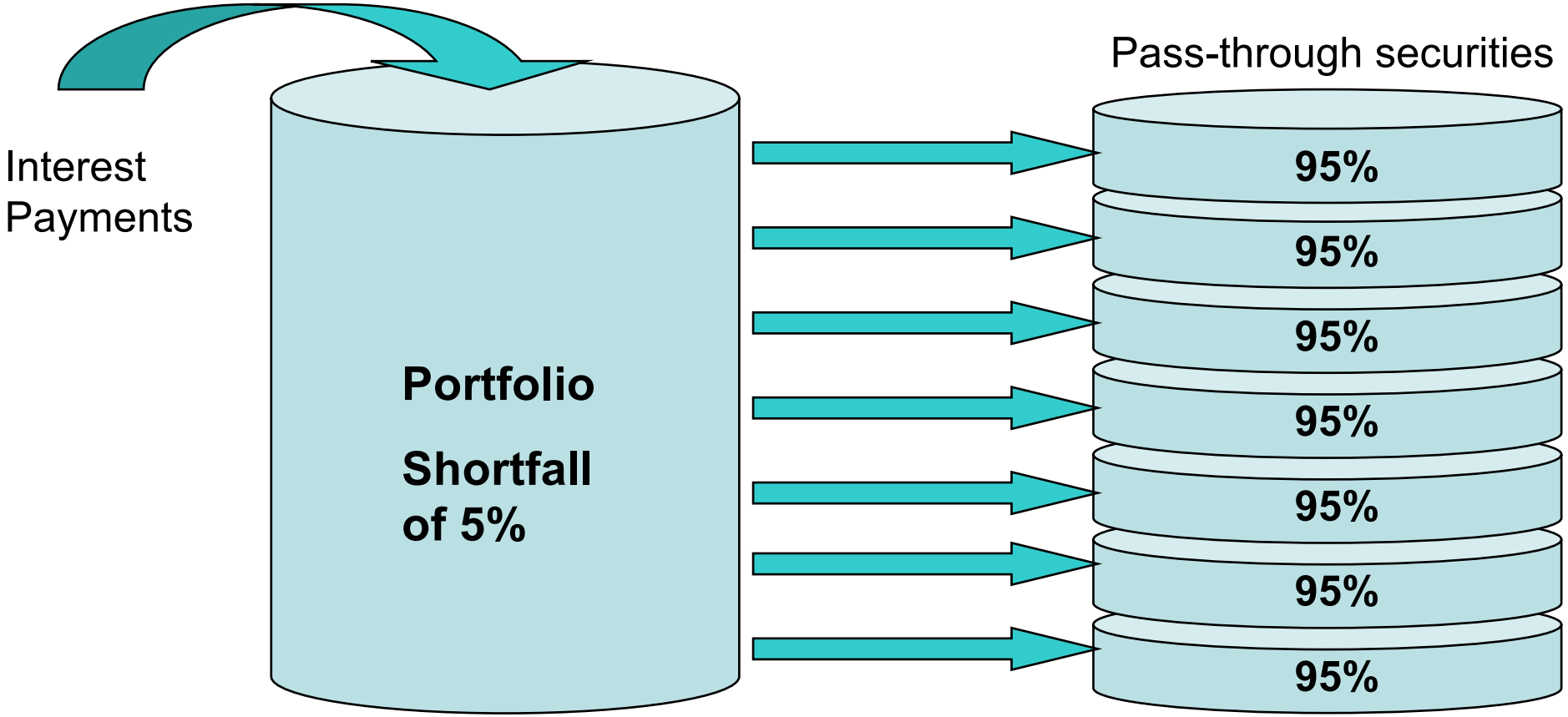
Exhibit A

Traditional "Pass-Through" Type of Security



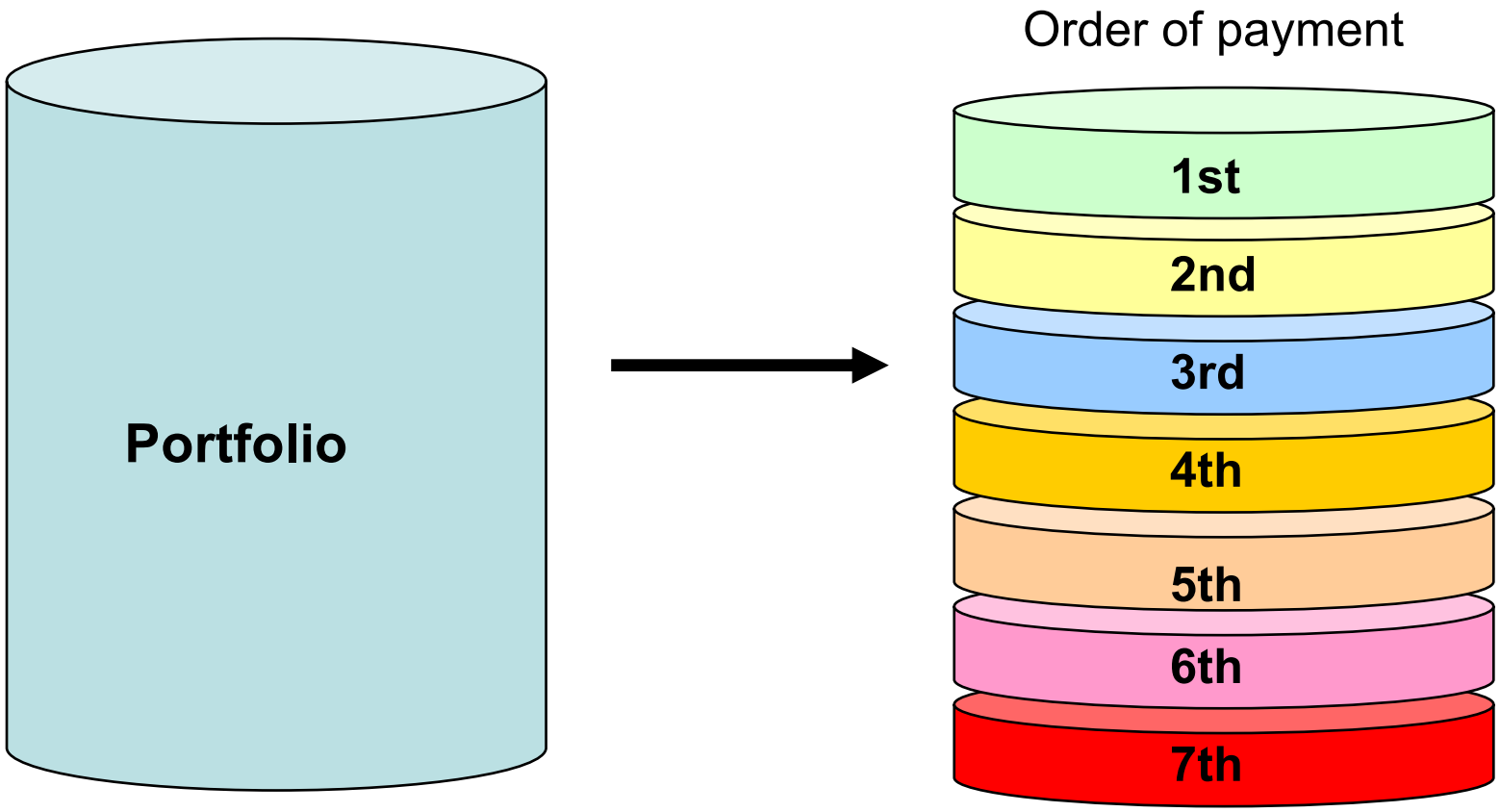
Assets put into the portfolio are debt obligations. For example, they could be residential mortgages or could be bank loans or trust securities. These assets generate interest or dividend payments into the portfolio. The portfolio is sliced up and sold to investors. The purchasers of the pass-through securities are entitled to the interest or dividend payments made into the portfolio by the underlying securities. Each slice is identical. Each slice has the same risk and return characteristics.

Interest is distributed pro-rata. Shortfalls are borne equally



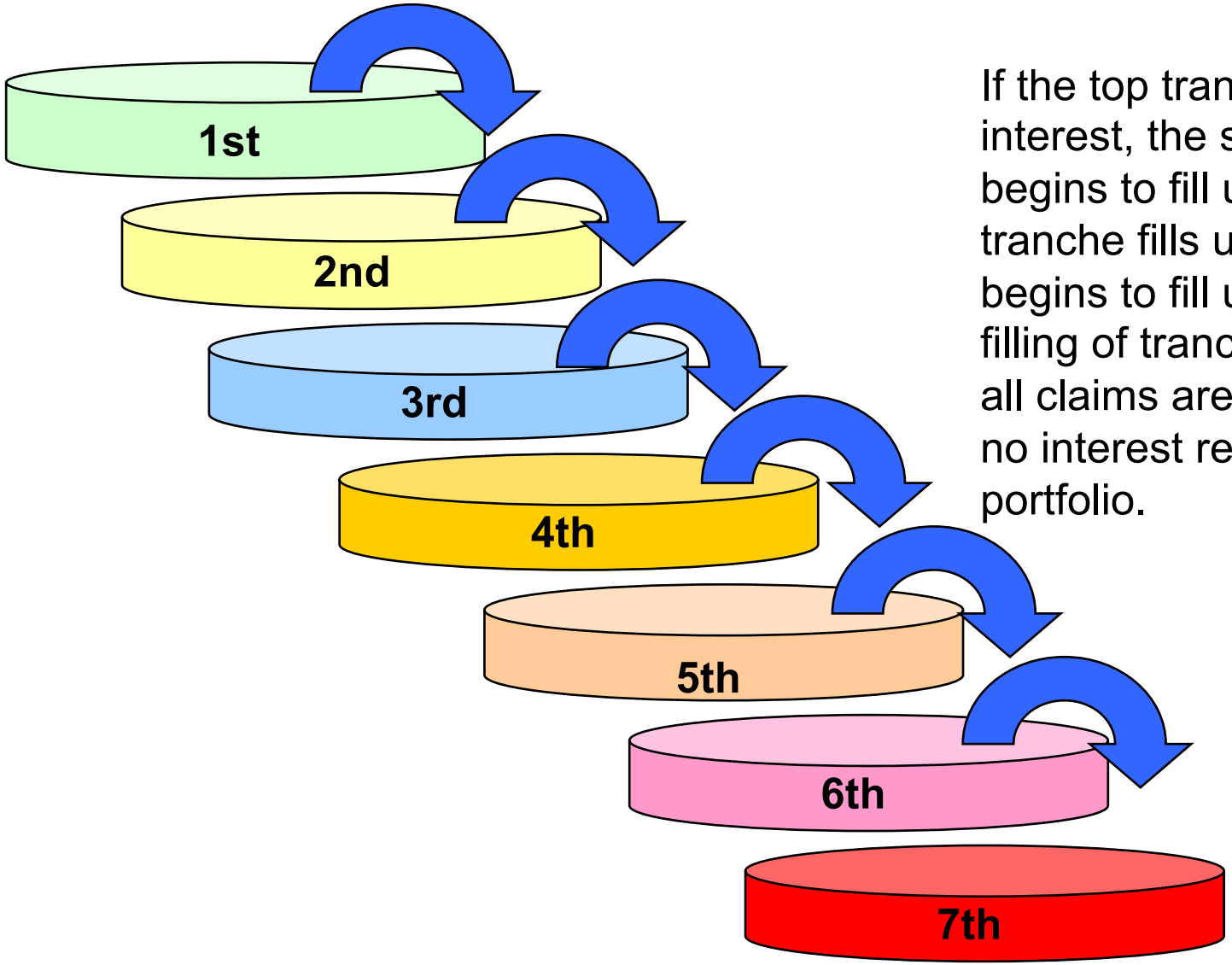
Interest payments made into the portfolio by the underlying debt instruments are distributed equally to each investor. If there is a shortfall of 5% in interest payments, each pass-through security gets 95% of its expected interest payment.

Structured securities (CDOs) have prioritized claims on interest



With a structured product, the portfolio of securities is the same, but the securities sold to each investor are not the same. Investors do not receive a pro-rata share of the interest. Each differing slice is called a "tranche." The top tranche must be paid all interest first. If there is interest left over, the second tranche gets paid. If there is enough to completely pay the second tranche, then the third tranche gets paid. And so on.

The tranche payment system is often called the “interest waterfall”



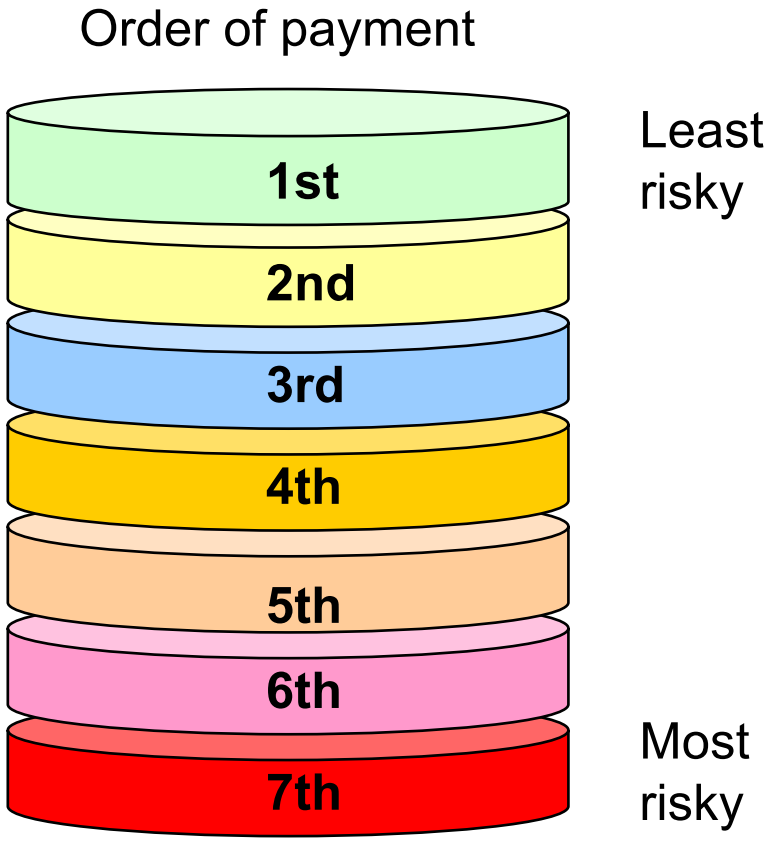
If the top tranche “fills up” with interest, the second tranche begins to fill up. If the second tranche fills up, the third tranche begins to fill up. This sequential filling of tranches continues until all claims are fully paid or there is no interest remaining in the portfolio.

Structured tranches clearly have differing risk profiles

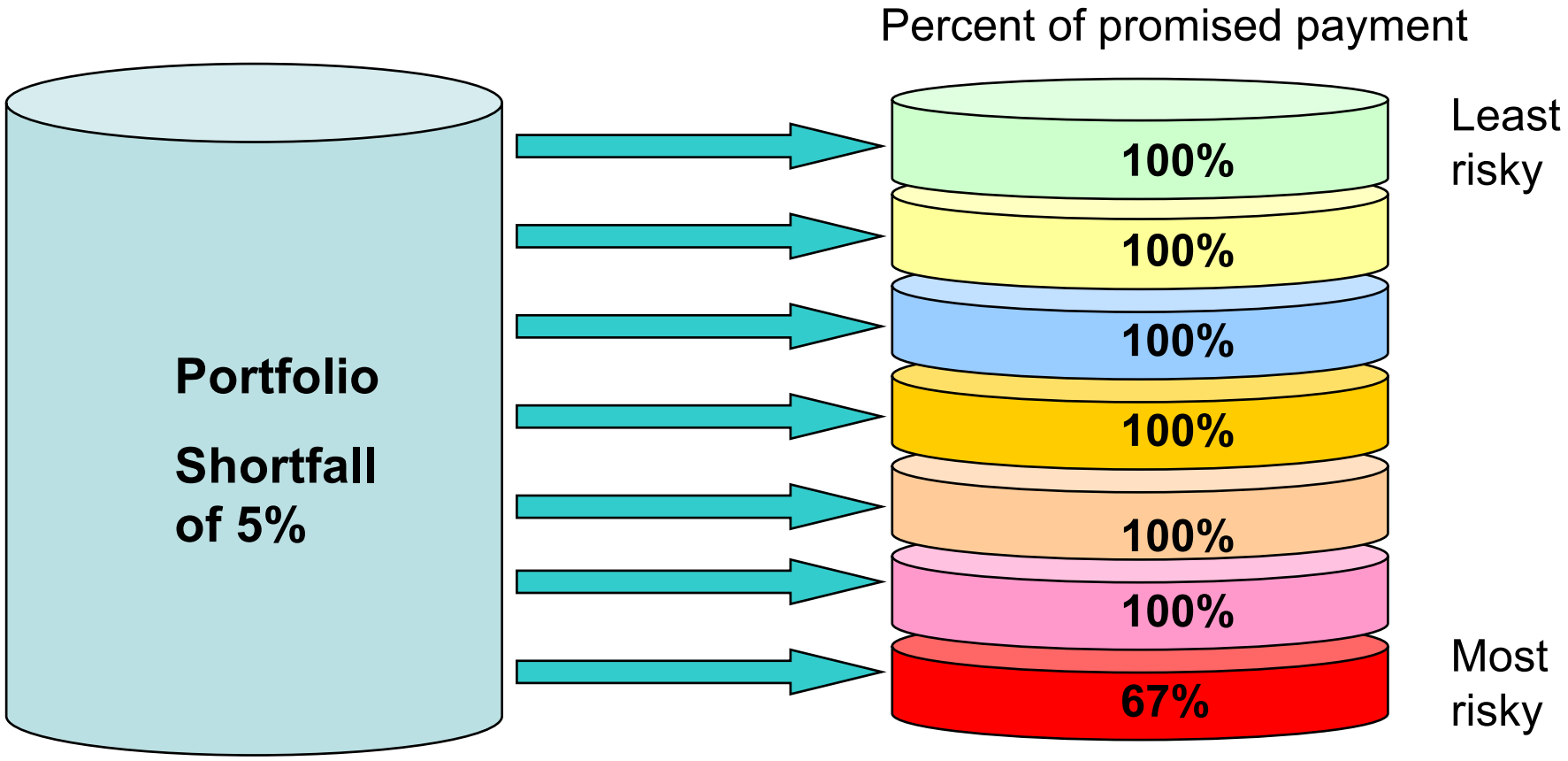
The 1st tranche is extremely safe – safer in fact than the average security in the underlying portfolio.

The majority of the underlying debt obligations could default completely and yet the 1st tranche will still be paid as long as enough of the underlying debt obligations do not default.

The 7th tranche is far riskier than the average debt obligation in the portfolio. This tranche bears the default risk of the entire portfolio



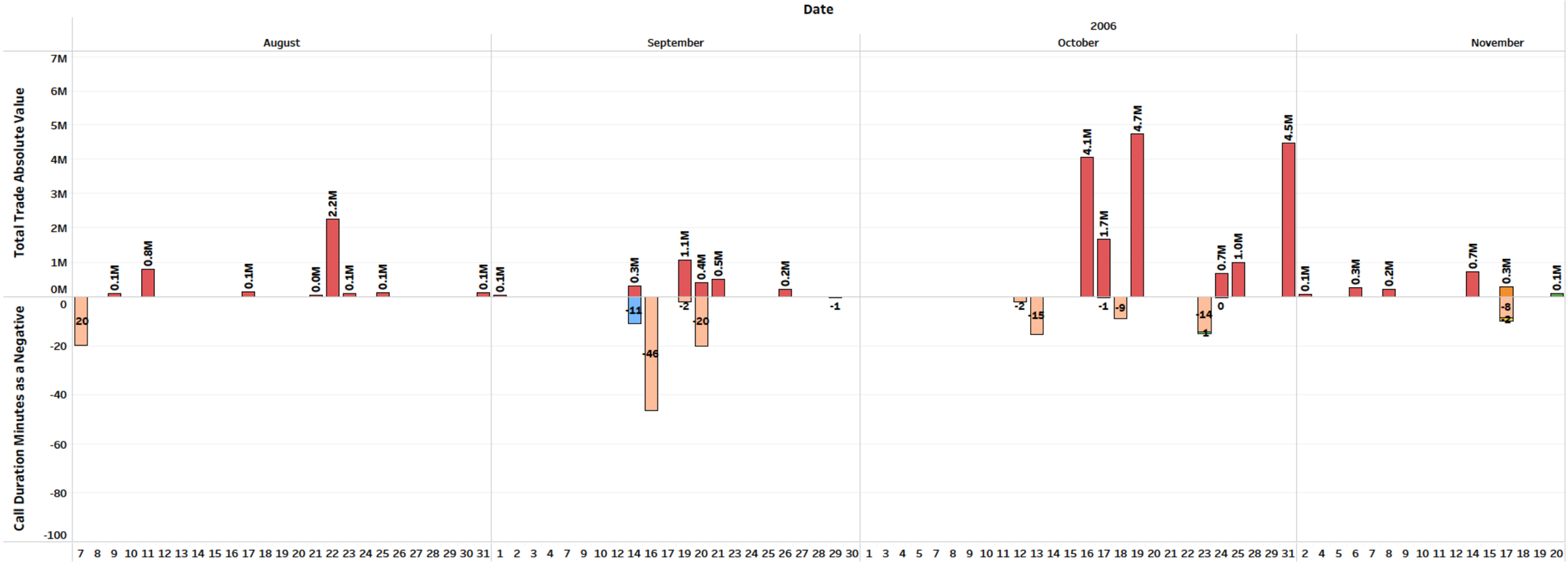
Shortfalls are magnified in the lowest tranches



If each tranche has the same principal value, then each tranche represents 15% of the portfolio. In the presence of a 5% shortfall, the bottom tranche absorbs the entire amount which leads to a shortfall in that tranche of 33%.

Exhibit B

All Accounts Phone Call and Non-Discretionary Trade Analysis - Daily



Account trade date obtained from monthly statements for accounts See attached Profit and Loss Reports. Phone calls include calls made to:

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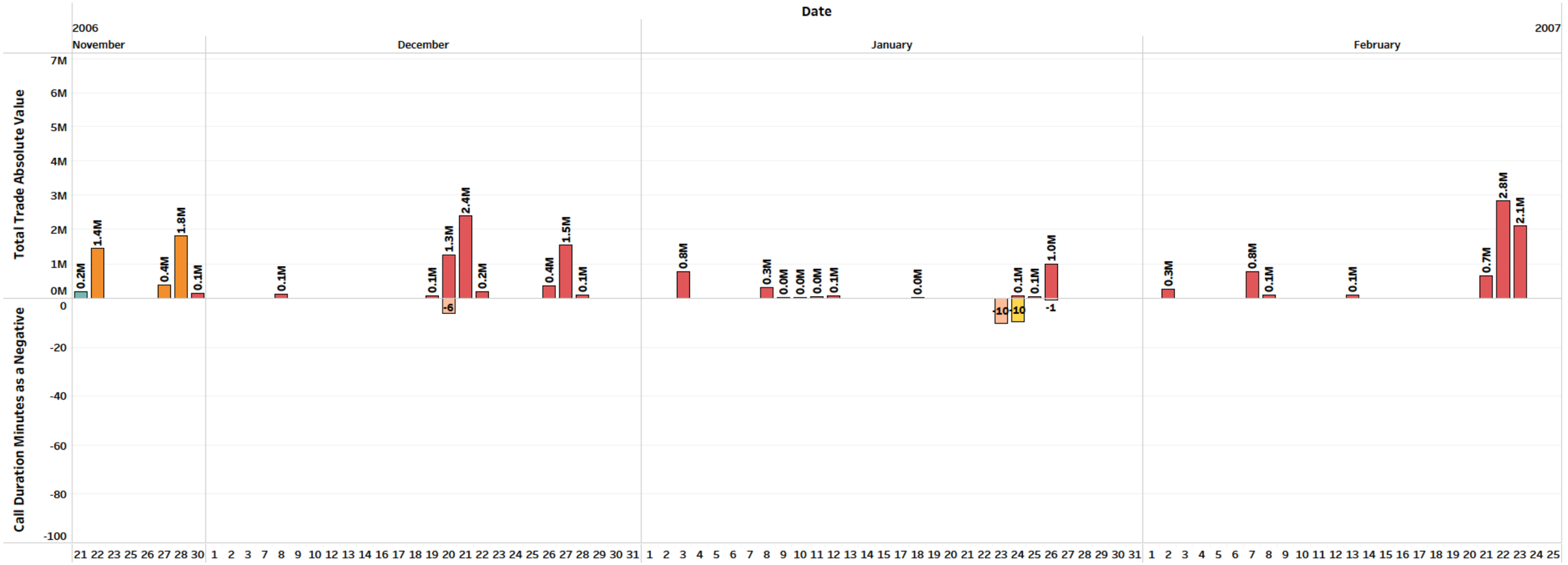

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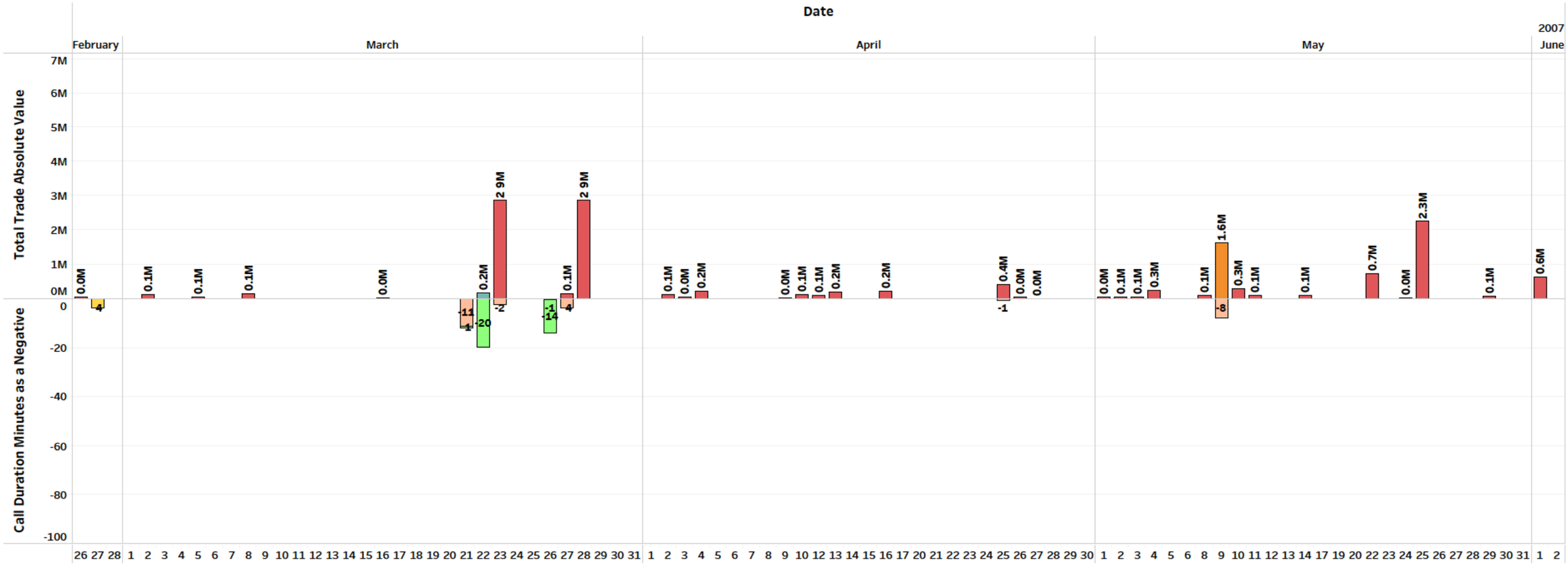

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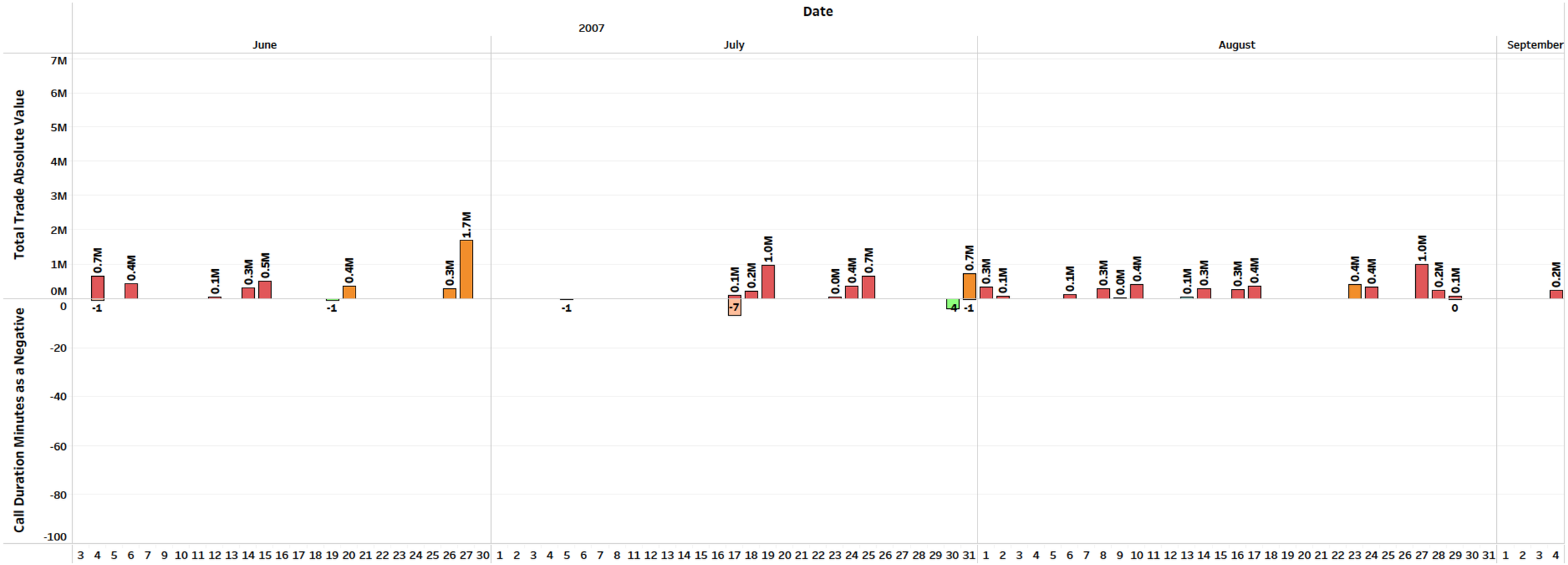

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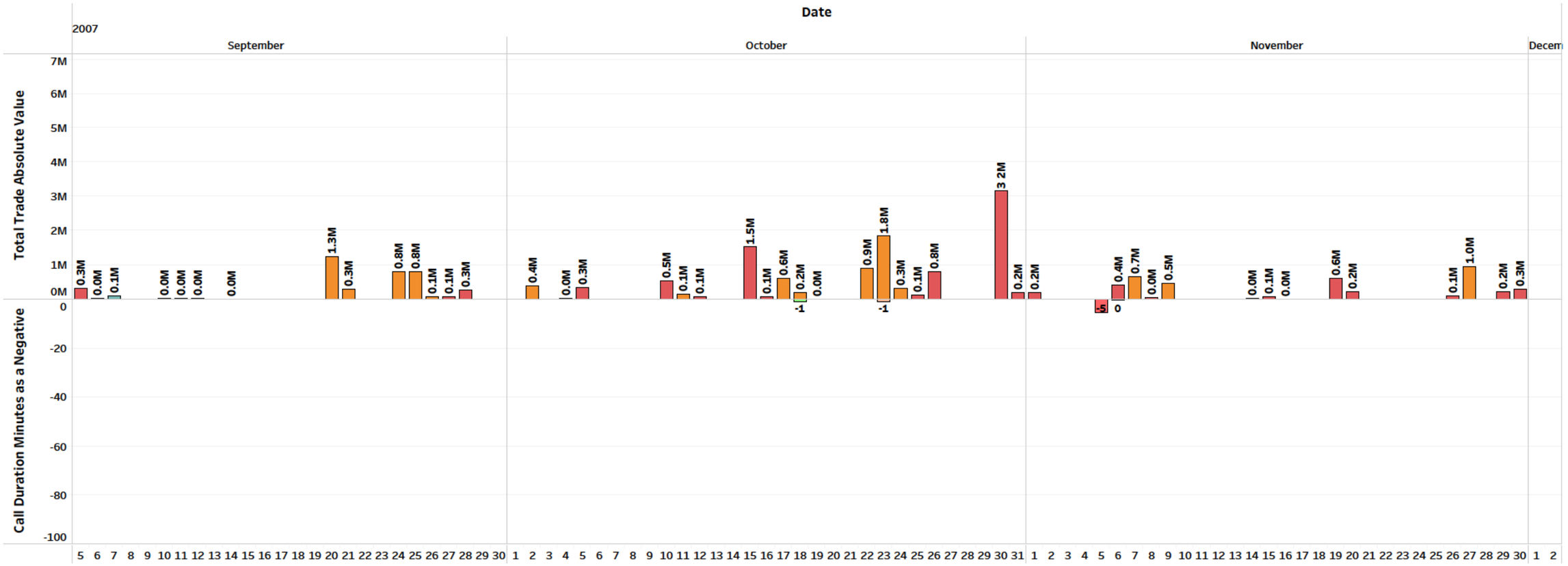

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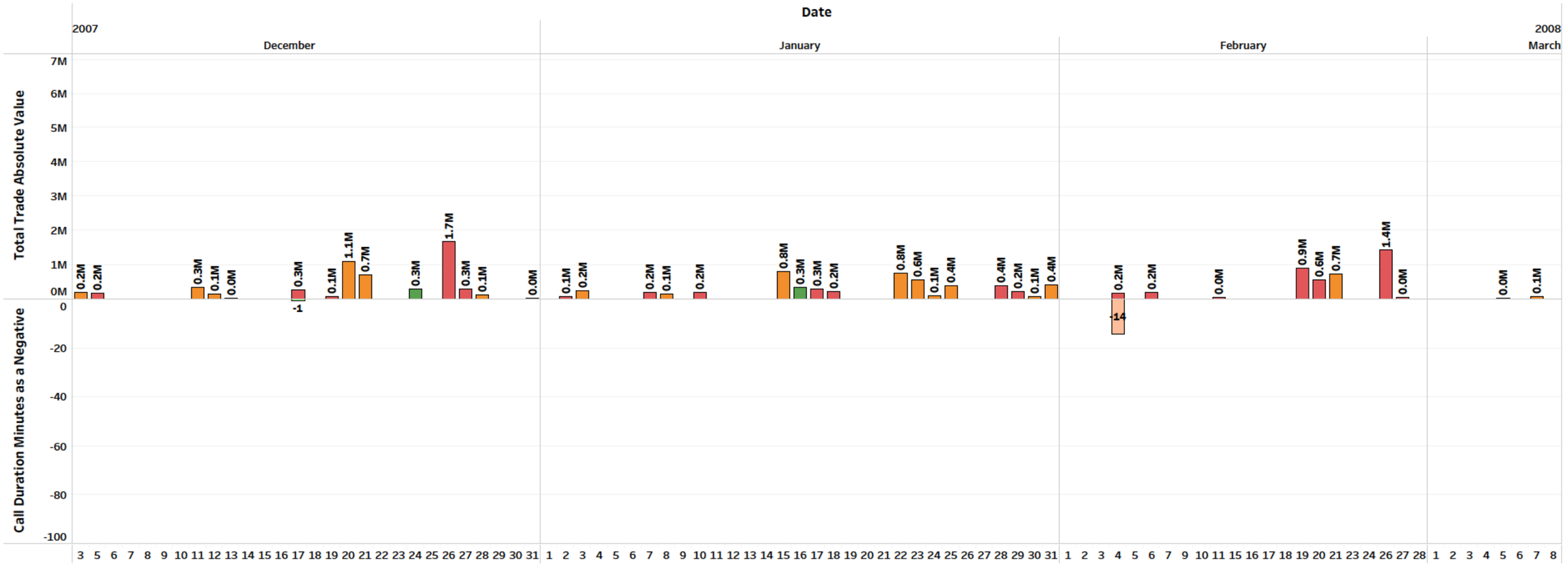

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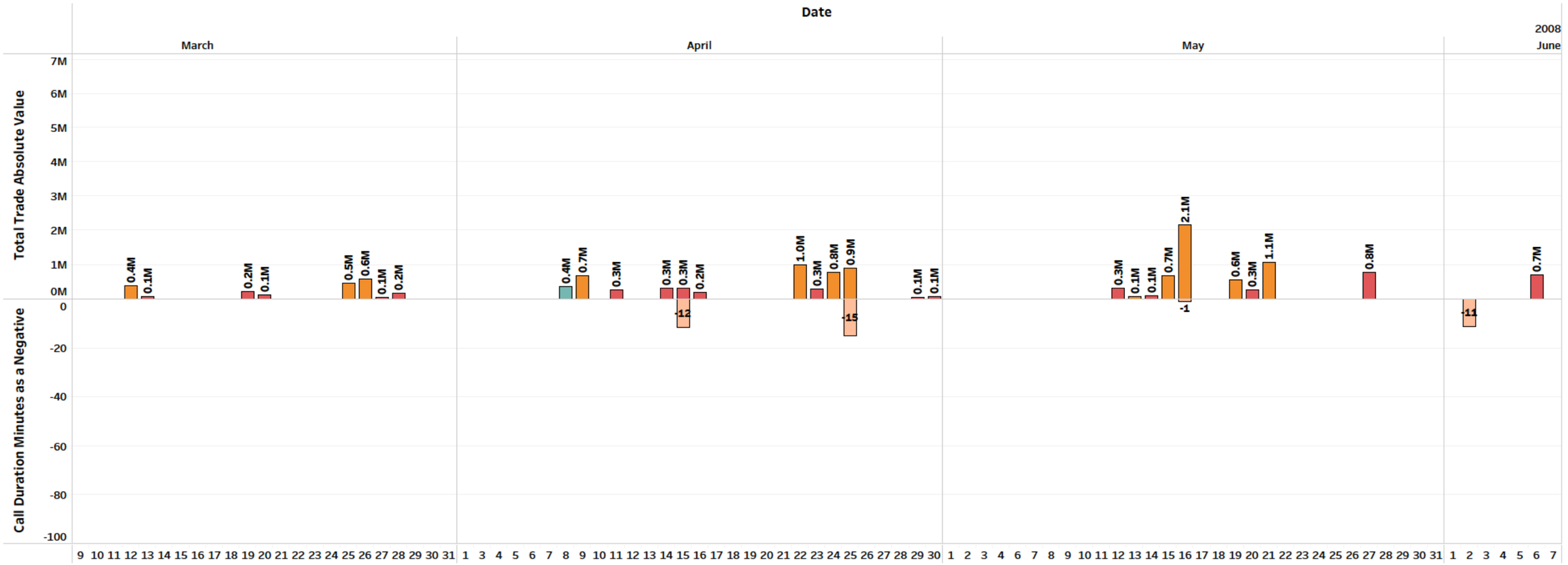

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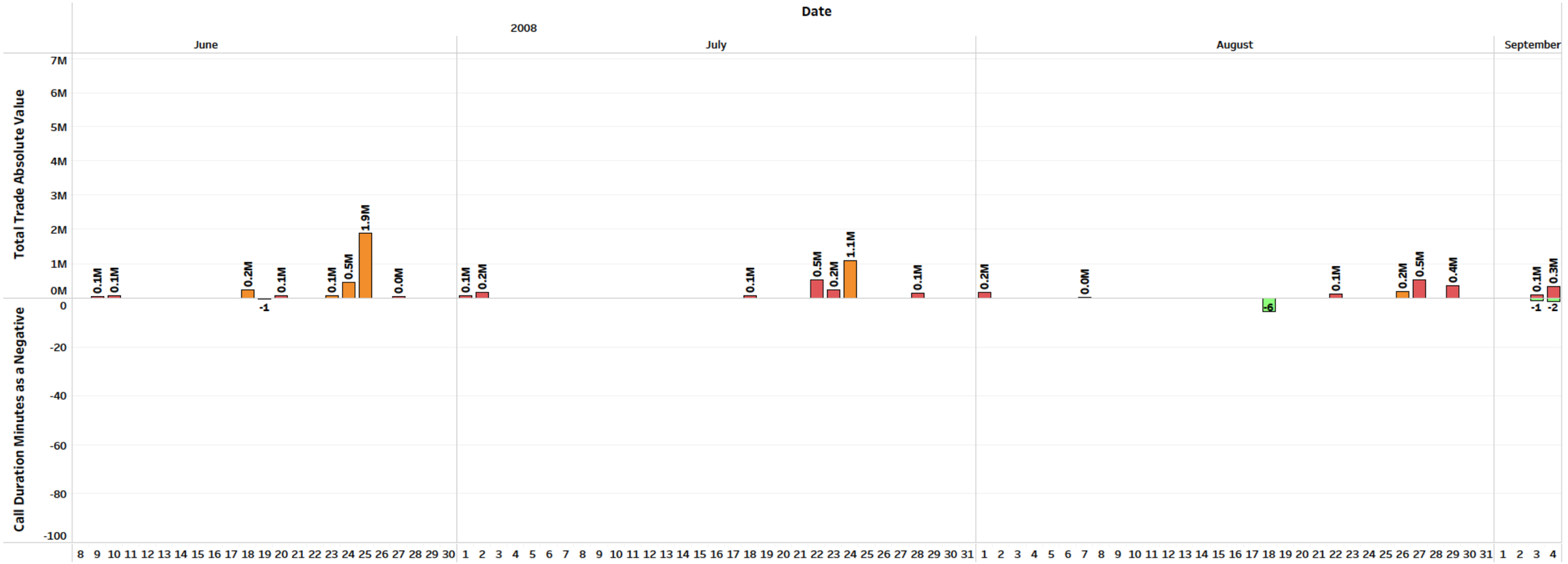

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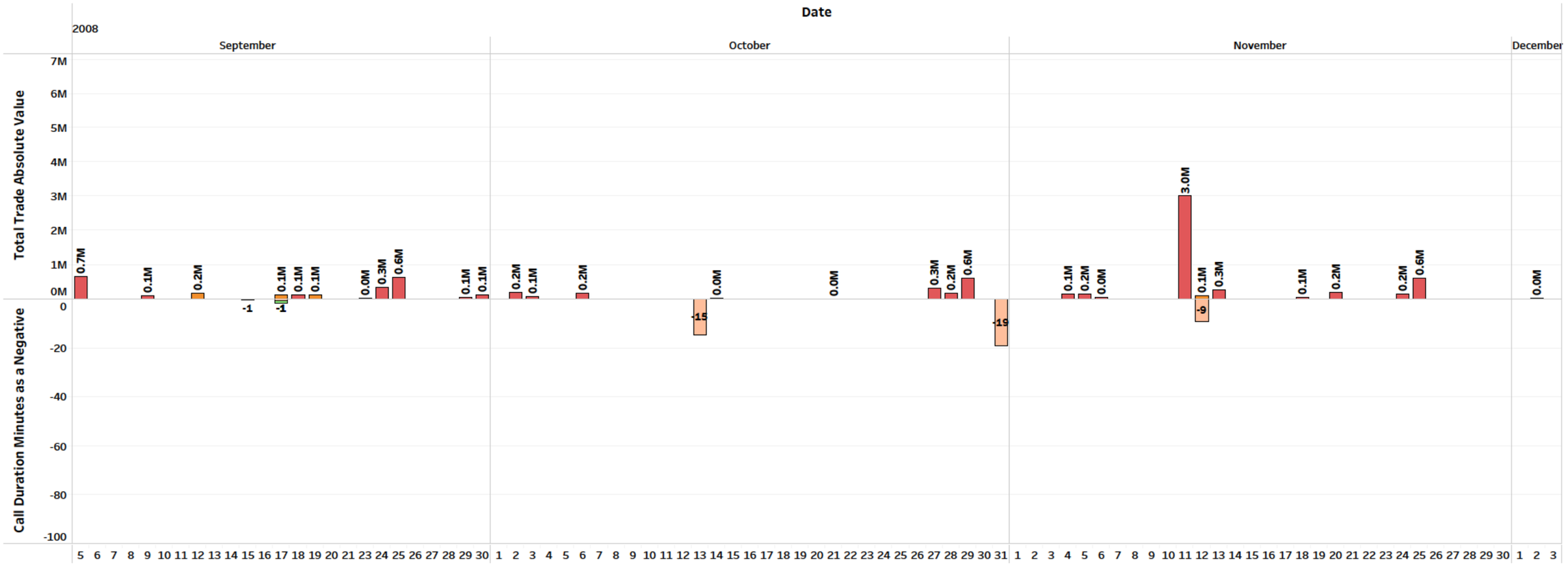

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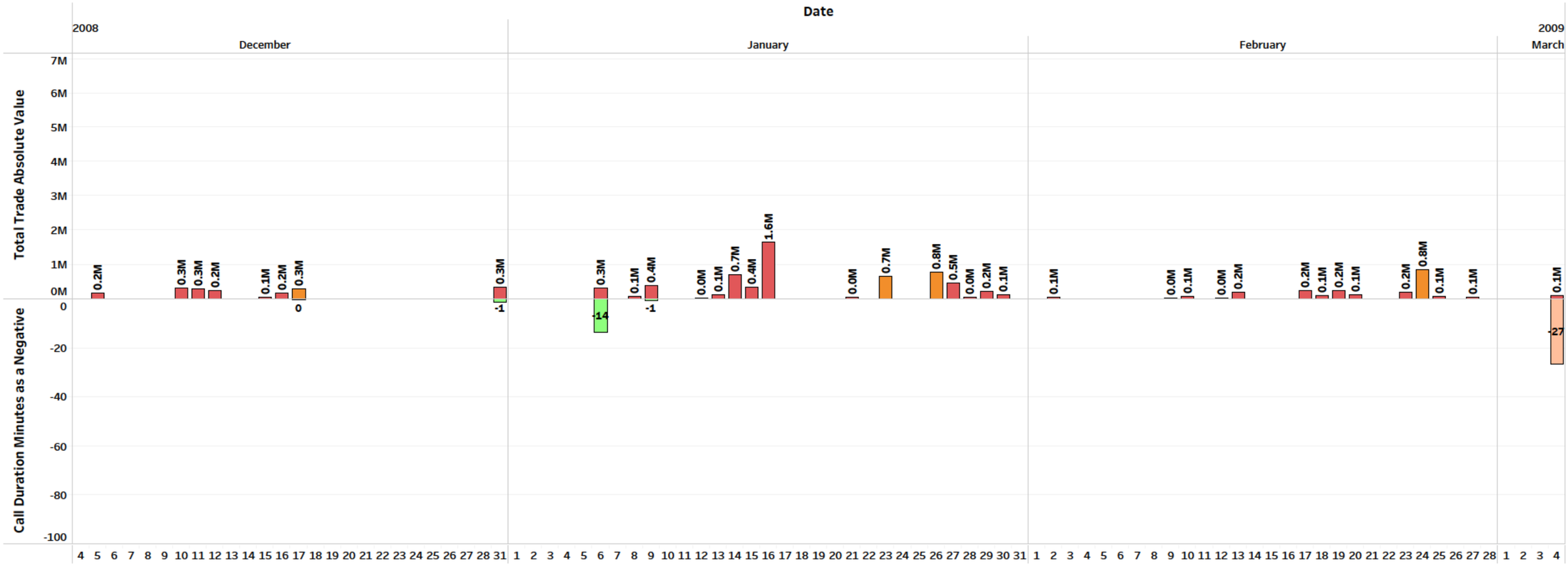

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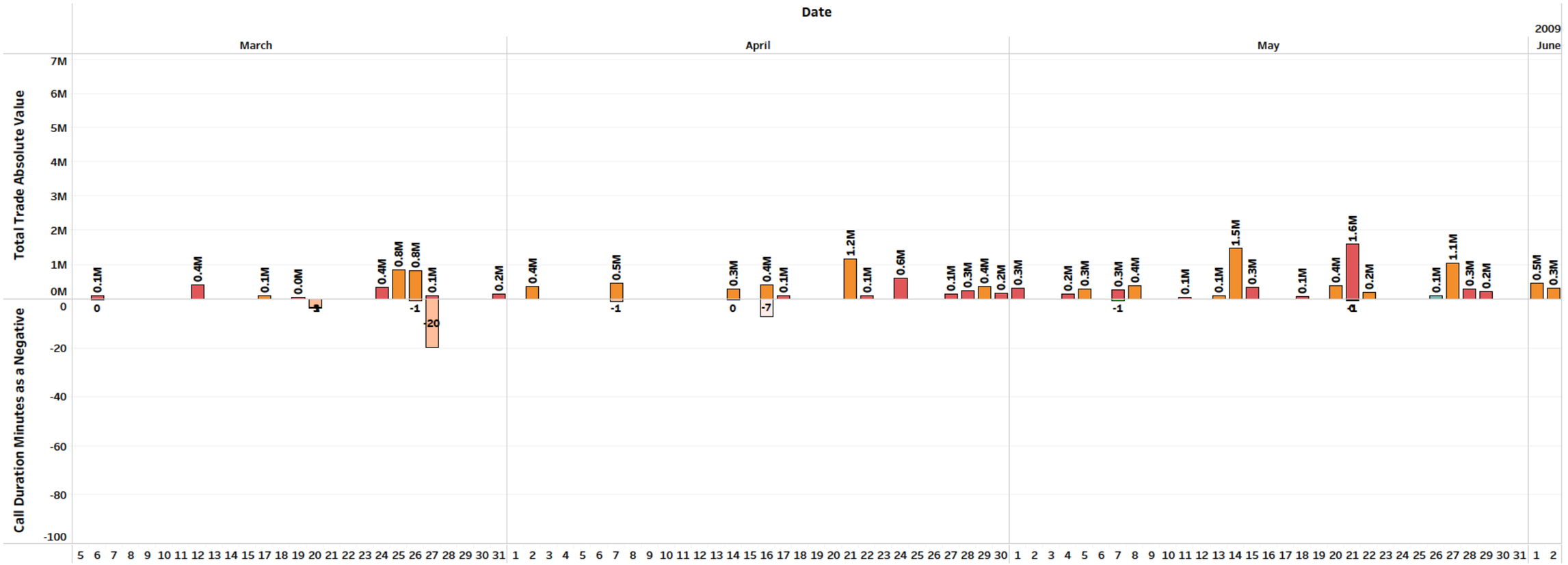

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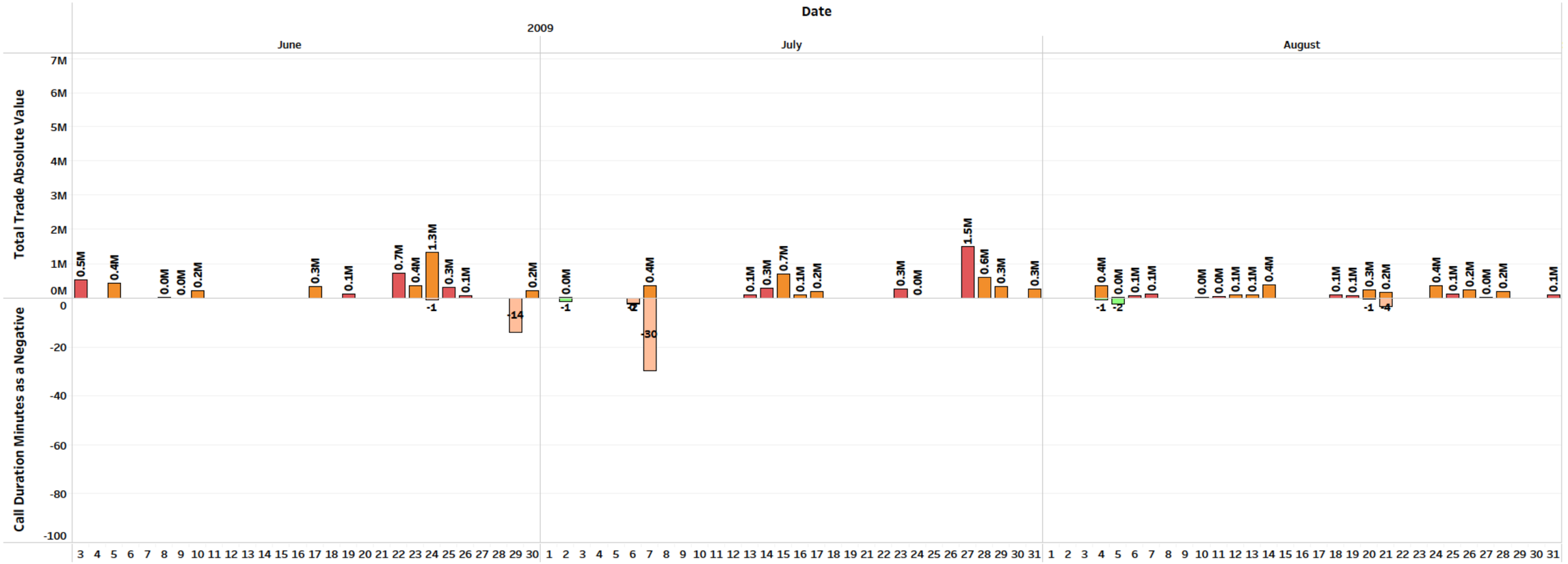

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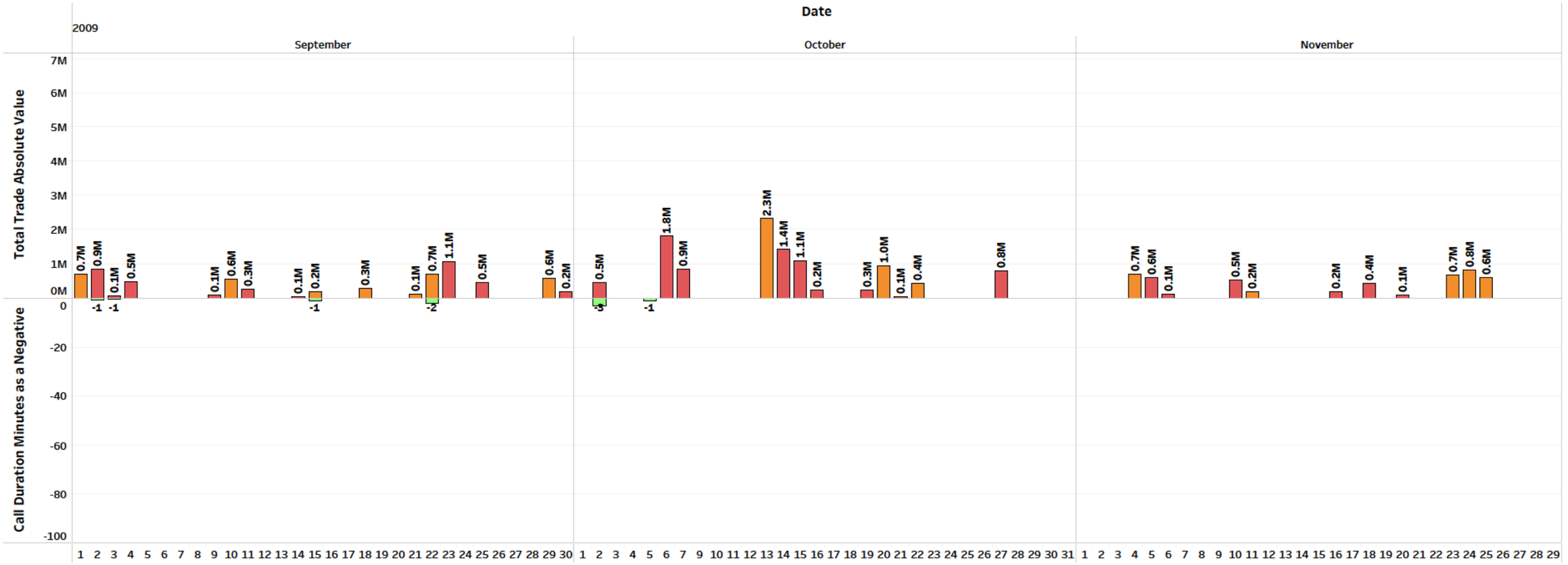

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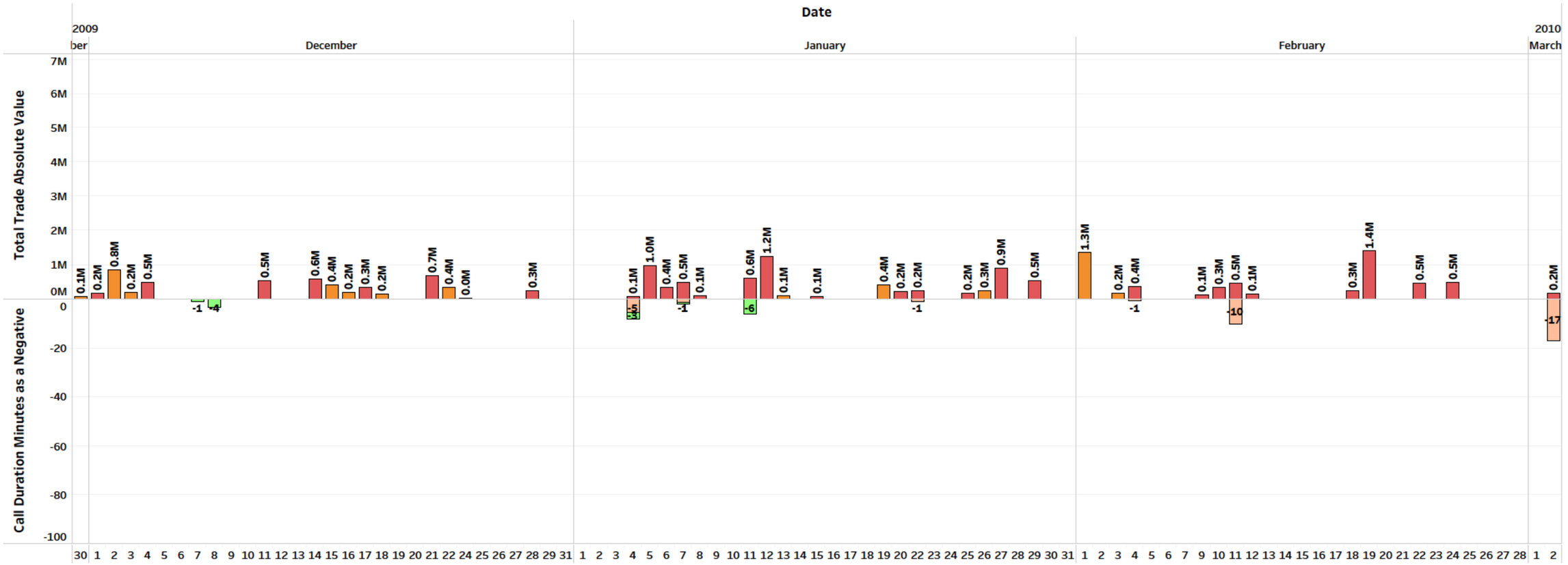

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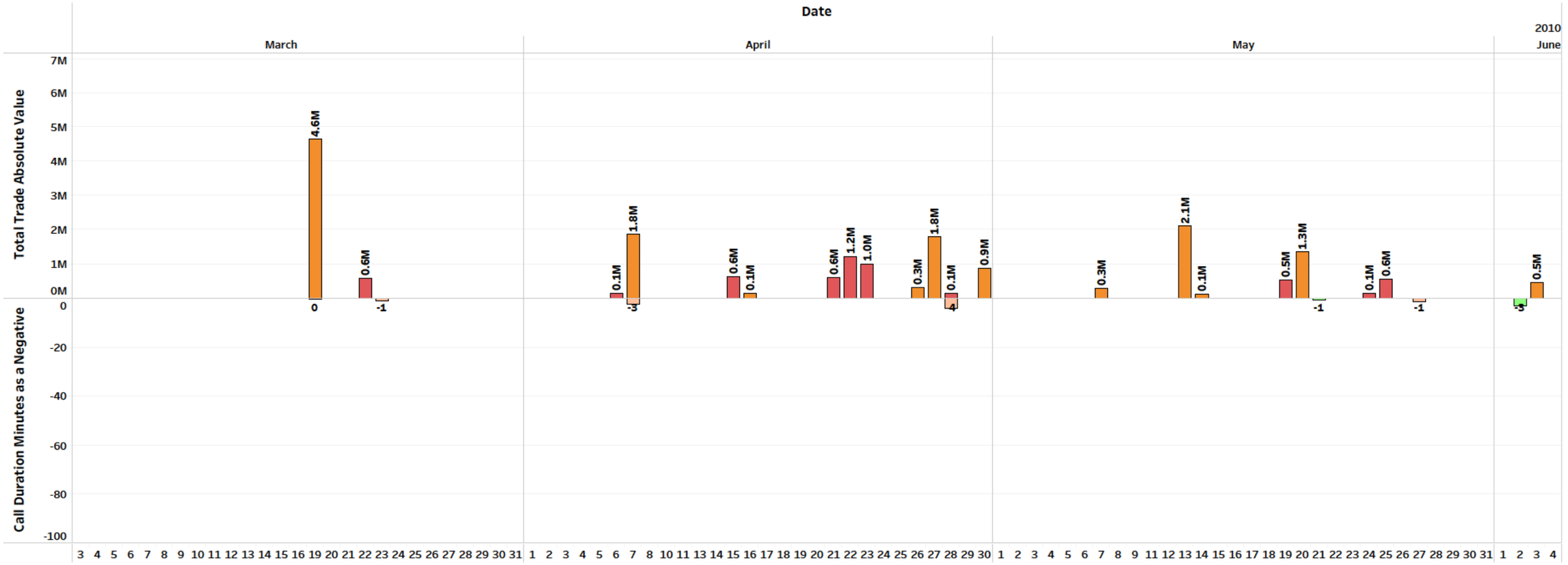

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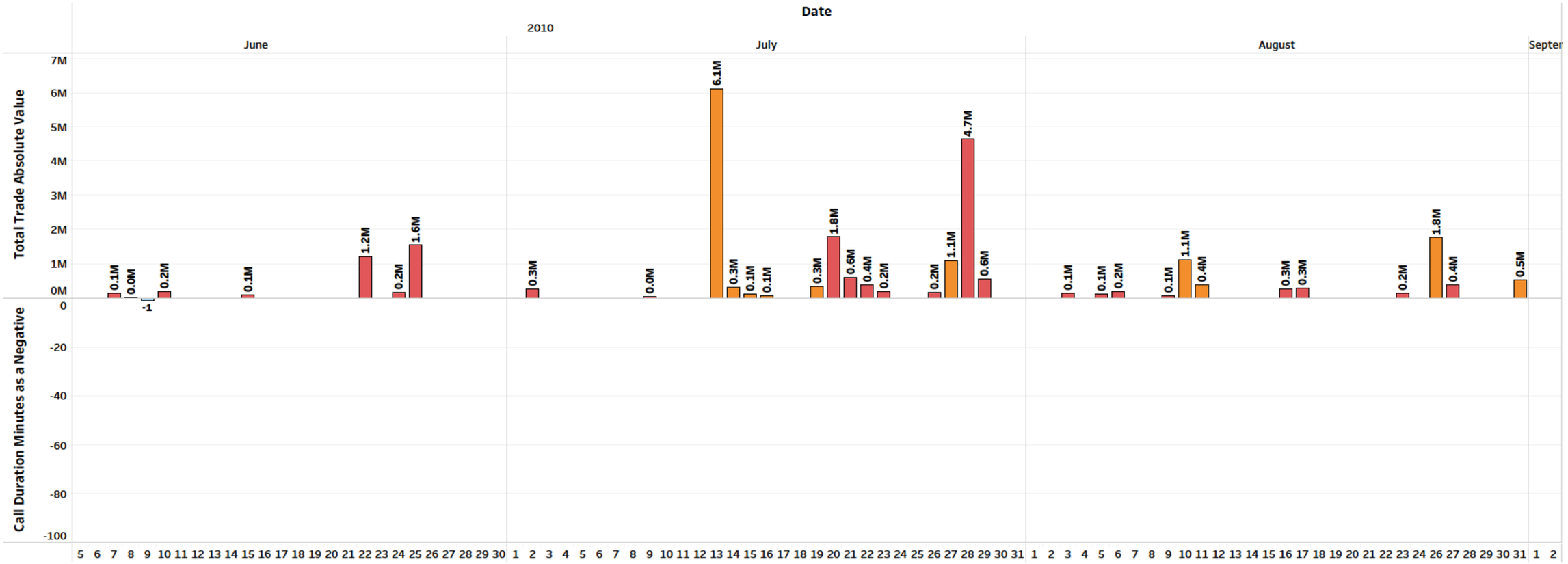

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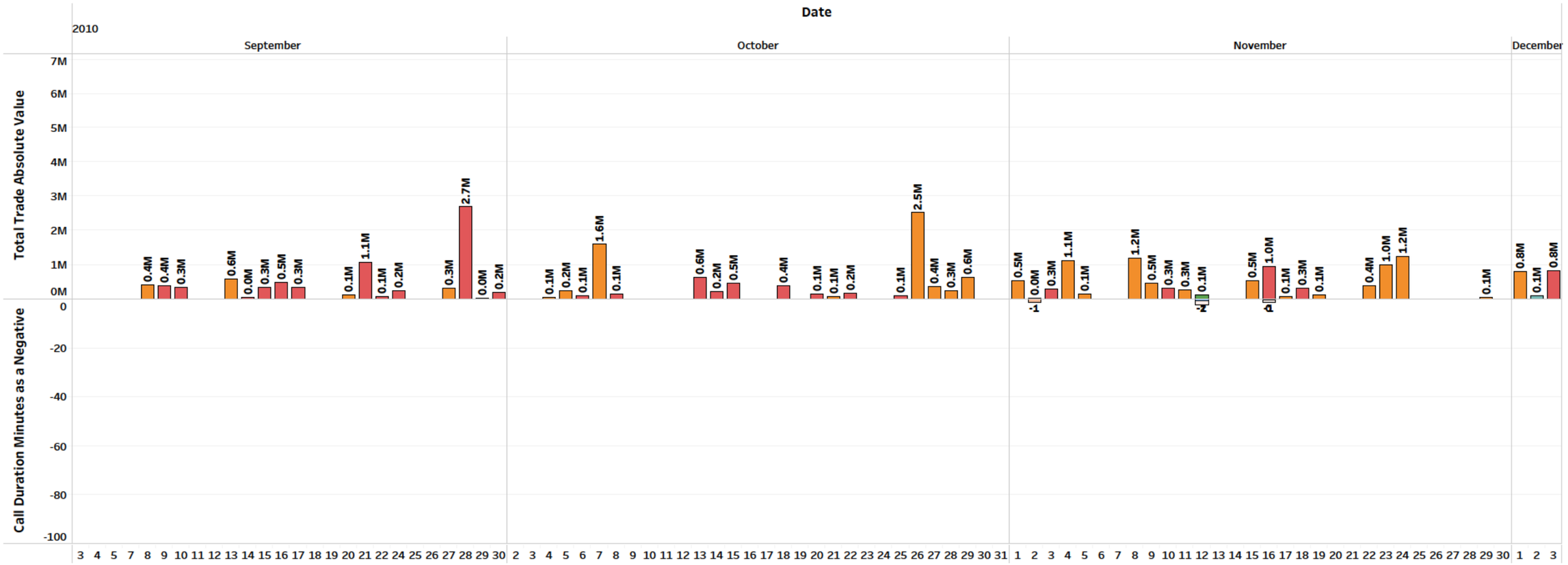

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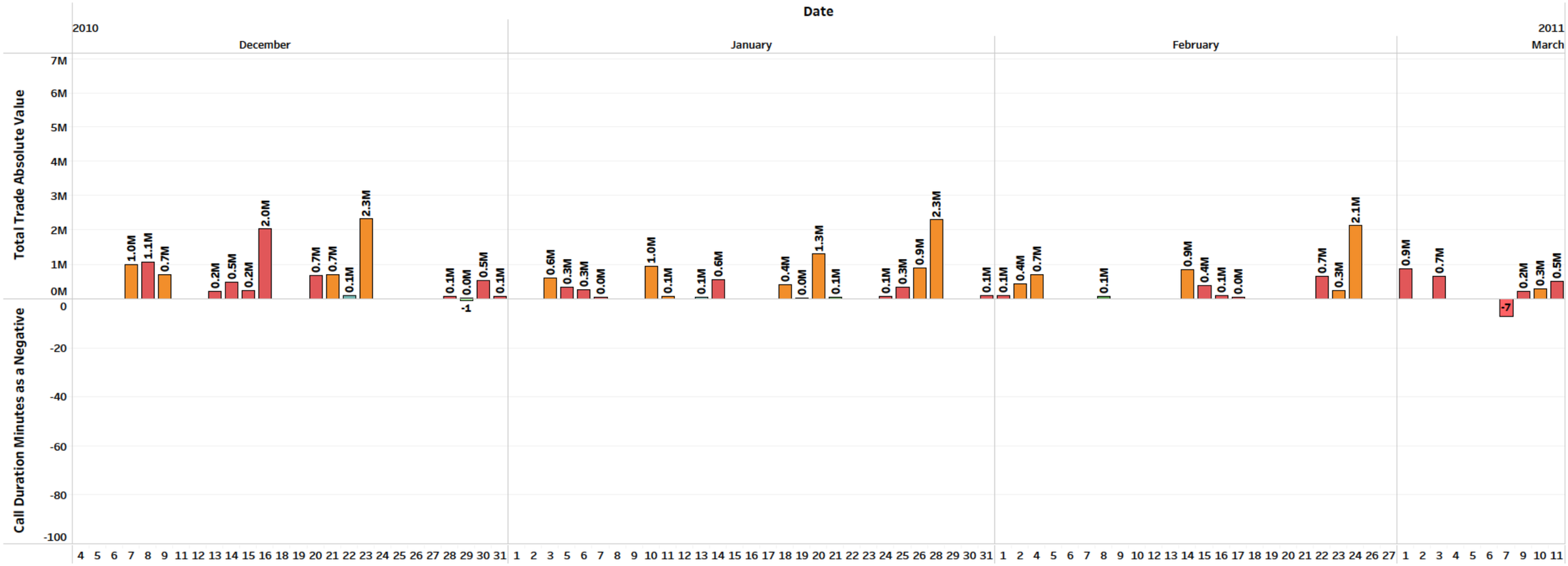

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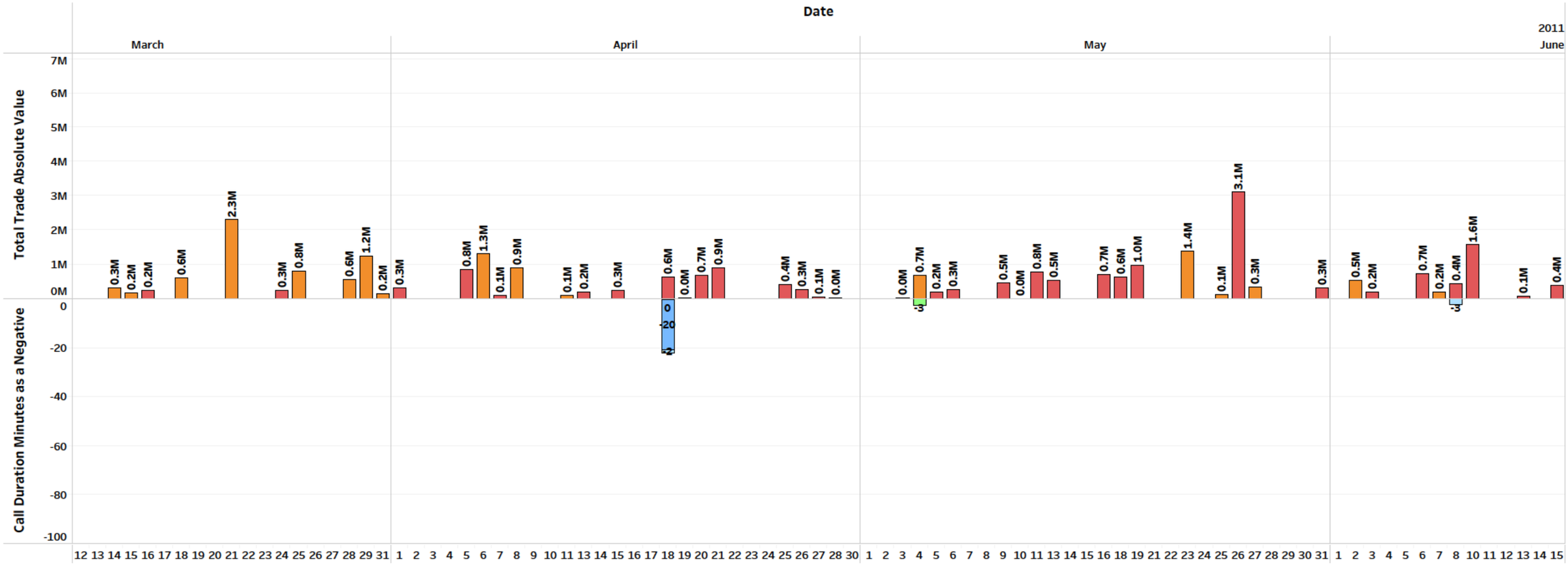

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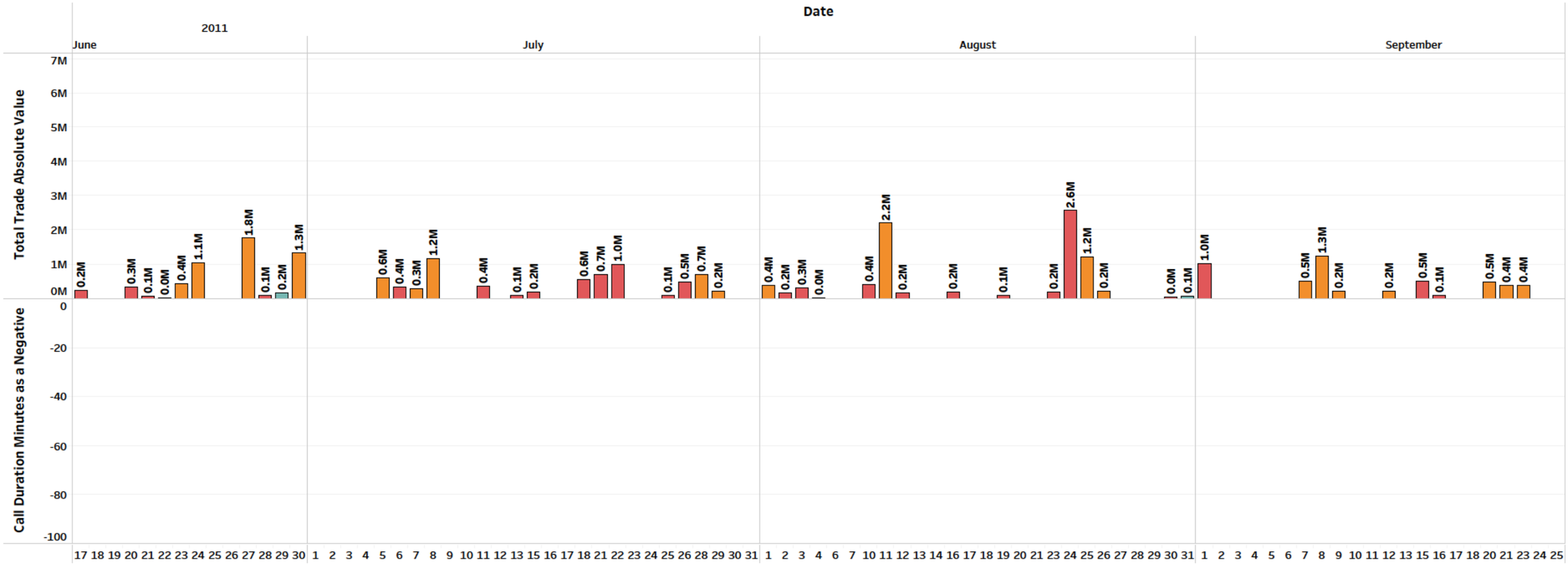

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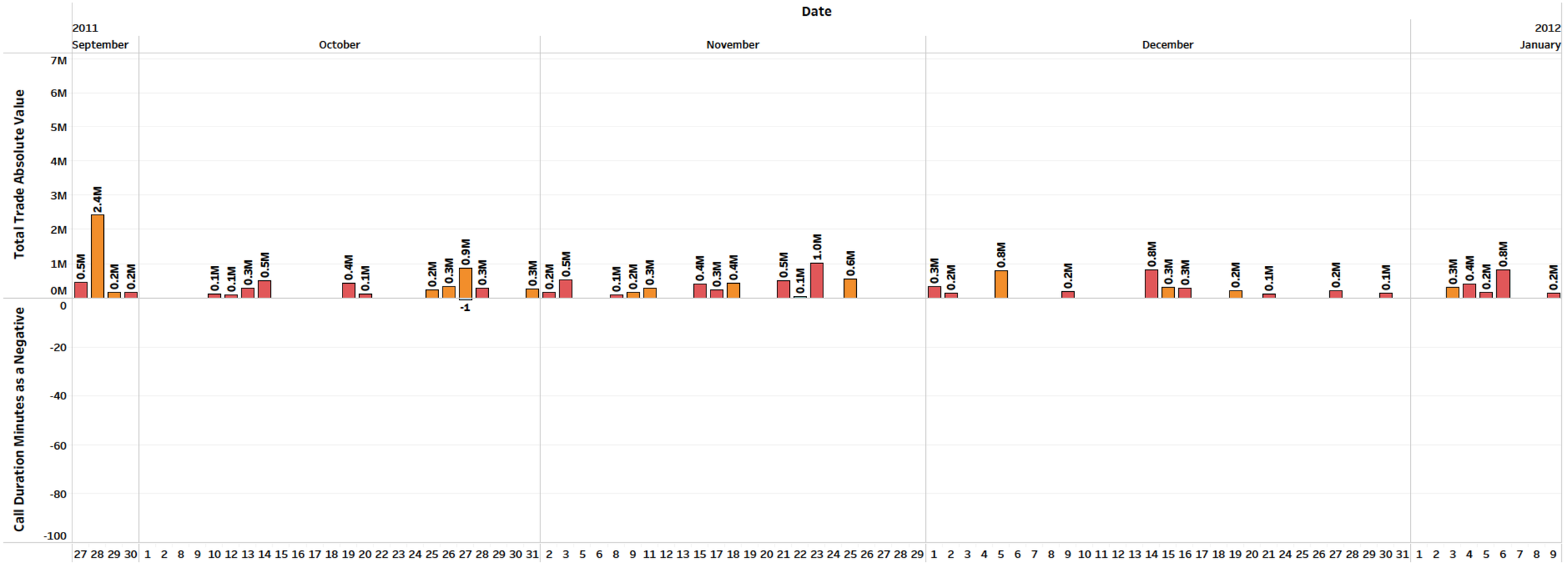

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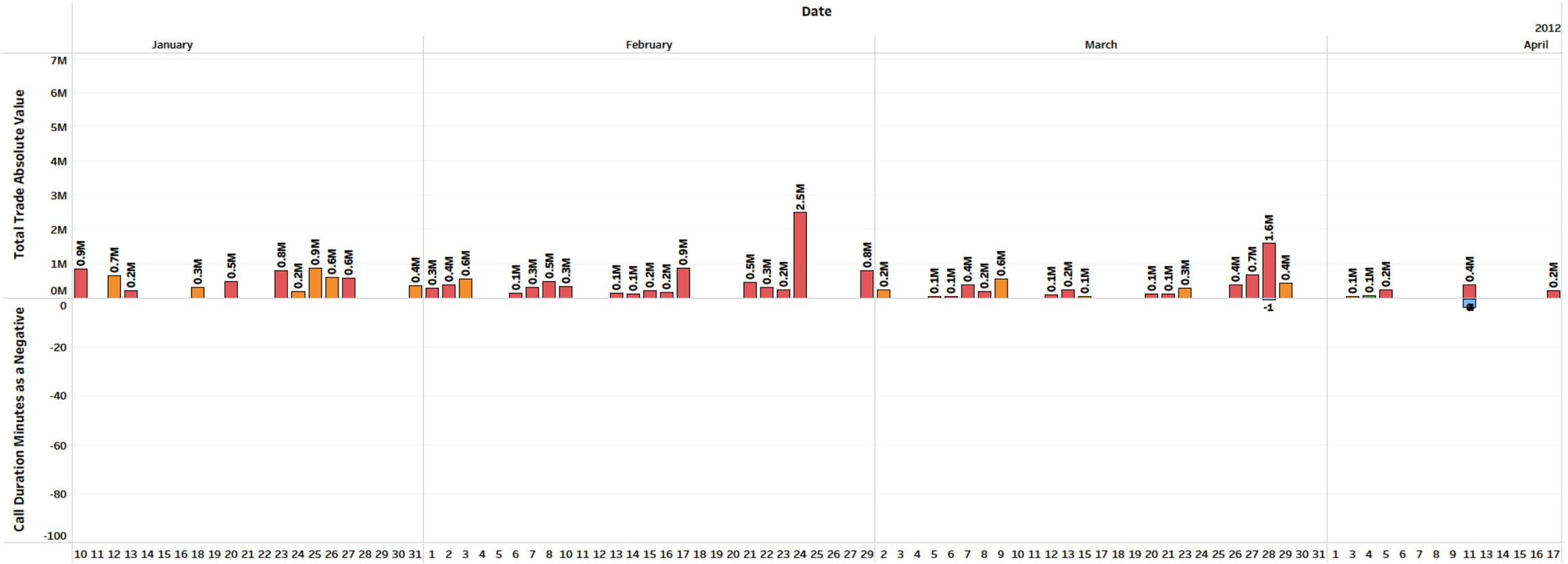

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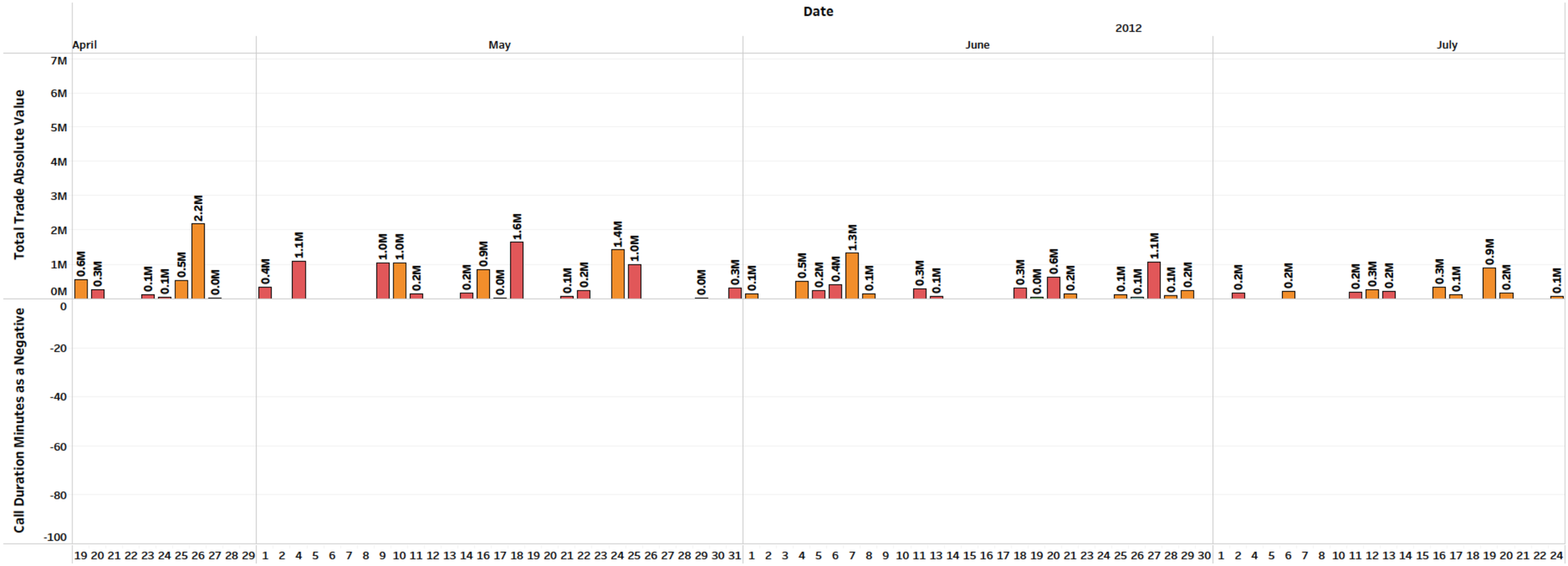

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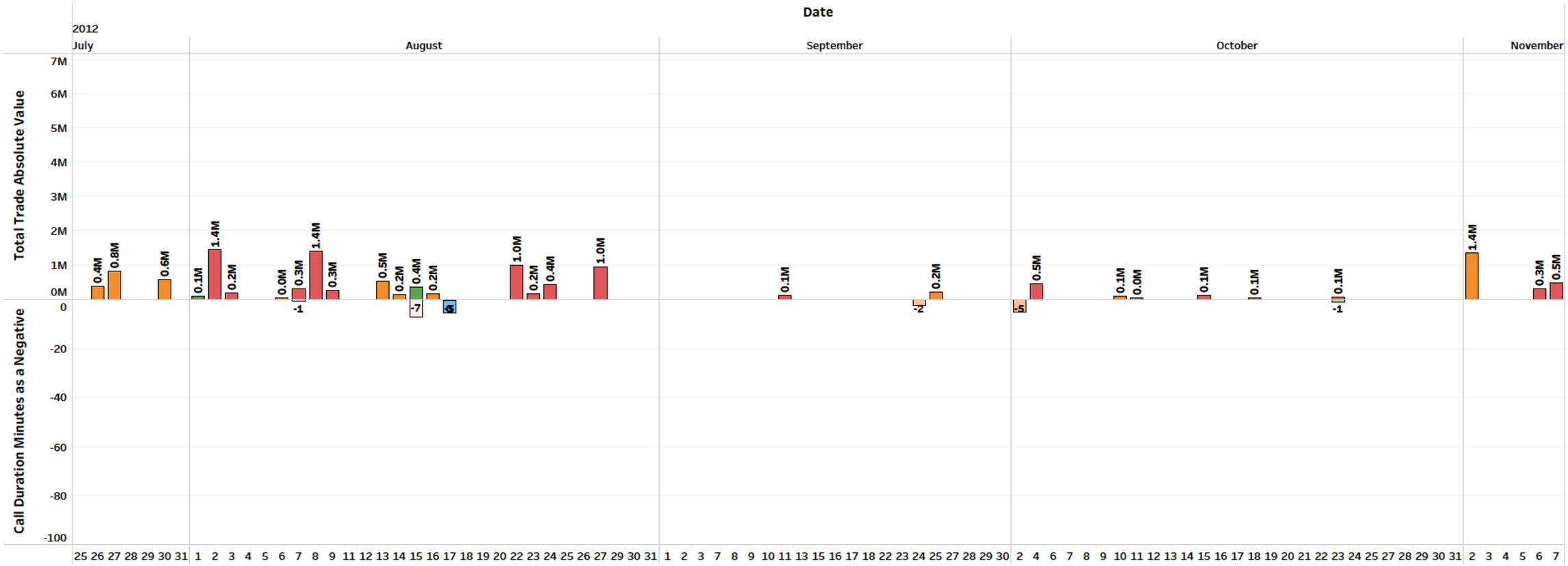

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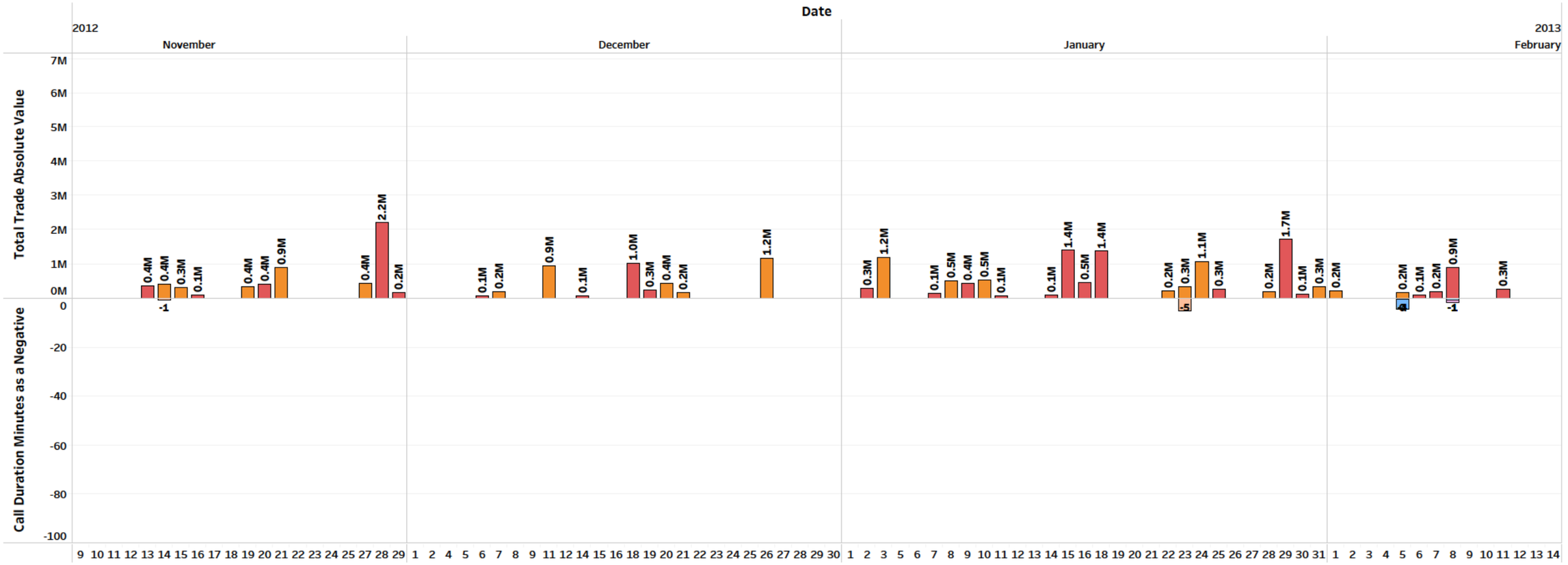

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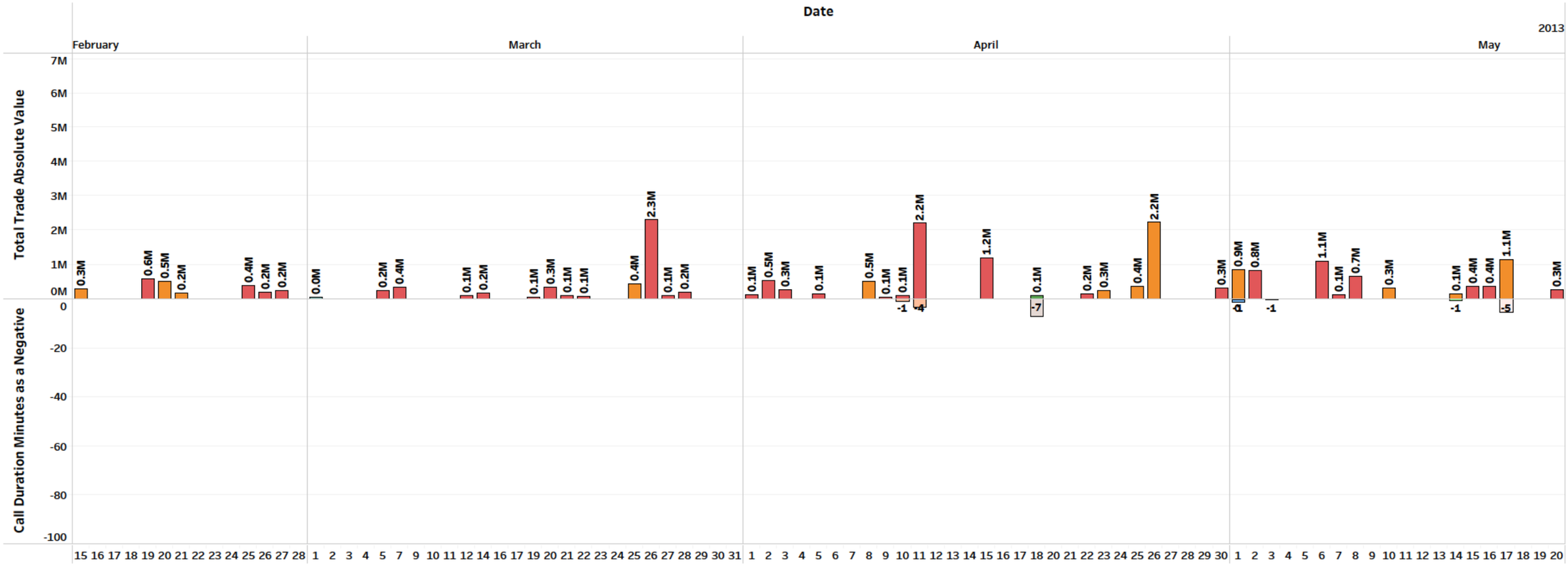

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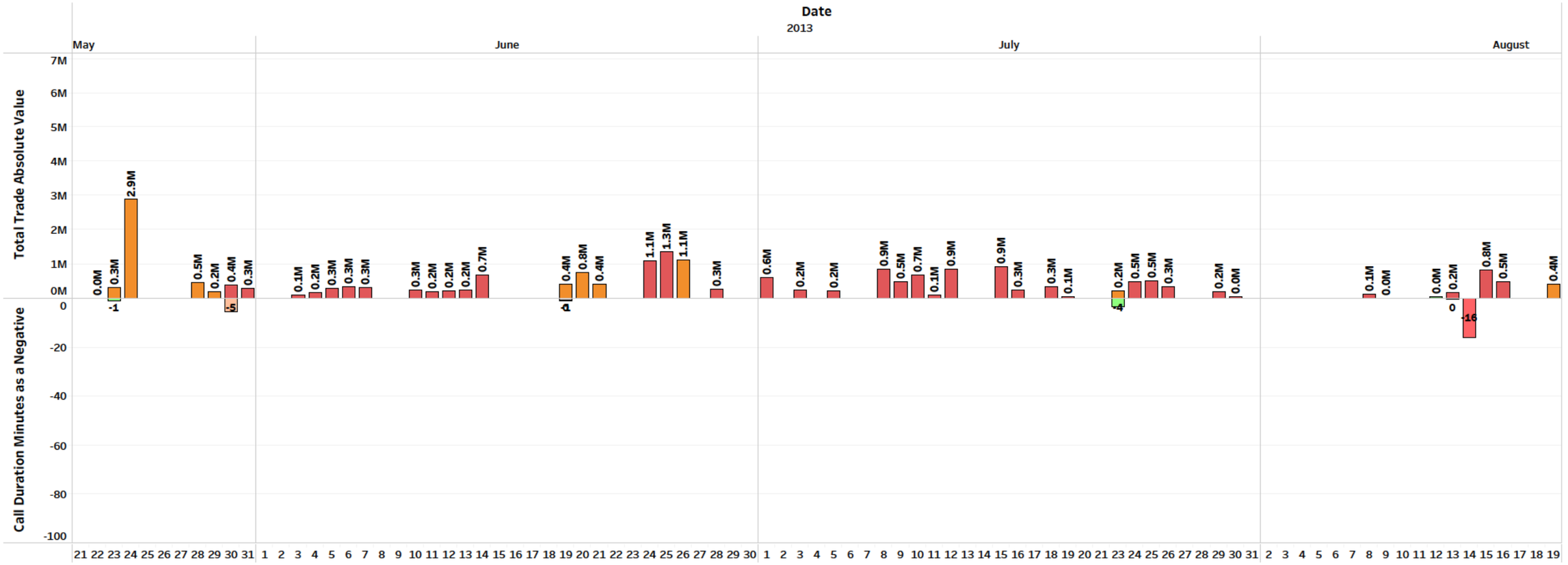

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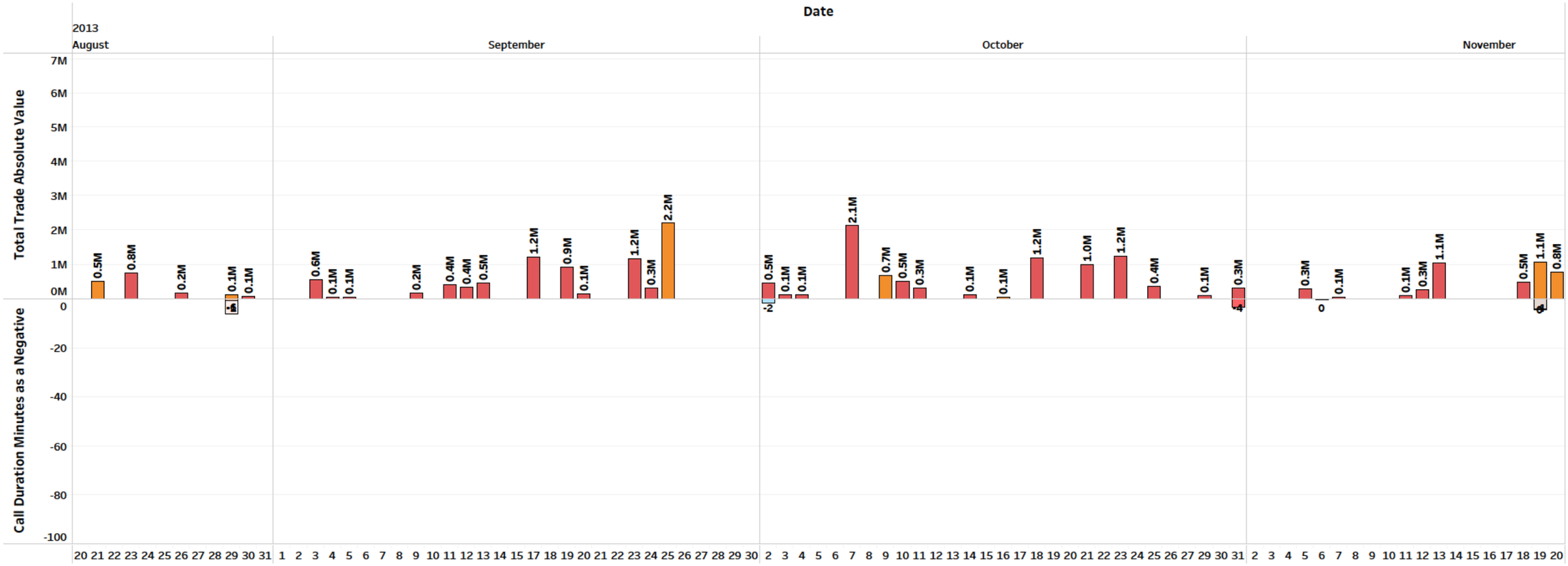

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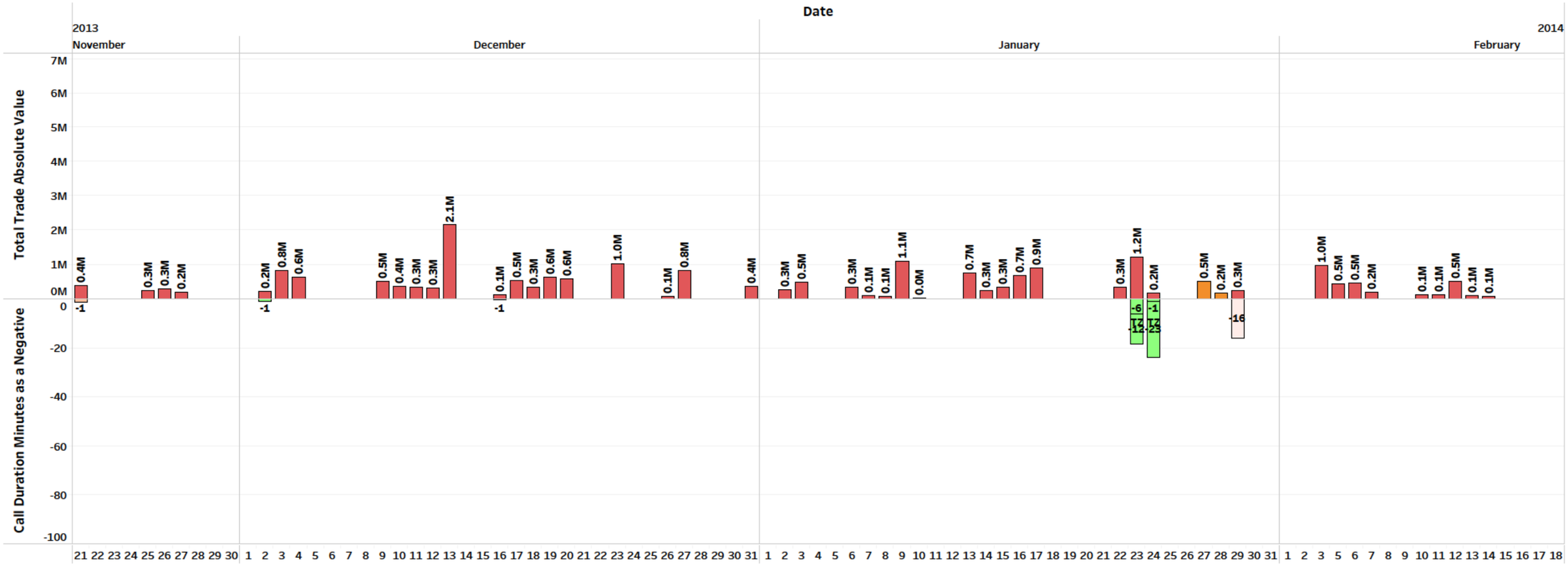

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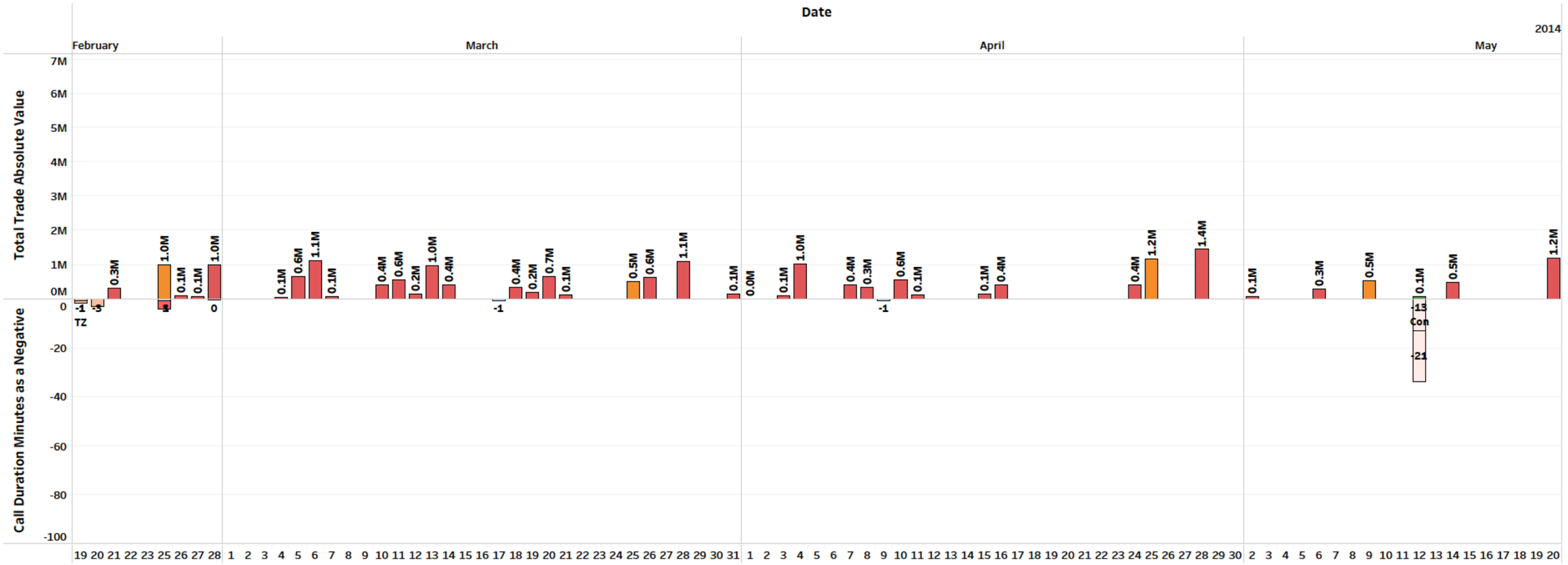

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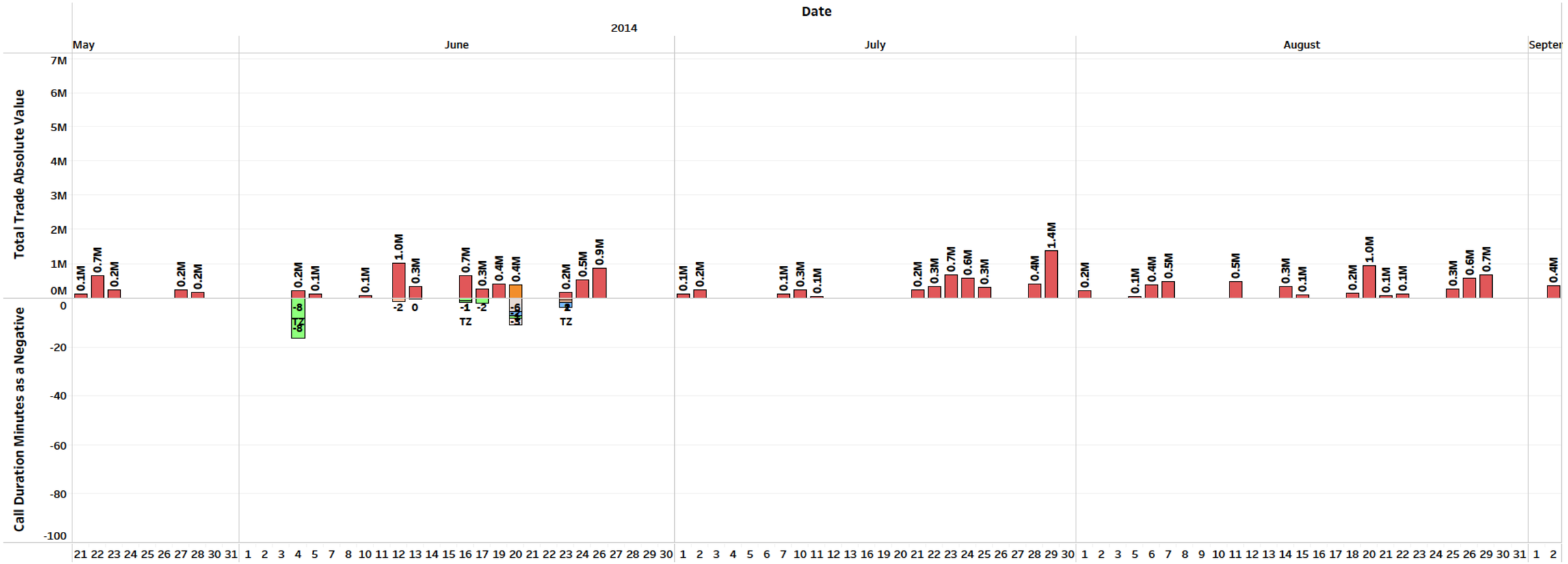

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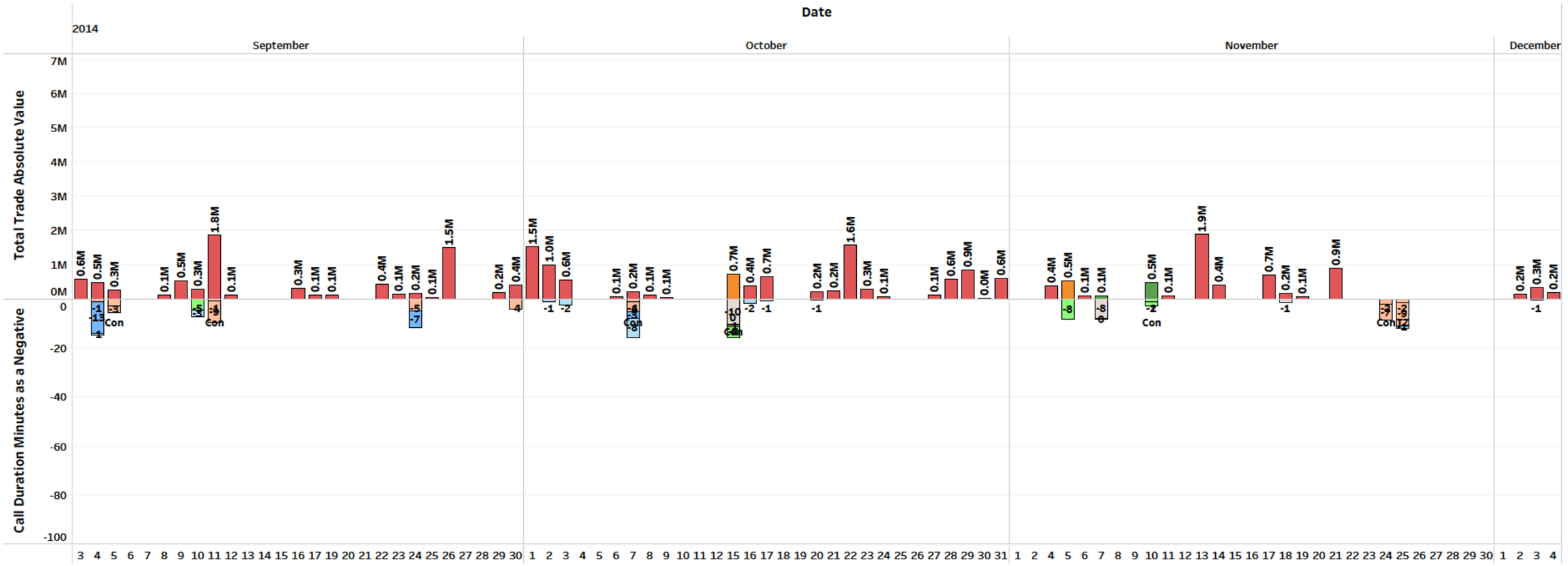

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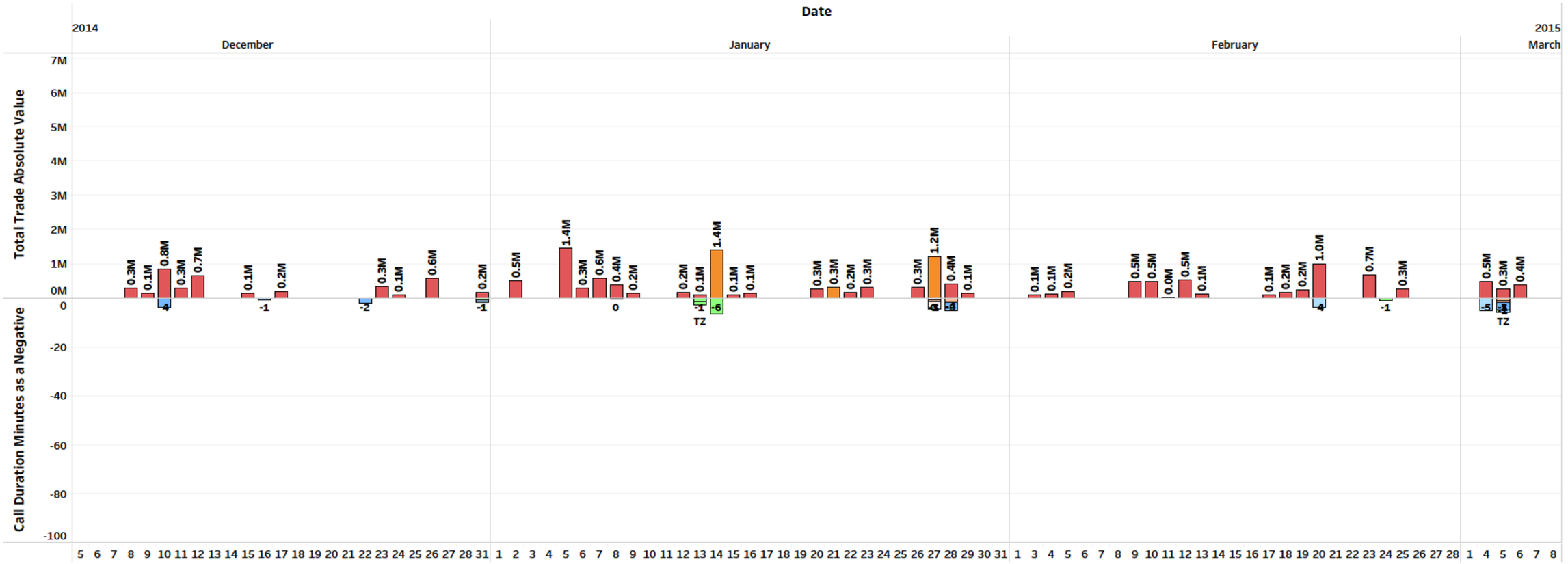

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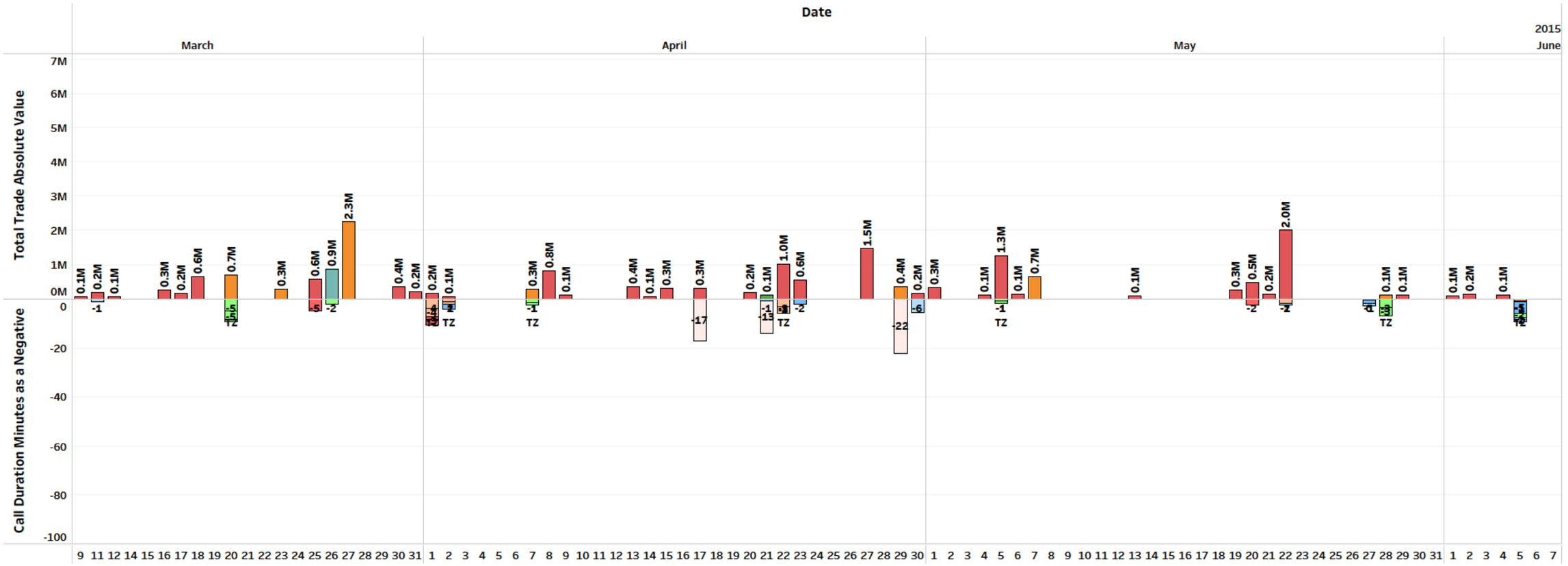

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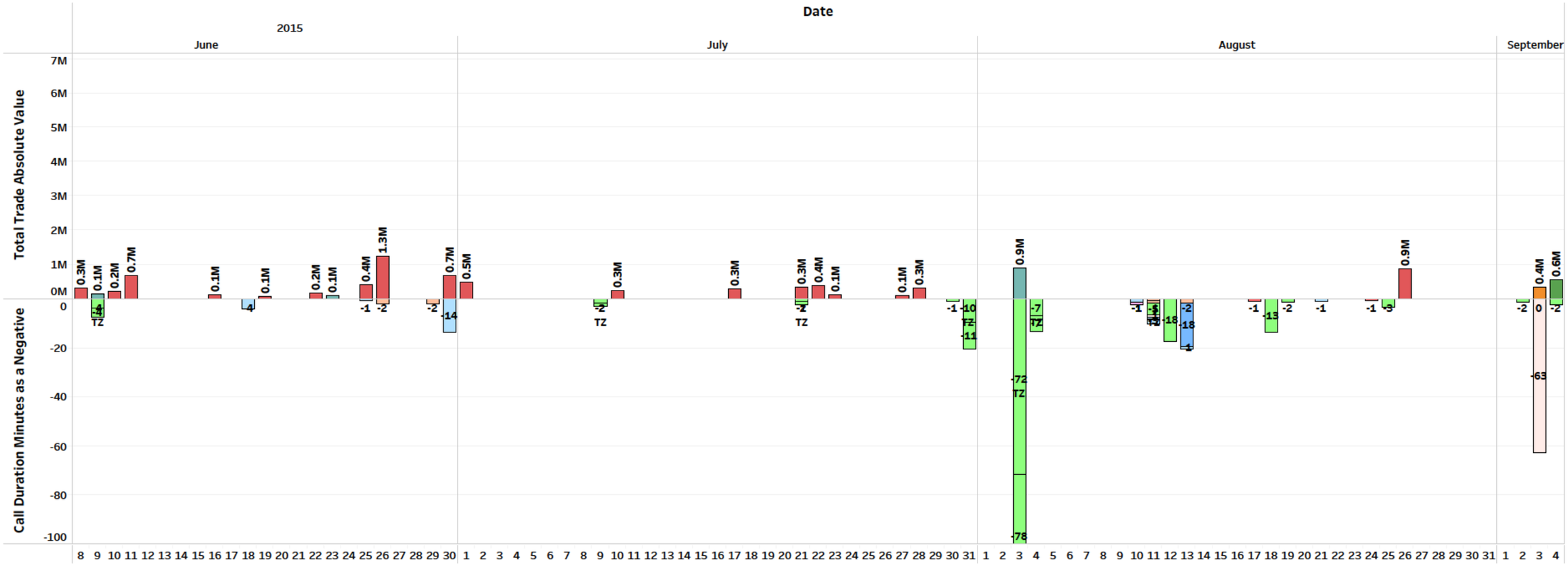

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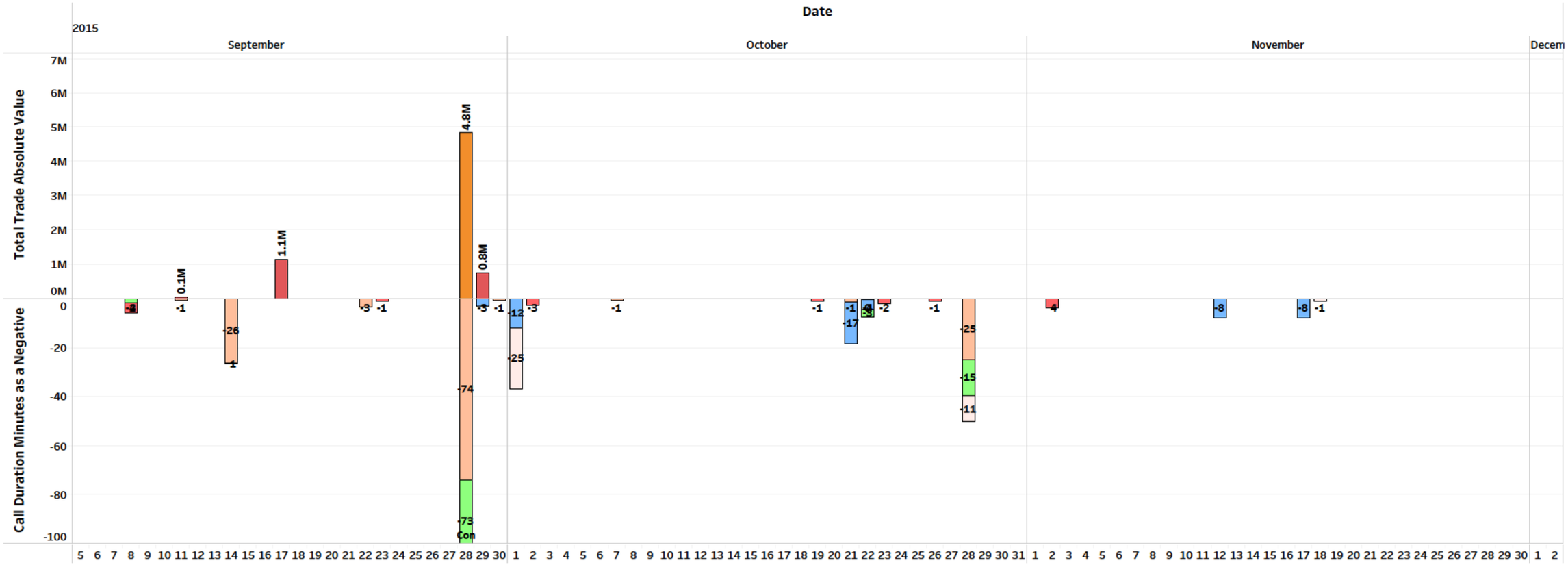

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Winning Arbitrations Based on Unsuitable Annuity and Life Insurance Recommendations

PIABA 2019 Annual Meeting
Barton Creek
October 23-25, 2019

JASON KANE ESQ.
FREDERICK ROSENBERG JD
SCOTT SILVER ESQ.

ANNUITY Claims

Case evaluation through Claimant's Case

Jason Kane

- Case Evaluation
- Potential Claims
- Statement of Claim
- Discovery
- Hearing Presentation
- Authorities

VA Regulation

- State Regulation
  - Insurance License
  - Series 63 Securities
- Finra (SRO) regulator
  - Finra Rules 2330
  - Regulatory Notices
  - NTM 05-50
  - Enforcement
- Licensed BDs Supervise Sales
  - Series 6 or 7 Licensed Reps
  - RIA : Investment Adviser Act 1940
    - Co-Registered with FINRA BD
    - Non-Finra, Registered RIAs
- Office of Comptroller of Currency (Banks)
  - Bank Trust Department Exempt under 33 Act
  - Exempt Brokerage Activities 33 Act

Claims arise under State Law. (NJ Example)

- **17B:25-42 - Violations, penalties**. . A violation of this act shall be a violation of N.J.S.17B:30-1 et seq. . Pursuant to the authority provided to the commissioner under N.J.S.17B:30-1 et seq., the commissioner may, upon finding a violation occurred or is occurring, order: (1) an insurer to take reasonably appropriate corrective action regarding any consumer harmed by a violation relating to an annuity issued by the insurer;
- **7B:30-3. Misrepresentations and false advertising of policies or annuity contracts**. "No person shall make, issue, circulate or cause to be made, issued or circulated, any estimate, illustration, circular or statement misrepresenting the terms of any policy or annuity contract issued or to be issued or the benefits or advantages promised thereby …"
- **17B:30-4. False information and advertising** "No person shall make, publish, disseminate, circulate, or place before the public, or cause, directly or indirectly, to be made, published, disseminated, circulated, or placed before the public, in a newspaper, magazine or other publication, or in the form of a notice, circular, pamphlet, letter or poster, or over any radio or television station, or in any other way, an advertisement, announcement or statement containing any assertion, representation or statement with respect to the business of insurance and annuities or with respect to any person in the conduct of his insurance and annuity business, which is untrue, deceptive or misleading".
- **17B:30-6 - "Twisting" prohibited** "No person shall make any misleading representations or incomplete or fraudulent comparison of any insurance policies or annuity contracts or insurers for the purpose of inducing, or tending to induce, any person to lapse, forfeit, surrender, terminate, retain, or convert any insurance policy or annuity contract, or to take out a policy of insurance or annuity contract in another insurer"

Annuities:

- All Insurance Contracts are Regulated.
  - Variable Deferred Annuities are Securities under the Act sold by Registered BDs, principally Regulated by FINRA. State Insurance Regulations apply.
  - Fixed Index Annuities are Insurance Contracts, Regulated under State Insurance Law and by FINRA when sold "as an investment" under the "Supervision" of a Member Firm NTM 05-50
- Long-term **Income** Investment
- Exchange of Cash for a fixed stream of distributions
- Guaranteed by an Insurance Company
- Three Types
  - Immediate Annuities- IA
  - Deferred Variable Annuities- VA
  - Deferred Fixed Index Annuities- FIA

Why Deferred Variable and Fixed Index Annuities

- Complex Products
  - Multiple-Choice Prospectus
  - Simplified Sales Materials, Summaries, and Illustrations
- Marketed to All Economic Sectors
- Long Term Complications
  - Latent Discovery or Injury
  - Continuing Negligent Advice
  - Tolling
- $2.5 Trillion in Current VA Asset Values VA
- Generates 3% +/- in fees ($75 Billion/yr)
  - Growing $250 Billion/yr.
  - 5% Commission = $1.25 Billion
- 95% Never Annuitize
- Notional Accounts and Benefits
- 19 Substantial Recent Disciplinary Action
- **Alliance Income for Life**: Largest annuity providers have banded together to market – this is not going away anytime soon

Common Complaints

- Depletion and Erosion of Surrender Value
- Unsustainable Income
- Delayed Discovery
- Switching
- Did not Understand the Investment
- Paying for Unnecessary Benefits
- Recommended for an IRA, Sep, or Erisa account
- Thought they were buying Life Insurance, especially seniors.
- Projections relied upon were erroneous and misleading

VARIABLE ANNUITY CLAIMS

- Case Evaluation
  - Client a sole victim or one of many victims of the broker or group.
  - Review the Recommended Annuity(s) and features
  - Supervision and Compliance Red Flags
  - Broker-Check BD and Rep for disciplinary history
  - The broker's specialization and strategies
  - Forecast the Damages (not NOPs)
  - Eligibility

VARIABLE ANNUITY SOC

- Incorporate Regulatory Actions as a Road Map to drafting Claims. e.g.
  - SEC Administrative Proceeding, File No. 3-15095 vs Massachusetts Mutual Life Insurance Co. Respondent. Cease and Desist and Sanctions related to Variable Annuities sales practices under the 1940 Act. Attached.
  - Met Life sanctioned $25Million. Spells out sanctionable conduct. Attached. July 2016
- Be specific in Pleading. The SOC should be your Closing outline.

VARIABLE ANNUITY SOC

- Statement of Claim- It's a Product not a stock.
  - Issues are Life-time Income ,features, and costs, not allocation or growth
  - Supervisory and Compliance Failures
  - Omissions and Mis-representations as inducements
  - Switching and reverse churning
  - Distinguish between Accumulation and Distribution Phases
  - Commissions: Sale of VAs is principal source of Commissions for Broker or group?
  - SOC should support Discovery of information linked to the losses claimed.
  - Projections and promotional material offered
  - Be sure to claim the cost of replacing any future income deficiency.

VARIABLE ANNUITY Panels

- Panel Selection: The most important element in Finra Arbitration
  - Confront Panel Conflicts ASAP with a written disclosure request to panel re: if any panelist owns a VA, sells or recommended a VA, or has family members that do.
  - Annuities involve potentially unfamiliar damage claims based upon lost future income. NOPs do not compensate for the loss of a lifetime income.
  - Deferred Annuities are complex, difficult to understand, and are about features and benefits, Impairment, and the ongoing costs of deferral, not allocation.
  - Take care in the Arbitrator selection process

VARIABLE ANNUITY HEARING

- Establish liability for the Recommendation and Causation for Damages
  - Make the liability case against the broker, the product, and the recommendation quickly.
- Income should be the first objective on the Claimant's NAF. Anything else and the Recommendation is unsuitable.
- Drill down into Broker Training and product familiarity ,
  - "The lack of such an understanding when recommending a security or strategy violates the suitability rule." Finra Rule 2111 .05(a).
- Focus on Alternatives not Presented (Rule 2330 comparisons)
  - Comparative long-term illustrations,
  - Immediate Annuity Constants
  - Income Equities and funds with DRIPs.
- Claims are Structural and unrelated to market performance or allocation, the drag on performance.
- Speak in the voice of the Claimant

VARIABLE ANNUITY HEARING

- Oversight Issues
  - Policies and Procedures.
  - Compliance monitoring
  - Levels of Supervision for VAs
  - Regulatory Notices and Disciplinary Rulings
  - Heightened Supervision
  - Enforcement and Monitoring
  - Product Approvals-Reasonable Basis Suitability
  - Exception Reports
  - Approval of Communications

VARIABLE ANNUITY HEARING

- Branch Compliance Issues
  - Supervision
    - Manuals
    - Annual Reviews
    - Correspondence
    - Complaints
    - Order Approval
  - Self-Supervision
    - Big Producers
    - Groups
  - Training
    - Sales Practices
    - Annuities
  - Branch Profit from VA

VARIABLE ANNUITY HEARING

- Broker Issues on VA cases:
  - Registrations and licenses
  - Compliance with the Manual
  - Who Supervised
    - Self Supervision,
    - Order Approval
  - Sales Training on Products
  - Scripts and presentations.
  - Correspondence and illustrations
  - Commissions, No-Breakpoints, share types
  - Sales Awards and Incentives,
  - Percent of total Commission/yr. represented by VA sales.
  - Basis of the Recommendation.

VARIABLE ANNUITY HEARING

- **Documentary Evidence**
  - Prospectus
  - Sales Illustrations and Projections, Recordings, Seminar Scripts
  - Compliance manuals
  - Correspondence
  - Broker Projections &
  - Financial Plans,
  - Investor Budgets
  - Demonstratives
  - Quarterly Statements
  - Surrender Value
  - Switch Letters
  - Brokers stated reasons supporting the Recommendation
  - New Account Forms
  - Applications
  - Complaint letters

VARIABLE ANNUITY HEARING

- Tell the Client's Story through Examination.
  - If the client did not intend to take an income or annuitize the Recommendation itself is unsuitable.
  - Use a Time Line to describe the Client's road to purchasing, holding, and annuitizing, and the Broker's involvement in those decisions.
    - Customer Objectives, age, financial condition and needs
    - Budgeting expectations
    - Reliance on distribution
    - Intention to Annuitize or not
    - Need for Insurance
    - Alternatives presented and compared.
  - Materials and illustrations relied upon
  - Riders recommended and why.
  - Regular Meetings and ongoing recommendations.
  - Note: Disclosure does not make an Unsuitable Recommendation, Suitable.

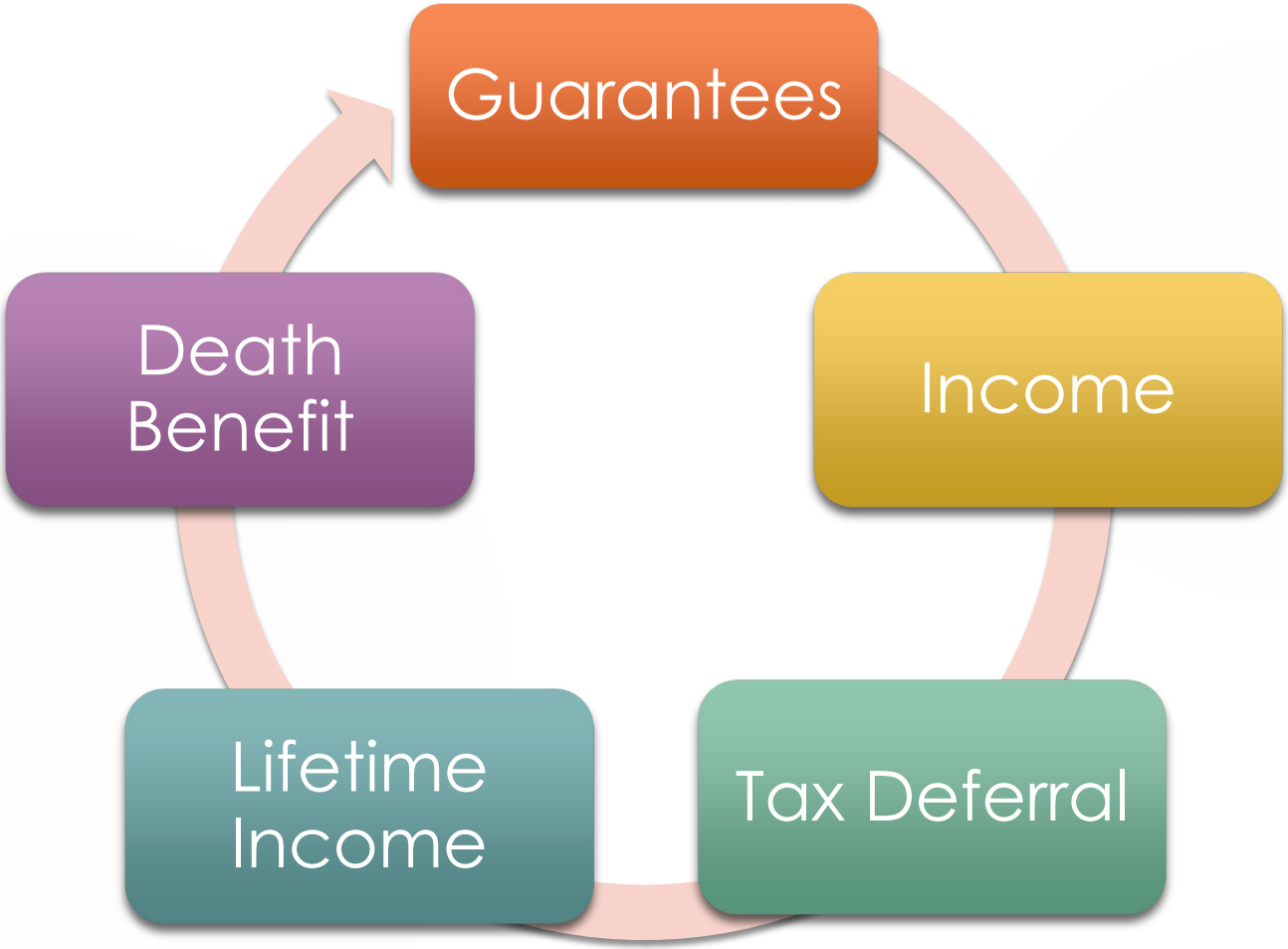
VARIABLE ANNUITY FEATURES

Frederick Rosenberg

- Relevant Features and Benefits
  - Tax Deferral-Tax Cost
  - Death Benefits
  - Penalty-Free Withdrawals GMWB
  - Lifetime Income Benefits GLIB, GMIB
  - Annuitization
  - Taking an Income

Promoted Features

Frederick Rosenberg



Immediate Annuity

- Immediate conversion of cash into a guaranteed stream of revenues calculated using an actuarial Constant.
- Constant: The annual payout percentage of the Annuity Base at election for any given age. Constant increases as life expectancy decreases & Payout Increases.
- Minimum growth rate, 2%-3%
- 80%-90% of distribution is a Return of Premium and not taxable.
- Various Options Impact Payout
  - Term: Life or Fixed Period
  - Lives covered
  - Return of Premium Guarantee
- Illiquid: Substantial Discounted Cash Flow (DCF) Value
- Depending on the age of the annuitant the limitations of immediate annuities are offset by higher lifetime payout and no market or enterprise risk.
- Payouts are guaranteed for life, require no sinking fund, eliminate reinvestment risk.

Deferred Variable Annuity

- VA Investment
  - Mutual Fund Sub-Accounts
  - Market Risk to Principal
  - Tax Deferred Appreciation
  - Diversified Allocation
- VA Phases
  - Accumulation-Appreciation
    - Guarantees
    - Enhancement Riders and bonuses
    - Step-Up-Roll-up
    - Permitted Withdrawals
    - Mortality
  - Distribution-Withdrawing Funds
    - Annuitization
    - Surrender- Full or Partial
    - Lifetime Income Benefits
- Notional Death Benefit (Taxable as Withdrawal)
- Converts capital gains to Ordinary income taxed on a first out basis
- High Annual Cost-High Hurdle 2.5%-3.5%

Fixed Index Annuity

- **An Insurance Contract (not a security) NTM 05-50 Supervision**
  - Guarantees of Principal and an Income
  - Competes With CDs and T-Bills : Cap on yearly Gains and Loss
  - Notional Balances Replace VA Sub Accounts
  - Living Benefit Riders
  - Death Benefit
  - Index based performance-(Dividends excluded?)
  - Principal Depletion
    - Fees and Mortality Expenses
    - Excess Withdrawals and Surrenders
  - Recapture
    - Bonus
    - Enhancements
  - Death Benefit Taxable
  - High Annual Costs 3%-4%
  - CDSC

How It Works

Accumulation Phase

Incentive Bonus

- Sub-Account Appreciation (loss)
- Notional Accounts Accrual
- Roll –up
- Step Up
- Withdrawals
  - May constitute a Surrender
  - CDSC
  - Penalty free withdrawal $ can rise or fall based upon market activity and fees and withdrawals that cause partial surrender
- 3% +/- annual cost
- Mortality

Distribution Phase

- Annuitize
- Surrender
  - CDSC
  - Recapture and Recalculation
- Lifetime Withdrawal Benefit
  - Contract Value Fixed
  - Distribution Fixed
  - Excess withdrawals =surrenders
  - Rider charges continue
- Lifetime Income Benefit
  - Minimum growth rate on Protected Balance
  - Withdrawals prohibited
  - Guaranteed payout rate (constant) of Income Base
  - Rider Charge until election
- Death

Death Benefit

- Death Benefit: Notional payout if, upon death, the portfolio declined to zero. The Death Benefit is initially the Contract Value.
- Step-up: A paid rider allows the Death Benefit to be ratcheted up if the portfolio appreciates.
- Excess withdrawals and partial surrenders could reduce Contract Value and the Notional Death Benefit proportionately.

Death Benefit

- The Death Benefit is a Put, a form of Portfolio Insurance .
- If at Death the portfolio is less than the Guaranteed Death Benefit, the Put will be In-the-Money and its value equal to the difference between the Notional (theoretical) Guaranteed Death Benefit and the portfolio's market value. The Investment Accounts will be "Put" to the Annuity Company in exchange for the Death Proceeds.
- If at death the Investment Accounts' value exceeds the Guaranteed Benefit, the Put will be Out-Of-The-Money and will be valueless and there will no benefit whatsoever or refund of rider premiums.
- Below is a Comparison of a Guaranteed Death Benefit vs. average market returns coupled with a $500K term policy for Life+20-year guaranteed for a 58-year-old male. Regardless of the Death Year, the Index/Term policy resulted in substantially better outcomes.

Death Benefit Analysis

- "MONEYNESS"
- The Put was In-the-Money in only six of the 12 years.
- The impact of fees resulted in a $1million deficit after 12 years of identical market performance.
- VA costs are $432,850 over 12 years vs with $104,080 in index costs (.25%/yr.) and Term Policy costs, $5,200/yr.
- Over 12 years the excess VA cost amount to a $327,700 drag on performance.

Death Benefit Analysis and Comparison

Variable Annuity with Step Up

	A	B	C	D	E	F	G	H	I	J
	Death Year	Open Value Contract Val	Avg Return	New Value Sub Acct	Costs** -3%	End Value	Notional Death Benefit	Upon Death	Put Value Death Bene.	*Death Delta VA vs idx*
age			8.1%	B x C		D + E	With Step-Up	G or F	G - F	*Term Life*
58	1	1,000,000	14%	1,140,000	(34,200)	1,105,800	1,000,000	1,105,800	0	(526,150)
59	2	1,105,800	-5%	1,050,510	(31,515)	1,018,995	1,105,800	1,105,800	86,805	(461,664)
60	3	1,018,995	-25%	764,246	(22,927)	741,319	1,105,800	1,105,800	364,481	(187,597)
61	4	741,319	34%	993,367	(29,801)	963,566	1,105,800	1,105,800	142,234	(449,494)
62	5	963,566	12%	1,079,194	(32,376)	1,046,818	1,105,800	1,105,800	58,982	(567,974)
63	6	1,046,818	14%	1,193,373	(35,801)	1,157,571	1,157,571	1,157,571	0	(671,986)
64	7	1,157,571	2%	1,180,723	(35,422)	1,145,301	1,157,571	1,157,571	12,270	(689,986)
65	8	1,145,301	17%	1,340,002	(40,200)	1,299,802	1,299,802	1,299,802	0	(767,699)
66	9	1,299,802	-7%	1,208,816	(36,264)	1,172,552	1,299,802	1,299,802	127,251	(649,129)
67	10	1,172,552	18%	1,383,611	(41,508)	1,342,103	1,342,103	1,342,103	0	(858,162)
68	11	1,342,103	10%	1,476,313	(44,289)	1,432,023	1,432,023	1,432,023	0	(928,392)
69	12	1,432,023	13%	1,618,187	(48,546)	1,569,641	1,569,641	1,569,641	0	(1,022,173)
					(432,850)					

* Contract Value will be adjusted proportionally for surrenders and partial surrenders and for recapture of bonuses and

** Assumes Annual Step-up Death Benefit. (Many policies, mostly older, allow only limited step-up on a 1 or 2 time basis

Note While all surrenders reduce benefits proportionally, each VA prospectus should be consulted to calculate partial surrenders

Index*** and $500K Life-20-yr Term Policy

	A	B	C	D	E	F	G	H	I	J
	Death Year	Open Value Contract Val	Avg Return	New Value Index Bal	0.25% Idx+ $5200/yr	End Value	Policy Death Benefit	Upon Death	Death Benefit	*Death Delta VA vs idx*
age			8.1%	B x C	Ins Prem	D + E	$ 500,000	G + F		*Term Life*
58	1	1,000,000	14%	1,140,000	(8,050)	1,131,950	500,000	1,631,950	500,000	526,150
59	2	1,131,950	-5%	1,075,353	(7,888)	1,067,464	500,000	1,567,464	500,000	461,664
60	3	1,067,464	-25%	800,598	(7,201)	793,397	500,000	1,293,397	500,000	187,597
61	4	793,397	34%	1,063,151	(7,858)	1,055,294	500,000	1,555,294	500,000	449,494
62	5	1,055,294	12%	1,181,929	(8,155)	1,173,774	500,000	1,673,774	500,000	567,974
63	6	1,173,774	14%	1,338,102	(8,545)	1,329,557	500,000	1,829,557	500,000	671,986
64	7	1,329,557	2%	1,356,148	(8,590)	1,347,558	500,000	1,847,558	500,000	689,986
65	8	1,347,558	17%	1,576,643	(9,142)	1,567,501	500,000	2,067,501	500,000	767,699
66	9	1,567,501	-7%	1,457,776	(8,844)	1,448,932	500,000	1,948,932	500,000	649,129
67	10	1,448,932	18%	1,709,739	(9,474)	1,700,265	500,000	2,200,265	500,000	858,162
68	11	1,700,265	10%	1,870,291	(9,876)	1,860,416	500,000	2,360,416	500,000	928,392
69	12	1,860,416	13%	2,102,270	(10,456)	2,091,814	500,000	2,591,814	500,000	1,022,173
					(104,080)					

*** Capital Gains treatment on Index Distributions vs Ordinary tax treatment on VA distributions, CDSC, and 72T restrictions

Moneyness and Step-Up

- As discussed above, the Death Benefit will be either in-or-out-of–the-money, a factor termed “Moneyness”.
- Living Benefits will also be in-or-out-of–the-money if the portfolio outpaces the guaranteed benefit.
- Step-Up benefits are fee-based features that ratchet up the guarantees to keep them from going out of the money. In substance, if the benefits are not ratcheted up the investor will be paying annual fees for features they cannot and will not use.
- Moneyness is important to Annuity companies because there is a substantially higher Surrender rate when benefits are out of the money.

Enhancements and Bonuses

Conditioned upon Annuitization or a Lifetime Income.

- Vesting Schedule
- Roll Up @Guaranteed Rate
- Step-up Benefit

→

Recapture: Proportional Upon Partial Surrender

- Bonuses and Step-up
- Guaranteed Notional Withdrawal Balance
- Roll-up Guarantee
- Death Benefit

Features Alphabet Varies by Company

- GMWB- Guaranteed Minimum Withdrawal Benefit
  - A guaranteed minimum withdrawal benefit (GMWB) rider guarantees that a certain percentage (usually 5-10%) of the contract value can be withdrawn annually until the entire amount is completely recovered, regardless of market performance assuming balance not fully depleted.
- GMIB- Guaranteed Minimum Income Benefit
  - A guaranteed minimum income benefit (GMIB) rider is designed to provide the investor with a base amount of lifetime income when they retire regardless of how the investments have performed. It guarantees that when the owner elects an Income, payments are based on the amount invested, credited with an interest rate--typically 5-8%/yr. An investor must take a stipulated fixed Income based on age at election. There is typically a seven-ten year holding period before it can be exercised. Age limits may also apply.
- GLWB-GLIB- Guaranteed Lifetime Withdrawal/Income Benefit
  - The guaranteed lifetime withdrawal benefit (GLWB) guarantees that a certain percentage (typically 2-8%, based on age) of the Contract Value can be withdrawn each year for as long as the contract holder lives. This percentage will be set based on the person's age when withdrawals begin. Rider Fees Continue and allocations are severely restricted. Withdrawals reduce contract value
- GMDB- Guaranteed Minimum Death Benefit
  - Provides for Step-Up of the Notional Death Benefit to keep pace with appreciation

GMWB Rider

- Permits annual withdrawals of 6%-10% of Contract Value without CDSC
- Not Annuitization or an Income Benefit
- Not a guarantee of Amount
- Only guarantees a penalty-free % withdrawal.
- Usually exceeds Lifetime Income Benefit when withdrawals begin
- Reduces gains first and premium second,
- May be treated as a partial or total surrender
- May reduce benefits including death benefit proportionally
- Automatic fixed withdrawals regardless of performance
- **Most common factor in Investor claims**

GMIB Rider

- Roll Up Benefit-(Notional)
  - Guarantees an Income Base at a fixed growth rate of 6%-10%.
  - Fees based on Notional Growth Account
  - Sets an age-based payout percentage based upon age, 3%-8%
  - Minimum withdrawal-free Step-up holding period 7-10 years
  - Guarantees a Lifetime Payout at % of Income Based on age and sex.
  - Restricts Portfolio Allocation
  - The Income Base is Notional-Cannot be Withdrawn except by taking an Income

It's the Constant Stupid!

- The "Constant" is the actuarily determined fixed percentage applied to Investment to calculate distributions. It increases as life expectancy decreases.
- Outweighs importance of Growth Rate for seniors over 65
- IA Distributions includes repayment of investment and return on investment
- Annuity Companies offset high Guaranteed growth rates with lower constants increasing fees and decreasing contract value vs. lower growth rate and higher constant, a lower fee alternative.
- Essential to formulate Damages

GMIB Roll Up *Actual Index Annuity*

- The annual charge is 1.25% of the Income Base, a notional account growing 8%/yr. for 12 years assuming no withdrawals. (Great American Valor II)
- Higher Notional Growth rates increase fees
- Rider cost is in addition to all other elected riders
- Fees and costs reduce account value, not Income Base.
- As the Income Base grows over the years, so does the Lifetime Income.
- E.G. At age 85, the investor can
  - **Take an Income** of$29,998 annually on an Income Base of $428, 400 extinguishing all benefits
  - or 2) **Pay an additional rider charge**, grow the Income Base by 8%, and maintain the Death Benefit for another year for a higher payout.
- Lifetime Income is based on substantially lower payout rate, the Constant, vs IA. (see next table).

GMIB Illustration

Yellow Column Added for illustration

Rollup Rate/Period: 8.00 % for 12 years

Rider Charge: 1.25 %

year	Age	Beginning Account Value	Beginning Income Base	Available Lifetime Income	Dist	1.25% Rider Charge	Fee % vs. acct val	Ending Income Base	Ending Account Value	Ending 5 Year Death Benefit	Lump Sum Death Benefit
1	80	306,000	306,000	-	-	3,825	**1.25%**	330,480	302,175	302,175	302,175
2	81	302,175	330,480	21,812	-	4,131	**1.37%**	354,960	298,044	298,044	298,044
3	82	298,044	354,960	23,782	-	4,437	**1.49%**	379,440	293,607	293,607	293,607
4	83	293,607	379,440	25,802	-	4,743	**1.62%**	403,920	288,864	291,961	291,961
5	84	288,864	403,920	27,870	-	5,049	**1.75%**	428,400	283,815	298,274	298,274
6	85	283,815	428,400	29,988	-	5,355	**1.89%**	452,880	278,460	452,880	365,670
7	86	278,460	452,880	32,154	-	5,661	**2.03%**	477,360	272,799	477,360	375,080
8	87	272,799	477,360	34,370	-	5,967	**2.19%**	501,840	266,832	501,840	384,336
9	88	266,832	501,840	36,634	-	6,273	**2.35%**	526,320	260,559	526,320	393,440
10	89	260,559	526,320	38,948	-	6,579	**2.52%**	550,800	253,980	550,800	402,390
11	90	253,980	550,800	41,310	-	6,885	**2.71%**	575,280	247,095	575,280	411,188
12	91	247,095	575,280	43,146	-	7,191	**2.91%**	599,760	239,904	599,760	419,832
13	92	239,904	599,760	44,982	-	7,497	**3.13%**	599,760	232,407	599,760	416,084
14	93	232,407	599,760	44,982	-	7,497	**3.23%**	599,760	224,910	599,760	412,335
15	94	224,910	599,760	44,982	-	7,497	**3.33%**	599,760	217,413	599,760	408,587
16	95	217,413	599,760	44,982	-	7,497	**3.45%**	599,760	209,916	599,760	404,838

Constants Control

IA vs GMIB -10-yr G'tee)

- Top Table
  - Assumes no growth in Account (Shoebox)
  - Payout based solely on IA Constant
  - IA Constant on a shoebox of $306K produces better income than the GMIB
- Middle Table
  - Assumes 2%/year Minimum Growth Rate
  - Payout based on IA Constant
  - produces a consistently 25% better outcome than the GMIB
- Bottom Table
  - Account Value equals notional Income Base
  - Payout based on IA Constant
  - 75% differential in Payout?
- Most take an income by or before 7 years.

Annuitization					GMIB w Roll-up				
Annuity year	Age	Account Value, grow/yr	Constant*	Annual $	Beginning Income Base	GMIB Lifetime Income/yr	Constant	GLWB Rider Fee	Excess Annuity $/yr.
1	80	306,000	8.95%	27,387	306,000	-	0.00%	(3,825)	27,387
2	81	306,000	9.73%	29,774	330,480	21,812	6.60%	(4,131)	7,962
3	82	306,000	9.97%	30,508	354,960	23,782	6.70%	(4,437)	6,726
4	83	306,000	10.20%	31,212	379,440	25,802	6.80%	(4,743)	5,410
5	84	306,000	10.45%	31,977	403,920	27,870	6.90%	(5,049)	4,107
6	85	306,000	11.19%	34,241	428,400	29,988	7.00%	(5,355)	4,253
7	86	306,000	11.64%	35,618	452,880	32,154	7.10%	(5,661)	3,464
8	87	306,000	12.11%	37,057	477,360	34,370	7.20%	(5,967)	2,687
9	88	306,000	12.61%	38,587	501,840	36,634	7.30%	(6,273)	1,953
10	89	306,000	13.12%	40,147	526,320	38,948	7.40%	(6,579)	1,199
11	90	306,000	13.66%	41,800	550,800	41,310	7.50%	(6,885)	490
* based upon constants from immediateannuities.com							Total Fees	(58,905)	

Annuitization					GMIB w Roll-up				
Annuity year	Age	Account Value, grow/yr 102%	Constant*	Annual $	Beginning Income Base	GMIB Lifetime Income/yr	0	GLWB Rider Fee	Excess Annuity $/yr.
1	80	306,000	8.95%	27,387	306,000	-	0.00%	(3,825)	27,387
2	81	312,120	9.73%	30,369	330,480	21,812	6.60%	(4,131)	8,557
3	82	318,362	9.97%	31,741	354,960	23,782	6.70%	(4,437)	7,959
4	83	324,730	10.20%	33,122	379,440	25,802	6.80%	(4,743)	7,320
5	84	331,224	10.45%	34,613	403,920	27,870	6.90%	(5,049)	6,743
6	85	337,849	11.19%	37,805	428,400	29,988	7.00%	(5,355)	7,817
7	86	344,606	11.64%	40,112	452,880	32,154	7.10%	(5,661)	7,958
8	87	351,498	12.11%	42,566	477,360	34,370	7.20%	(5,967)	8,196
9	88	358,528	12.61%	45,210	501,840	36,634	7.30%	(6,273)	8,576
10	89	365,698	13.12%	47,980	526,320	38,948	7.40%	(6,579)	9,032
11	90	373,012	13.66%	50,953	550,800	41,310	7.50%	(6,885)	9,643
* based upon constants from immediateannuities.com							Total Fees	(58,905)	

Annuitization					GMIB w Roll-up				
Annuity year	Age	Account Value, grow/yr 100%	Constant*	Annual $	Beginning Income Base	GMIB Lifetime Income/yr	Constant	GLWB Rider Fee	Excess Annuity $/yr.
1	80	306,000	8.95%	27,387	306,000	-		(3,825)	27,387
2	81	330,480	9.73%	32,156	330,480	21,812	6.60%	(4,131)	10,344
3	82	354,960	9.97%	35,390	354,960	23,782	6.70%	(4,437)	11,608
4	83	379,440	10.20%	38,703	379,440	25,802	6.80%	(4,743)	12,901
5	84	403,920	10.45%	42,210	403,920	27,870	6.90%	(5,049)	14,340
6	85	428,400	11.19%	47,938	428,400	29,988	7.00%	(5,355)	17,950
7	86	452,880	11.64%	52,715	452,880	32,154	7.10%	(5,661)	20,561
8	87	477,360	12.11%	57,808	477,360	34,370	7.20%	(5,967)	23,438
9	88	501,840	12.61%	63,282	501,840	36,634	7.30%	(6,273)	26,648
10	89	526,320	13.12%	69,053	526,320	38,948	7.40%	(6,579)	30,105
11	90	550,800	13.66%	75,239	550,800	41,310	7.50%	(6,885)	33,929
* based upon constants from immediateannuities.com							Total Fees	(58,905)	

GLWB Rider

- Fixed withdrawal based on % of Contract Value
- Allocation Constraints
- Minimum rate applied to Withdrawal Base, (Notional)
- Withdrawals deplete Protected Balance reducing Estate
- Excess withdrawals treated as surrenders and reduce benefits including death benefit proportionally
- Distributions continue until death even if Balance Depleted
- Lifetime, Payout 25 years @(4%);20 years @(5%)
- GLWB vs. Annuitization

GLWB vs. Annuitization $1,000,000 58 Yr Male

- GLWB-
  - 4% Constant (25 year payout)
  - $3,333/mo. ($40,000/yr)
  - Declining Contract Value
  - Partial Liquidity
  - Death Benefit
  - Continues until Death with 10-year guarantee
- Immediate Annuity Life+20
  - 5.65% Constant (payout in 16 years)
  - $4,705/mo. ($56,460/yr.) $1,129,000 payout.
  - $1,371/month increased Cash Flow ($164,600 in first 10 years)
  - DCF Liquidity

Fees and Expenses

- Paid or Reimbursed by Liquidation of Account Assets
  - Commission-No Breakpoints……..……6.0%+/-
  - Contingent Deferred Sales Charge (CDSC).8yrs ……..0%-8%
  - 12(b) Trailing commissions/yr……0.25%-1%+/-
  - Mortality and Admin/yr……1.4%+/-
  - Riders/yr……0.5%-3.5%+/-
  - Portfolio Manager's Fees and Admin/yr ……1.0%+/-

VARIABLE ANNUITY DAMAGES

Scott Silver

- Switching-Twisting
- Market Adjust Damages (not WMA) for accounts in Accumulation: The Cost-Drag of Deferral
- Benefit of the Bargain vs NOPs for accounts in distribution
- Replacement cost of future income.
- Profitability no Barrier to Recovery
- Authorities

Switching

Older VA Policy

Benefits and Step-Up maxed out

Market Performance Outpaces Benefits

1035 Exchange

CDSC applies

New VA Policy

Bonus Incentive

New Commission Paid

Enhanced Features & Benefits

CDSD Resets

Restarts Living Benefits, Guarantees, and Death Benefits

Supervisory Review (Need Customer Written Consent)

VARIABLE ANNUITY SWITCHING

- Switching FINRA Rule 2330 (B)(1) (b) provides that in the case of an exchange of a deferred variable annuity, the exchange must be consistent with the suitability determination required by paragraph (b)(1)(A) of this Rule, taking into consideration whether:
  - "(i)the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements)
  - (ii)the customer would benefit from product enhancements and improvements
  - (iii)the customer has had another deferred variable annuity exchange within the preceding 36 months
  - (iv)The determinations required by this paragraph shall be documented and signed by the associated person recommending the transaction."

VARIABLE ANNUITY Twisting

- **NJ 17B:30-6 - "Twisting" prohibited** "No person shall make any misleading representations or incomplete or fraudulent comparison of any insurance policies or annuity contracts or insurers for the purpose of inducing, or tending to induce, any person to lapse, forfeit, surrender, terminate, retain, or convert any insurance policy or annuity contract, or to take out a policy of insurance or annuity contract in another insurer"

VARIABLE ANNUITY DAMAGES

Market Adjusted Damages: Calculates impairment of performance from the fees and costs. (Miley damages)

- Losses are unrelated to allocation.
- Profitable VAs can suffer substantial Impairment masked by market growth.
- The impact of Impairment grows in direct relation to the drag that 2%-4% excess annual costs have on the existing portfolio over the long-term.
- The impact can amount to well over original Premium in 12-15 years
- Damages amount to the Impairment of return caused by the drag of fees and cost. It is measured by market adjusting for the drag, MAD, unrelated to portfolio performance.

VARIABLE ANNUITY DAMAGES

- **Portfolio Adjusted Damages:** Deferred Annuities generally restrict sub-account allocations depending on guarantees and living benefit riders elected.
- For example, some benefits require an allocation in fixed income be maintained that may not be required in the absence of the rider.
- In that case, and others, an adjusted portfolio allocation or a correlated index can provide an analog for performance comparisons ex-costs and allocation requirement.

VARIABLE ANNUITY DAMAGES
Accounts in Distribution

- **Benefit of Bargain:**
- **Baseline Analysis accounts for both Principal Loss and Income Loss**
- **Claimant invested 500K expecting to be able to take penalty-free fixed automatic withdrawals of $2,083/mo, 5%.**
- **Principal erosion from 3.5% drag from costs & fees**
- **Client holds through Surrender period having reduced distributions to $1,800/mo.**
- **Remaining balances unable to restore distributions to promised level creating a budget shortfall over a lifetime.**

Statement P & L					Benefit of Bargain Comparison			
7/31/2019							VA Drag	return/mo
2:30:00 PM		Dist/month	ann%	Deposit	Open bal	Surrender	3.50%	5.00%
Mon/Yr	principal	211,200	%	500,000	-	$ 367,937	0.29%	0.42%
Jan-10	500,000	2,083	5.00%	500,000	$ 500,000		$ 1,458	$ 2,083
Jan-11	482,778	2,083	5.18%		$ 500,000		$ 1,408	$ 2,083
Jan-12	466,149	2,083	5.36%		$ 500,000		$ 1,360	$ 2,083
Jan-13	450,093	2,083	5.55%		$ 500,000		$ 1,313	$ 2,083
Jan-14	434,590	2,083	5.75%		$ 500,000		$ 1,268	$ 2,083
Jan-15	419,621	2,083	5.96%		$ 500,000		$ 1,224	$ 2,083
Jan-16	405,168	1,800	5.33%	-	$ 500,000		$ 1,182	$ 2,083
Jan-17	391,212	1,800	5.52%	-	$ 500,000		$ 1,141	$ 2,083
Jan-18	377,737	1,800	5.72%	-	$ 500,000		$ 1,102	$ 2,083
Oct-18	367,937	1,800	5.87%	-	$ 500,000	$ 367,937	$ 1,073	$ 2,083
		211,200		500,000		$ 367,937		$ 220,833
					Projected Inc	220,833		
		Contribution		(500,000)	Return of Principal	500,000		-
		Dist+Surrender		579,137	Bargained for	720,833		Oct-18
		Gain(Loss) nop		79,137	Dist+Surrender	(579,137)		BOB Dams
		Surrender	0%		Deficiency	(141,697)		(141,697)

VARIABLE ANNUITY DAMAGES

- Loss of Promised Income:
  - Claim to restore the income stream promise to meet Claimant's defined and budgeted financial needs over a lifetime.
  - Claimant is not simply claiming losses adjusted for market performance, but for the income distributions bargained for to meet defined and budgeted financial needs over a lifetime.
  - An Award must be adequate to restore the promised lifetime income.
  - Given that Respondents typically specialize in Annuities, recommended Annuities to Claimant, and derive much of their revenue from annuity sales, an Immediate Annuity to make up the deficiency is the logical damage model.

Arbitrator Manual

Damages: FINRA Arb Manual

- Types of Remedies: "Depending upon the relief parties request, there are several types of remedies arbitrators may consider. If the panel is satisfied by a preponderance of the evidence that the respondent is liable for the alleged loss, the panel should determine an appropriate remedy". Remedies may include:
  - Net Out of Pocket
  - Benefit of Bargain
  - Well Managed Account
  - Rescission
  - Disgorgement
  - Statutory
- Breakpoint Violation and Excess fees (See Disciplinary Actions)
- Insurance?

FINRA Regulation

- FINRA Rule 2330: Rule Adopted specifically for Variable Annuity sales per NTM 07-53
- Regulatory Notice
  - Regulatory Notice 10-05 FINRA Reminds Firms of Their Responsibilities Under FINRA Rule 2330 for Recommended Purchases or Exchanges of Deferred Variable Annuities January 21, 2010
  - Regulatory Notice 09-32 SEC Approves Amendments to NASD Rule 2821 Governing Purchases and Exchanges of Deferred Variable Annuities June 11, 2009
  - Regulatory Notice 07-53 SEC Approves New NASD Rule 2821 Governing Deferred Variable Annuity Transactions November 6, 2007
  - Regulatory Notice 07-36 FINRA Clarifies Guidance Relating to SEC Regulation S-P under Notice to Members 07-06 (Special Considerations When Supervising Recommendations of Newly Associated Registered Representatives to Replace Mutual Funds and Variable Products) August 13, 2007
- Notice To Members
  - NTM 04-45 NASD Seeks Comment on Proposed Rule to Impose Specific Sales Practice Standards and Supervisory Requirements on Members for Transactions in Deferred Variable Annuities June 9, 2004
  - NTM 99-35 The NASD Reminds Members of Their Responsibilities Regarding the Sales of Variable Annuities May 1, 1999
  - NTM 96-86 NASD Notice to Members 96-86 - December 1, 1996
  - NTM 05-50 Supervision of Annuities

Recent Finra Actions on Variable Annuities

News Release

For Release: Wednesday, November 2, 2016
Contact(s): Nancy Condon (202) 728-8379

FINRA Fines Eight Firms a Total of $6.2 Million for Supervisory Failures Related to Variable Annuity L-Shares

News Release

For Release: Tuesday, May 8, 2018
Contact(s): Michelle Ong (202) 728-8464

FINRA Sanctions Fifth Third Securities, Inc., $6 Million for Cost and Fee Disclosure Failures and Unsuitable Recommendations Related to Variable Annuity Exchanges

News Release

For Release: Monday, November 28, 2016
Contact(s): Michelle Ong (202) 728-8464
Nancy Condon (202) 728-8379

FINRA Fines VALIC Financial Advisors, Inc. $1.75 Million for Failure to Prevent Conflicts of Interest in its Compensation Policy and for Other Supervisory Failures Related to Variable Annuity Sales

News Release

For Release: Tuesday, May 3, 2016
Contact(s): Michelle Ong (202) 728-8464
Nancy Condon (202) 728-8379

FINRA Sanctions MetLife Securities, Inc. $25 Million for Negligent Misrepresentations and Omissions in Connection With Variable Annuity Replacements

Largest FINRA Fine Relating to Variable Annuities

Sec and Finra Publications

SEC
https://www.sec.gov/investor/pubs/varannty.htm
https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_variableannuities
https://www.sec.gov/investor/pubs/sec-guide-to-variable-annuities.pdf
https://www.sec.gov/fast-answers/answersvarannhtm.html
https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/updated-investor-bulletin-variable-annuities
https://www.investor.gov/additional-resources/general-resources/publications-research/publications/variable-annuities
FINRA
https://www.finra.org/sites/default/files/InvestorDocument/p125846.pdf
https://www.finra.org/investors/your-guide-annuities-variable-annuities
http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-08.pdf
http://www.finra.org/sites/default/files/2019_AC_Ethical_Culture.pdf
http://www.finra.org/sites/default/files/2019_AC_Regulatory_Exams.pdf
https://www.finra.org/sites/default/files/InvestorDocument/p125846.pdf
http://www.finra.org/sites/default/files/2019_Risk_Monitoring_and_Examination_Priorities_Letter.pdf

FINRA Disciplinary Actions

- VA Related Disciplinary Actions 2017-2018
  - http://www.finra.org/industry/finra-disciplinary-actions-online

CASE #	Action
2014040870001	METLIFE Securities Inc AWC
2013035051401	Fifth Third Securities, Inc. BD 628 AWC
2014039071101	Cadaret Grant & Co., Inc. BD 10641 AWC
2015043319901	NEXT Financial Group, Inc. BD 46214 AWC
2015043369501	JH Darbie & Co Inc CRD 43520 AWC
2015043369502	Wolf A Popper CRD 365826 AWC
2015043390301	Park Avenue Securities LLC CRD 46173 AWC
2015043583901	Ameritas Investment Corp. BD 14869 AWC
2015043641901	World Equity Group CRD 29087 AWC
2015048048801	Hank M Werner CRD 1615495 OHO
2015048048801	Legend Securities Inc Decision
2015047177001	National Planning Corporation CRD 12984 AWC
2016047566601	GWN Securities Inc CRD 128929 AWC
2016047636601	Royal Alliance Associates CRD 421 AWC
2016048243101	Securities America, Inc. CRD 10205 AWC
2016049232201	Geoffrey Colin Turner CRD 4007735 AWC
2016050025401	Frederick David Holloway CRD 248814 Complaint
2016050474001	Donald Lane Preston CRD 4704220 AWC
2017052410201	Lincoln Investment CRD 519 AWC
2017054170501	Xavier Patino CRD 5528139 AWC

- *Cut and Paste Link in Browser. Then, paste case number in Search Box for Decision*

PIABA ANNUAL MEETING
Non FINRA Arbitrations – A Look at RIA Issues

Two Sessions:
October 25, 2019, 9:45 am to 10:45 am
October 25, 2019, 11:00 am to 12:00 pm

Favorite Causes of Action Against Investment Advisors

Jane L. Stafford[1]

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[1] Jane L. Stafford has represented and commenced actions against investment advisors for almost 35 years, successfully navigating this industry segment requiring a knowledge of the law and underlying investment concepts used in this industry. Further information may be found on the website of the firm she founded in 2004, at https://www.staffordassoc.com/.

Preface

These materials present favored causes of action against investment advisors by individual investors. The causes of action rank as favorites based on required proof, available remedies and statutes of limitations.

1. Introduction

a. Shifting Business Model

The number of registered investment advisors continues to increase, from 10,511 in 2012 to 12,578 in 2018.[2] In comparison, FINRA reports a decrease in registered representatives from 630,391 in 2012 to 629,902 in 2016, a net decrease of about 1.0%.[3] The number of firms decreased from 4,290 in 2012 to 3,607 in 2018, a net decrease of 16%.

The genesis of the shift in business models commenced on May Day, or May 1, 1975 when broker commission rates became deregulated.[4] Since that date, market competition has continually diminished commission rates, resulting in a shift away from commission business to asset-based fee business and many financial advisors entering the more lucrative investment advisory business. Because of the relatively minimal barriers to entry in this industry,[5] many unscrupulous, unknowledgeable and unqualified individuals have entered this field. Coupled with the complete control exercised over client assets, the resulting harm to investors becomes concerning.

b. Three Favorite Causes of Action

The three favorite causes of action against investment advisors arise under the Employee Retirement and Income Security Act of 1974 (ERISA), state securities statutes and the common law claim of breach of fiduciary duty. They have favorable standards of proof, remedies, and statute of limitations. Statutes of limitations become a more common issue based on the relationship between the advisor and client, with a high degree of trust by the client and the lesser attention devoted to the handling of the account, and even more so with discretionary management of funds.

[2] Number of Registered Investment Advisors (RIASs)* employed in the United States from 2012 to 2018, The Statistics Portal, Statista 2018, *at* https://www.statista.com/statistics/614815/number-of-rias-employed-usa/.

[3] FINRA, Registered Representatives Statistical Review, *at* https://www.finra.org/media-center/statistics#reps.

[4] Securities Acts Amendments of 1975, Public Law 94-29, states in its preface: An Act to amend the Securities Exchange Act of 1934 to remove barriers to competition," *at* http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1970/1975_0604_1975Amendments.pdf.

[5] For example, investment advisors have no or minimal net capital requirements, supervisory procedures are less, and operational costs are significantly less with the use of custodial, broker-dealer platforms.

Pleading these causes of action depends on the conduct of the person as an investment advisor, not the registration status of the person. First, the person does not have to be registered as an investment advisor or an investment advisor representative for these remedies to be available. These actions may be brought as against a firm registered as an investment advisor or an individual registered under a firm as an investment advisor representative[6] of the firm. A person may either be registered with the U.S. Securities and Exchange Commission or appropriate state regulatory agencies. Registration is not a precondition to the cause of action.

For information on the regulatory scheme and conduct by investment advisors, reference is made to other materials.[7] This presentation and accompanying materials assumes some familiarity with the topic. These materials also do not purport to be an extensive review of ERISA, its complexity and its numerous requirements.

A person's conduct must fall within governing definitions of an investment advisor, and the causes of action follow. For statutory causes of action, reference must be made to the definitions under the statute, whether under ERISA or state securities laws. Common law claims will depend on the facts and circumstances.

For reference, the Investment Advisors Act of 1940 defines an investment advisor:

> Any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. . ..[8]

State securities laws have similar, if not identical, definitions. The person's conduct invokes the remedies in these causes of action.

[6] Persons within the definition of an investment advisor may register as an investment advisor constituting the firm or as an investment advisor representative of a registered investment advisor depending on the structure. *See* Section 102(15) and (16) of the Uniform Securities Act, defining investment advisor and investment advisor representative. Natl. Conference of Comm'rs on Uniform State Laws, Uniform Securities Act (Last Revised or Amended in 2005) (Jan. 19, 2017), at https://www.uniformlaws.org/viewdocument/final-act-with-comments-82?CommunityKey=8c3c2581-0fea-4e91-8a50-27eee58da1cf&tab=librarydocuments.

[7] See e.g., J. Stafford, *Considerations in Cases Against Independent Investment Advisors – Case Review, Procedures, Causes of Action and Discovery Considerations*, 25 PIABA Bar J. 435 (2018)

[8] Investment Advisors Act, Section 202(a)(11) Definitions. The Investment Advisers Act commences at 15 U.S.C. §80b-1, *at* http://legcounsel.house.gov/Comps/Investment%20Advisers%20Act%20Of%201940.pdf. *See also supra* note 6.

2. Why Favorites

The reasons for choosing favorites summarize the benefits:

Cause of action	Benefits
ERISA breach of fiduciary duty ERISA breach of fiduciary duty (continued)	• Standards of care listed in detail. • Statutory damages include relief deemed appropriate. • Provisions to extend damages beyond net out of pocket. • Longer statute of limitations.
State securities statues	• Statutory damages include attorney's fees, costs and interest • Statutory language for liability broad
Common law breach of fiduciary duty	• Longer statute of limitations • Ability to toll statute based on discovery and other facts • Potential for punitive damages

3. Employee Retirement and Income Security Act of 1974[9] [10]

Even in 1974, Congress recognizes the increasing amount of individuals' retirement and other savings in qualified retirement accounts,[11] and enacts ERISA for protection of such accounts. At the end of September 30, 2018, retirement assets stood at $29.2 trillion, according to the Investment Company Institute (ICI), which is a 3.2% increase over year-end 2016.[12]

Congress references the need to protect individuals' savings by stating the remedial nature of the statute in the statute's beginning language:

[9] ERISA may be found commencing at https://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title29-chapter18-front&num=0&edition=prelim. The Code of Federal Regulations promulgated under ERISA, commence at 29 CFR Part 2509 et seq, at https://www.ecfr.gov/cgi-bin/text-idx?SID=3d974393878d7206ab5524ad0a40e2c7&mc=true&tpl=/ecfrbrowse/Title29/29chapterXXV.tpl.
[10] Reference to ERISA is usually by the statutory section, not the United States Code. For ease, reference herein is to the United States Code.
[11] 29 U.S.C. §1001(a) *supra* note 9.
[12] M. Satter, Retirement Assets Hit $29.2T: ICI Report, ThinkAdvisor (December 27, 2018, at https://www.thinkadvisor.com/2018/12/27/retirement-assets-hit-29-2t-ici-report/?slreturn=20190824154854.

> The Congress finds that the growth in size, scope, and numbers of employee benefit plans in recent years has been rapid and substantial . . . that the continued well-being and security of millions of employees and their dependents are directly affected by these plans; . . . and that it is therefore desirable . . . that minimum standards be provided assuring the equitable character of such plans and their financial soundness.
>
> It is hereby declared to be the policy of this chapter to protect . . . the interests of participants in employee benefit plans and their beneficiaries, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts.[13]

With any remedial statute, the onus shifts from the protected class to the culprit, based on the underlying intent to enforce the statute in a manner to protect individuals' and their retirement savings, and to impose remedies under the statute. The difficulty may be more educating the court or other deciding body regarding ERISA's standards and remedies.

a. Retirement Assets Subject to ERISA[14]

ERISA covers only employee sponsored plans[15] and excludes individual retirement without participation or involvement by the employer.[16] ERISA's fiduciary standards and its remedial provisions only cover these employees sponsored plans, such as defined benefit plans and 401(k) plans. The genesis of ERISA comes in part from the interest of Congress in tax deferral and the Pension Benefit Guaranty Corporation's insurance for ERISA plans. The perceived limited nature of individual retirement accounts seems not to have merited the protections under ERISA.

If looking at an IRA rollover, the question becomes the status of the assets while any malfeasance occurred. For example, IRA assets rolled over from a protected plan allows ERISA to govern management during the period of malfeasance while a protected plan.

[13] 29 U.S.C. §1001 (Congressional findings and declaration of policy), *supra* note 9.
[14] ASPPA Net Staff, ASPPA, *U.S. Retirement Assets Reach $26 Trillion* (June 28, 2019) at https://www.asppa.org/news-resources/browse-topics/us-retirement-assets-reach-26-trillion.
[15] 29 U.S.C. §1101(coverage), *supra* note 9. Scope of coverage applies to "any employee benefit plan described in Section 1003(a), which section references coverage only to employee benefit plan if established or maintained by any employer engaged in commerce or in any industry or activity affecting commerce; or an employee organization.
[16] 29 CFR 2510.3-2(d), *supra* note 9, sets forth exclusion of individual retirement accounts in which no contributions are made by the employer, participation is voluntary, the sole involvement of the employer is without endorsement to publicize the program, collect contributions and remit them to the sponsor, and the employer receives no consideration.

b. Fiduciary Duty and Required Standards

ERISA imposes fiduciary duties and required standards of care on investment advisors acting as fiduciaries. ERISA defines someone as a fiduciary and subject to its fiduciary standards:

> [A] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.[17]

Most if not all investment advisors will be deemed to have some control sufficient to fall within this definition of a fiduciary. Confirmation or proof may reside either in the investment advisory agreement, which will contain language regarding a grant of discretionary authority, or any advisor's Form ADV, which most likely contains disclosures of the advisor's assets under discretionary management.[18]

Once a fiduciary, ERISA imposes its own statutory standards on such a fiduciary. ERISA's emanates from trust law,[19] and the statutory language specifically mimics in a manner states' trust laws,[20] which require prudent administration[21] and incorporate the Uniform Prudent Investor Act.[22] The Uniform Prudent Investor Act sets forth a standard of care requiring management of assets as a prudent investor by "considering the purposes, terms, distribution requirements,"[23] and then lists the considerations in doing so much beyond FINRA's suitability rule.[24]

[17] 29 U.S.C. §1002(21)(A), *supra* note 9. Cf. 29 U.S.C.§1002(38) (defining investment manager), *supra* note 9; 29 CFR §2510.3-21 (definition of fiduciary), *supra* note 9.
[18] See Form ADV, Part 1a, Item 5.F(2). Advisors' Form ADV's may be found on the Investment Adviser Public Disclosure (IAPD) website at https://www.adviserinfo.sec.gov/.
[19] 29 U.S.C. §1103 (establishment of trust), *supra* note 9.
[20] See Natl. Conference of Comm'rs on Uniform State Laws, Uniform Trust Code (Last Revised or Amended in 2010) (May 17, 2018), *at* https://www.uniformlaws.org/viewdocument/final-act-with-comments-91?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d&tab=librarydocuments. This Uniform Trust Code incorporates the Uniform Prudent Investor Act, *infra* note 22.
[21] *Id.* Section 804, p. 114.
[22] Natl. Conference of Comm'rs on Uniform State Laws, Uniform Prudent Investor Act (4/18/95), *at* https://www.uniformlaws.org/committees/community-home/librarydocuments?communitykey=58f87d0a-3617-4635-a2af-9a4d02d119c9&tab=librarydocuments
[23] *Id.* Section 2, p. 5
[24] FINRA Rule 211 Suitability, FINRA Manual, *at* https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111.

Under ERISA, as a fiduciary an investment must discharge its duties solely in the interests of the client within the following requirements, using:

> The care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; and
>
> By diversifying the investments of the plan so as to minimize the risk of large losses.[25]

In fulfilling this fiduciary duty, a fiduciary must give "appropriate consideration to those facts and circumstances . . ., the fiduciary knows or should know, are relevant to the particular investment or investment course of action involved."[26] The appropriate considerations are:

> (i) A determination by the fiduciary that the particular investment or investment course of action is reasonably designed . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action, and
>
> (ii) Consideration of the following factors as they relate to such portion of the portfolio:
>
> (A) The composition of the portfolio with regard to diversification;
>
> (B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and
>
> (C) The projected return of the portfolio relative to the funding objectives of the plan.[27]

This language amplifies what prudent management and fiduciary duties. Its intent protects retirees, not an investment advisor. It spells out what someone should do in managing assets, and if something has gone wrong, it is more than likely an advisor ignored or was ignorant of these requirements

Case law buttresses these concepts. The fiduciary duties are customarily referred to as the "highest known to the law."[28] Courts have further stated "the duty to conduct an

[25] 29 USC §1104(a) (prudent man standard of care), *supra* note 9. *See also* 29 U.S.C. § 1104(a)(1) (duty of loyalty and exclusive purpose duties of loyalty), *supra* note 9.
[26] 29 CFR 2550.404a-1(b)(i), *supra* note 9.
[27] 29 CFR 2550.404a-1(b), *supra* note 9.
[28] *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982), *cert. denied*, 459 U.S. 1069 (1982).

independent investigation into the merits of a particular investment" is "the most basic of ERISA's investment fiduciary duties." [29]

The Employee Benefits Security Administration, under the Department of Labor, promulgates extensive materials delineating violations of ERISA and example violations.[30] It promulgates a multitude of publications to assist fiduciaries in meeting their obligations.[31]

c. Remedies

The statutory language for breaching this fiduciary duty provides broad remedies. The scope of liability extends and is measured as follows:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate.[32]

Under this language, a good argument may be made for damages based on a well-managed portfolio. The investment advisor has a duty to manage the assets prudently, and upon a failure to do so, the liability is measured by the losses incurred and such remedial relief necessary. Of course, the language includes recoupment of fees paid to the advisor.

Co-fiduciaries are also liable for a breach of "fiduciary responsibility of another fiduciary under certain circumstances," as follows:

> (1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;
>
> (2) if, by his failure to comply with section 1104(a)(1) of this title in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or

[29] *In re Unisys Savings Plan Litig.*, 74 F.3d 420, 435 (3d Cir. 1996).
[30] *See* Department of Labor, Employee Benefits Security Administration, General Compliance Assistance, Fiduciary Duties, *at* https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/retirement.
[31] *E.g.,* Department of Labor, Employee Benefits Securities Administration, *Meeting Your Fiduciary Responsibilities*, at https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/publications/meeting-your-fiduciary-responsibilities.pdf.
[32] 29 U.S.C. §1109(a) (liability for breach of fiduciary duty), *supra* note 9.

> (3) if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.[33]

Of course, once again, depending on the circumstances, this language may be used to bring in the trustees of a plan and any attendant insurance, as well as any other parties fitting the definition of a fiduciary. It opens the number of responsible parties and resources.

d. Statute of Limitations

An action for breach of fiduciary duty must be commenced no later than after the earlier of the following:

> (1) six years after (A) the date of the last action which constituted a part of the breach or violation, or (B) in the case of an omission the latest date on which the fiduciary could have cured the breach or violation, or
>
> (2) three years after the earliest date on which the plaintiff had actual knowledge of the breach or violation;
>
> except that in the case of fraud or concealment, such action may be commenced not later than six years after the date of discovery of such breach or violation.[34]

For most statutory claims, ERISA allows six years to bring an action. Especially with discretionary accounts, clients fail to watch their accounts closely and often do not realize the harm until much later. At least ERISA, recognizes the fiduciary responsibilities and reliance on the fiduciary which causes the harm to go undetected much easier and much longer.

e. Pitfalls, or Stupid Defense Arguments to Know

At least two incorrect defenses exist: exculpatory language in a contract; and the right to bring action belongs not to the participant. Neither of these arguments work.

ERISA specifically statutes that "exculpatory provisions" to relieve a fiduciary from responsibility or liability "shall be void as against public policy."[35] Not dissimilar to prohibited hedge clauses under the Investment Advisors Act,[36] these clauses are unenforceable.

[33] 29 U.S.C. §1105 (liability for breach of co-fiduciary), *supra* note 9.
[34] 29 U.S.C. §1113 (limitation of actions), *supra* note 9.
[35] 29 U.S.C. §1110, *supra* note 9.
[36] Investment Advisors Act, Section 215 Validity of Contracts, *supra* note 8; Uniform Securities Act, Section 215(l) Validity of Contracts; No contractual Waiver, *supra* note 6.

An argument may also be made that an individual may not pursue civil enforcement and impose civil monetary liability. The language of Section 502 provides some, but insufficient, ambiguity, by stating:

> A civil action may be brought –
>
> > (3) by a participant, beneficiary, or fiduciary (A) to enjoin any act or practice which violates any provision of this subchapter or the terms of the plan, or (B) to obtain other appropriate equitable relief (i) to redress such violations or to enforce any provisions of this subchapter. [37]

However, the section must be read in its entirety. Although civil enforcement by a participant is limited to certain relief, it does allow a participant to "enforce any provision of this subchapter."[38] The referenced subchapter I[39] includes imposition of the fiduciary duty [40] and liability for the breach thereof.[41]

4. State Securities Statutes

These materials generally reference the Uniform Securities Statute as representative of most state securities laws. The governing state's securities statute and rules promulgated under the statute must be reviewed as statutory language and rules promulgated under the statutes vary substantially from state to state.

State securities statutes present the only viable, or favorite remedy. The only remedy available under the Investment Advisors Act of 1940 is under Section 215 of the Act, which states contracts that violate the Act "shall be void . . . as regards to the rights of the person who has violated the Act.[42] Hence, so a person may void the contract but not pursue damages other than recoupment of fees.

The U.S. Supreme Court in *Transamerica Mortgage Advisors, Inc. v. Lewis*[43] stated:

> When Congress declared in Section 215 that certain contracts are void, it intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission or for an injunction against continued operation of the contract and for restitution.

Therefore, only under §215 does the limited private right of action to void a contract against a violator of the Investment Advisors Act exist.

[37] 29 USC §1132 (civil enforcement), *supra* note 9.
[38] 29 U.S.C. §1132(a)(3), *supra* note 9).
[39] *See* Subchapter I – Protection of Employee Benefits Rights, §§1101 through 1191c, *supra* note 9.
[40] *Supra* note 25 (29 USC §1104(a) (prudent man standard of care) and 29 U.S.C. § 1104(a)(1) (duty of loyalty and exclusive purpose duties of loyalty)).
[41] *Supra* note 32 (29 U.S.C. §1109 (liability for breach of fiduciary duty)).
[42] Investment Advisers Act of 1940, Section 215 Validity of Contracts, *supra* note 8.
[43] *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 18-19 (1979)

The Court in *Transamerica Mortgage Advisors, Inc. v. Lewis* also determined the phrase in Section 206 of the Investment Advisors Act, which makes it unlawful for an investment advisor "to employ any device, scheme, or artifice to defraud . . . [or] engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," does not establish a private cause of action upon violation of the phrase; the words are merely "designed to protect investment advisor's clients."[44]

a. Prohibited Conduct and Standards of Conduct

Most state securities statutes extend liability on investment advisors the same as they impose liability for other violations, and specifically reference prohibited conduct by investment advisors. The Uniform Securities Act sets forth prohibited conduct in providing investment advice:

> (a) [Fraud in providing investment advice.] It is unlawful for a person that advises others for compensation, either directly or indirectly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, or selling securities or that, for compensation and as part of a regular business, issues or promulgates analyses or reports relating to securities:
>
> (1) to employ a device, scheme, or artifice to defraud another person; or
> (2) to engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.
>
> (b) [Rules defining fraud.] A rule adopted under this [Act] may define an act, practice, or course of business of an investment adviser or an investment adviser representative, other than a supervised person of a federal covered investment adviser, as fraudulent, deceptive, or manipulative, and prescribe means reasonably designed to prevent investment advisers and investment adviser representatives, other than supervised persons of a federal covered investment adviser, from engaging in acts, practices, and courses of business defined as fraudulent, deceptive, or manipulative. [45]

The language of this Section extends to investment advisors irrespective of whether registered by referencing the prohibited conduct, not the person. This Section also allows the adopting of rules defining fraudulent, deceptive, or manipulative, which may be used as proof of prohibited conduct beyond what should be common sense.

[44] *Id.* pp. 19-24. *See also* Investment Advisor Act, Section 206 Prohibited Transactions by Registered Investment Advisors, *supra* note 8.
[45] Section 509(f), pp. 134-135, Uniform Securities Act, *supra* note 6.

Rules defining fraud when promulgated and adopted by the states usually encompass almost all acts and conduct, or any, by advisors who mismanage assets. The North American Securities Administrators Association issues a model rule defining unethical business practices, [46] indicative of conduct constituting fraud, deception or manipulation. It lists 23 prohibited acts. If something is unethical or dishonest, it should constitute fraud or deceit within the context of the statute.

Then, many states when adopting a form of this model rule, state that violation of the rule's provisions constitute grounds for discipline or disqualification of the investment advisor or investment advisor representative.[47] Some rules reference specifically what provisions conduct constitutes fraudulent conduct,[48] and other rules simply reference the listing of prohibited conduct.[49] However referenced, if prohibited by rule, a good argument exists that the enumerated conduct acts as a fraud or deceit, or alternatively, breach of fiduciary duty.

If nothing else, the model rule and the tandem state rules provide an identifiable source of prohibited conduct, not otherwise available because of the lack of a self-regulatory organization such as FINRA. For example, the model rule by NASAA lists the following as an unethical business practice:

> (a) Recommending to a client to whom investment supervisory, management or consulting services are provided the purchase, sale or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the client on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known by the investment adviser.[50]

[46] NASAA Model Rule 102(a)(4)-1, Unethical Business Practices of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers, (May 19, 2019), *at* https://s30730.pcdn.co/wp-content/uploads/2019/05/NASAA-IA-Unethical-Business-Practices-Model-Rule.pdf.

[47] *E.g.*, 15 CSR 30-51-172 Dishonest or Unethical Business Practices by Investment Advisers and Investment Advisor Representatives, p.16, *at* https://www.sos.mo.gov/cmsimages/adrules/csr/current/15csr/15c30-51.pdf (Missouri). Okla. Admin Code §660:11-7-42, at https://www.securities.ok.gov/Act-Rules/Rules.asp (Oklahoma).

[48] KAR § 81-14-5(b) Dishonest and unethical practices of investment advisers, investment adviser representatives, and federal covered investment advisers, at https://www.ksc.ks.gov/index.aspx?NID=175#R14_5 (Kansas); 7 Texas Admin. Code § 116.15 (advertising restrictions), at https://texreg.sos.state.tx.us/public/readtac$ext.TacPage?sl=T&app=9&p_dir=P&p_rloc=138481&p_tloc=&p_ploc=1&pg=8&p_tac=&ti=7&pt=7&ch=116&rl=10.

[49] 69W-600-0131 Prohibited Business Practices for Investment Advisers and Their Associated Persons, at https://www.flrules.org/gateway/RuleNo.asp?title=REGISTRATION%20OF%20DEALERS,%20INVESTMENT%20ADVISERS,%20ASSOCIATED%20PERSONS&ID=69W-600.0131 (Florida).

[50] *Supra* note 46.

Otherwise, no suitability rule exists regarding investment advisors.[51] Reference must be made to the state statutes, even for federally registered advisors. States may define what constitutes fraud and deception for registration of investment advisor representatives and enforcement actions regarding federally registered investment advisors.[52]

The state of residence of the client should be reviewed. States have become more vigilant in adopting rules regarding investment advisors and in enforcing those rules, especially with the industry's shifting business model and public focus on retirement savings.

b. Remedies

Not dissimilar to and as specific than ERISA, state security statutes provide for statutory relief other than losses. The Uniform Securities Act imposes liability an advisor as follows:

> [A] person that receives directly or indirectly any consideration for providing investment advice to another person and then employs a device, scheme, or artifice to defraud the other person or engages in an act, practice, or course of conduct that operates would operate as a fraud artist on the other person is liable to the other person. [53]

Joint and several liability exists against control persons, managing partners, executive officers and persons with a similar status,[54] and individuals who materially aid the conduct giving rise to the liability.[55] These persons may defend such liability if they "sustain the burden of proof that they "did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist.[56]

The Uniform Securities Act provides for statutory damages equal to the following:

> [T]he consideration paid for the advice and the amount of any actual damages caused by the fraudulent conduct, interest [at the legal rate of interest] from the date of the fraudulent conduct, costs, and reasonable

[51] *Cf.* Proposed Rule, Suitability of Investment Advice Provided by Investment Advisers, Investment Advisers Act Release No. 1406 (March 16, 1994), *cited by* Commissioner Louis A. Aguilar, Speech by SEC Commissioner: A Shared Responsibility: Preserving the Fiduciary Standard, note 6 (March 26, 2010) ("Investment advisers are fiduciaries who owe their clients a series of duties, one of which is the duty to provide only suitable investment advice. This duty is enforceable under the antifraud provisions of the Advisers Act, section 206, and the Commission has sanctioned advisers for violating this duty."), *at* https://www.sec.gov/news/speech/2010/spch032610laa.htm.

[52] Section 203A(b)(2), Investment Advisors Act of 1940, *supra* note 8.
[53] Section 509(e), Uniform Securities Act, *supra* note 6.
[54] Section 509(g)(1) and (2), Uniform Securities Act, *supra* note 6.
[55] Section 509(g)(3), Uniform Securities Act, *supra* note 6.
[56] Section 509(g), Uniform Securities Act, *supra* a note 6.

attorneys' fees determined by the court, less the amount of any income received as a result of the fraudulent conduct.[57]

This section will not apply against a broker-dealer if the advice is incidental to transaction business as a broker-dealer and no special compensation is received for the investment advice.[58]

c. Statutes of Limitations

Short statutes of limitations with state securities statutes cause this remedy to be less useful. Oftentimes and frequently, individuals engaging an investment advisor do so because they desire someone else manage their money, and they trust that person implicitly. These individuals infrequently review account statements and believe the investment advisor when assurances are rendered as to poor performance of an account.

Notwithstanding, the statute of limitations are shorter under the Uniform Securities Act. A person may not bring an action under these provisions "unless the action is instituted within the earlier of two years after discovery of the facts constituting the violation and five years after the violation."[59]

Unlike common law claims, tolling of the statute based on discovery and fraudulent concealment will be difficult if not unavailable to extend this statute of limitations. It acts as a statute of repose, and ample argument exists that any legislature in defining the statute displaces such common law concepts of tolling and discovery.[60] The question will be when the violation actually occurred, especially as typically an ongoing violation exists until and account closes and transfers.

5. Common Law Breach of Fiduciary Duty

Case law imposes a fiduciary duty under common law on investment advisors to their clients.[61] A fiduciary relationship is defined in Black's Law Dictionary as one "in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship."[62] A fiduciary relationship is also described as a relationship where there is a duty of trust, utmost loyalty and good faith to another. When a fiduciary relationship is deemed to be present, the law imposes an obligation to act in the best interest of the party to whom the duty is owed and to place that person's interests above the fiduciary's own interests.

a. Standards of Conduct

[57] Section 509(f)(1), Uniform Securities Act, *supra* note 6.
[58] Section 509(f)(2), Uniform Securities Act, *supra* note 6.
[59] Section 509(j)(2), Uniform Securities Act, *supra* note 6.
[60] *See SRM Global Master Fund Ltd. P'ship v. Bear Stearns Cos.*, 829 F.3d 173, 177 (2nd Cir., 2016); *P. Stolz Family P'ship v. Daum,* 355 F.3d 92, 103-04 (2d Cir. 2004).
[61] *SEC* v. *Capital Gains Research Bureau, Inc., et al.*, 375 U.S. 180 (1963);
[62] Black's Law Dictionary p. 640 (7th ed. 1999).

As a fiduciary, an investment advisor owes the client a fiduciary duty to act in the client's best interests and with the utmost care, integrity and loyalty.[63] This fiduciary duty requires advisors to manage their clients' portfolios in the best interest of clients.

Within the client's best interest, an investment advisor owes the client a duty to manage the accounts according to the individual investment needs, objectives, goals and desires for the client. This duty requires an advisor to have a reasonable basis for its recommendations meeting the client's investment needs, objectives and desires.[64] The advisor has a further duty to disclose all material facts relevant to its engagement.[65]

The Investment Advisors Act of 1940 reflects Congress's recognition of the nature of a fiduciary relationship and its intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser to act in its own interests rather than those of the client. The Commission promulgates rules establishing standards of care to which an investment advisor must adhere, including disclosures, conflicts of interests, compliance programs, codes of ethics and designating chief compliance officers,[66] among others. These rules set forth standards of care, and violation of these standards of care evidences breach of the fiduciary duty.[67]

b. Remedies

Generally, losses under common law are those losses resulting from the breach of fiduciary duty, which may or may not extend to theories of a well-managed portfolio. Notwithstanding, it may be a credibly argued that the fiduciary duty requires an advisor to manage assets according to the clients' investment needs, objectives, goals and desires for any account, which includes income or accretion in value, not just preservation of principal, or income inuring only to the benefit of the advisor.

In comparison, unlike the statutory claims, depending on the state statute, provisions may exist for punitive damages.[68] Some statue statutes exclude punitive damages from statutory damage claims. However, if the statute references such other relief as deemed appropriate, or similar language, an opportunity for punitive damages exist.

[63] *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11 (1979); *Santa Fe Industries, Inc.* v. *Stone*, 430 U.S. 462, 471, n. 11 (1977). *See also* Section 206 of the Investment Advisors Act of 1940, *supra* note 8.

[64] *In the Matter of Jamison, Eaton & Wood, Inc.*, Investment Advisors Act Release No. 2129 (May 15, 2003); *In the Matter of Mark Bailey & Co., and Mark Bailey*, Investment Advisors Act Release No. 1105 (Feb. 24, 1988); *In the Matter of Kidder, Peabody & Co., Incorporated, Edward B. Goodnow*, Investment Advisors Act Release No. 232 (Oct. 16, 1968).

[65] *Id.*

[66] *E.g.*, Rule 204A-1 Investment adviser code of ethics; Rule 206(4)-7 Compliance procedures and practices, at https://www.ecfr.gov/cgi-bin/text-idx?node=17:4.0.1.1.22&rgn=div5.

[67] *Securities and Exchange Commission v. Ralston Purina Co.* 346 U.S. 119, 126 (1953); *Securities and Exchange Commission v. Koscot Interplanetary, Inc.,* 497 F.2d 473, 479 (5th Cir. 1974).

[68] Mo. Rev. Stat. §510.263.7. *See also*, *Everett v. Pabilonia,* 526 A.2d 543, 546 (1987).

Given current public sentiment attendant to the rampant fraud and loss of investor confidence being experienced by the investing public, it may well be easily argued that strong measures should be imposed against those professionals who violate the law and trust resting with them. Hence, good grounds may exist for exemplary damages, especially given these claims may not necessarily be with FINRA's Office of Dispute Resolution.

Again, depending on state law, varying standards will exist for an award for punitive damages. Set forth below are some standards for punitive damages, which are highly summarized and should be used for comparison purposes only and further research done if such damages are to be plead:

State	**Standards**[69]
Kansas	• Willful conduct, wanton conduct, fraud or malice.[70]
Missouri	• Reckless indifference or conscious disregard for the rights of others. • Wrongdoer knew or should have known that its conduct "created a high degree of probability of injury" and "thereby showed complete indifference to or conscious disregard for the rights of others."[71]
Oklahoma	• Tiered based on level of conduct: o Guilty of reckless disregard for the rights of others; o Intentionally and with malice towards others; or o Intentionally and with malice and engaged in conduct life-threatening to humans clear and convincing evidence[72]
Texas	• Proof by clear and convincing evidence that the harm results from: (1) fraud; (2) malice; or (3) gross negligence.[73]

Especially with the advent of tort reform, the particular state statute needs to be reviewed regarding punitive damages. Additional limitations may exist on the amount or manner in which punitive damages are assessed.

[69] Standards omit level of proof, which is typically "clear and convincing evidence." Supra notes 70 through 73.
[70] K.S.A §60-3701(c)l.
[71] *Alcorn v. Union Pacific R.R. Co.*, 50 S.W.3d 226, 247 (Mo. banc 2001). *Cf. Lewellen v. Franklin*, 441 S.W.3D 136 (Mo. 2014).
[72] O.S. §23-9.1.
[73] Tex. Civ. Prac. & Rem. §41.003(1a)

c. Statute of Limitations

Breach of fiduciary duty will often have a longer statute of limitations based on a recognition that the fiduciary holds a superior position of knowledge and skill over the person to whom the duty is owed, who may not understand or comprehend that a breach of the fiduciary duty has occurred. As a result, the statute of limitations may often be extended based on various principles, whether discovery, concealment or equitable principles, unavailable under other claims, but again depending on the particular state's common law.

Set forth below is just a sampling of some of the statute of limitations for breach of fiduciary duty:

State	Statute of Limitations
Kansas	• Two years[74] • Cause of action shall not be deemed to have accrued until the act giving rise to the cause of action first causes substantial injury, or, if the fact of injury is not reasonably ascertainable until sometime after the initial act, then the period of limitation shall not commence until the fact of injury becomes reasonably ascertainable to the injured party, but in no event shall an action be commenced more than 10 years beyond the time of the act giving rise to the cause of action.[75]
Missouri	• Five years[76] • The cause of action shall not be deemed to accrue when the wrong is done or the technical breach of duty occurs, but with the damage resulting therefrom is sustained and is capable of ascertainment , and, if more than one item of damage, then the last item, so that all resulting damage may be recovered, and full and complete relief obtained. [77][78]
Oklahoma	• Two years[79]after the cause of action shall have accrued.[80] • Discovery rule delays statute until "inured party knows or, in the exercise of reasonable diligence, should have known of the injury."[81]

[74] K.S.A. §60-513(a)(4).
[75] K.S.A. §60-513(b).
[76]Mo. Rev. Stat. §516.120(4).
[77]K.S.A. §516.10.
[78] *Koester v. American Republic Investments, Inc.,* 11 F.3d 818 (8th Cir.).
[79] Okla. Stat. tit. 12, §95.A.3.
[80] Okla. Stat. tit. 12, §92.
[81] *Horton v. Hamilton*, 2015 OK 6, 345 P.3d 357, 360 (Okla., 2015) citing *Digital Design Grp., Inc. v. Info.*

State	Statute of Limitations
Texas	• Four years. [82]

These illustrations are solely for demonstrative purposes. Governing state law must be referenced

Tolling based on discovery, fraudulent concealment, equitable estoppel and other equitable doctrines will be more easily available in a claim based on breach of fiduciary duty.[83] The doctrine of fraudulent concealment tolls or suspends the running of limitations after it has begun if the facts necessary to know that a cause of action has accrued is concealed. It tolls the statute until the wrongdoing is discovered or could have been discovered with reasonable diligence.[84] Courts characterize fraudulent concealment as an affirmative defense and require it be pled accordingly.[85]

Additionally, the fiduciary relationship tilts application of the discovery rule, as an injury being inherently undiscoverable because of the relationship.[86] The courts will apply the discovery rule when it is otherwise difficult for the injured party to learn of the wrongful acts.[87]

Some courts apply an equitable tolling doctrine, which focuses on excusable ignorance of the wrongful conduct.[88] In limited instances, this equitable tolling may even toll statutes of repose.[89]

These concepts of fraudulent concealment, discovery doctrine and equitable tolling depend highly on the jurisdiction and the court's inclination. The cases cited are for reference only. Further research on current law in any particular jurisdiction must be conducted and within the facts existing.

Builders, Inc., 2001 OK 21, ¶ 17, 24 P.3d 834, 839

[82] Tex. Civ. Prac. & Rem. § 16.004(5)

[83] *E.g*., *Friedman v. Kelly & Picerne, Inc*. (R.I. Super., 2012); *Sauceda v. Kerlin*, 164 S.W.3d 892 (TX, 2005); *Niehoff v. Maynard*, 299 F.3d 41 (1st Cir., 2002)

[84] *Shell Oil Co. v. Ross,* 357 S.W.3d 8, 17 (Tex. App. 2010); *Sauceda v. Kerlin,* 164 S.W.3d 892, 917 (Tex. 2005). *See also, DeLuna v. Burciaga*, 857 N.E. 2d 229, 242-43 (Ill. 2006).

[85] *Arnold V KPMG LLP,* 543 F Supp. 230, 237 (S.D.N.Y. 2008); *Achee v. Port Drum Co.,* 197 F. Supp. 723, 737 (E.D. Tex. 2002).

[86] *West v. Proctor*, 353 S.W.3d 558 (Tex. App, 2011); *Hagney v. Lopeman,* 590 N.E.2d 466, 469 (Ill. 1992); *Vogel v. A. G. Edwards & Sons, Inc*., 801 S.W. 2d 746, 755 (Mo. App. E.D. 1990), *citing Burr v. Nat'l Life & Acc. Ins. Co*., 667 S.W.2d 5, 7 (Mo. App.1984) (relationship creates a sense of security which may be false, only actual discovery of the fraud serves to begin the period). *See also Cohen v. S.A.C. Trading Corp*., 711 F.3d 353, 363 (2d Cir. 2013) (reasonable diligence in discovery).

[87] *S.V. v. R.V*., 933 S.W.2d 1, 6 (Tex. 1996).

[88] *Cf., Rhodes v. Guiberson Oil Tools Div*., 927 F.2d 876, 878 (C.A.5 (La) 1991), *citing Felty v. Graves-Humphreys*, Co., 785 F.2d 516, 519 (4th Cir.1986).

[89] *First Interstate Bank of Denver, N.A. v. Central Bank & Trust Co. of Denver*, 937 P.2d 855, 860 (Colo. App., 1996); *Cange v. Stotler and Co., Inc*., 826 F.2d 581, 587 (C.A. 7 (Ill.) 1991), *citing Glus v. Brooklyn Eastern Dist. Terminal*, 359 U.S. 231, 232-233 (1959) (not permit a party to assert a defense if the defense would enable the party to take advantage of his own wrongdoing).

6. Conclusion

Of course, other causes of action exist including negligence and general equitable relief. These materials set forth favorite causes of action and the reasons for those favorite causes of actions, not a listing of all causes of action.

In proceeding against investment advisors, a good familiarity with the standards of conduct and the regulatory scheme becomes essential. Investment advisors act within a substantially variant framework than broker-dealers and registered representatives, or at least they are supposed to do so.

DEFENDING MOTIONS TO DISMISS FOR ELIGIBILITY AND STATUTES OF LIMITATION AS WELL AS MOTIONS TO VACATE

Sam Edwards, Stefan Apotheker, Luis Miñana

Introduction

As FINRA arbitration has become more and more favorable to customers over the last decade, respondents have attempted to find more and more ways to avoid the consequences of FINRA arbitration. This typically begins with Respondents filing Motions to Dismiss under FINRA's eligibility rule. If that does not work, Respondents often later attempt to invoke statutes of limitation as a bar to certain claims. Both eligibility motions and limitations motions are likely to increase in number as the more than decade long bull market has hidden a lot of wrongdoing from investors that will not be uncovered until the market corrects. Even surviving respondents' motion practice is often not enough, as there is a noticeable rise in respondents filing motions to vacate awards where customers win.

This article will address the issues raised and best defenses to these various strategies from respondents who are trying to avoid responsibility for wrongdoing on technical grounds when the facts and the law otherwise do not support their position.

Motions to Dismiss in FINRA Arbitration

FINRA strongly discourages the granting of motions to dismiss prior to an evidentiary hearing on the merits. FINRA has repeatedly emphasized this policy in a variety of different contexts. For example, the FINRA Arbitrator's Guide states:

> FINRA believes that parties have the right to a hearing in arbitration. Therefore, motions to dismiss filed prior to the conclusion of a party's case-in-chief are discouraged and granted only under limited circumstances.

See also, FINRA Office of Dispute Resolution Party's Reference Guide, p. 33 ("The rules 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.")

On September 26, 2007, FINRA issued a press release reiterating FINRA'S position that motions to dismiss are improper in FINRA arbitration proceedings. The September 26, 2007 press release states:

> The Financial Industry Regulatory Authority (FINRA) announced today that its Board of Governors approved rule amendments designed to limit significantly the number of dispositive motions – more commonly known as motions to dismiss – filed in its arbitration forum and to impose strict sanctions against parties who engage in abusive motions practices.

FINRA senior staff have also gone on record arguing that dispositive motions must be limited in FINRA Arbitration. "In many instances dispositive motions were being used to needlessly delay arbitration hearings, which resulted in investors not getting cases heard on a timely basis and incurring extra costs," said Linda Fienberg, President of FINRA Dispute Resolution at the time.

"We believe the proposed revisions will curb any abuses and ensure that investors maintain the right to have their arbitration claims heard."

Concurrently, FINRA also released its "Notice to Parties on Motions to Dismiss Claims Prior to Award (Dispositive Motions) under the Code of Arbitration Procedure for Customer Disputes and Industry Disputes" (hereinafter may be referred to as FINRA'S "Notice to Parties on Motions to Dismiss"). FINRA's Notice to Parties on Motions to Dismiss reinforces its position that motions to dismiss are improper in arbitration proceedings. FINRA'S Notice to Parties on Motions to Dismiss states:

> FINRA is aware that parties increasingly are filing motions to decide claims before a hearing (commonly referred to as dispositive motions) in arbitration cases. Even though nearly 90% of these motions are denied, FINRA is concerned that parties are spending additional resources to defend against these motions, thus increasing the costs and processing times of the arbitration process.
>
> The proposed amendments also would require the panel to assess against the filing party all forum fees associated with hearings on dispositive motions if the panel denies the motion, and would require the panel to award costs and attorneys' fees to the party that opposed a dispositive motion deemed frivolous by the panel ….

As a result, in attempt from a respond to seek a dispositive motion dismissing a case should be met first with FINRA's own words making it clear that such motions are strongly disfavored.

Fighting Eligibility Motions

One of the very limited grounds to dismiss a FINRA arbitration claim is that the claim is outside of the eligible time period. FINRA Code of Arbitration Rule 12206, often called "The Six-Year Rule", provides that FINRA claims must be filed within six years. More specifically, Rule 12206(a) states: "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." While the time period is very clear, "six years", when that time period begins is not as the rule offers no clear definition of what triggers the relevant "occurrence or event."

For many years, courts around the country were forced to address this issue as it was considered a "gateway" issue that must be resolved by courts, not the arbitrators since they would have no authority to rule on an issue outside of the eligible time period. The question has typically come down to whether the triggering event is the purchase of the security at issue or when the cause of action would accrue under the law. Courts were split as to when to begin the time period for FINRA's eligibility rule for decades.

Among the most notable cases, the 11th Circuit Court of Appeals addressed the issue head on in 1997. In *Kidder, Peabody & Co. v. Brandt,* a group of investors filed an arbitration claim against their brokerage firm for the brokerage firm's wrongful conduct in connection with the sale of shares in a limited partnership. *Kidder, Peabody & Co. v. Brandt,* 131 F.3d 1001, 1002 (11th Cir. 1997). The investments at issue were purchased more than six years prior to the date the investors filed their arbitration claim. *See id*. at 1002. The brokerage firm argued the investor's claim was not timely as the "occurrence or event" giving rise to the investors' claims – the purchase of the limited partnerships – did not occur within six years. *See id*. at 1002. The trial court rejected the brokerage firm's argument that the investors' claims were ineligible, and the brokerage firm

appealed. *See id*. at 1002-1003. On appeal, the brokerage firm argued that in order for the investors' claims to be eligible for arbitration, all of the predicate acts for the claim (most notably the purchase of the limited partnerships) must occur within six years of the filing of the claim. *See id*. at 1003. The appellate court expressly rejected the brokerage firm's position and held:

> we reject Kidder's interpretation of the "occurrence or event giving rise to the... claim" language of §15.[1] Instead, we hold that under § 15 the "occurrence or event" which "gives rise to the... claim" is the last occurrence or event necessary to make the claim viable. A claim is viable when all the elements of that claim can be established such that it could withstand a motion to dismiss for failure to state a claim for relief pursuant to Federal Rule of Civil Procedure 12(b)(6).
>
> *Id*. at 1004.

The appellate court further explained the reasons why the brokerage firm's reasoning is fatally flawed:

> In other instances, separate "occurrences or events" establish the various elements of a claim. For example, an action for negligence based on the defective design of a product is not viable until an injury is caused by that product. Although the duty and breach elements of such a claim are established by the company's act of marketing the product, that act does not establish the causation and injury elements of the claim. The incident in which the product causes injury, not the company's act of marketing a defective product, is the "occurrence or event which gives rise to the ... claim" within the meaning of §15. Hypothesizing some dates for the occurrences or events in this example reveals the flaw in Kidder's position. Suppose that the company marketed the defectively designed product in year one and that, as a result of that defective design, the product caused injury in year eight. **Under Kidder's theory, even if a claimant filed an arbitration complaint the moment after his or her claim arose-the moment after he or she was injured-the claim would be ineligible for arbitration. We decline to adopt an interpretation of §15 that would render some claims ineligible for arbitration before they even come into existence.**
>
> *Id*. at 1004. (Emphasis added.)

The *Brant* Court is not along in finding that the purchase date is not necessarily the appropriate date for the "occurrence or even." *See, e.g., Osler v. Ware*, 114 F.3d 91 (6th Cir. 1997)("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.").

In another 11th Circuit Court of Appeals case, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cohen*, the same court again decided the purchase date is not controlling. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cohen,* 62 F.3d 381 (11th Cir. 1995). In *Cohen*, an investor filed an

[1]The §15 referenced is from the predecessor to Rule 12206(a) from the NASD Code of Arbitration Procedure. While there have been many changes to the Code since the transition from the NASD to FINRA, the language for the eligibility rule has been consistent for decades with the only change being language concerning who decides eligibility.

arbitration claim against his brokerage firm for, among other things, fraud, misrepresentations and material omissions in connection with the various investments. *See id.* The brokerage firm filed a court action seeking to enjoin the investor's arbitration claim on the ground that the investor's claims were purportedly ineligible for arbitration because the investments at issue were purchased more than six years prior to the filing of the arbitration. *See id*. at 382. The trial court ruled in favor of the investor and the brokerage firm appealed.

When rejecting the brokerage firm's argument, the *Cohen* court held:

> It is not a foregone conclusion, however, that the purchase date is the relevant occurrence or event giving rise to the Cohens' claims, as neither §15 nor any other provision of the NASD Code so provides... For example, with respect to the Cohens' claim for breach of fiduciary duty... each misrepresentation might be an event or occurrence giving rise to a claim for breach of fiduciary duty.

Id. at 383.

In addition to the above, a number of other courts across the nation have come to the same conclusion. *See e.g., FSC Sec. Corp. v. Freel*, 811 F.Supp. 439 at 444 (D. Minn. 1993), ("It has been determined that the purchase date is not the event or occurrence that gave rise to this dispute. Also, Section 15 does not refer specifically to the purchase date as the time that the six year limitation begins to run..."); *EQ Financial Consultants, Inc. v. Blackward*, 1998 WL 1989710 (Mich.App. 1998)("We reject petitioners' argument that the six-year eligibility period imposed by this rule can accrue only on the date that the relevant securities are purchased."); *Equity Securities Trading Co., Inc. v. Gillan*, 1997 WL391794 at *3 (M.D. Fla. 1997)("Plaintiffs maintain that Defendants' claims are 'unsuitability of purchase' claims whereby the events or occurrences should be considered the investment dates… [t]his Court refuses to interpret 'events or occurrences' in this fashion. First, the plain meaning of the words 'events or occurrences' is not limited to 'purchase date'. The drafters could have used 'purchase date' if 'purchase date' is what they meant... Second, and more important... 'events or occurrences' are not limited to the purchase date of the stock in dispute, and allowed for the possibility of events other than the purchase date to trigger the beginning of the six year limitation under Section 10304 of the NASD Code [now FINRA Rule 12206]..."); *Mid-Ohio Securities Corp. v. Estate of Burns*, 790 F.Supp.2d 1263 at 1271 (D. Nev. 2011)("[c]ourts have recognized that the relevant event or occurrence from which the time period begins to run is not necessarily the purchase or sale of securities."); *Gibraltar Securities Co. v. Bitter*, 1997 WL 728086 (M.D. Fla.1997)("Defendant argues that Plaintiffs... Mismanaged the accounts by investing in unsuitable securities… lulled Clients into buying and holding the following investments by Rosenberg's statements that the investments were safe... Defendant's Statement of Claim adequately sets forth events or occurrences, other than the purchase date, that took place within the six years."); *Hantz Financial Services, Inc. v. Monroe*, 2012 WL 205830 (Mich. App. 2012)("Similar to this case, the investor seeking arbitration was alleging wrongful acts that occurred after the date of the initial investment... Thus, there is no merit to Hantz Financial's assertion that it is an obvious error of law to hold that the date of an 'occurrence or event' under Rule 12206 is anything other than the date of investment."); and *Smith Barney Inc. v. Vogele,* 967 F.Supp. 165 (E.D.Va.,1997)("Significantly, circuit courts of appeal outside of the Fourth Circuit, have rejected a per se rule that the 'occurrence or event' giving rise to a dispute is always the purchase of an investment product... 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.")

While there is ample law to support the argument that the purchase date is not the only date that should be considered, other courts, however, came to the opposite conclusion. For example, respondents often cite *Edward D. Jones v. Sorrells*, 957 F.2d 509 (7th Cir. 1992) to support that the purchase date is the relevant date for determining the "occurrence or event." Brokerage firms also often rely on *Merrill Lynch v. Jana*, 835 F.Supp. 406 (N.D. Ill. 1993) and *Mutual Service Corp. v. Spaulding*, 871 F.Supp. 324 (N.D. Ill. 1994) to argue the purchase date is controlling.

This split in authority made it very difficult to determine whether claims were eligible for arbitration in many instances. The split in authority eventually drew the attention of the Supreme Court. In *Howsam v. Dean Witter Reynolds*, the Supreme Court ruled that the arbitrators, not the courts, should resolve the eligibility issue for FINRA cases. 537 U.S. 79, 123 S.Ct. 588 (2002). Specifically, the Supreme Court found "applicability of the NASD time limit rule is a matter presumptively for the arbitrator, not for the judge." Id. at 85. According to the Supreme Court, "the NASD arbitrators, comparatively more expert about the meaning of their own rule, are comparatively better able to interpret and to apply it." *Id*.

As a result of *Howsam*, the eligibility issue is now determined by FINRA arbitrators, not a court. FINRA Rule 12206 was updated to reflect this change, with the rule now stating explicitly "The panel will resolve any questions regarding the eligibility of a claim under this rule." FINRA Rule 12206(a). Nevertheless, brokerage firms have challenged that authority in the past, but not with any meaningful success. *See, e.g., Oshidary v. Purpura-Andriola*, 2012 WL 2135375 (N.D.Cal. 2012) ("**The Panel was free to interpret Rule 12206 as it saw fit, in particular with respect to the triggering date, i.e. the 'occurrence or event giving rise to the claim**.'... the Panel believed the triggering event was a 2006 board meeting 'in which the claimant's were informed that their loans and monetary investments into the company weren't worth anything.' ... It was not manifest disregard of the law to so find. **There is no 'well defined, explicit, and clearly applicable' law regarding whether the trigger date must be the date of investment**.")(Emphasis added.)

Federal courts are reluctant to rely upon cases pre-dating *Howsam* for this very reason. In *Mid-Ohio Securities Corp.*, the court reviewed the historic circuit split concerning whether the six year rule was a substantive or procedural issue limiting a customer's right to arbitrate and/or recover. 790 F. Supp. 2d at 1271. However, the court then noted that the split had been affirmatively decided by the Supreme Court in *Howsam.* 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).

Still, even after *Howsam*, brokerage firm continue to often argue that the "occurrence or event giving rise to the claim" is the purchase of the security at issue. The problem with that argument is obvious: the rule does not mention "purchase date" and, in fact, the Code of Arbitration for Industry Disputes uses the exact same language. FINRA cannot have meant for the purchase date to be the triggering event since it used the same language where that would clearly be an inapplicable standard. See, Industry Code of Arbitration Procedure Rule 13206. Rather, most arbitrators accept that the "occurrence or event" is the accrual of the cause of action or, alternatively, when the investor "knew or should have known" of the claims.

The basic argument is that no "injury" occurred at the time of purchase and therefore it cannot be the triggering event as no cause of action has accrued at that point in time. This concept is perhaps best articulated by the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*, where the Supreme Court held:

> First, as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss because the inflated purchase price is offset by ownership of a share that possesses equivalent value at that instant.
>
> *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 367 125 S. Ct. 1627, 1628 (2005).

Alternative to the argument that the "accrual" date begins the eligibility period, the time when the investor "knew or should have known" (the discovery rule) is also an acceptable basis for extending out the claim. Most torts, such as negligence, breach of fiduciary and fraud, have limiations that are based on when the claims was discovered, or at least discoverable, not at the time of the actual wrongdoing. Need cites outside of PR. See, e.g., *Rishell v. Medical Card System, Inc.,* 982 F.Supp.2d 142 (D.Puerto Rico 2013)(Under Puerto Rico law, former chief executive officer's (CEO) cause of action alleging misrepresentation by corporation accrued, and one-year statute of limitations began to run on date CEO knew or should have known of the alleged misrepresentation.); *Salgado v. Piedmont Capital Corp.,* 534 F.Supp. 938 (D. Puerto Rico 1981)(Under federal securities laws... the cause of action accrues, when plaintiff knew or through the exercise of reasonable diligence should have known of the alleged fraud.")

Along with courts accepting this analysis, FINRA supports it as well. FINRA has clearly and consistently stated that claims arising from misconduct occurring *after* the date of purchase may be the relevant occurrence or event giving rise to a claim, regardless of whether the investments at issue were purchased more than six years prior to the filing of the claim.
For example, the FINRA Arbitrator's Guide explicitly states that investors may bring arbitration claims for wrongful conduct that occurred within the six year eligibility period, in connection with securities that were purchased well beyond the six year eligibility period. FINRA describes this fairly common scenario as a "continuing occurrence or event" under FINRA 12206, and provides the following explanation:

> 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.
>
> FINRA "Arbitrator's Guide" at p. 2-3, November 2018.

Under the current FINRA Code of Arbitration Procedure, eligibility motions are determined by the arbitrators. Previously, however, the NASD Director of Arbitration – FINRA's predecessor – was tasked with determining eligibility motions. NASD Directors consistently held that the purchase date was not the triggering point for the "occurrence or event" under the Code. *See* NASD Private Letter Rulings (Cases No. 91-01780 and 91-01781)("It has been determined that the purchase date is *not* the event or occurrence that gave rise to this dispute. Also, Section 15 does not refer specifically to the purchase date as the time that the six year limitation begins to run.")(Emphasis added.); *See also*, NASD Private Letter Rule (Case No. 90-01342)("Please be advised that the Director of Arbitration has reviewed and reconsidered the motion to dismiss... the decision to deny this motion stands. It has been determined that the purchase date is *not* the event or occurrence

that gave rise to this dispute. Also, section 15 does not refer specifically to the purchase date as the time that the six-year limitation begins to run.")(Emphasis added.)

Moreover, the NASD was specifically asked to review and amend the eligibility rule to specify that the eligibility rule is based upon the purchase or sale of the security at issue; the NASD explicitly declined.

> 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, and now FINRA, 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. FINRA's guidance, policies and interpretations of its own rules provide clear evidence that the purchase date does <u>not</u> automatically trigger the eligibility period.

Fighting Statutes of Limitations

Even if a case remains after a Rule 12206 challenge, brokerage firms often later argue that the applicable statutes of limitations have passed and, as a result, the claim should be dismissed. Rule 12206 specifically says that it "does not extend applicable statutes of limitations …." Rule 12206(c). That rule necessarily then begs the question: what limitations apply to a FINRA arbitration hearing.

While some states have said the limitations used in court also apply to arbitrations in their state, a number of others have explicitly said statutory and common law limitations periods used in court do not apply to arbitrations. Others have language in their statues of limitations that appear to limit their applicability to court actions. Regardless, it can be argued that the FINRA Rules proscribe the longer period of time, six years, and that is the agreement of the parties.

The basic argument is that arbitration is a creature of contract that is not governed by traditional rules of procedure. Rather, the parties have agreed that FINRA rules, not the rules of any particular state, will apply to the hearing. Effectively, the six-year eligibility rule operates as a modification to the general statutes of limitation. There is nothing unusual or inappropriate in parties agreeing to change a statute of limitation, as many states allow the parties to litigation to make such agreements. For example, under Texas law, parties can legally change the statute of limitations through contract, including their arbitration agreement. *See EZ Pawn Corp. v. Mancias*, 934 S.W.2d 87, 89, 40 Tex.Sup.Ct.J. 104 (Tex. 1996) and *In Re Luna*, 2004 Tex. App. Lexis 8241, 21 I.E.R. Ca. (BNA) 1353 (Tex. App. – Hous.[14th Dist.], September 9, 2004.

Moreover, it makes perfect sense that the statute of limitations for a securities arbitration is six years. The primary reason for statutes of limitation is the fear that evidence will become stale or destroyed if too much time is allowed to pass. *See Pearson v. Exxon Corp*., 2000 U.S. App. Lexis 25473 (6th Cir., 10/4/2000, filed). As there are no national standards for keeping documents, it is reasonable that statutes of limitation be only a few years, allowing potential defendants to legally throw away evidence in the normal course of business without fear of a spoliation claim. However, there are very particular standards on the type of documents brokerage firms must keep and rules requiring the records be kept for generally 6 years. *See* SEC Rules 17a-3 and 17a-4. As a result, a modification of the general statute of limitations that correlates with the time period documents must be preserved is certainly a reasonable interpretation of the six-year eligibility rule.

Additionally, since the remedies and causes of action available in arbitration are different than those available in court, it stands to reason that arbitration needs its own statute of limitation to apply to those claims. The most obvious example is a claim based on a violation of SRO rules. Brokerage firms often include boilerplate language in answers stating the typical defense that violations of SRO do not form the basis of a cause of action. However, FINRA has made it clear, through the statements of Linda Feinberg and others, that violations of SRO rules are actionable in NASD cases.[2] Accordingly, since there is the ability to recover damages in arbitration that might be otherwise unavailable, at a minimum, the six-year rule should work as the statute of limitation for those claims.

The brokerage firm's defense to the six-year eligibility rule being the appropriate statute of limitation for FINRA claims is almost universally the language contained in the Code which states "[t]his Rule shall not extend applicable statutes of limitations …." FINRA Rule 12206(c). The two basic defenses to this argument are (1) a reading of 12206(c) from a statutory constructionist standpoint clearly demonstrates the language is not meant to apply to the six-year rule and (2) normal statutes of limitation to not apply to arbitration and therefore the language is irrelevant.

Rule 12206 has three sections discussing eligibility and statutes of limitation in FINRA arbitration. *See* FINRA Rule 12206. It is important to read these sections together to determine how they interact. Specifically, section (a) discusses the eligibility rule and defines the time period for bringing a FINRA complaint. Section (b) discusses the movement of a case from arbitration to court. Section (c) then follows to discuss the opposite situation, moving a case from court to arbitration. It is no accident that the phrase "shall not extend applicable statutes of limitation" is contained in section (c), just after a discussion of removing a case to court. Clearly, FINRA was seeking to clarify that when a case has been removed to court, the six-year rule no longer applies.

Since this can be a confusing argument, it is imperative that you carefully explain it to the panel. The best way to convey the point to a panel is to put the rule in front of them and ask the panelists to look at it. On its face, the argument logically and visually makes sense by the simple organization of the rule. Then, the point can be brought to the panel by asking: If the part of the rule stating it "shall not extend applicable statutes of limitations" applied to Section (a), why is it included in section (c)? Presumably, the drafters of the FINRA Code could have easily included this term as a part of section (a). However, because FINRA's intent was clearly to speak only about the ramifications of the rule when the case is removed to court, they placed it as far from section (a) as possible.

[2]At the First NASAA Arbitration Forum, held 7/20/04 at the National Press Club in Washington, D.C., Linda Fienberg represented that one of the benefits of arbitration is that "in NASD SRO arbitration, unlike in court, you get an equitable result. You do not have to have a claim that is cognizable under state or federal law. It can be cognizable under NASD rules."

The second contention to make to the panel is the often-used argument that statutes of limitation do not apply to arbitrations. The issue of whether statutes of limitation should even apply to arbitration hearings has been the subject of endless debate. Arbitration is considered to be an equitable forum in which a panel has great latitude to ignore harsh legal strictures in order to achieve justice and fairness. As a result, applying absolute deadlines to filing claims is seemingly inconsistent with arbitration itself.

As discussed above, the FINRA Code states that the rule does not extend the "*applicable* statutes of limitations." FINRA Rule 12206(c) (*emphasis added*). Brokerage firms have a habit of leaving out the term "applicable" in their arguments as it begs the question of whether any statutes of limitation apply to FINRA arbitrations.

In Texas, the fact that state statutes of limitation do not apply to arbitration proceedings is demonstrated in the use of the word "suit." For example, the statute providing for the four-year limitations period reads, "[a] person must ***bring suit*** on the following actions not later than four years after the day the cause of action accrues…" Tex. Civ. Prac. & Rem. Code Ann. § 16.004 (Vernon 2005) (emphasis added). Under Texas law, bringing suit and initiating arbitration have been viewed as separate and distinct concepts for 150 years. In 1855, the Texas Supreme Court stated, "[t]he words *court* and *suit* have a distinct meaning, and suggest a very different idea from arbitrators and arbitration. These words have been understood and construed in the connection in which they are used to mean either the District Court or that of a justice of the peace, as the case may be." *Yarborough v. Leggett*, 1855 WL 4956 (Tex. 1855). Indeed, it is commonly accepted black-letter law that "suit" connotes "any proceeding by a party or parties against another *in a court of law*." Black's Law Dictionary (8th ed. 2004)(emphasis added). Arbitration does not take place within the state's established judicial system, and traditional rules of civil procedure do not apply to arbitration proceedings. As a result, Texas statutes of limitation should not bar arbitration claims because they only serve to bar *suits* which are filed in courts of law after the given time period.

While this may seem too legalistic an interpretation of the statute, it is consistent with interpretation of statutory law in other jurisdictions. In California, for example, the statute of limitations reads differently, providing that "[t]he periods prescribed for the commencement of *actions* … are as follows." Cal. C.C.P. § 335 (West 2005) (emphasis added). "Actions," as defined under the California C.C.P. are "an ordinary proceeding *in a court of justice*…" Cal. C.C.P. § 22 (West 2005) (emphasis added). Clearly, California statute of limitation periods only govern the administration of justice by the courts, and are, by their own terms, inapplicable to arbitration.[3] As in Texas, statutory limitations periods should not bar claims in arbitration in California.

Colorado has similar issues. In Colorado, the fact that state statutes of limitation do not apply to arbitration proceedings is demonstrated in the use of the word "action." Under Colorado law, a "statute of limitation pertains to the remedy only. Its essential attribute is to limit the time within which an ***action*** may be brought." *Industrial Com'n of Colo. v. Weaver***,** 81 Colo. 191, 254 P. 444 (Colo. 1927). As an example, the Colorado statute providing for the two-year limitations period reads, "[t]he following ***civil actions***, regardless of the theory upon which suit is brought, or against whom suit is brought, shall be commenced within two years after the cause of action accrues, and not thereafter" C.R.S.A. § 13-80-102(1) (emphasis added). The Colorado Supreme Court

[3]Several states have statutes of limitation provisions similar to California's, which provide limits on "actions." For a comprehensive list of cases in which courts have ruled that arbitration proceedings did not constitute "actions," and thus statutes of limitation were not applicable, see *Statute of Limitations as a Bar to Arbitration Under Agreement*, 94 A.L.R.3d 533 (2004).

has held that, a “civil action” is “a proceeding on the part of one person, as actor, against another, for the infringement of some right of the first, ***before a court of justice***, in the manner prescribed by the court or law.” *Hernandez v. Downing*, 154 P.3d 1068, 1070 (Colo. 2007) (citing *Clough v. Clough,* 10 Colo.App. 433, 439, 51 P. 513, 515 (1897)) (emphasis added). Indeed, it is commonly accepted black-letter law that “action” connotes “any proceeding by a party or parties against another *in a court of law*.” Black’s Law Dictionary (8th ed. 2004) (emphasis added).

Some other state courts have come to the same conclusion. The Connecticut Supreme Court in *Skidmore v. Connecticut General Life Ins. Co.,* stated that “Arbitration is not a common-law action, and the institution of arbitration proceedings is not the bringing of an action under any of our statutes of limitation.” 25 Conn. Supp. 76, 85, 197 A.2d 83 (Conn. Supp. Ct. 1963). Further, the *Skidmore* Court continued, “there appears to be no sound reason, in the absence of an express statutory provision, for including an arbitration proceeding within the type of actions intended to be encompassed within the bar of the Statute of Limitations.” *Id*. In *Lewiston Firefighters Ass’n v. Lewiston*, 354 A.2d 154 (Me. 1976), the Maine Supreme Court pointed out that arbitration is not an action at law, and that a six-year statute of limitations was not an automatic bar to a claim by a firefighters' association to backpay under the contractual parity pay provisions of a collective bargaining agreement containing arbitration procedures.

The court in *Har-Mar, Inc. v. Thorsen & Thorshov, Inc*., 300 Minn. 149, 155, 218 NW.2d 751 (1974), held that in view of the special nature of arbitration proceedings and the statutory and common-law meaning of the term “action," the six-year statute of limitations was not intended to bar arbitration of the defendant's fee dispute solely because such claim would be barred if asserted in an action in court. The court noted that the statutory term "action" in the sense of a judicial proceeding includes recoupment, counterclaim, setoff, suit in equity, and any other proceeding in which rights are determined. *Id.* at 152. The court further noted that the few Minnesota cases which have attempted a common-law definition of the term "action" have restricted it to the prosecution in a court of justice of some demand or assertion of right by one person against another, the court stated that it thus appeared that the six-year statute of limitations, both by statutory definition and at common law, was intended to be confined to judicial proceedings. *Id.* at 152–53.

It is important to note to the arbitration panel that such an interpretation of the eligibility rule serves the customers and brokerage-dealers in securities arbitration evenly. Investment firms and broker-dealers bring claims in arbitration, just as customers do, and may benefit from not having their potential claims time-barred by statutes of limitation.

Fighting Motions to Vacate

There has been a noticeable increase in the number of Motions to Vacate that brokerage firms have filed against successful FINRA arbitration participants. PIABA members need to become better informed at how to fight against these motions.

The Federal Arbitration Act (“FAA”) was enacted to combat the judicial hostility towards arbitration that had historically existed. *See Hall Street Assocs. v. Mattel, Inc*., 552 U.S. 576, 581 (2008). When brokerage firms file baseless Motions to Vacate, they are hoping that remaining judicial hostility towards arbitration will favor them. However, the law will not.

Courts have repeatedly held judicial review of an arbitration award “is severely circumscribed.” *Apex Plumbing Supply, Inc. v. U.S. Supply Co.*, 142 F.3d 188, 193 (4th Cir. 1998). “A court sits to determine only whether the arbitrator did his job—not whether he did it well, correctly, or

reasonably, but simply whether he did it." *U.S. Postal Serv. v. Am. Postal Workers Union*, 204 F.3d 523, 527 (4th Cir 2000). "Indeed, the scope of review of an arbitrator's valuation decision is among ***the narrowest known at law*** because to allow full scrutiny of such awards would frustrate the purpose of having arbitration at all--the quick resolution of disputes and the avoidance of the expense and delay associated with litigation." *Apex Plumbing Supply,* 142 F.3d at 193 (emphasis added). The strict deference courts owe to arbitrators applies to factual findings as well as legal determinations. *See Wells Fargo Advisors, LLC v. Watts*, 540 Fed. Appx. 229, 231 (4th Cir. 2013).

Most importantly, the limited review afforded arbitration awards means that courts cannot overturn awards, even when the court vehemently disagrees with the award. "The FAA notably does not authorize a district court to overturn an arbitral award just because it believes, however strongly, that the arbitrators misinterpreted the applicable law. When parties consent to arbitration, and thereby consent to extremely limited appellate review, they assume the risk that the arbitrator may interpret the law in a way with which they disagree. Any more probing review of arbitral awards would risk changing arbitration from an efficient alternative to litigation into a vehicle for protracting disputes." *Wachovia Sec., LLC v. Brand*, 671 F.3d 472, 478 n.5 (4th Cir. 2012) (internal citations omitted).

Moreover, courts have very little to address given FINRA arbitrators rarely give any reason for their award. *See Stroh Container Co. v. Delphi Industries, Inc*., 783 F.2d 743, 750 (8th Cir. 1986) ("In the case before us, the arbitrators' decision does not clearly delineate the law applied, nor expound the reasoning and analysis used. Rather, the award presents…'only a cursory discussion of what the arbitrators considered to be the key points underlying the award.' It therefore cannot be said that it clearly appears that the arbitrators identified applicable law and proceeded to reach a contrary position in spite of it."). It is well-settled that arbitrators are not required to disclose the basis upon which their awards are made and courts will not look behind the award in an attempt to analyze their reasoning process. *See MCI Constructors, LLC v. City Of Greensboro*, 610 F.3d 849, 863 (4th Cir. 2010) (*citing United Steelworkers of Am. v. Enter. Wheel & Car Corp*., 363 U.S. 593, 598 (1960)); *see also Remmey v. PaineWebber, Inc*., 32 F.3d 143, 151 (4th Cir. 1994) ("[A]rbitrators need not state reasons for reaching a particular result").

It is important to note that the burden of proof is on the party seeking to vacate an arbitration award, not on the panel or the party seeking confirmation, and that burden is a "heavy burden" to meet. *See Henry M. Jackson Found. for the Advancement of Military Med., Inc. v. Norwell, Inc.,* 596 F. App'x 200, 201 (4th Cir. 2015). When the asserted basis for vacating an award is manifest disregard of the law, the burden of proof is no less stringent. "In making a claim based on 'manifest disregard,' an appellant once again ***shoulders a heavy burden."*** *Remmey*, 32 F.3d at 149 (emphasis added).

While there is some question after the Hall Street decision whether manifest disregard remains a viable basis to vacate an arbitration award, to the extent it remains, the standard is a high one. *See Wachovia*, 671 F.3d at 481 n.7 (describing the circuit split post *Hall Street*). First, manifest disregard requires "the applicable legal principle [be] clearly defined and not subject to reasonable debate." *Brand*, 671 F.3d at 483. If the legal rule at issue is not "clearly defined" and without any "reasonable debate", there is no reason to go further as manifest disregard cannot apply. However, even if the issue respondent has raised is clearly defined and recognized, there are a number of other elements that must be met.

> [A]n arbitration award is enforceable even if the award resulted from a misinterpretation of law, faulty legal reasoning or erroneous legal conclusion, and

> ***may only be reversed when arbitrators understand and correctly state the law, but proceed to disregard the same.*** A court's belief that an arbitrator misapplied the law will not justify vacation of an arbitral award. Rather, ***a party seeking vacatur must show that the arbitrators were aware of the law, understood it correctly, found it applicable to the case before them, and yet chose to ignore it in propounding their decision***. If an arbitrator, for example, ***stated the law, acknowledged that he was rendering a decision contrary to law, and said that he was doing so because he thought the law unfair, that would be an instance of manifest disregard***.

Hilb Rogal & Hobbs Co. v. Golub, 2006 U.S. Dist. LEXIS 58214, 5 (E.D. Va. Aug. 18, 2006) (internal citations omitted) (emphasis added).

It is not enough for the parties to have just briefed the issues correctly, either. In *Holden v Deloitte & Touche LLP*, the court stated "If party's briefing of 'correct' legal rules (as that party saw them) and panel's failure to apply that party's 'correct' legal rules were enough to qualify as 'manifest disregard' under 9 USCS § 10(a)(4), then repeated teaching of precedent, that even gross errors of fact or law are inadequate to vacate arbitral award, would mean nothing." *Holden v Deloitte & Touche LLP*, 390 F. Supp. 2d 752 (ND Ill. 2005). Rather, "the plaintiff must show that the arbitrator was 'aware of the law, understood it correctly, found it applicable to the case before [him], and yet chose to ignore it in propounding [his] decision.'" *Weirton Med. Ctr. v. Quorum Health Res., LLC*, 734 F. App'x 896, *3 (4th Cir. 2018) (*citing Remmey v. PaineWebber, Inc*., 32 F.3d 143, 149 (4th Cir. 1994).

In the end, the law is clear, "[m]isapplication or misconstruction of the law does not constitute manifest disregard." *Jones v. Dancel*, 792 F.3d 395, 402 (4th Cir. 2015). Arbitrators sit to provide a fair resolution and are given great discretion as to how to achieve that result.

Conclusion

Although FINRA has worked hard to effectively get rid of motion practice in FINRA arbitrations, it still exists and is likely to be prolific when the next economic downturn arrives. Moreover, given the results of FINRA arbitration are becoming fairer, it is equally likely that brokerage firms will turn to the courts in an attempt to vacate arbitration awards. It is important to be ready for these issues as they are sure to be important in the coming years.

BUSINESS DEVELOPMENT COMPANIES – THE BASICS

Christine Lazaro[1]

Business Development Companies ("BDCs") are a type of closed end fund. They were created by Congress in 1980, through amendments to the Investment Company Act of 1940 (the "1940 Act").[2]

BDCs were first created when a venture capital pool manager lobbied Congress to make it easier to invest in venture capital pools and private equity investments.[3] While there was early interest in BDCs, their popularity waned through the 1990s.[4] Since 2000, they have once again regained their popularity.[5]

BDCs provide funding to small and mid-sized businesses. Following the financial crisis, BDCs were able to provide loans to businesses that may not have been able to receive financing from more traditional sources.[6] In 2009, the first non-traded public REITs were issued, raising almost $100 million that year.[7]

This article will describe the regulations that govern BDCs: federal, state, and SRO. Next, the article will examine recent enforcement actions concerning the sale of BDCs by broker-dealers. Finally, the article will discuss concerns raised by the sale of non-traded BDCs to investors.

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[2]Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477,94 Stat. 2275 (1980).

[3]*See* Matt Forstenhausler, Rob Meiner, and Eyal Seinfeld, "Business development companies: history, operational, accounting and tax considerations"; EY (2016), https://www.ey.com/Publication/vwLUAssets/EY-business-development-companies-history-operational-accounting-and-tax-considerations/$File/EY-business-development-companies-history-operational-accounting-and-tax-considerations.pdf.

[4]*Id.*

[5]*Id.*

[6]*Id.*

[7]Bruce Kelly, "Nontraded BDC Sales in Worst Year Since 2010," Investment News (Nov. 22, 2017), https://www.investmentnews.com/article/20171122/FREE/171129954/nontraded-bdc-sales-in-worst-year-since-2010.

I. BDC Structure and Regulation

a. Federal Securities Acts

BDCs are defined in the 1940 Act as closed end funds that meet certain criteria.[8] BDCs must elect to be regulated by the SEC as a business development company,[9] and are restricted in terms of the types of investments the fund may make, with at least 70% of the fund assets invested in "eligible" assets.[10] Eligible assets may include "a domestic issuer that either does not have any class of securities listed on a national securities exchange, or has a class of equity securities listed on a national securities exchange, but has an aggregate market value of outstanding voting and non-voting common equity of less than $250 million."[11]

BDCs must register their securities with the SEC under the Securities Exchange Act of 1934.[12] BDCs may be public exchange traded or non-traded securities, or they may be offered as private offerings. As public companies, BDCs are still required to make the appropriate filings with the SEC on a regular basis whether they are traded or non-traded.[13]

b. Internal Revenue Code

BDCs may elect to be treated as a "regulated investment company" ("RIC") under the Internal Revenue Code.[14] To qualify as an RIC, the BDC must meet three main requirements. First, the BDC must derive at least 90% of its income from dividends, interest, gains from the sale or exchange of securities and other qualifying income associated with the business of investing in securities.[15] Second, BDCs must invest at least 50% of its assets in cash items, securities of other RICs, government securities or other securities. However, any investment in any one security may not exceed 5% of the BDC's total assets, and may not be more than 10% of the outstanding voting shares of any single issuer.[16] A BDC may not invest any more than 25% of its assets in (1) any single issuer (other than US Government securities or other RICs); (2) any two or more issuers controlled by the BDC and engaged in the same or similar businesses; or (3) one or more "qualified publicly traded partnerships."[17] Finally, the BDC must distribute at least 90% of its

[8] 15 U.S.C.A. § 80a-2(48).

[9] 15 U.S.C.A. § 80a-53.

[10] 15 U.S.C.A. § 80a-54.

[11] Kevin Mahn, "The ABCs of Business Development Companies", Forbes (Dec. 1, 2014), https://www.forbes.com/sites/advisor/2014/12/01/the-abcs-of-business-development-companies/#523304f969db.

[12] 15 U.S.C.A. § 80a-53.

[13] *See supra* note 3. A BDC may register as a private placement as well; however, this paper will focus on public BDCs.

[14] 26 U.S.C.A. § 851.

[15] 26 U.S.C.A. § 851(b)(2).

[16] 26 U.S.C.A. § 851(b)(3)(A).

[17] 26 U.S.C.A. § 851(b)(3)(B).

annual taxable income to shareholders as dividends.[18] The benefit of qualifying as an RIC is the exemption of corporate level taxes.

c. FINRA Rules

Under the FINRA rules, BDCs are regulated as Direct Participation Plans or Programs ("DPPs").[19] DPPs are any "program which provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution. . ."[20] There are a number of different types of DPPs, including MLPs and REITs.

Broker-dealers are not permitted to underwrite or participate in a public offering of a BDC unless certain conditions have been met, including both the BDC and the broker-dealer establishing suitability standards; the broker-dealer making certain disclosures; and the BDC having reasonable expenses.[21] These conditions are described in further detail below.

The BDC itself must have established standards of suitability which are disclosed in the program's prospectus.[22] In addition to the broad suitability requirements contained within FINRA Rule 2111, a broker must also satisfy the stricter suitability rules for selling non-traded DPPs if recommending a non-traded BDC, which may go beyond those set forth by the BDC itself. [23] For example, the broker must have reasonable grounds to believe that the customer is "in a financial position appropriate to enable him to realize to a significant extent the benefits described in the prospectus, including the tax benefits where they are a significant aspect of the program;" and that the customer has the net worth to sustain the level of risk in the BDC, including the loss of the investment and the lack of liquidity.[24] There is also a books and record requirement; the broker must maintain documents that explain how suitability was determined for each customer.[25]

If a broker-dealer is planning on participating in a public offering of a BDC, it must "have reasonable grounds to believe, based on information made available to him by the sponsor through a prospectus or other materials, that all material facts are adequately and accurately disclosed and provide a basis for evaluating the program."[26] The broker-dealer must receive at a minimum, facts relating to: "(i) items of compensation; (ii) physical properties; (iii) tax aspects;

[18]26 U.S.C.A. § 852.

[19]Investopedia, "Direct Participation Program (DPP)", https://www.investopedia.com/terms/d/dpp.asp.

[20]FINRA Rule 2310.

[21]FINRA Rule 2310(b).

[22]FINRA Rule 2310(b)(2)(A).

[23]FINRA Rule 2310(b)(2)(B).

[24]*Id.*

[25]*Id.*

[26]FINRA Rule 2310(b)(3).

(iv) financial stability and experience of the sponsor; (v) the program's conflict and risk factors; and (vi) appraisals and other pertinent reports."[27]

When recommending the purchase of a BDC, the broker must tell the customer "all pertinent facts relating to the liquidity and marketability of the program." [28] Pertinent facts include whether the sponsor of the BDC has offered prior programs that had a planned liquidation date and whether the prior programs actually liquidated during that time period.[29]

Brokers are also required to consider the expenses of the BDC if it is participating in the underwriting or public offering of the program. Brokers may not participate if the organization and offering expenses are not fair and reasonable.[30] FINRA provides guidance for firms, explaining that the expenses are unfair and unreasonable if: (i) the organization and offering expenses exceed 15% of the gross offering amount; (ii) total compensation exceeds 10% of the proceeds; (iii) compensation is to be paid out of the proceeds of the offering before the proceeds are released from escrow; (iv) compensation includes any of the following: a percentage of the management fee, a profit sharing arrangement, brokerage commissions, an over-riding royalty interest, a net profits interest, a percentage of revenues, a reversionary interest, a working interest, a security or right to acquire a security having an indeterminate value; (v) the program charges to reinvest dividends; or (vi) firms are reimbursed for due diligence expenses no included in a detailed and itemized invoice.[31]

FINRA also restricts the non-cash compensation that a broker or broker-dealer may receive for selling BDCs. FINRA does permit the following types of non-cash compensation: (i) gifts that do not exceed $100 and are not conditioned on achievement of a sales target; (ii) an occasional meal or event ticket so long as they are not frequent or extensive; and (iii) payment for training or educational meetings so long as attendance is not conditioned on achievement of a sales target and the location is appropriate for the purpose of the meeting – meaning it cannot be in an exotic locale.[32]

FINRA has also expressed concerns about the valuation of BDCs on customer account statements. In 2014, FINRA filed a proposed rule change with the SEC to address this issue.[33] In October 2014, the SEC approved the proposal.[34] In its approval, the SEC stated:

[27]FINRA Rule 2310(b)(3)(B).

[28]FINRA Rule 2310(b)(3)(D).

[29]*Id.*

[30]FINRA Rule 2310(b)(4)(A).

[31]FINRA Rule 2310(b)(4)(B).

[32]FINRA Rule 2310(c)(2).

[33]Securities Exchange Act Release No. 71545 (Feb. 12, 2014), 79 FR 9535 (Feb. 19, 2014) (Notice of Filing of Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities).

[34]Securities Exchange Act Release No. 73339 (Oct. 10, 2014), 79 FR 62489 (Oct. 17, 2014) (Order Approving SR-FINRA-2014-006, as Modified by Amendment No. 1).

> The proposal, as amended, is designed to address longstanding concerns with the current industry practice of displaying a DPP [BDC] or REIT security's immutable offering price as its per share estimated value on customer account statements throughout the offering period (which can last several years), despite the fact that the value of the DPP [BDC] or REIT security fluctuates. FINRA's proposed rule change would require members to include in customer account statements per share estimated values of unlisted DPP [BDC] and REIT securities that are developed in a manner reasonably designed to ensure they are reliable. The Commission believes that the proposal would, therefore, greatly improve the accuracy and transparency of the value of DPP [BDC] and REIT securities and, in turn, better protect the investing public.[35]

Under the amended rule, firms may only report values of BDCs based on one of two methodologies: (1) the net investment value; or (2) the appraisal value. The net investment methodology provides that, within 150 days of the second anniversary of the program breaking escrow, the firm may use the "net investment" value disclosed by the issuer's most recent periodic or current report.[36] For the appraisal value methodology, the firm may use a per share estimated value reflecting an appraised valuation disclosed in the issuer's most recent periodic or current report, which is consistent with the valuation requirements of the 1940 Act and the rules thereunder."[37]

In addition to the new valuation methodologies, broker-dealers also have new disclosure obligations. If the firm is using the "net investment" methodology, the firm must include the following statement: "IMPORTANT—Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement." [38] The broker-dealer must also disclose that the BDC is "not listed on a national securities exchange, are generally illiquid and that, even if a customer is able to sell the securities, the price received may be less than the per share estimated value provided in the account statement."[39]

Although the rule amendment was approved in October 2014, it was not effective until April 11, 2016.[40] As a result of this amendment, non-traded BDCs were revalued on customer account statements by April 2016, sometimes resulting in sharp drops in their valuations, which had been otherwise consistent since purchase.

[35] *Id.* at 62491.

[36] FINRA Rule 2231(c)(1)(A).

[37] FINRA Rule 2231(c)(1)(B).

[38] FINRA Rule 2231(c)(2).

[39] *Id.*

[40] FINRA Reg. Notice 15-02, "DPP and Unlisted REIT Securities; SEC Approves Amendments to FINRA Rule 2310 and NASD Rule 2340 to Address Values of Direct Participation Program and Unlisted Real Estate Investment Trust Securities" (Jan. 2015), http://finra.complinet.com/net_file_store/new_rulebooks/f/i/FINRA_Notice_15-02.pdf.

d. NASAA Guidance

NASAA, the North American Securities Administrators Association, “formulates Model Rules and Statements of Policy for implementation by its members as an ongoing priority to promote and encourage uniformity among its members in the interest of investor protection and to provide a regulatory framework for responsible capital formation.”[41] Although NASAA has not adopted a Statement of Policy specifically for BDCs, it has adopted Omnibus Guidelines, which apply to any securities for which NASAA has not developed a specific policy statement.[42]

The Omnibus Guidelines set forth a number of requirements that must be met for a BDC to comply with state blue sky laws. For example, the Omnibus Guidelines mandate a minimum amount of experience that a Sponsor of the BDC must have.[43] The Sponsor must have “at least three years relevant experience demonstrating the knowledge and experience to acquire and manage the type of assets being acquired.”[44] With respect to net worth, the Sponsor must a net worth that is the greater of either (i) $100,000, or (ii) 5% of the first $20 million of this offering and any DPP offerings within the prior 12 months, and 1% of any amount in excess of $20 million.[45]

[41]NASAA, “Regulatory Policy”, https://www.nasaa.org/policy/regulatory-policy/.

[42]NASAA, “Omnibus Guidelines” (May 7, 2007), https://s30730.pcdn.co/wp-content/uploads/2011/07/f-Omnibus_Guidelines.pdf.

[43]Sponsor is defined within the Omnibus Guidelines as:

> Any PERSON directly or indirectly instrumental in organizing, wholly or in part, a PROGRAM or any PERSON who will control, manage or participate in the management of a PROGRAM, and any AFFILIATE of such PERSON. Not included is any PERSON whose only relation with the PROGRAM is that of an independent manager of a portion of PROGRAM assets, and whose only compensation is as such. "SPONSOR" does not include wholly independent third parties such as attorneys, accountants, and underwriters whose only compensation is for professional services rendered in connection with the offering of PROGRAM INTERESTS. A PERSON may also be deemed a SPONSOR of the PROGRAM by:
>
> > (a) taking the initiative, directly or indirectly, in founding or organizing the business or enterprise of the PROGRAM, either alone or in conjunction with one or more other PERSONS;
> > (b) receiving a material participation in the PROGRAM in connection with the founding or organizing of the business of the PROGRAM, in consideration of services or property, or both services and property;
> > (c) having a substantial number of relationships and contacts with the PROGRAM;
> > (d) possessing significant rights to control PROGRAM properties;
> > (e) receiving fees for providing services to the PROGRAM which are paid on a basis that is not customary in the industry; or
> > (f) providing goods or services to the PROGRAM on a basis which was not negotiated at arm's length with the PROGRAM.

Omnibus Guidelines I.B.27.

[44]Omnibus Guidelines II.A.

[45]Omnibus Guidelines II.B.

The Omnibus Guidelines also set forth program suitability requirements, requiring that investors have (i) a minimum annual income of $70,000 and a minimum net worth of $70,000; or (ii) a minimum net worth of $250,000.[46]

Both the Sponsor and the broker must determine that the BDC is a suitable and appropriate investment for the investor.[47] The suitability requirements are similar to those set forth by FINRA Rule 2310. Either the Sponsor or the broker must determine that the prospective investor (i) meets the minimum income and net worth standards; (ii) can benefit from participation in the program; (iii) is able to bear the economic risk of the investment; and (iv) understands the risks of the investment, including that the investor may lose their investment, the lack of liquidity, the restrictions on transferring the BDC, and the tax consequences.[48]

The Omnibus Guidelines also set forth content requirements and restrictions with respect to the BDC's subscription agreements. For example, the Sponsor may require that an investor make the following representations in the subscription agreement: (i) the investor meets the income and net worth standards; (ii) the investor has received a copy of the prospectus; and (iii) the investor knows the investment is illiquid.[49]

The Sponsor may not require that investor make any representations which are "subjective or unreasonable" that would cause the investor to believe they have given up rights they have under federal or state law, or shift the burden to determine suitability to the investor.[50] Additionally, the Sponsor may not require that the investor make any of the following representations: (i) the investor understands or comprehends the risks associated with the investment; (ii) the investment is suitable; (iii) the investor has read the prospectus; or (iv) the investor relied solely on the prospectus and not any representations from any person (such as the broker).[51]

Finally, Sponsors may earn reasonable management compensation, however, for BDCs, such compensation is limited to participation of net gains.[52]

Many states' blue sky regulations contain an explicit adoption of the NASAA Statements of Policy. For example, Kansas adopted the Omnibus Guidelines as well as a number of other statements.[53] Certain states, including Kansas, have also adopted additional suitability requirements:

> In addition to the income and net worth standards and other suitability requirements contained within the NASAA guidelines and statements of policy adopted under subsection (b), the administrator may require that the registration

[46]Omnibus Guidelines III.B.1.

[47]Omnibus Guidelines III.C.1.

[48]Omnibus Guidelines III.C.2.

[49]Omnibus Guidelines III.D.2.

[50]Omnibus Guidelines III.D.4.

[51]Omnibus Guidelines III.D.5.

[52]Omnibus Guidelines IV.D.2.(a).

[53]Kan. Admin. Regs. 81-7-2(b)(10).

> statement include a statement that recommends or requires each purchaser to limit the purchaser's aggregate investment in the securities of the issuer and other similar investments to not more than 10 percent of the purchaser's liquid net worth. For purposes of this subsection, liquid net worth shall be defined as that portion of the purchaser's total net worth that is comprised of cash, cash equivalents, and readily marketable securities, as determined in conformity with GAAP.[54]

It is important to check the relevant state's blue sky regulations to determine whether the NASAA Omnibus Guidelines apply to the purchase of a particular BDC.

II. BDC Enforcement Actions

There are not many enforcement actions related to the sale of BDCs due to their relatively recent increase in popularity. However, in 2016, FINRA issued a targeted examination letter seeking information from firms regarding their sales of non-traded BDCs and their due diligence practices.[55] FINRA requested information about the BDCs each firm sold; the firm's role in the offering; which other broker-dealers had selling agreements for the BDCs; how many customers purchased the BDC; and the firm's due diligence procedures.[56] Additionally, in 2014, FINRA conducted a review of firms selling non-traded REITs and BDCs to ensure customers had received volume discounts.[57] FINRA has not released the results from these examinations and reviews.

In addition to the targeted examinations and reviews, FINRA has also fined several firms for their BDC sales practices. Two FINRA enforcement actions focused on issues with concentration limits. First, FINRA fined Berthel Fisher $775,000 in part because it did not have adequate procedures to ensure the firm complied with concentration levels for BDCs. Berthel did not appropriately identify BDCs as alternative investments for purposes of calculating the account concentration levels. [58] It also did not train its supervisory staff to analyze state suitability standards.[59]

FINRA also fined LPL $950,000 in part for failing to have adequate procedures to ensure the firm complied with both internal concentration limits, as well as limits set by the BDCs or the states.[60]

[54]Kan. Admin. Regs. 81-7-2(c).

[55]FINRA, "Targeted Examination Letter on Non-Traded Business Development Companies" (Aug. 2016), http://www.finra.org/industry/non-traded-business-development-companies.

[56]*Id.*

[57]FINRA, NAC Decision Enforcement No: 2014042291901- Gopi Krishna Vungarala, 11 (Oct. 2, 2018), http://www.finra.org/sites/default/files/NAC_2014042291901_Vungarala_100218_0.pdf.

[58]FINRA, Letter of Acceptance, Waiver and Consent No. 2012032541401 - Berthel Fisher & Company Financial Services, Inc. and Securities Management & Research, Inc. (Dec. 2013), http://www.finra.org/sites/default/files/fda_documents/2012032541401_FDA_DM7X1975.pdf.

[59]*Id.*

[60]FINRA, Letter of Acceptance, Waiver and Consent No. 2011027170901 – LPL Financial LLC (Jan. 2014), http://www.finra.org/sites/default/files/fda_documents/2011027170901_FDA_D823266.pdf.

LPL was also fined by the Arkansas Securities Commissioner because it inconsistently classified non-traded BDCs and REITs as equities rather than alternative investments.[61]

The final case concerns sales of non-traded REITs and BDCs to a Native American Tribe. With respect to the firm, FINRA found that:

> FINRA found that from July 2011 through at least January 15, 2015, Vungarala was the tribe's PKS registered representative and also the tribe's Treasury Investment Manager responsible for managing the tribe's investment portfolio. PKS failed to adequately review the risks inherent in that relationship or establish procedures designed to mitigate the risks. FINRA found that as a result of these supervisory failures, Vungarala was able to misrepresent to the tribe that neither PKS nor he would receive commissions on its purchases, and he was therefore able to induce the tribe to invest more than $190 million in non-traded REITs and BDCs. In fact, Vungarala personally received at least $9 million in commissions from the tribe's investments.
>
> FINRA also found that PKS failed to identify that more than 200 of the tribe's purchases were eligible for discounts based on the volume of the purchases. FINRA found that Vungarala's commissions would have been reduced to approximately $6 million if the tribe received the volume discounts for which it was eligible; however, Vungarala misrepresented to PKS that the tribe did not want to receive the volume discounts. PKS failed to take reasonable steps to verify this statement even after it received inquiries about the missed discounts from a REIT issuer and FINRA staff.
>
> In addition, FINRA found that, between April 2009 and October 31, 2014, PKS failed to maintain and enforce an adequate supervisory system and written supervisory procedures to ensure compliance with the securities laws and FINRA rules when it sold non-traded REITs and BDCs. PKS did not have procedures that were reasonably designed to identify accounts that were eligible for volume discounts, and did not provide any guidance to its representatives or supervisors regarding how to ensure that the sales volume discounts were applied appropriately.[62]

FINRA fined the firm $750,000 and ordered restitution in the amount of $3,373,303.68.[63] Additionally, FINRA barred the broker for the fraudulent misrepresentations and omissions he made with respect to his receipt of commissions on the trades, and the Tribe's eligibility to receive

[61] *In the Matter of LPL Financial LLC*, Case No. S-16-0069, Arkansas Securities Commissioner (Jan. 2019), http://www.securities.arkansas.gov/!userfiles/LPL%20Financial%20LLC%20S-16-0069-19-OR02(1).pdf.

[62] FINRA, "FINRA Orders Purshe Kaplan Sterling Investments to Pay $3.4 Million in Restitution to Native American Tribe; Firm Also Fined $750,000 for Failures to Supervise" (Feb. 22, 2017), http://www.finra.org/newsroom/2017/finra-orders-purshe-kaplan-sterling-pay-34-million-native-american-tribe; FINRA, *Dep't of Enforcement v. Purshe Kaplan Sterling Investments and Gopi Krishna Vungarala*, Disciplinary Proceeding No. 2014042291901, Order Accepting Offer of Settlement (Feb. 21, 2017), http://www.finra.org/sites/default/files/PKSI_action_022217.pdf.

[63] *Id.*

volume discounts.[64] FINRA also ordered that the broker disgorge the $9,682,629 he received in commissions on the trades.[65]

III. BDC Concerns

Non-traded BDCs raise many of the same concerns as non-traded REITs. BDCs are structured very similarly to REITs, both a form of DPP. They have high costs, liquidity concerns, and transparency issues.[66] BDCs are raising less money each year. When non-traded BDCs were first sold in 2009, they raised almost $100 million.[67] The following year, sales more than tripled to $369 million. Non-traded BDCs hit their peak in 2014, raising $5.5 billion. In 2016, non-traded BDCs raised $1.5 billion. For the first nine months of 2017, non-traded BDCs raised only $624 million.

Non-traded BDCs, like non-traded REITs have high expenses. Broker-dealers may receive 10% of the offering proceeds for selling shares,[68] making them a very lucrative investment for the firm. Under the FINRA rules, the startup costs are considered unreasonable if they exceed 15%, so it is not unusual to see such high levels of initial expenses. This means that for a $10 investment, only $8.50 is being invested.

When FINRA changed the statement valuation rules in 2016, this affected both non-traded BDCs and non-traded REITs. Overnight, investors saw the values of their holdings decline, sometimes dropping 15% or more. In anticipation of this rule change, "shareholders withdrew $25.7 million from non-traded BDCs in the second quarter of 2015 and another $47.3 million in the third quarter."[69] Some BDCs, such as Business Development Corp. of America, froze redemptions.[70] Both non-traded BDCs and REITs also suffer similar liquidity concerns. They do not trade on an exchange, so beyond the redemption programs offered by the BDC itself, there may be limited opportunities to sell shares on a secondary market. As stated above, the redemption programs are also often subject to suspension. The BDCs often hold illiquid investments, so there are limitations on redemptions built into the prospectus. Accordingly, if a BDC suspends redemptions, investors may be stuck holding the BDC for years.

[64] *See supra* note 57 at 44.

[65] *Id.*

[66] Daniel Kurt, "What Are Nontraded BDCs?," Investopedia (Oct. 24, 2018), https://www.investopedia.com/articles/retirement/051616/what-are-nontraded-bdcs-and-should-you-stay-away-them.asp.

[67] Bruce Kelly, "Nontraded BDC Sales in Worst Year Since 2010," Investment News (Nov. 22, 2017), https://www.investmentnews.com/article/20171122/FREE/171129954/nontraded-bdc-sales-in-worst-year-since-2010.

[68] *Id.*

[69] *Id.*

[70] *Id.*

Non-traded BDCs may also retain discretion as to the payment of interest. While BDCs are obligated to pay out 90% of their taxable income to retain their status as RICs, if it is an unprofitable year, there may be no income to pay out. Distributions may be suspended, leaving investors with an illiquid investment that is not generating any yield at all.

CONCLUSION

BDCs have been around for decades, but they were not used much during the 1990's and only recently have surged in popularity. Although BDCs are closed-end funds, they are very similar to non-traded REITs. As the recent enforcement actions demonstrate, non-traded BDCs and non-traded REITs raise many of the same concerns. Although they may appear to be high yield investments, they come with a lot of risks.

Representing Institutional Investors in FINRA Arbitration

MODERATOR – DAVID MILLER, SHEPHERD, SMITH, EDWARDS & KANTAS

PANEL – JAMES SWANSON – FISHMANHAYGOOD, LLP

JASON BURGE - FISHMANHAYGOOD, LLP

Discussion Map

- Institutions in FINRA Arbitration
  - Eligibility for arbitration
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- Filing the Claim
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- Trying and Settling the Case
  - Getting ready for trial
  - Getting authority to settle

Institutions in FINRA Arbitration

HOW AND WHY TO PURSUE FINRA ARBITRATION

FINRA Rule 12200

Parties must arbitrate the dispute under the Code if:

- Arbitration under the Code is either:
  - (1) Requested 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 Code Arb. Proc. 12200

FINRA Rule 12200

"issuers are customers of their underwriter when the underwriter recommended a swap transaction."

Ross Sinclaire & Associates v. Premier Sr. Living, LLC, No. CIV 11-5104 YGR, 2012 WL 2501115, at *2 (N.D. Cal. June 27, 2012)).

"The FAA thereby places arbitration agreements on an equal footing with other contracts, and requires courts to enforce them according to their terms."

Rent-A-Center, W., Inc. v. Jackson, 130 S. Ct. 2772, 2776 (2010)(citing Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 443 (2006); Volt Info. Sci., Inc. v. Bd. of Trs. of the Leland Stanford Junior Univ., 489 U.S. 468, 478 (1989)).

FINRA Rule 12200

"There is a strong federal policy encouraging the expeditious and inexpensive resolution of disputes through arbitration." Metz v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 39 F.3d 1482, 1488-89 (10th Cir. 1994). See Southland Corp. v. Keating, 465 U.S. 1, 10 (1984) ("Congress declared a national policy favoring arbitration."); Hill v. Ricoh Ams. Corp., 603 F.3d 766, 771 (10th Cir. 2010)("[T]he FAA is a „congressional declaration of a liberal federal policy favoring arbitration agreements.‟")(quoting Moses H. Cone Mem‟l Hosp. v. Mercury Constr. Corp., 460 U.S. at 24). Congress enacted the FAA with the express purpose of granting arbitration agreements the same enforceability as any other contract provision. See Volt Info. Scis., Inc. v. Bd. of Trs. of the Leland Stanford Junior Univ., 489 U.S. at 474 (stating that Congress designed the FAA to "overrule the judiciary‟s longstanding refusal to enforce agreements to arbitrate and place such agreements upon the same footing as other contracts").

Exceptions

"Golden Empire's claims are inextricably linked to the Broker-Dealer Agreements and cannot escape application of the Forum Selection Clause. Though Golden Empire argues that its breach of fiduciary duty, fraud, and negligent misrepresentation claims arise solely out of the Underwriter Agreements, even a cursory review of the Statement of Claim reveals that assertion to be false. Golden Empire"s FINRA action hinges on Goldman"s placement of "cover bids" to support ARS auctions in its role as broker-dealer. .... Thus, the Court concludes that the entirety of Golden Empires dispute with Goldman arises from the Broker-Dealer Agreements and is subject to the Forum Selection Clauses limiting jurisdiction to the Southern District."

Goldman, Sachs and Co. v. Golden Empire Schools Financing Authority, 922 F. Supp. 2d at 443-44 (citations omitted).

Why FINRA Arbitration?

Institutional Customers Like Arbitration in some circumstances:

- Private Forum:
  - Minimized concerns with investors and donors;
  - Shields internal personnel involved in critical decision;
  - Even a loss has minimal disclosure about allegations, facts and reasons for a loss.
- Less Discovery:
  - Still robust documents discovery;
  - No depositions and no interrogatories reduces the burden on personnel.

Getting the Client

PREPARATION IS KEY

Getting the Client

- Client Expectations
  - Detailed Legal Theory
  - Application Legal Theory to Institutions Experience/Facts
  - Damages Analysis
  - Strengths and Weaknesses of Case
  - Experience and Qualifications of Legal Team
  - Litigation Expectations
    - Cost
    - Time Commitment
    - Settlement Expectations

Getting the Client

- Institutions have much more exposure in bringing litigation:
  - Relationships with business partners;
  - Negative publicity;
  - Risk of loss is much higher;
  - Distraction from normal operations.
- Highlight the advantages of FINRA arbitration.
- Managing Expectations from the start is critical:
  - You will be held to account for your initial analysis when it is time to settle;
  - Institutions will not agree to more resource commitment than initially agreed upon.

Getting the Client

Identifying Allies:

- Who are the internal people that benefit from litigation?
  - Those who can recommend seeking a recovery with little risk to themselves,
  - Those who can personally benefit from a recovery for the institution,
  - Those who want to do the “right thing” for their shareholders, investors, donors, constituency,
  - Those who feel betrayed by the member firm.
- Internal Allies are key:
  - Will help get the client;
  - Will help coordinate discovery;
  - Will give you access to witnesses;
  - Will help getting authority to settle.

Getting the Client

Identifying Roadblocks:

- Who are the personnel with exposure to litigation?
  - Who has a personal relationship with respondent;
  - Who looks bad for falling for a scam or being misled;
  - Who will bear the burden of the demands of litigation.

Drafting the Claim

NOT A TYPICAL SUITABILITY CASE

Drafting the Claim

- Arbitrators will hold institutions to a higher standard in pleadings,
  - Must specify allegations that support causes of action;
  - No suitability claims, no equitable claims ;
  - For certain institutions contextualize the damages for the arbitrators;
    - 5,000 Pensioners are at risk of reduced benefits,
    - 100 fewer hospital beds,
    - 5 fewer snowplows on the roads.
- Do not run away from sophistication. Make sophistication an ally in your case. “With proper disclosure, institutional investor would have the experience and ability to analyze the risk, protect itself and mitigate damages.”
- Don’t tip your hat as to who the key players are or who the decision makers are.

Amending the Claim

- Arbitrators will hold institutions to their pleadings,
  - Amend the pleadings quickly as new facts are discovered during the litigation,
  - Don’t wait until the pre-hearing brief to outline your case for the first time,
  - Don’t plead fraud or conspiracy without a very good basis,
  - Don’t call out individuals with respondents unless necessary.

Discovery

SUBSTANTIALLY MORE WORK

Discovery

- Much more laborious process:
  - Put out litigation hold immediately, (Respondent will scream if documents are not preserved);
  - Get document retention policy;
  - Get internal Organizational Chart;
  - Put together an internal team at the institution to gather discovery;
  - Identify where documents are;
    - Warehouses
    - Old computers
    - Tape drives
    - Basements
    - Third party custodians (accountants, lawyers, financial advisors).

Discovery

- E-Discovery (applies for both Claimants and Respondents):
  - Document production is orders of magnitude larger than typical case;
  - Need robust E-discovery platform;
  - Need Organizational Charts from Respondents;
  - Focus on custodians and search terms (this will be the fight).
- Work rapidly so that you can do multiple rounds of discovery requests.
- Understand privilege rules and roles of prior attorneys to ensure proper claims for privilege and creation of privilege logs. (Arbitrators will require this for institutional clients).

Prepping For Trial

WITNESSES

Witnesses

- Institutional Clients Have Substantially More Witnesses
  - Turnover means key client witnesses no longer available;
  - Relevant client witnesses may not be friendly (allegiance to Respondent or worried about looking bad);
  - Witnesses likely have no personal stake in the outcome,
    - More worried about looking bad if testimony goes poorly;
    - Don't necessarily care about client getting a recovery;
  - More Client witnesses means more opportunity for them to contradict one another.

Prepping Witnesses

- Need to Start Very Early on Prepping Witnesses
  - Witnesses need to be given detailed understanding of the case;
    - The allegations likely involves only one aspect of their job function;
    - They might only understand a piece of the allegations (individual witnesses don't have the big picture);
    - Recollections get fuzzy. Will need to spend lots of time on their documents;
  - Client witnesses need to fit prep and testimony into their workday. Need to start early and often to ensure that you spend enough time with them.
  - If you are playing into Institutional Client sophistication, witnesses have to come across as competent and knowledgeable.
  - Need to find something to get the witnesses mad so that they care about the case.

Settlement

MEET THE BOARD

Getting Authority

- Need constant communication with the clients especially the “allies” on the status of the case;
  - No surprises for your allies,
  - You need to make your allies look good throughout the process;
  - Need their endorsement on any settlement recommendation;
  - Allies need to prep you for any roadblocks with the decision makers.

Getting Authority

- Will need detailed memorandums for the decision makers (board of directors) outlining;
  - What Discovery has shown;
  - Outlook for the case;
  - Positive or negative developments;
  - Damages reports;
  - Authority you are seeking and reasoning.
- Prepare to be grilled. Many questions about the benefits/damages of settling. Might have more to do with internal politics than benefit to the institution.

Evaluation of ARS Issuances and Possible Loss Recovery Options

[redacted]

Samuel B. Edwards &
David W. Miller

[redacted]

Legal analysis of [redacted] options to take legal action against investment banks who promoted issuing auction rate securities and entering into related derivative transactions.

8/20/2013

Presented By:

SHEPHERD SMITH EDWARDS & KANTAS
A SECURITIES LAW FIRM

And

GENERAL PROPOSAL

It is our collective firms' proposal that [redacted], by and through the [redacted], bring an arbitration claim before the Financial Industry Regulatory Authority, Inc. ("FINRA") against the underwriters and broker-dealers who recommended issuing Auction Rate Securities ("ARS") and also entering into related interest rate swaps. The underwriter/broker-dealer respondents would include at least [redacted]

The claim would be premised on the fact that the underwriters and broker-dealers recommended to [redacted] to issue ARS with the representation that the auction rate market allowed issuers to sell long-term debt at short-term rates. Additionally, swap agreements were entered into in conjunction with the ARS using an index that was meant to mirror the auction rate market, thereby supposedly creating a synthetic fixed rate security that would allow [redacted] to issue bonds at below market rates. In reality, there is undeniable evidence that the entire ARS market was a fraud perpetrated by the major underwriters and broker-dealers. Specifically, the underwriters and broker-dealers were manipulating the auction process, which would not exist but for their undisclosed "support bids." When the "support bids" were pulled, the ARS market collapsed. The argument is had [redacted] known that the entire ARS market was a fraud, it would not have agreed to issue ARS, or enter into swap agreements based on an ARS index.

As a result of the mass fraud of the ARS market, [redacted] and related issuers have sustained substantial damages. Damages relating to the fraudulent structuring and sale of the ARS securities can be measured in a number of ways. First, as the associated swaps were an essential piece of an integrated transaction, and because the benefits of those transactions were predicated on a manipulated market, the swap transactions should be unwound. This measure of damages essentially equals the swap termination costs, which are very large, and projected to remain so for the foreseeable future. Additionally, when the ARS market collapsed, many of the issuers were forced to pay the "Maximum Rate" on their bonds, which were often as high as 20%. Moreover, because the swaps did not perform as represented during the tumultuous 2008 and 2009 time period, many issuers paid high floating rates on their bonds and high fixed rates on their swaps, while they received very low floating rate payments from the swaps. The net effect was large overpayments that lasted more than a year, and to a smaller extent continued to the present and will likely continue into the future. Lastly, many of the ARS issuers were forced to restructure their bonds into daily or weekly remarketing structures, which have very high maintenance costs that will last until maturity.

FIRMS' AND ATTORNEYS' EXPERIENCE

The team of attorneys includes seasoned litigators, arbitration attorneys and former Wall Street insiders with decades of experience in representing parties in large and complex cases, and specifically securities disputes. Additionally, the attorneys work with a network of firms across the country making the team capable of handling cases of any size and in any jurisdiction.

[redacted]

Shepherd, Smith, Edwards & Kantas, LLP

SSEK is a Houston based law firm with a national practice focused on securities matters. In particular, SSEK and its attorneys specialize in representation of customers in arbitrations before the Financial Industry Regulatory Authority ("FINRA"). Many of the attorneys and staff members are former Wall Street professionals. The firm has more than 100 years of combined experience in securities law and the securities business.

- Sam Edwards has spent more than a dozen years exclusively representing investors, institutions and public entities against Wall Street. Mr. Edwards' particular area of practice focuses on representing parties in complicated securities transactions, including representing issuers against investment banks. He is a lecturer and author of numerous articles published in bar journals and the Practicing Law Institute's materials on securities arbitration. Mr. Edwards is licensed to practice law in Texas, Michigan and California, as well as numerous federal courts across the country.

- David Miller is a former investment bank insider who worked with a number of Wall Street firms before becoming an attorney. After receiving his economics degree from Vanderbilt University, Mr. Miller worked as a bond trustee in the trust departments of J.P. Morgan Chase, the Bank of New York and Wells Fargo. During that time, he worked with billions-of-dollars of Collateralized Debt Obligations ("CDOs") and related derivative contracts, including large swaps. Mr. Miller also worked with Citigroup's investment bank and BP oil negotiating Master ISDA Agreements and natural gas trading agreements while attending law school. He now works exclusively on complex securities matters for investors and issuers. Mr. Miller is licensed to practice law in Texas and Florida.

THE AUCTION RATE CASE

Prior to the financial crisis in 2008, which was largely created by Wall Street financial engineering of needlessly sophisticated products, underwriter/broker-dealers recommended to many municipalities that they issue as a part of their bond structures an instrument called an Auction Rate Security. ARS were supposed to give municipal issuers the benefit of financing long-term debt at short-term prices.

In simplest terms, instead of trading over-the-counter, like most bonds, ARS went to periodic auctions, typically seven days for municipal issues, whereby the rate the issuer would pay for the following week was set through a Dutch Auction, while the principal always traded at par. Because of the short reset dates and the supposed liquidity at par, ARS rates historically trended at or near short-term commercial paper rates.

From the municipality's point of view, ARS provided the opportunity to issue long-term debt, but to pay only a short-term interest rate. From the underwriter/broker-dealers' point of view, ARS represented an opportunity for substantial ongoing fees whereby the underwriter/broker-dealers and their various arms played permanent roles (such as Auction Agent) that would allow the underwriter/broker-dealers to continue to collect fees throughout the life of the ARS. However, it was represented to municipal issuers that, even with those ongoing fees (typically in the 25 basis point range), the "all-in" rate municipal issuers would pay would still be less than if the debt were more traditional fixed or floating long-term debt.

Since ARS were, by their nature, variable rate instruments, underwriter/broker-dealers often proposed to municipal issuers that interest rate swaps, and other derivative investments, be purchased in conjunction with the issuance of the ARS. These derivative investments were sold either as a hedge against rising interest rates for a part of the issuance or, more commonly, as a way to create a synthetic fixed rate on an otherwise variable interest bond. The index generally used as variable component was the SIFMA index, which was supposed to track the ARS municipal market within one or two basis points or some percentage of LIBOR, also represented to track ARS interest rates.

In order for ARS to work, a successful auction must take place, which requires that there are sufficient bidders at each auction to purchase the bonds for those seeking to sell their ARS. When there are not enough bidders, the auction "fails." From an issuer's standpoint, the failed auction results in the issuer being forced to pay a penalty rate, called the "maximum rate." For most municipal issuers, that rate was substantially above market, as high as 20% for some municipalities. The principal behind the maximum rate is that it would attract sufficient bidders to make the next auction clear. However, the maximum rate could substantially increase the costs for issuers. Nevertheless, the ARS market was represented as being robust and fluid and that there had rarely been a failed auction, therefore appearing to be low risk to issuers.

However, that representation was false. The fact that failures were an increasing possibility was well known by the underwriters and broker-dealers as far back as February 2005, when PricewaterhouseCoopers first changed the accounting treatment of ARS from cash equivalents to short-term securities. The rest of the "Big Four" accounting firms followed suit thereafter.

The basis of the change in accounting was a change in the definition of "cash equivalents" that ARS clearly did not meet. Specifically, the Statement of Financial Accounting Standard 95, Statement of Cash Flows ("SFAS 95"), was issued by the Financial Accounting Standards Board ("FASB") to achieve better disclosure of information related to cash flows for customers. SFAS 95 defines cash equivalents as "short-term, highly-liquid investments that are both a) readily convertible to known amounts of cash, and/or b) so near their maturity that they present insignificant risk of change in value." Since ARS were not readily convertible to cash, as they are dependent on an auction system – i.e., a sale to another investor. Moreover, SFAS 95 states "only investments with original maturities of three months or less qualify under that definition."

As a result of this accounting change, many large corporate holders of ARS, who typically had been the majority holders, began to leave the ARS market in favor of instruments that could be held on the books as cash or a cash equivalent. Nevertheless, with full knowledge of the above, underwriters and broker-dealers continued to recommend to municipalities they issue more ARS debt so that the large fees attached to ARS would remain.

In 2006, the Securities Exchange Commission ("SEC") announced the institution of proceedings against 15 broker-dealer firms[1], for engaging in illegal practices in the auction rate securities market. The firms consented to the entry of an SEC cease-and-desist order providing for censures, undertakings, and more than $13 million in penalties.

In announcing the settlement, the SEC said that "investors may not have been aware of the liquidity and credit risks associated" with ARS because of the bid rigging of the various firms. Of course, the issuers were also unaware of this bid rigging. The SEC found that, between January 2003 and June 2004, each firm engaged in practices that were not adequately disclosed, which constituted violations of the securities laws.

This bid rigging included intervening in auctions by bidding for a firm's proprietary account or asking customers to make or change orders in order to prevent failed auctions, to set a "market" rate, or to prevent all-hold auctions; submitting or changing orders, or allowing

[1] Bear, Stearns & Co., Inc.; Citigroup Global Markets, Inc.; Goldman Sachs & Co.; J.P. Morgan Securities, Inc.; Lehman Brothers Inc.; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Morgan Stanley & Co. Incorporated/ Morgan Stanley DW Inc.; RBC Dain Rauscher Inc.; A.G. Edwards & Sons, Inc.; Morgan Keegan & Company, Inc.; Piper Jaffray & Co.; SunTrust Capital Markets Inc.; Wachovia Capital Markets, LLC; and Banc of America Securities LLC. *See* SEC Release No. 34-53888 (May 31, 2006) (Administrative Proceeding No. 33-8684).

customers to submit or change orders, after auction deadlines; having an express or tacit understanding to provide certain customers with higher returns than the auction clearing rate; and providing certain customers with information that gave them an advantage over other customers in determining what rate to bid. By engaging in these practices, the SEC found that the firms violated Section 17(a)(2) of the Securities Act of 1933, which prohibits material misstatements and omissions in any offer or sale of securities. According to the SEC, because of the brokerage firms' bid rigging, the "true liquidity risks, volatility and fragmented nature of this market was not made clear to issuers or investors."[2]

Around the same time the major brokerage firms were sanctioned, institutional investors significantly increased their exit from the auction rate securities market. At the end of 2006, institutional investors held about 80% of all ARS, according to Treasury Strategies, a consulting firm in Chicago. In comparison, just one year later, at the end of 2007, institutional investor ownership of ARS had fallen to just 30%. A huge percentage of the institutional dumping of ARS occurred in the latter half of 2007, when institutional investors shed $98 billion in ARS, forcing the firms to purchase the excess or, alternatively, allow the auctions to fail.

During this time, ARS became more of a managed bidding system rather than a true auction. More and more, the firms stepped in to make the system work, distorting the normal price discovery of a true independent auction. More importantly, the firms, failed to disclose the significantly increasing risk that the underwriters and/or other broker-dealers might stop this support and the disproportionate impact this would have on ARS, bringing a grinding halt to the entire process and forcing issuers to pay enormous penalty rates, far in excess

In the Fall of 2007, the stresses on the auction market began to show. In August 2007, roughly $6 billion in ARS failed, which accounted for almost 5% of the ARS market. In September and October 2007, additional ARS failed because the underwriters/broker-dealers stopped bidding in the auctions. As 2008 began, the inventories of all the major ARS underwriters and broker-dealers had grown to historical levels, making failure imminent.

During the week of February 11, 2008, almost all the major brokerage firms decided to stop propping up the market. At that point, a large portion of the auction rate market experienced mass failures. The fraud of the ARS market was exposed, and could not have been known by most issuers prior to that point.

As a result of the failed auctions, issuers were hit with the maximum rate on their bonds, more than doubling the interest costs for most municipal ARS. While interest rates were falling during this time period, issuers who entered recommended swap transactions were unable to refinance their debt as the cost of the swap plus the cost of newly issued bonds would far exceed

[2] Martha Mahan Haines, Chief, Office of Municipal Securities for the SEC, September 29, 2006, http://www.sec.gov/news/speech/2006/spch092906mmh.htm.

fixed rate issues at the time, forcing issuers to continue to pay huge rates or find expensive alternatives to remarket their bonds. To this day, the ARS market continues to fail in large part.

FINRA ARBITRATION

The Financial Industry Regulatory Authority is a quasi-governmental body that is responsible for regulating the brokerage industry. FINRA was established under Section 15A of the Securities and Exchange Act of 1934 as a self-regulatory organization. *See* 15 U.S.C. § 78(o)(3). In conjunction with its regulatory role, FINRA also has a Division of Arbitration that oversees a private arbitration forum where both customers of FINRA members and the members themselves can resolve their disputes.

The Advantages of FINRA Arbitration

It is the team's belief that claims against the underwriter/broker-dealers would be best heard in arbitration before FINRA. FINRA arbitration, as opposed to court, or even other arbitration forums, has a number of significant advantages that would benefit [redacted]. For example:

- FINRA arbitrations are largely private affairs, limiting the publicity of the cases. The filings, hearings and record are closed and not accessible to the public. Only the final award, if any, is published;

- FINRA cases are much quicker than other forums, generally being resolved in 15 to 18 months rather than years of litigation in court and then endless appeals;

- FINRA arbitrations typically have no depositions or interrogatories, meaning [redacted] employees and officers will likely not be called upon to give sworn testimony prior to the arbitration;

    - Under FINRA Rule 12510, "depositions are strongly discouraged … the panel may permit depositions, but only under very limited circumstances …" generally limited to obtaining testimony of a witness that will not be available to testify at the arbitration.

    - Under FINRA Rule 12507, "Standard interrogatories are generally not permitted in arbitration." Rather, there are only "Requests for information" that are limited to "identification of individuals, entities related to the dispute" and "such requests should be reasonable in number and not require narrative answers or fact finding."

- FINRA arbitrations have only limited circumstances where a case can be dismissed prior to a full hearing before the arbitration panel, resulting in a much better opportunity for the positive resolution of cases as they generally cannot be dismissed early on procedural grounds.

    - FINRA Rule 12504 says "Motions to dismiss a claim prior to the conclusion of a party's case in chief are discouraged" and can only be granted in two very limited circumstances: (1) "the non-moving party previously released the claim(s) in dispute by a signed settlement agreement and/or written release" and (2)"the moving party was not associated with the account(s), security(ies), or conduct at issue."

- FINRA arbitrations can generally be brought up to six years from "the occurrence or event giving rise to the claim", a longer period than often allowed in court (See FINRA Rule 12206); and

    - Although FINRA's six-year eligibility rule is said "not to extend the applicable statutes of limitation", there is some question as to whether statutes of limitation apply at all to arbitration. As a result, FINRA panels rarely dismiss on statute of limitations grounds.

    - Moreover, statutes of limitation are not grounds for dismissal of a case prior to the arbitration. As a result, even if limitations were applied, it would not be until after the conclusion of [redacted] being able to put on its case-in-chief, a risk the underwriters/broker-dealers are unlikely to take.

- FINRA arbitration allows claims that might not be available in other forums. Specifically, FINRA recognizes the right to bring claims for FINRA rule violations. For example, FINRA requires that it members "deal fairly" with all customers. Failure to adhere to this rule can be a basis for complaint in FINRA arbitration where it might be rejected in court.

The [redacted]'s Standing to Bring a FINRA Arbitration

While FINRA arbitration is typically brought by brokerage customers who have written arbitration agreements with their firm, a specific written agreement between the parties is not the only way to invoke FINRA arbitration. Upon becoming a FINRA member, the member organization agrees to abide by all FINRA rules and regulations, including the FINRA Code of Arbitration (the "FINRA Code"). *See* FINRA Bylaws, Article 4 §1. Under the FINRA Code, FINRA members have agreed to arbitrate business-related disputes with their customers.

Under FINRA Rule 12200:

> Parties must arbitrate a dispute if:
>
> - Arbitration under the Code is either:
>   (1) Required by 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.

As a result of Rule 12200, all "customers" of brokerage firms have a right to seek arbitration, regardless of having a written arbitration agreement. Therefore, the only question is whether the [redacted] is a "customer" based on the issuer/underwriter relationship.

A number of federal courts have held that an issuer of securities is the customer of its underwriter. In *Patten Securities Corp. v. Diamond Greyhound & Genetics, Inc.*, a case involving an issuer and underwriter, the Third Circuit Court of Appeals affirmed the District Court's order compelling the underwriter, Patten Securities Corp., to arbitration at the NASD (n/k/a FINRA). 819 F.2d 400 (3d.Cir. 1987)(abrogated on other grounds). In its analysis, the Court noted that during the 1983 annual meeting of the NASD's National Arbitration Committee, the NASD issued the following interpretative statement concerning the arbitrability of issuer/underwriter disputes:

> *"An issuer of securities should be considered a public customer of a member firm where a dispute arises over a proposed underwriting."*

Id. at 406.[3]

Since *Patten*, the Southern District of New York has twice ruled that an issuer-underwriter relationship by itself is sufficient to establish a FINRA claimant's customer status. *See J.P. Morgan Securities Inc. v. Louisiana Citizens Prop. Ins. Corp.*, 712 F. Supp. 2d 70, 76 (S.D.N.Y. 2010)("any ambiguity in the meaning of customer … should be construed in favor of arbitration")(internal citations omitted), and *UBS Financial Servs., Inc., v. W. VA. Univ. Hosps. Inc.*, 760 F. Supp. 2d 373 (S.D.N.Y. 2011).

[3] The relevant rules of FINRA, the successor of the NASD, have changed so that the former NASD interpretive statement is no longer formally binding on FINRA members, but it remains a good indication of FINRA's view on this issue.

The more recent *W. VA. Univ. Hosps.* decision specifically addressed the question of whether a municipal auction rate securities issuer was the customer of the underwriter of its auction rate bonds. The District Court refused the plaintiff's request to enjoin the defendant from arbitrating its dispute before FINRA, finding that, in view of the Second Circuit's admonition that ambiguities in the meaning of "customer" should be resolved in favor of arbitration, the hospital system as the issuer of $329 million worth of auction rate securities was the customer of UBS under Rule 12200. 760 F. Supp. 2d 373, 378 (S.D.N.Y. 2011).

UBS appealed the decision to the Second Circuit and lost. The Second Circuit affirmed the District Court's holding that the West Virginia University Hospital was UBS' "customer" for purposes of arbitration. See *UBS Financial Servs., Inc., v. W. VA. Univ. Hosps. Inc.*, 660 F. 3d 643 (2nd Cir. 2011). The Court held that the "term customer includes at least a non-broker or non-dealer who purchases, or undertakes to purchase a good ***or service*** from a FINRA member." *Id*. at 650 (emphasis added). Although not expressly adopting the lower court's determination that an issuer is the customer of its underwriter, the appellate court left that determination undisturbed and found that the hospital system became UBS' customer with respect to FINRA Rule 12200 because, in addition to the naked issuer-underwriter relationship, the hospital system had contracted with the member to obtain other services as well. *Id.*

Since the law concerning "customer status" has been generally favorable to issuers, the brokerage industry has begun to fight the arbitrability issue through contract language, sometimes calling for jury waivers and court in New York. For example, [redacted] Broker-Dealer agreements with both Goldman and Citigroup contain language stating the agreements "shall be construed in accordance with the laws of the State of New York" and "shall be brought in the United States District Court in the County of New York …." There is currently a split in authority as to the applicability of such language and whether it can overcome the customer status of an issuer. Until that split is resolved, it is the team's intention to assert claims outside of the Broker-Deal agreements to attempt to avoid such problems.

[redacted]

As an example of the harm sustained by [redacted] from these complex financing vehicles, the team generated a rough estimate of the damages relating to the Series 2004A-D ARS Bonds (the "04 Bonds") and the Series 2005A-B ARS Bonds (the "05 Bonds" collectively with the 04 Bonds, the "ARS Bonds"). This has been compiled using publicly available data, including Bloomberg, the Offering Circulars and the Financial Statements of [redacted]. From that data the team has been able to derive the following estimates.[4]

[4] Given that the team did not have all materials available to them in seeking to determine possible damages, these numbers are necessarily estimates. In order to perform a full analysis, we would need access to the full deal transcripts with all agreements and subsequent revisions and all rate set notifications. The numbers used for the

Losses relating to the issuance of the ARS Bonds can be measured in a number of different ways, all of which result in substantial damages. The underlying theme in the different methodologies is that the ARS structure and the associated swaps were sold as financing vehicles that would allow for financing large projects slightly below the prevailing fixed market rates. However, undisclosed to [redacted] was that the effectiveness and reliability of this complex financing structure was predicated on markets and rates that were being manipulated by the underwriters. When that manipulation collapsed under its own weight, there were substantial dislocations that resulted in necessary restructuring; locking issuers such as [redacted] into rates that are higher than anticipated and significantly higher than the prevailing market.

The first series of damages relate to the direct costs of the underwriters/broker dealers' manipulation of the ARS market and ultimately causing its collapse. When the ARS market collapsed in February of 2008, [redacted] had to pay the "Maximum Rate" of 12% on certain tranches of the ARS Bonds. This rate was fairly short lived as the 04 Bonds were called using a short term lending facility from Wells Fargo & the 05 Bonds were converted to Remarketing Bonds in December of 2008. However, even in this short period, the surge in rates cost [redacted] an estimated $2,245,000.

Furthermore, because the ARS market collapsed, and because [redacted] was faced with paying the maximum rate on all of its bonds, it was forced to very quickly convert the ARS Bonds to a new structure. This forced restructuring resulted in two types of damages: initial refinancing costs and ongoing higher support fees. Both of those costs have resulted in the brokerage firms profiting from the very fraud they perpetuated.

Just to restructure the ARS Bonds, [redacted] incurred $6,870,000 in refinance and new issue costs.[5] In addition to collecting those initial fees for restructuring the ARS bonds, the brokerage firms recommended new structures that paid the brokerage firms substantially higher fees for the ongoing support they would be providing for the newly issued bonds. Originally, the auction agent/broker dealer fee for these issuances was anticipated at 0.25%.[6] However, once reissued, the support costs for the Series 2008 B, C & D Bonds increased to .58%.[7] This 33BP increase in

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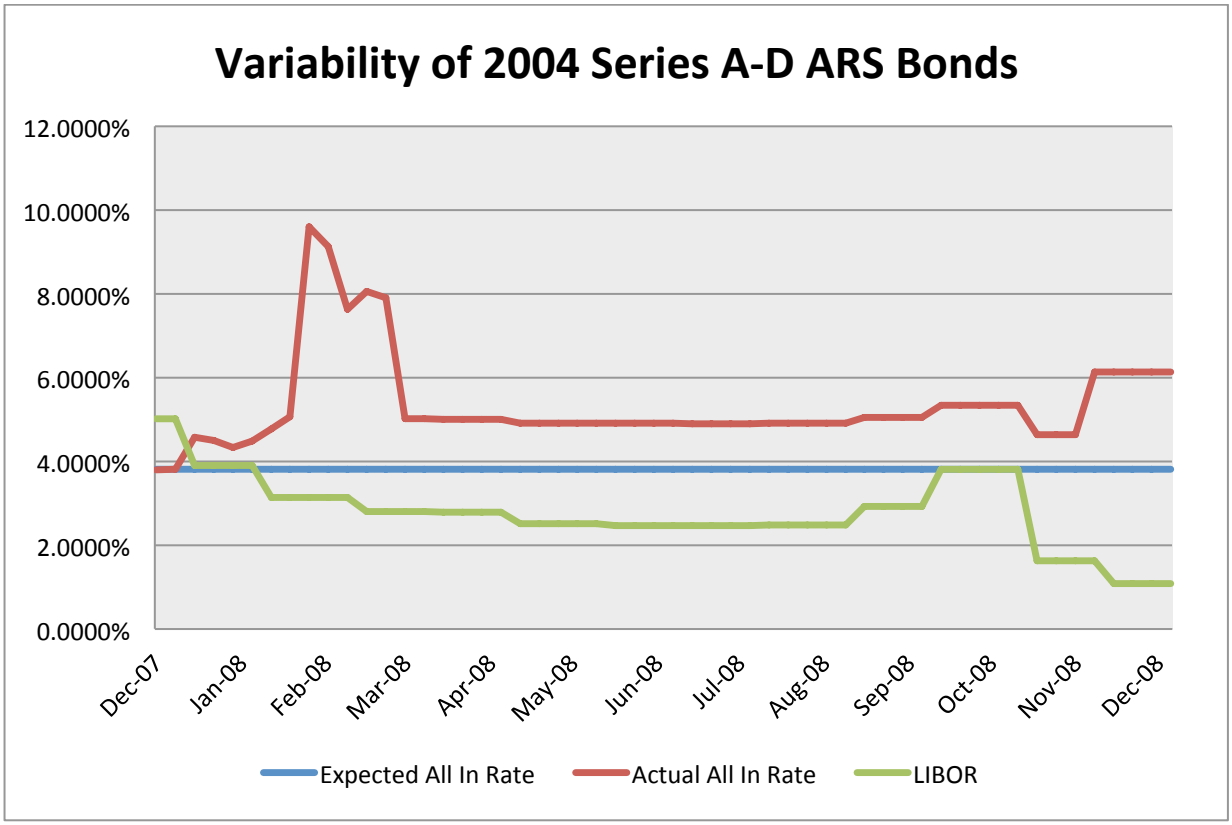
analysis in this presentation were purposely conservative. It is our expectation that many of the damages may increase once all the records are reviewed.

[5] [redacted]

[7] [redacted]

support costs has result in an additional $742,500 a year and will continue through the life of the bonds, causing an additional $11,000,000 in costs to [redacted].

However, these losses pale in comparison to the losses on the restructured 2004A Bonds. The 04 Bonds were refinanced into Series 2008A Bonds and converted to a fixed rate structure with an all in fixed rate of 6.14%.[8] This is significantly higher than the original expected financing costs of the 04 Bonds which were represented as having a synthetic fixed rate of 3.5%.[9] *See Chart Below.* By comparing the Expected Debt Service requirements between the 04 Bonds and the Series 2008A Bonds, it appears that the all in financing costs increased by $45,800,000 over the life of the bonds.[10]



8 [redacted]

10 [redacted]

In addition to the costs associated directly with the failure of the ARS market and the subsequent required refinancing, [redacted] had been obligated to pay on the Swaps associated with the ARS Bonds. These Swaps were marketed as the vehicles that synthetically fixed the rates on the ARS bonds, because the floating amount receivable under the terms of the Swaps mirrored the rates payable under the ARS structure. Typically, these interest rate swaps were represented as only deviating from the floating ARS rates by a few basis points. While this representation had historically been true, from 2005 to 2007, this only remained true in large part because the underwriters were artificially supporting the ARS market, and, to a lesser extent, actually manipulating market ARS rates and LIBOR Rates. Yet, by early 2008, there was no longer an ARS market, and other market forces had broken the correlation between the Swap rates and the floating rates payable on the ARS Bonds.

Once this correlation was broken, [redacted] had to pay the prevailing market rates, plus the fixed rate component of the Swaps, but received virtually nothing from the floating rate component of the Swaps to offset the rising interest costs. For example, on February 19, 2008 one of the winning bids for the ARS Bonds was 11.2%. At the time, LIBOR was only 3.1368%. Under the swap terms [redacted] would have only received around 2.2%. This break in correlation resulted in an all in financing cost almost 9% over the expected rate.[11]

Analysis of other ARS bond issuances that converted to a remarketing structure, like the 05 Bonds, shows that this break in this correlation lasted approximately a year. For instance, in November of 2008, the rates on the 2005 A & B Bonds were set around 4.5%.[12] During that time however, the floating rate component received under the Swaps would have been less than 1.4%, a 3.1% disconnect. A mere 2% disconnect during that tumultuous 2008-2009 time period could have resulted in $4,000,000 in excess financing costs for the Bonds. Since mid-2009, the floating component of the Swaps have somewhat re-converged with the remarketing rates on the 2008 Series B, C & D Bonds.

Cumulatively, because of the ARS market collapse, the resulting restructure and the ineffective swaps, the annual costs of the ARS Bonds greatly exceed the expected and bargained for costs, and exceed the rates that were available under more traditional financing methods. There have already been millions of dollars in losses on the ARS Bonds. More importantly, over the life of these bonds, this will cause significant future harm to [redacted]. Below is a chart that identifies some of those losses the team has been able to find using available data. Additional damages may be found once all the documents are reviewed.

[11] This analysis was conducted from a compilation of data from the Wells Fargo Auction Rate notices and LIBOR index information published in Bloomberg.

[12] See Verification Report of [redacted]., November 25, 2008, Exhibit B-1 and B-2.

DAMAGES SUMMARY		
[redacted] - [redacted],		
ACCRUED AND FUTURE DAMAGES RESULTING FROM FRAUDULENT STRUCTURE		
Auction Rate Failure Damages	$	2,245,246
Non Correlation Damages From Swaps	$	4,000,000
2008 New Issue Costs	$	6,871,937
Present Value of Excess Interest Due to Conversion to Remarketing	$	11,046,525
Present Value of Excess Interest Due to Conversion to Fixed Rate	$	45,800,000
TOTAL ACCRUED AND FUTURE DAMAGES	$	69,963,708
SWAP TERMINATION FEES		
Swap Termination Fees Paid	$	7,600,000
Remaining Swaps as of March 31, 2012	$	30,724,000
TOTAL TERMINATION FEES	$	30,724,000

The above damages all relate to direct losses from the ARS fraud and the damages that have resulted from manipulation of that market. Together, those damages exceed $69,000,000 based on a conservative estimate. In addition to those damages, there are further losses related to the Interest Rate Swaps (the "Swaps") associated with the ARS Bonds. At the issuance of the 04 Bonds and 05 Bonds, [redacted] entered into an ISDA agreement with Goldman Sachs. Those Swaps were part of an obligation of [redacted] to hedge the ARS Bonds. However, a mere 3 years into the life of those Swaps, the ARS market had already collapsed and the swaps no longer served their purpose. Those Swaps are currently costing [redacted] millions of dollars a year. Additionally, in 2008, [redacted] paid $7,600,000 to terminate a portion of the outstanding Swaps. Moreover, to stop these costs would result in the need to pay a termination fee. As of March 31, 2012, the termination costs of these Swaps was $30,724,000. [13]

As a result of the above, the ultimate goal of any arbitration would be to unwind the Swaps that currently have a termination value of over $30,000,000. However, a direct attack of the Swaps may not be successful as there have been certain settlements that may cover basic claims of the Swaps being misrepresented. In particular, a series of cases have been brought against the various swap dealers for their anti-competitive behavior and marketing of swaps, and [redacted] elected to participate in the resulting settlement. Acceptance of the settlement has two impacts. First, it requires the municipality to release all claims against the relevant bank in the *Municipal Derivatives Antitrust Litigation. See, infra.* Second, it will create certain litigation

[13] [redacted]

risks in a FINRA arbitration. In particular, it will provide the defendant bank with a basis to challenge proposed consequential damages in the form of termination fees on derivative swaps. Such swap termination fees have routinely been alleged in the type of FINRA arbitration we propose to bring.

However, the team believes [redacted] can potentially survive any claim of a prior release in arguing the Swaps were a part of the ARS fraud and an integrated transaction that has nothing to do with the anti-competitive conduct or even marketing alleged in the settlements. Rather, it has to do with the manipulation of the ARS market and index that was the basis of the Swap. The settlement agreement specifically excludes "conduct related to attempts to manipulate underlying interest rates used in the pricing of Municipal Bond Derivatives." The argument is that the entire ARS market was a sham and therefore the market and the index tracking it were manipulated. As a result, the conduct is not covered under the settlement.

Additionally, even if [redacted] is unsuccessful in eliminating the Swaps, the team believes it will conservatively be able to prove up accrued and future consequential damages in excess of $69,000,000 resulting from the collapse of the manipulated ARS market and the subsequent increased costs from the forced restructuring of the ARS Bonds. As a result, the direct and consequential damages of a FINRA Action on the ARS Bonds ranges from more than $30,000,000 to almost $69,000,000 depending on whether the remaining Swaps could be terminated.

TIMING FOR TAKING ACTION

The time for [redacted] and other issuers to take action concerning their ARS losses is coming to a quick close. As discussed *supra*, FINRA has an eligibility rule that precludes all claims that are more than six years past "the occurrence or event giving rise to the claim." Underwriters/broker-dealers will clearly argue that the six year runs from no later than the collapse of the ARS market, if not earlier. As a result, all claims likely will need to be on file no later than early February 2014 to be timely filed under FINRA rules.

However, it is not wise to wait until that last minute. Even though FINRA rules allow up to six years to file a claim, many statutes of limitations are far less forgiving. Additionally, there is some evidence that there was public information available as early as August 2007. Also, depending on the particular bond or swap, there may be other triggers for limitations and/or eligibility that come into play in the next few months. If [redacted] is interested in taking action, we would strongly encourage [redacted] to take action on the ARS Bonds and any other issuances as soon as possible.

[redacted] SPECIFIC ARBITRATION ISSUES

As with any litigation/arbitration claim, there will be obstacles [redacted] must overcome to be successful in the action. As discussed below, while these issues present some meaningful hurdles and certain litigation risks, it is the team's belief that such barriers can be overcome and that the benefits of taking action far outweigh the litigation risks.

A. [redacted] ARS Evidence

Given the premise of the case, it will be paramount for the success of the case to demonstrate that the underwriters/broker-dealers knew of the problems in the ARS market, and failed to disclose the truth of ARS issuances to [redacted] This will need to be done on both a general (market-wide) level and then with the specific [redacted] issuances to be successful. Additionally, the earlier the team can demonstrate knowledge of the problems, the stronger the case will be.

As to the general knowledge of problems in the ARS market, both Citigroup and Goldman have settled multiple regulatory claims concerning their knowledge and failure to disclose that the ARS market was not robust, but rather being heavily supported by the brokerage firms. For example, in 2008, Goldman settled claims from the New York Attorney General's office where Goldman was forced to make "Assurance of Discontinuance" in its manipulation of the ARS market. *See In the Matter of Goldman, Sachs & Co., AOD 08-177.* Among the NY Attorney General's findings were that "Since it began participating in the auction rate securities market, Goldman Sachs submitted 'cover' bids", "When customer demand for its auction rate securities declined, Goldman Sachs' 'cover' bids filled the increasing shortfall, thereby sustaining the impression [sic] that auctions managed by Goldman Sachs were functioning", and "From the Fall of 2007 through early February of 2008, demand for auction rate securities continued to erode and Goldman Sachs's auction rate securities inventory increased significantly." Most importantly, the NY Attorney General found that "Goldman Sachs did not disclose these increasing risks [sic] to all of its customers." Id.

Citigroup, like Goldman, signed agreements with numerous regulators where virtually identical findings of facts were listed in the letter of acceptance. Additionally, Citigroup has been a party to a number of FINRA arbitrations involving ARS that it has lost. In one recent case in Texas, the Panel, in finding against Citigroup took the rare step of listing some of its findings from the arbitration and included in the award a finding that Citigroup's "management failed to warn the sales staff so that the staff could properly advise Claimants …" who was a sophisticated Texas Corporation. As a result, it is the team's belief that there will be ample evidence that at least as early as the fall of 2007, Goldman and Citigroup were aware of significant problems in the ARS market, but failed to disclose those issues and instead, worked to hide the problems from all their customers, including issuers.

As it relates to [redacted] in particular, the information the team has reviewed supports that both Goldman and Citigroup manipulated the auction's pertaining to [redacted] ARS Bonds. For example, the team has reviewed the Wells Fargo auction results for [redacted], the Series 2004B ARS Bonds.

Beginning at the very issuance of the Series B Bonds, it appears as if both Citigroup and Goldman bid in the auction, each offering to buy 7,733 shares at a specific rate. It is clear that these bids are directly from Goldman and Citigroup as; only Citigroup and Goldman are large enough entities to purchase that many shares for their own accounts and the bids appear every week in the same share amount, 7.733 shares. Therefore, it can reasonably be assumed that the bids were for the brokerage firms' own accounts, and that these bids were intended to act as a backstop to ensure that the auctions were always successful. Specifically, these bids are the 'cover bids' complained of by the New York Attorney General. See first auction result below:

WELLS FARGO

Order Summary By Order Type

For securities auctioning 09/29/2005

[redacted] Deal No.: A-6 Deadline: 13:00 Winning Rate: 2.650%

Min Rate: 0.000% Max Rate: 12.000% All Hold: 2.123%

Sell Orders

Broker	Holder Code	Order type	Shares Ordered	Shares Filled
Citigroup Global Markets, Inc.	CITI	Sell	292	292
Goldman, Sachs and Co.	GOLD	Sell	640	640
		Subtotal:	**932**	**932**

Hold Orders

Broker	Holder Code	Order type	Shares Ordered	Shares Filled
Citigroup Global Markets, Inc.	CITI	Hold	2,029	2,029
Goldman, Sachs and Co.	GOLD	Hold	4,757	4,757
		Subtotal:	**6,786**	**6,786**

Buy and Hold at Rate Orders

Broker	Holder Code	Order type	Rate	Shares Ordered	Shares Filled
Goldman, Sachs and Co.	GOLD	Hold at Rate	2.500%	5	5
Goldman, Sachs and Co.	GOLD	Hold at Rate	2.550%	10	10
Citigroup Global Markets, Inc.	CITI	Buy	2.550%	50	50
Citigroup Global Markets, Inc.	CITI	Buy	2.630%	500	500
Citigroup Global Markets, Inc.	CITI	Buy	2.650%	500	382
Citigroup Global Markets, Inc.	CITI	Buy	2.670%	500	
Citigroup Global Markets, Inc.	CITI	Buy	2.680%	500	
Citigroup Global Markets, Inc.	CITI	Buy	2.700%	700	
Goldman, Sachs and Co.	GOLD	Buy	2.700%	7,733	
Citigroup Global Markets, Inc.	CITI	Buy	2.760%	700	
Citigroup Global Markets, Inc.	CITI	Buy	2.810%	700	
Citigroup Global Markets, Inc.	CITI	Buy	2.860%	1,500	
Citigroup Global Markets, Inc.	CITI	Buy	2.910%	7,733	
		Subtotal:		**21,131**	**947**
		Totals:		**27,917**	**7,733**

Beginning as early as November of 2005, these backstop bids were being partially filled. This means two things. First, it was the broker-dealers, as early 2005, that were providing the support for the auctions to ensure that auctions were successful. Second, it was the broker-dealers who were actually dictating what rates [redacted] would be paying on its debt.

WELLS FARGO

Order Summary By Order Type

For securities auctioning 11/03/2005

[redacted] Deal No.: A-6 Deadline: 13:00 Winning Rate: 2.600%

Min Rate: 0.000% Max Rate: 12.000% All Hold: 2.250%

Sell Orders

Broker	Holder Code	Order type	Shares Ordered	Shares Filled
Citigroup Global Markets, Inc.	CITI	Sell	1,494	1,494
		Subtotal:	**1,494**	**1,494**

Hold Orders

Broker	Holder Code	Order type	Shares Ordered	Shares Filled
Citigroup Global Markets, Inc.	CITI	Hold	2,232	2,232
Goldman, Sachs and Co.	GOLD	Hold	3,658	3,658
		Subtotal:	**5,890**	**5,890**

Buy and Hold at Rate Orders

Broker	Holder Code	Order type	Rate	Shares Ordered	Shares Filled
Goldman, Sachs and Co.	GOLD	Buy	2.480%	4	4
Goldman, Sachs and Co.	GOLD	Hold at Rate	2.500%	349	349
Citigroup Global Markets, Inc.	CITI	Buy	2.600%	1,000	171
Goldman, Sachs and Co.	GOLD	Buy	2.600%	7,733	1,319
Citigroup Global Markets, Inc.	CITI	Buy	2.649%	1,000	
Citigroup Global Markets, Inc.	CITI	Buy	2.689%	500	
Citigroup Global Markets, Inc.	CITI	Buy	2.750%	1,000	
Citigroup Global Markets, Inc.	CITI	Buy	2.850%	7,733	
		Subtotal:		**19,319**	**1,843**
		Totals:		**25,209**	**7,733**

This activity continued until July 2007. In that time, Goldman and/or Citigroup's support bids were often partially filled (about 1/3 of the time). Therefore, for a significant number of the auctions, Goldman and Citigroup were supporting the auctions and setting the rates for [redacted]. However, in July of 2007, Citigroup stopped placing support bids completely. This coincided with some of the first auction rate failures. Moreover, Goldman's support bids were partially filled in all but 8 auctions from July 2007 until the entire ARS market collapsed in February of 2008. Thus, in the summer of 2007, when it was becoming clear to the brokerage firms that the ARS market was disintegrating, Citigroup bowed out, and Goldman began to artificially support the auctions. Yet, [redacted] was not informed that the market was crumbling.

At the end of 2007 and the beginning of 2008, the ARS market had all but disappeared. Beginning December 27, 2007, to January 31, 2008, there were no buyers for the ARS Bonds and Goldman had to purchase all ARS shares that were tendered. On January 31, 2008 there were only two buyers for 70 shares. On February 2, 2008 there were only two buyers for 75 shares. Then, on February 14, 2008, Goldman's support bid for this CUSIP disappears and the rate on the CUSIP goes from 3.8% to 8.0% in a single week.

WELLS FARGO

Order Summary By Order Type

For securities auctioning 01/17/2008

[redacted] Deal No.: A-6 Deadline: 13:00 Winning Rate: 3.350%

Min Rate: 0.000% Max Rate: 12.000% All Hold: 2.177%

Sell Orders

Broker	Holder Code	Order type	Shares Ordered	Shares Filled
Citigroup Global Markets, Inc.	CITI	Sell	10	10
Goldman, Sachs and Co.	GOLD	Sell	286	286
		Subtotal:	**296**	**296**

Deem Hold Orders

Broker	Holder Code	Order type	Shares Ordered	Shares Filled
Citigroup Global Markets, Inc.	CITI	Deem Hold	10	10
		Subtotal:	**10**	**10**

Hold Orders

Broker	Holder Code	Order type	Shares Ordered	Shares Filled
Citigroup Global Markets, Inc.	CITI	Hold	2,483	2,483
Goldman, Sachs and Co.	GOLD	Hold	4,171	4,171
		Subtotal:	**6,654**	**6,654**

Buy and Hold at Rate Orders

Broker	Holder Code	Order type	Rate	Shares Ordered	Shares Filled
Goldman, Sachs and Co.	GOLD	Hold at Rate	3.100%	30	30
Goldman, Sachs and Co.	GOLD	Hold at Rate	3.200%	5	5
Goldman, Sachs and Co.	GOLD	Hold at Rate	3.250%	350	350
Goldman, Sachs and Co.	GOLD	Hold at Rate	3.300%	388	388
Goldman, Sachs and Co.	GOLD	Buy	3.350%	7,733	296
		Subtotal:		**8,506**	**1,069**
		Totals:		**15,170**	**7,733**

A review of the other 2004 Series A, C & D auctions show many similarities. As a result, both the general evidence and the specific evidence supports the conclusion that without the support bids from Goldman or Citigroup, the auctions would have failed or the rates would have been significantly higher. In fact, there had not been a real ARS market for years, and when Goldman and Citigroup decided to stop supporting the auctions, they failed immediately.

B. Sophistication Defense/[redacted] Knew What it Was Doing

In all cases involving issuers, there is a general concern that the issuer will be deemed a sophisticated party to the transaction that is not entitled to rely on any misrepresentations or omissions related to the bond issuance. For [redacted], this is particularly relevant as [redacted] used its own financial advisor in the transactions, [redacted]. It is possible that a panel of arbitrators might find that neither Goldman nor Citigroup were operating as advisors in these transactions, but rather, this was merely an arm's length transaction between sophisticated parties. However, the team believes given the general fraud of the ARS market and the specific manipulation of [redacted] ARS issuances, this sophisticated client defense can be overcome.

It is important to keep the focus on the fact that this was a fraud on the market and market participants are never required to discover fraud. The SEC, virtually every state regulator as well as many private arbitration panels have already determined that the ARS market was a fraud, especially during the Fall 2007 and Winter 2008 time frame. [redacted] could not have uncovered the fraud, even with the exercise of due diligence. Since the ARS bonds never failed during this time period and the rates were never significantly higher than the market, there was no reason for [redacted] to have any concerns. Even the day-to-day people [redacted] would have dealt with at Citigroup and Goldman would not have been aware of the fraud. Rather, only a very limited group within either institution knew that there were no real auctions during this time period and that the firms were providing support from the very first auction. The inability to uncover this fraud was equally unavailable to any [redacted] advisor, including [redacted]. Simply put, there was no way that the ARS fraud could have been detected. As a result, the fact that [redacted] is a sophisticated issuer should not be an issue in the case.

Additionally, Goldman and Citigroup may claim they disclosed their participation, or at least the potential for their participation, in the auctions. Specifically, the Broker-Dealer agreement for both Goldman and Citigroup contained language saying "BD and other Broker-Dealers may participate in Auctions for their own accounts." *See 2004 Goldman Sachs, & Co. Broker-Dealer Agreement.* While this disclosure informs [redacted] that Goldman may bid in an auction, if falls far short of disclosing that Goldman and Citigroup may be required to bid in the auctions to keep them from failing and that, as a result, the success of the auctions, and ultimate rates [redacted] will pay will be entirely dependent on Goldman and Citigroup's willingness to continue to support the auctions. To the best of the teams' knowledge, such a disclosure was never made to any issuer, including [redacted]. As a result, while there are minimal disclosures, none of those disclosures outline the real risks and therefore the team believes they will not affect the value of the case.

C. Possible Limitations of Damages Because of Swap Settlements

While [redacted] has significant damages not associated with the Swaps, there are large losses in the Swaps the team would like to recover as well. However, a direct attack of the Swaps may not be successful as there have been certain settlements that may cover basic claims of the Swaps being misrepresented. In particular, a series of cases have been brought against the various swap dealers for their anti-competitive behavior and marketing of swaps. [redacted] elected to participate in the Settlement under the settlement with Goldman. Acceptance of the settlement has two impacts. First, it requires [redacted] to release all claims against the relevant banks in the *Municipal Derivatives Antitrust Litigation. See, infra.* Second, it will create certain litigation risks in a FINRA arbitration. In particular, it will provide the brokerage firms with a basis to challenge proposed consequential damages in the form of termination fees on derivative swaps. Such swap termination fees have routinely been alleged in the type of FINRA arbitration we propose to bring.

However, the team believes [redacted] can potentially survive any claim of a prior release in arguing the Swaps were a part of the ARS fraud and an integrated transaction that has nothing to do with the anti-competitive conduct or even marketing alleged in the settlements. Rather, it has to do with the manipulation of the ARS market and index that was the basis of the Swap. The settlement agreement specifically excludes "conduct related to attempts to manipulate underlying interest rates used in the pricing of Municipal Bond Derivatives." The argument is that the entire ARS market was a sham and therefore the market, and the index tracking it were manipulated. As a result, the team will argue the conduct is not covered under the settlement. However, this theory is currently untested.

D. Losing Future Bond Issuance Support From [redacted]

The team understands that [redacted], along with all of the issuers we have worked with, have concerns about losing the ability to conduct future business with Goldman and/or Citigroup if [redacted] elects to seek a recovery against them. It is not been our experience that such suits impact future business. As discussed above, the direct person [redacted] is dealing with at these institutions almost surely was as surprised as [redacted] to learn there was no auction market.

Additionally, losing the ability to do business with a partner that has not treated [redacted] right may not be a negative result. Below are excepts from a letter published in the New York Times from an executive director of Goldman who decided to leave after seeing the culture of the firm change to one that was only interested in making money off its clients, not doing what is best for them.

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March 14, 2012

Why I Am Leaving Goldman Sachs

By GREG SMITH

TODAY is my last day at Goldman Sachs. After almost 12 years at the firm — first as a summer intern while at Stanford, then in New York for 10 years, and now in London — I believe I have worked here long enough to understand the trajectory of its culture, its people and its identity. And I can honestly say that the environment now is as toxic and destructive as I have ever seen it.

To put the problem in the simplest terms, the interests of the client continue to be sidelined in the way the firm operates and thinks about making money. Goldman Sachs is one of the world's largest and most important investment banks and it is too integral to global finance to continue to act this way. The firm has veered so far from the place I joined right out of college that I can no longer in good conscience say that I identify with what it stands for.

Mr. Smith went on in the letter to explain that the culture has become to pus clients into the products that are most profitable, regardless of whether it was right for them.

What are three quick ways to become a leader? a) Execute on the firm's "axes," which is Goldman-speak for persuading your clients to invest in the stocks or other products that we are trying to get rid of because they are not seen as having a lot of potential profit. b) "Hunt Elephants." In English: get your clients — some of whom are sophisticated, and some of whom aren't — to trade whatever will bring the biggest profit to Goldman. Call me old-fashioned, but I don't like selling my clients a product that is wrong for them. c) Find yourself sitting in a seat where your job is to trade any illiquid, opaque product with a three-letter acronym.

Today, many of these leaders display a Goldman Sachs culture quotient of exactly zero percent. I attend derivatives sales meetings where not one single minute is spent asking questions about how we can help clients. It's purely about how we can make the most possible money off of them. If you were an alien from Mars and sat in on one of these meetings, you would believe that a client's success or progress was not part of the thought process at all.

It makes me ill how callously people talk about ripping their clients off. Over the last 12 months I have seen five different managing directors refer to their own clients as "muppets," sometimes over internal e-mail. Even after the S.E.C., Fabulous Fab, Abacus, God's work, Carl Levin, Vampire Squids? No humility? I mean, come on. Integrity? It is eroding. I don't know of any illegal behavior, but will people push the envelope and pitch lucrative and complicated products to clients even if they are not the simplest investments or the ones most directly aligned with the client's goals? Absolutely. Every day, in fact.

Sadly, [redacted] ARS mess is exactly the type of product Mr. Smith is warning of in his letter. ARS were more complicated investments that traded in an opaque market that allowed

Goldman to hide the many different ways it was making money at the expense of its client, [redacted]. Moreover, when the fraud was exposed, rather than correcting the misdeed, Goldman, found more ways to make money from [redacted].

CONCLUSION

[redacted] appears to have viable claims against the various underwriters and broker-dealers for their role in advising[redacted] to issue hundreds of millions of dollars in ARS Bonds and then support those Bonds with complicated and disadvantageous swap agreements, all while manipulating the market for the Bonds and the Swaps. As with any significant case, there will be substantial hurdles that must be overcome to be victorious. Specifically,[redacted] will need to demonstrate that it was a customer of the brokerage arm of the underwriters to invoke FINRA arbitration and also be to demonstrate that the claims are not precluded under any previous Global Municipal Derivatives Settlements. Additionally, there are limitations issues, even in FINRA arbitration, that [redacted]must overcome and that should encourage [redacted] to act swiftly if it is interested in going forward.

However, it is the team's opinion that the strengths far outweigh the hurdles for [redacted]s case. Ultimately, the underwriters and broker-dealers behind the ARS defrauded both issuers and investors by manipulating the market. Yet, even after being caught and having to admit their wrongdoing, Wall Street was able to turn their fraud into a huge profit center. In the case of just the ARS Bonds, Goldman collected millions of dollars in new issue fees and continuing service fees because of the collapse of the ARS market that they caused. More importantly, [redacted], rather than the underwriters/broker-dealers are the ones paying for Wall Street's fraud. The team firmly believes that if [redacted] FINRA claims survive, which they are likely to do, and a panel of arbitrators is told of this miscarriage of justice, there is a high likelihood of a significant recovery for [redacted].

FINANCIAL INDUSTRY REGULATORY AUTHORITY
DIVISION OF ARBITRATION

In the Matter of the Arbitration Between:	§	
[redacted]	§	
Claimants,	§	**FINRA Case No.:**
	§	[redacted]
vs.	§	
[redacted];	§	
Respondent.	§	

STATEMENT OF CLAIM

To the Honorable Members of this Arbitration Panel:

PARTIES, JURISDICTION, VENUE, AMOUNT IN CONTROVERSY

1. Claimant, [redacted] Claimants complain of the acts and omissions of Respondent [redacted], a Member Firm of the Financial Industry Regulatory Authority, Inc. ("FINRA") [redacted] Member number with FINRA is CRD Number [redacted]. As Customers of Respondent, Claimants invoke the jurisdiction of FINRA's Division of Arbitration to have this claim for an aggregate sum of more than **$20,000,000**, plus interest, costs and attorneys' fees, heard before an **ALL PUBLIC** [redacted]

SUMMARY OF CLAIMS

2. This case exemplifies the ability of [redacted] and similar firms to use their market power to defraud clients through the manufacturing of fictitious markets for the purpose of extracting large fees. Even more shocking, this case is a sad representation of how [redacted] and similar firms are able to profit from their own wrongdoing – as its fraud has been uncovered and the house of cards folded, [redacted] was able to generate more profits from its clients, such as Claimants, as a direct result of the market collapse it helped to cause.

3. In the Fall of 2007, [redacted] was hired as an investment banker, underwriter and strategic capital advisor to the [redacted] for the refinancing of a portion of [redacted] debt. It was ultimately determined that [redacted] issue almost $190 million of taxable auction rate bonds (the "2007 ARS Bonds"), a type of security offering [redacted] had been recommending to the [redacted] for several years. As [redacted] had explained over the years, issuing auction rate securities ("ARS") would allow the [redacted] and [redacted] to refinance its debts at lower rates. In this case, the 2007 ARS Bonds would allow the [redacted] and [redacted] to refinance the existing tax-exempt bonds into taxable bonds, but still pay a rate that was below the current fixed rate.

4. Claimants issued the 2007 ARS Bonds based on their extensive relationship with [redacted] who led Claimants to believe the ARS market best met their financing needs. Moreover, Claimants issued the 2007 ARS Bonds based on their belief they would trade at short-term rates in a stable, reliable marketplace, which is what [redacted] had always represented. However, unbeknownst to the [redacted] or [redacted], but well known to [redacted], the ARS market had never fully developed as represented and certainly was not stable or reliable at the time the 2007 ARS Bonds were being issued, in November 2007.

5. Rather, demand for ARS had been shrinking significantly leading up to the 2007 ARS Bonds' issuance. In fact, unbeknownst to the [redacted] or [redacted], but known to [redacted], by October of 2007, the auction rate market had all but vanished. [redacted] and other firms hid the dire status of the ARS market by propping it up with their own "support bids" that concealed the true risks of the ARS market at the time. Most importantly, by the time of the 2007 ARS Bonds' issuance, [redacted] was keenly aware that the ARS market could only survive if [redacted] and the other firms continued in their ruse. However, the viability of falsely propping up the market was quickly ending as inventory of ARS within [redacted] and other firms grew beyond what the firms were willing to hold.

6. In February of 2008, a mere three months after the issuance of the ARS Bonds, without warning its customers, [redacted] and similarly situated firms withdrew their support from the ARS market, ensuring a massive wave of auction rate failures and elevated the interest rates ARS issuers would be forced to pay. As a result of the collapse of the ARS market, the [redacted] and [redacted] were forced to pay extremely elevated rates along with the costs of an integrated interest rate swap. This new burden, which greatly increased Claimants' costs of funds, forced the [redacted] and [redacted] to refinance or convert all of their 2007 ARS Bonds in the midst of a financial crisis, ultimately locking them into more costly fixed rate issuances and forcing the [redacted] and [redacted] to pay millions of dollars to terminate an ineffective interest rate swap transaction [redacted]

7. What is even worse, despite being sanctioned by virtually every securities regulator for its wrongdoing, [redacted] used the collapse of the ARS market, which it helped cause, to generate new profits from the [redacted], [redacted] and other similarly situated issuers. Effectively, [redacted] profited from its own fraud. As a result of [redacted]'s actions and inactions, multiple breaches of the duties it owed to the [redacted] and the [redacted], and violations of the laws and rules meant to protect Customers, such as the [redacted] and the [redacted] Claimants have been damaged more than $20,000,000 in current

and future costs, all of which are ultimately borne by the citizens of the [redacted].

FACTS OF THE CASE

Claimants

[redacted]

8. [redacted] By the powers afforded to the [redacted] under the [redacted], [redacted] the [redacted] is charged with selecting and negotiating with potential underwriters and advisors for bonds to be issued by [redacted], like [redacted], where the debt is paid with [redacted] funds (typically called [redacted] Contract Bonds). As such, the [redacted] receives recommendations and advice from underwriters, investment bankers and capital advisors, such as [redacted], concerning [redacted] Contract Bonds. [redacted] then works with the political subdivision, such as the [redacted], and the underwriters, investment bankers and capital advisors, for the issuance of such debt, which is ultimately paid by the [redacted] and its citizens.

[redacted]

9. [redacted]. The [redacted] was initially established to build and operate the [redacted], but has been expanded over the years to manage other sports, entertainment, and convention facilities throughout the [redacted] including [redacted] and the [redacted] Convention Center. [redacted] was also responsible for building the T[redacted] and renovating the [redacted] sports facilities. [redacted] focuses its efforts on supporting tourism and its positive impacts on the local economy as well as job creation throughout [redacted] In order to fund its capital projects, [redacted] issues debt in the form of [redacted] Contract Bonds.

Introduction to Auction Rate Securities

10. Auction Rate Securities were initially created in the 1980's as a way for borrowers to issue long-term debt, but pay only short-term interest rates. In form, ARS are variable-rate bonds with interest rates that reset at frequent periodic auctions. The auctions are generally held every 7, 28, or 35 days, making ARS short-term investments for buyers, even if the final maturity of the ARS is 20 years or more. In each auction, existing holders and prospective buyers state the interest rate they require to purchase or continue to hold the ARS at par value until the next auction. In a typical ARS auction, bid orders are accepted starting with the lowest interest rate bid until all securities available for sale are matched with purchase orders. The rate at which the final sell order is filled is known as the "clearing rate." The clearing rate applies to the entire issue of ARS, including all other buy orders, and to the bonds of existing holders who chose to hold rather than sell their bonds in the auction. This type of auction process is referred to as a "Dutch auction."[1]

11. In theory, an ARS transaction was a winning proposition for all parties involved. Issuers, like the [redacted], were purportedly able to issue long-term debt, but pay rates more in line with short-term paper. Purchasers of ARS were able to purchase short-term paper for rates slightly above what they could obtain for other short-term investments like money market funds or commercial paper. Of course, the underwriters, like [redacted], benefit as well because they receive ongoing fees so long as the ARS are outstanding as well as potential large profits from swaps and other derivatives often sold with ARS.

12. While originally a niche offering for issuers, because of the attractive fees ARS generated for investment banks, such as [redacted], and the perceived advantage of ARS for issuers, the number of

[1] For example, if an ARS issuance had 1,000 sale orders at a given auction and the following bids: Buyer 1 will buy 500 bonds at 3.5%, Buyer 2 will buy 500 bonds at 3.75% and Buyer 3 will buy 500 bonds at 4%, the auction would clear at a rate of 3.75%. Both Buyer 1 and Buyer 2 would have their orders filled at 3.75% and Buyer 3 would not receive any bonds. Additionally, all holders of the ARS issuance would be paid 3.75% until the next auction.

ARS issuances grew substantially over the years. Eventually, the ARS market reached approximately $330 billion in outstanding securities with roughly half of the ARS market (approximately $160 billion) issued by municipal issuers like the [redacted].

The Reality of Auction Rate Securities and the ARS Market

13. While the theory of ARS sounded attractive, in practice, the market was limited. In order for the benefits of ARS to be realized, a large, robust and functioning market for ARS must exist. This is true because there was a risk ARS auctions could fail. ARS would "fail" in an auction when there were insufficient purchase bids to cover all of the ARS offered for sale. In such a situation, all bids are ignored and, instead, the clearing rate is set at a "maximum rate." When the ARS fails and the maximum rate is instituted, the issuer, such as [redacted] is forced to pay the maximum rate on the bonds until the next clearing auction.[2] If the auction continues to fail, the issuer must continue to pay the maximum rate.[3]

14. In many cases, the maximum rate the issuer could be forced to pay in a failed auction was tied to an index, such as LIBOR, e.g., the maximum rate was often 175% of LIBOR or LIBOR plus a certain percentage. In such a situation, the maximum rate would represent a premium over similar short-term investments. In other cases, the ARS was structured with a fixed maximum rate, e.g., the maximum rate could be as high as 12% or more. In such a situation, the issuer would pay a predetermined fixed rate even though prevailing short-term and long-term rates were far below that number, potentially making the rate unsustainable for the issuer.

[2] For example, if an ARS issuance had 1,000 sell orders at a given auction and the following bids: Buyer 1 will buy 400 bonds at 3.5%, Buyer 2 will buy 400 bonds at 3.75% and Buyer 3 will buy 100 bonds at 4%, the auction would fail as there were only 900 bonds bid at the auction versus the 1,000 bonds for sale. In that situation, none of the purchase orders would be executed and, instead, the maximum rate would be paid to all holders (including the 1,000 who tried to sell) until the next successful auction.

[3] Even if an auction does not "fail", the lack of a robust and functioning ARS market would necessarily create large swings in the interest rates issuers would pay as bids above the market for similar short-term investments would be filled to complete the "Dutch Auction" process resulting in the issuer having to pay elevated rates.

15. Understandably, if issuers were aware of the lack of a functioning market and the high potential for large swings in the interest rates they had to pay, no issuer would be willing to issue auction rate debt. Moreover, the prospect of failed auctions and being forced to hold the ARS paper for longer than anticipated would have deterred many purchasers of ARS and caused other purchasers to demand higher rates, thus eliminating the economic benefit to the issuers. Of course, [redacted] and other firms were very aware of this fact and used their influence and market dominance to control the auctions and falsely create an appearance of a functioning ARS market to induce issuers, such as the [redacted] and the [redacted] to continue to issue ARS and also to keep issuers from refinancing their ARS into another structure that was less profitable for [redacted] and other firms.

16. In order to create this false appearance of a robust market, [redacted] artificially supported ARS issuances to make it look as if the ARS market was functioning when it was not. In practice, [redacted] placed "support bids" in almost every ARS auction in which it was the lead. Typically, that would mean that for an issuance of 3,000 bonds, for example, [redacted] would provide a bid for the entire 3,000 bonds in each auction to cover the issuance at a rate it could justify to the issuer. This would either keep the auction from failing, and therefore instituting the required maximum rate, or, in some instances, keep the rate from jumping significantly and therefore informing issuers that the ARS market was not functioning as represented.

17. While it was not unreasonable for an underwriter to provide some occasional limited support for an issuance, the level of support required for ARS was unimaginable for any issuer. Over the years, the underwriters, such as [redacted], were decided to support the ARS more and more. Ultimately, this resulted in a fully manipulated market that appeared to issuers, such as the [redacted] to be stable and functioning. However, the apparent lack of failures and the seeming stability of the ARS market were artificially manufactured. Moreover, at all times, [redacted] was aware that if it stopped

placing support bids, many of the auctions would either fail or clear at elevated rates.

18. Moreover, there was a problem for [redacted] and the other firms in this market manipulation scheme. In order to artificially prop up the ARS market, [redacted] had to buy the ARS into their own inventory. Over time, that inventory had swelled considerably, creating a great amount of stress on [redacted]s balance sheet. Every day and with every auction, unbeknownst to issuers, such as the [redacted], the ARS market was getting closer to folding. Nevertheless, [redacted] continued to willingly hide this fact from issuers and continued to underwrite ARS, knowing full well that the whole ARS market was on the verge of collapse.

[redacted] Restructures [redacted] Debt

19. In 2007, [redacted] were looking to refinance a significant amount of [redacted] existing debt. The issuances sought to be refinanced were issued between 1992 and 2005 and were comprised of fixed and variable rate tax-exempt debt. The debt being replaced was costing the [redacted] and the [redacted] between 3.5% and 6.0%, but most of the rates were below 5.25%. Because of developments with the underlying project, the [redacted] needed to convert those bonds to taxable debt and hopefully take advantage of favorable interest rates. [redacted], who had a long-standing relationship with the [redacted] was selected as the underwriter and capital advisor to help structure, issue and manage the new debt. Ultimately, it was determined the new debt should be issued as taxable auction rate securities, a type of bond vehicle [redacted] had been recommending to the [redacted] for many years. On November 1, 2007, the [redacted] issued the [redacted] for a total par amount of $[redacted].

20. Under the terms of the issuance, [redacted] was the lead Manager, and [redacted] would underwrite the bonds and then manage the bidding for the outstanding ARS. For their

services, [redacted] collected an underwriter's discount and ongoing fees. The 2007 ARS Bonds were secured and serviced by proceeds payable from the [redacted] under a [redacted] Contract between the [redacted]

The Associated Swap Transactions

21. Under the auction rate structure, the 2007 ARS Bonds had a variable rate that would reset with each auction. Most of the bonds that were to be refinanced with the 2007 ARS Bonds were fixed rate bonds. Thus, the 2007 ARS Bond issuance would convert the outstanding debt from a fixed rate of about 4.75% to a floating rate that would closely track the monthly London Interbank Offer Rate ("LIBOR"), which, at the time, was about 4.9%. Initially, [redacted] reported a onetime loss on this transaction, but the transaction fulfilled other funding requirements. Moreover, if rates were to move down, which they ultimately did, [redacted] would benefit from that rate movement.

22. Additionally, not all of the bonds being refinanced with the 2007 ARS Bonds were fixed. There were two refinanced bonds that were issued as variable rate bonds, the Series 2002 B-1 and B-2. When issued in 2002, these bonds had been "synthetically fixed" with a derivative known as in interest rate swap. Under the terms of the existing swap transactions (the "2002 Swap"), [redacted] would pay Merrill Lynch a fixed rate of 4.50% on a total notional amount of $87,835,000. In return, the [redacted] would receive a floating payment equal to 70% of the monthly LIBOR from Merrill Lynch. The amount received on the variable component under the 2002 Swaps was supposed to equal, or closely approximate, the variable amounts payable under the Series 2002 B-1 and B-2 bonds. This would leave [redacted] with only its fixed rate payment under the 2002 Swap. When all other costs were factored in, [redacted] was supposed to have a synthetically created all-in fixed rate of a little more than 4.75% for the remaining life of those bonds.

23. Ultimately, it was determine that the 2002 Swap would create a similar synthetic fixed rate if

applied to the 2007 ARS Bonds. Rather than terminate the 2002 Swap or apply it to another variable instrument, it was determined that it was best that the 2002 Swap be integrated into the 2007 ARS Bond issuance, thus creating a "hedge" against rising interest rates for about half of the new bonds. As a result, [redacted] maintained the 2002 Swap.

24. While the 2002 Swap may have worked as a hedge against rising interest rates, it was not a hedge against the primary risk of the 2007 ARS Bonds at the time: that the auctions for 2007 ARS Bonds would fail or that a weak demand for ARS in general would result in a rise in the rate for the 2007 ARS Bonds. In the event of a failed auction or elevated rates because of lack of interest in ARS, the 2002 Swap would provide no benefit and would instead add over 4.5% to the all-in costs of already unsustainable elevated rates. That is, if a rise in ARS rates occurred because of factors other than a general rise in interest rates, the 2002 Swap would provide no protection and, in fact, would become an additional liability for the 2007 ARS Bonds.

25. At the time of the issuance of the 2007 ARS Bonds in November 2007, [redacted] failed to disclose that it was actively engaged in manipulating the ARS Market. Most importantly, [redacted] failed to disclose that, without [redacted]s support, the auction rate market would have already collapsed. The 2002 Swap would do nothing to help [redacted] should [redacted] decide to withdraw its support and allow the auctions to fail. Rather, the effectiveness of the 2002 Swap was, at that point, entirely reliant on the willingness of [redacted] to support the 2007 ARS Bonds or ensure that rates set in the auctions were in line with rates payable under the 2002 Swaps.

26. [redacted] did not disclose this potential and increasingly likely risk to the [redacted] The reason for this omission was likely because [redacted] had also recommended the issuance of hundreds of millions of dollars' worth of ARS issuances to the [redacted] political authorities. Likewise, an affiliate of [redacted] had hundreds of millions of dollars of interest rate swaps

associated with the [redacted] outstanding ARS debt. To put the [redacted] on notice in November of 2007 that the whole ARS market was crumbling could have precipitated a massive unwinding of extremely lucrative interest rate swaps and the refinancing of almost a billion dollars worth of ARS for which [redacted] was the underwriter and recipient of large fees.

The ARS Market Collapses

27. As the market continued to deteriorate over the next few months, [redacted] had to increasingly intervene in ARS auctions to keep them from failing. As ARS inventory was growing each month, [redacted]'s risk managers had to raise the ceiling for purchasing debt, such as ARS, on its balance sheet several times to meet the lack of demand in the ARS market and to continue to create the false impression of a robust and stable ARS market.

28. In February of 2008, without warning its customers of its intended action or the impending consequences, [redacted], simultaneously with other firms, decided it no longer wanted the risk of buying ARS for its own account and withdrew its support bids. By the end of the month, a majority of the ARS market had come to a screeching halt. A large number of ARS were failing and those that were not failing were paying elevated rates, often two to three times the rate the issuer had paid in previous auctions. With one decision not to support ARS anymore, [redacted] had caused the entire market to collapse.

The Regulators Take Action Against [redacted] and Other ARS Underwriters

29. After the fraud in the ARS market had been unveiled, regulators, both state and federal from around the country, including the [redacted] swiftly took action. Over time, their investigations uncovered the extent of the ARS fraud on both investors and issuers. After their investigations, [redacted] was forced to enter into multiple consent orders with Regulators relating to the

[redacted]s wrongful conduct. While the majority of the focus for the consent orders was investors, who had filed numerous FINRA arbitrations and other complaints, the findings of fact equally apply to issuers, such as [redacted]:

30. Below are some of the findings of fact against [redacted], as an example of the fraudulent conduct uncovered:

a. "Since it began participating in the auction rate securities market, [redacted] submitted "cover" bids, purchase orders for the entirety of an auction rate security issue for which it acted as the sole or lead auction manager."

b. "For risk management purposes, [redacted] imposed limits on the amounts of securities its Municipal Money Markets unit could hold (which included [redacted] auction rate securities holdings)."

c. "In August of 2007, the credit crisis and other deteriorating market conditions began to strain the auction rate securities market."

d. "When client demand for its auction rate securities declined, [redacted] "cover" bids filled the increasing shortfall, thereby sustaining the impression for certain investors that auctions managed by [redacted] were functioning."

e. "As a result, [redacted] auction rate securities inventory grew significantly, requiring [redacted] to raise its risk management limits for its Municipal Money Markets business (which included auction rate securities) several times."

f. "[redacted] was aware of the increasing strains in the auction rate securities market, and increasingly questioned the viability of the auction rate securities market. [redacted] did not disclose these increasing risks of owning or purchasing auction rate securities to all of its clients."

g. "In February of 2008, [redacted] and other firms stopped supporting auctions. Without the benefit of "cover" bids, the auction rate securities market collapsed."

h. "Because many investors could not ascertain how much of an auction was filled through [redacted] "cover" bids, those investors could not determine if auctions were clearing because of normal marketplace demand, or because [redacted] was making up for the lack of demand through "cover" bids."[4]

31. In the Consent Orders with the [redacted] agreed, among other things, to: (i) buy back ARS from a number of investors; (ii) arbitrate investors' consequential damages

[4] [redacted]

claims under the auspices of the Financial Industry Regulatory Authority and (iii) refund refinancing fees to municipal auction rate issuers that issued ARS between August 1, 2007 and February 12, 2008. Under FINRA rules related to the consequential damages claims, which are the very type of claims being alleged in this case, the Underwriters were not even allowed to argue that they did not defraud investors. Respondents should be similarly precluded from arguing that they did not defraud issuers such as the Claimants.

Result of [redacted] Fraud and Other Wrongdoing

32. This disastrous series of financial transactions has cost Claimants tens of millions of dollars in excess interest, refinancing costs and swap costs. For example, as discussed above, ARS structures contained a maximum rate to which the interest rate on the bonds would default in the event that there were not sufficient bids to clear an auction. [redacted] structured the 2007 ARS Bonds to have an unbelievably high maximum rate of 21 . This high maximum rate structure was put in place for [redacted] s benefit. Given that [redacted] knew there was a limited market for ARS at the time the 2007 ARS Bonds were issued, it was well-aware that the interest received from Claimants 2007 ARS Bonds was likely to be going almost entirely to [redacted]. Moreover, as [redacted] was aware that the ARS market may soon collapse and therefore issuers, such as the [redacted] would then be paying the maximum rate or at least significantly elevated rates, [redacted] made sure to include a high maximum rate in the 2007 ARS Bond issuance that would mean the high interest rates, up to 21 , that the [redacted] would be paying would go straight to [redacted] bottom line.

33. Fortunately for Claimants, the maximum rate was never reached. However, once ARS auctions started to fail *en masse*, traditional ARS investors predictably abandoned the product, and ARS no longer generated the low short-term interest rates expected of a money-market like investment. Even for those issuers whose ARS did not experience failures, the flight of the traditional ARS investor from the

market meant that ARS began to clear at significantly elevated rates. For Claimants, this meant their interest rates went as high as 20.5%. When combined with the payments under the 2002 Swap, the [redacted] payments to service parts of their debt of roughly 25%.

34. These high rates necessitated the restructuring of the 2007 ARS Bonds, which is discussed in more detail below, and the cancellation of the 2002 Swaps, both of which resulted in millions in additional losses along with the elevated rates the [redacted] were paying in the wake of the ARS market collapse.

[redacted] Restructures The ARS Bonds

35. As the rates the [redacted] had to pay on the 2007 ARS Bonds increased significantly, it was clear the bonds were unsustainable. As a result, the [redacted] immediately had to start taking remedial measures to stop the millions in excess interest they were going to be paying because of the roughly $190,000,000 in outstanding ARS bonds and associated Swaps.

36. Unfortunately, the options were limited. Because of the rush for liquidity, the sudden wave of municipal issuers looking to refinance, and the unfolding financial crisis an environment created in no small part by [redacted] demand for [redacted] bonds decreased. Ultimately, it was determined that a fixed rate refinancing was the best option, but the rate required to sell the bonds was 5.976%. Claimants believed that they had refinanced their existing debt into a low fixed and variable rate issuance that would benefit from falling LIBOR. Instead, a mere six months after issuance, the [redacted] were stuck paying almost 6%, a higher rate than most of the bonds that were refinanced, even though LIBOR had plummeted.

37. Additionally, with the remarketing of the ARS Bonds into fixed rate mode, the [redacted] and [redacted] had to pay additional placement fees and other costs of issuance. Moreover, the refinancing left [redacted] saddled with the 2002 Swap that provided no benefit, but was instead an additional liability.

Unfortunately, since the collapse of the ARS market, the 2002 Swap had become more expensive each day. Ultimately, Claimants had to terminate the 2002 Swap at a cost that had grown to over $11,000,000. Moreover, since [redacted] did not have the $11,000,000 in cash, it had to raise capital at additional costs which are ongoing to get out of the swap.

[redacted] Profits From Its Fraud

38. [redacted] underwrote the 2007 ARS Bonds at a time it was well-aware of the risks of mass auction failures and [redacted] own manipulation of the ARS market. Moreover, [redacted] was aware the [redacted] could not have known of these market risks as [redacted] was working hard to conceal them.

39. [redacted] made fees from the issuance of the 2007 ARS Bonds, it received ongoing fees as long as the 2007 ARS Bonds were outstanding, and it profited from its ability to control the auction market and to manipulate rates. Once the ARS market collapsed, and the fraud was uncovered, [redacted] actually profited more. [redacted] received massive interest payments from [redacted] debt that it held because of the large "maximum rate" [redacted] had saddled Claimants with when it structured the 2007 ARS Bonds.[5] [redacted] had successfully converted its own fraudulent conduct into yet another profit center.

CONCLUSION

40. In the Fall of 2007, unbeknownst to the [redacted] the ARS market had substantially declined and was on the verge of collapse. It had become a manipulated market that depended on the willingness of [redacted] and others to continue their ruse or issuers would suffer great consequences. Despite having this knowledge, [redacted] underwrote $190,000,000 for the [redacted] of ARS Bonds. Within only a few months of issuing the 2007 ARS Bonds, the ARS market collapsed,

[5] For NJSEA, this meant Goldman was receiving up to 20.5% initially.

resulting in Claimants being forced to refinance their 2007 ARS Bonds at a rate significantly higher than represented, and, even higher than most of the earlier issued debt the 2007 ARS Bonds were supposed to refund. The [redacted] were also forced to cancel expensive swaps that had a more than $11,000,000 termination fee. Last, extremely elevated rates, over 20%, were paid to [redacted] and any other holders of the 2007 ARS Bonds, allowing [redacted] to profit from its structuring of the 2007 ARS Bonds and manipulation of the ARS market.

41. Ultimately, just six months after issuing the 2007 ARS Bonds, Claimants lost more than $20,000,000 in termination fees, elevated interest rates and future financing costs. The [redacted], the [redacted] asks this FINRA arbitration panel to right this wrong and return the over $20,000,000 Claimants have lost or will lose because of [redacted]'s wrongdoing.

CLAIMS FOR DAMAGES

FINRA arbitration claims do not require a strict pleading of causes of actions or to delineate common law or statutory claims. Rather, under FINRA Rule 12302, Claimants need only specify "the relevant facts and remedies requested", which has been done above. Nevertheless, Claimants' claims asserted in this Statement of Claimant would support the following causes of action, among others:

Count One

VIOLATION OF FINRA AND MSRB RULES

42. As herein described, Respondent violated numerous NASD/FINRA and MSRB rules which were instituted to protect customers such as Claimants.

43. Respondent violated relevant rules, regulations, and customs of the NASD/FINRA, including but not limited to: rule 2110 (standards of commercial honor and principles of trade); rule 2310 (suitability of recommendations to customers), including IM-2310-2 (fair dealing with customers); and rule 3010 (supervision of registered representatives).

44. Additionally, as described herein, Respondent violated relevant rules, regulations, and customs of the MSRB, including but not limited to MSRB Rule G-17, which requires that each municipal advisor shall deal fairly with all persons [including issuers] and shall not engage in any deceptive, dishonest, or unfair practice.

45. Through its officers, employees or agents, Respondent recommended the defective financing scheme to Claimants, including the 2007 ARS Bonds and the integration of the 2002 Swap.

46. As a FINRA member, Respondent had a duty to perform due diligence on any product it was recommending to its customers, including the 2002 Swap integration and the 2007 ARS Bonds, to gain a thorough understanding of the characteristics and potential risks of those products prior to recommending them to any client and to explain those characteristics and risks fully and faithfully.

47. As a member firm of NASD/FINRA, Respondent had a further duty, imposed by Rule 2310, to make only those recommendations to the Claimants that were suitable in light of the Claimants investment needs, objectives, and risk tolerances, and to make full disclosure of the risks and characteristics of the securities and issuances when making a recommendation.

48. By recommending the 2007 ARS Bonds to Claimants and that they integrate the 2002 Swap rather than use other more traditional financing methods available, Respondent violated FINRA rule 2310 in that it failed to make full disclosure of the characteristics and risks of the 2002 Swap and the ARS Bonds, and because the 2002 Swap and the 2007 ARS Bonds were unsuitable for the Claimants in light of their needs, objectives and risk tolerances, and the Claimants were damaged thereby.

49. Respondent did not deal fairly with the Claimants in violation of FINRA rule IM-2310-2 and MSRB Rule G-17 and failed to uphold principals of commercial honor and fair trade in violation of FINRA rule 2110, and the Claimants were damaged thereby.

Count Two

NEGLIGENT MISREPRESENTATIONS

50. As herein described, Respondent made numerous misrepresentations and omissions of material fact to the Claimants regarding the risks and characteristics of the 2002 Swap and the 2007 ARS Bonds.

51. These material representations and omissions were false and misleading.

52. These material representations and omissions were part of an ongoing attempt of Respondent to hide the true risks of Claimants debt issuances.

53. Respondent should have known at the time it made the representations and omissions that its affirmative statements as alleged herein were false and/or that their omissions were misleading by virtue of being incomplete.

54. The Claimants believed the misrepresentations made to them or their agents, or believed that no facts existed inconsistent with Respondent s omissions, and reasonably and justifiably acted in reliance upon those beliefs to their detriment.

55. Respondent was negligent, and failed to exercise ordinary care in making these representations and omissions.

56. Claimants relied upon these representations and omissions in agreeing to the financing structures Respondent presented.

57. But for Respondent s material omissions and the material misrepresentations, the Claimants would not have agreed to the transactions structured and presented by Respondent, or would have refinanced the transactions on favorable terms.

Count Three

BREACH OF FIDUCIARY DUTY

58. In light of its position of superior knowledge and its role as a municipal underwriter in negotiated transactions, Respondent owed a fiduciary duty to Claimants. Respondent was engaged as underwriter and advisor to Claimants. As an advisor, Respondent owed a fiduciary duty to Claimants and was required to use the utmost care and put Claimants interest ahead of its own.

59. Respondent breached its duty by advising that Claimants enter into and maintain the complex, volatile and risky financing structures described in this Statement of Claim. Respondent further breached its fiduciary duty and put its interests ahead of Claimants by artificially supporting the ARS market and then, without warning, withdrawing from that market for their own profit, to the detriment of Claimants.

Count Four

FRAUD

60. As herein described, Respondent perpetrated a fraud on Claimants, both by action and omission and is liable to Claimants for all losses resulting from that fraud. Respondent made numerous misrepresentations and omissions to the Claimants regarding the risks and characteristics integrating the 2002 Swap and in issuing the 2007 ARS Bonds. These misrepresentations and omissions were made to obtain an unjust advantage over Claimants.

61. Respondent had a duty to provide accurate information about the auction rate market and Respondent s practices to Claimants. This duty is further confirmed by the MSRB rules, which directly mandate such disclosures.

62. The omitted facts were material to Claimants decision to issue the 2007 ARS Bonds, and to maintain the 2002 Swaps. Had Claimants known that the success of their debt issuances was dependent

on Respondent's support bids and that if and when Respondent ceased its support bidding policy the market would collapse and no longer result in short-term interest rates, Claimants would not have issued the 2007 ARS Bonds and/or would have refinanced its 2007 ARS Bonds on favorable terms rather than the transaction described herein.

63. Respondent was well aware Claimants were relying on Respondent to provide accurate information about the ARS market, and that Respondent was better positioned to have accurate information about the state of the broader auction rate market than Claimants as well as the need for Respondent to intervene in Claimants' 2007 ARS Bonds. Claimants justifiably relied on Respondent to provide this information. Yet Respondent chose to remain silent about these facts because of the profits Respondent stood to gain from the transactions.

64. Respondent's fraudulent actions have caused damage to Claimants as outlined above. Respondent is liable for all damages sustained as a result of its conduct.

Count Five

NEGLIGENCE

65. As described above, Respondent held itself out as an expert in the investigation, analysis, evaluation, risk-management and structuring of debt obligations and other derivative products.

66. Respondent failed to exercise ordinary care and diligence in establishing and structuring the 2002 Swap and the 2007 ARS Bonds in a manner that would manage risk and cost and otherwise be suitable for the needs of Claimants, as alleged in this Statement of Claim.

67. Respondent had a duty to structure a debt product that suitably met Claimant's financing needs, or refinance existing debt in a manner that suitably met Claimant's financing needs. Respondent also had a duty to properly advise and inform Claimants of the true costs and risks associated with each

financial obligation Claimants undertook in connection with the 2007 ARS Bonds. Respondent had a duty to advise Claimants of the true characteristics, risks, costs and effectiveness of the 2002 Swap.

68. Respondent failed to exercise ordinary care and diligence in accurately and faithfully advising Claimants in a suitable manner and advising Claimants of the true costs and risks associated with each financial obligation that they undertook in connection with the 2007 ARS Bonds.

69. Respondent failed to exercise ordinary care and diligence in accurately and faithfully advising Claimants of the true characteristics, risks, costs and effectiveness of the 2002 Swap and the 2007 ARS Bonds.

Count Six

BREACH OF DUTY OF GOOD FAITH AND FAIR DEALING

70. As a matter of law and in accordance with regulatory requirements, Respondent was required to deal fairly and in good faith with Claimants. As described above, Respondent violated that duty in the manner in which they advised Claimants as well as in the information withheld.

71. For example, the duty of good faith and fair dealing required Respondent to disclose to Claimants that their auctions would largely fail but for Respondent's support. Respondent was required to disclose that the market for ARS was illusory and the apparent stability in the market was manufactured. Respondent's failure to deal fairly and in good faith with Claimants is actionable under [redacted] law and the law of any other state that applies to this arbitration.

Count Seven

UNJUST ENRICHMENT

72. As described in the Statement of Claim, Respondent has profited handsomely as a result of the collapse of the ARS market, which Respondent in large-part caused. Through its wrongful acts and self-dealing, Respondent was unjustly enriched by its receipt of profits, commissions, mark-ups, mark-

downs, fees, excess interest and/or spreads and should be required to disgorge any profits from its wrongful conduct.

VICARIOUS LIABILITY

73. During the time of the acts of Respondent which harmed Claimants, the investment bankers and advisors, as well as the other employees of Respondent who were a part of the ARS fraud, were agents of, employed by, and had actual and apparent authority to represent Respondent. Therefore, Claimants invoke the doctrines of agency liability, "respondeat superior," and vicarious responsibility for acts of the agents/employees of Respondent.

PRAYER AND REQUEST FOR RELIEF

As described above, Respondent and its current and former agents proximately and otherwise caused damages to Claimants, including fees, interest payments, lost opportunities, consequential losses and ongoing expenses. Respondent is therefore liable to Claimants under the laws of [redacted] and for the laws of any other state that may apply to this action for all such damages to Claimants.

WHEREFORE, Claimants seek that an award be entered ordering Respondent to pay Claimants all direct and/or consequential damages and statutory and/or punitive damages, plus interest and costs, all according to proof, in an amount which Claimants reserve the right to amend at any time including during hearings held on these matters, as follows:

(1) All sums paid on the 2002 Swap Agreement from the issuance of the 2007 ARS Bonds until the termination of the 2002 Swap "plus, additionally or alternatively,

(2) The cost of unwinding the 2002 Swap "plus, additionally or alternatively,

(3) All sums paid by Claimant over and above the synthetic fixed rate to service the 2007 ARS Bonds "plus, additionally or alternatively,

(4) All incurred and future financing costs of the refinanced 2007 ARS Bonds over and above the bargained for synthetic fixed rate to service the 2007 ARS Bonds plus, additionally or alternatively,

(5) All incurred and future financing costs of the refinanced 2007 ARS Bonds over and above the applicable LIBOR plus, additionally or alternatively,

(6) All advisory fees, closing fees, underwriting fees and other fees and expenses incurred by Claimant in connection with the 2007 ARS Bonds, and the 2008 remarketing or refunding vehicles plus, additionally or alternatively,

(6) Rescission of any or all transactions as sought plus, additionally or alternatively,

(7) Statutory damages as provided by applicable law plus, additionally or alternatively,

(8) Pre-award and pre-judgment interest on all damages from the date of the initial transaction until the date of the award and/or judgment and until such sums are paid, all at the highest rate allowed by law plus, additionally or alternatively,

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

(10) Punitive damages plus, additionally or alternatively,

(11) Any and all other relief available to Claimant, in law or equity or otherwise, which may be granted to them by this Arbitration Panel.

Respectfully submitted, One of Our Attorneys,

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CRYPTOCURRENCY BASICS

Richard Mayer[1]

I. How Do Cryptocurrencies Work?

a. What is Bitcoin?

Bitcoin is a virtual currency that was first introduced to the world in 2009 by a man, or group of people, under the name Satoshi Nakamoto.[2] The concept of cryptocurrency was described by Wei Dai on the "Cypherpunks Mailing List" in 1998, and Bitcoin was the first.[3] Bitcoin is currently in its eleventh year of operation and it shows no signs of slowing down.[4]

Virtual currencies are essentially a chain of digital signatures.[5] They have no physical backing, tangibility, or intrinsic value, but the value is supported by supply and demand.[6] Theoretically, as the number of Bitcoins put into circulation declines, the value of each coin should increase.[7] Bitcoin is designed to circumvent the necessity for a third party, like a major financial institution, in effecting transactions between individuals; its aim is to advance past the inadequate trust-based model of transactions to a peer-to-peer version that is verified by a self-regulating ledger.[8] This new system is to be based on cryptographic proof rather than trust; all that is required is two parties who desire to transact with each other directly.[9] This decentralized system has become

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[2]Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, Bitcoin, 1, 1 (Nov. 8, 2008), https://bitcoin.org/bitcoin.pdf.

[3]*What is Bitcoin?* Bitcoin, https://bitcoin.org/en/faq#what-is-bitcoin (last visited Nov. 10, 2018).

[4]Bruce Haring, *Bitcoin's Tenth Anniversary Marked By Growth, Opportunity, New Horizons*, BlockTribune, (Nov. 4, 2018), https://blocktribune.com/bitcoins-tenth-anniversary-marked-by-growth-opportunity-new-horizons/ ("Ten years ago, the white paper that launched a multi-billion dollar industry was issued. . . . A decade later, the cryptocurrency and blockchain industry spans the globe, with everyone from institutional investors to governments to private enterprises actively pursuing solutions.").

[5]Nakamoto, *supra* note 2, at 2 ("We define an electronic coin as a chain of digital signatures. Each owner transfers the coin to the next by digitally signing a hash of the previous transaction and the public key of the next owner and adding these to the end of the coin.").

[6]Joshua Baron et al., The Current State of Virtual Currencies, NATIONAL SECURITY IMPLICATIONS OF VIRTUAL CURRENCY: EXAMINING THE POTENTIAL FOR NON-STATE ACTOR DEPLOYMENT, 5, 5-6 (2015).

[7]Joshua J. Doguet, *The Nature of the Form: Legal and Regulatory Issues Surrounding the Bitcoin Digital Currency System*, 73 LA. L. REV. 1119, 1131 (2013).

[8]Nakamoto, *supra* note 2.

[9]*Id.*

commonly known as Blockchain, and it will be discussed in greater depth below.[10] The ultimate goal is to avoid expensive transaction costs and other intrusions that comes with transactions through banks and national governments. [11] The push for decentralization comes from the desire to have a currency that is less prone to exploitation and manipulation while keeping transaction costs low.[12]

The only ways to acquire Bitcoins are to "mine" them or to conduct a transaction with a user or entity that already possesses Bitcoin.[13] Coins cannot be mined in advance because the creation of a new coin is based on the chain of transactions associated with the most recently created coin.[14]

Like gold, Bitcoin exists in a limited supply; only 21 million coins can ever be created.[15] On April 26, 2018, the 17 millionth Bitcoin was mined, leaving 4 million more to be mined.[16] The remaining coins are not projected to be completely mined for another 122 years.[17] However, Bitcoins may be divided into the eighth decimal, which allows for the overall value and accessibility to grow.[18] Bitcoin owners must keep their wallets and private keys in a place where they know that they will be safe; this information may not be recovered and without access, the Bitcoins associated with the account will also be inaccessible.[19] The coins will remain in both the wallet and the Blockchain, but they will be dormant; thus raising the value of the accessible Bitcoins due to supply and

[10]Nikolei M. Kaplanov, Nerdy Money: Bitcoin, the Private Digital Currency, and the Case Against Its Regulation, 25 LOY. CONSUMER L. REV. 111, 118 (2012).

[11]Nakamoto, *supra* note 2.

[12]Stephanie Lo & J. Christina Wang, *Bitcoin as Money?*, FED. RESERVE BANK OF BOS.: CURRENT POLICY PERSPECTIVES NO. 14-4, 1, 2 (2014), https://www.bostonfed.org/-/media/Documents/Workingpapers/PDF/cpp1404.pdf.

[13]Baron, *supra* note 6, at 13-14 (stating Bitcoins can be mined or acquired from another person or exchange-service).

[14]Thomas Lowenthal, *Bitcoin: Inside the Encrypted, Peer-to-Peer Digital Currency*, Ars Technica, (June 8, 2011, 9:00 AM), https://arstechnica.com/tech-policy/2011/06/bitcoin-inside-the-encrypted-peer-to-peer-currency/.

[15]Nathan Reiff, *What Happens to Bitcoin After All 21 Million are Mined?*, Investopedia, (Aug. 4, 2018, 9:23 AM EDT), https://www.investopedia.com/tech/what-happens-bitcoin-after-21-million-mined/.

[16]Evelyn Cheng, *There Are Now 17 Million Bitcoins in Existence—Only 4 Million Left to 'Mine,'* CNBC (last updated April 26, 2018, 2:33 PM), https://www.cnbc.com/2018/04/26/there-are-now-17-million-bitcoins-in-existence--only-4-million-left-to-mine.html.

[17]*Id.*

[18]Lowenthal, *supra* note 14.

[19]*See* April Glaser, *People Who Can't Remember Their Bitcoin Passwords Are Really Freaking Out Now*, Slate, (Dec. 08, 2017, 3:37 PM), https://slate.com/technology/2017/12/people-who-cant-remember-their-bitcoin-passwords-are-really-freaking-out.html ("[I]t's probably best to make sure the password is stored somewhere safe and retrievable, at least to one other person.").

demand.[20] Having a fixed amount necessitates the question of what happens once all 21 million coins have been mined, but the answer is not currently clear.

b. What is Blockchain?

For this system to be successful without a trusted party facilitating the transaction, "transactions must be publicly announced [], and we need a system for participants to agree on a single history of the order in which they were received."[21] The Blockchain records each and every transaction; it is essentially a ledger that is open to the public that lists every user's account balance.[22]

The Blockchain system is composed of nodes, which are a network of connected computers that each run Bitcoin client software to generate proof-of-work.[23] Proof-of-work is used "to create distributed trustless consensus and solve the double-spending problem."[24] Double-spending is an issue relating to counterfeiting and the same piece of currency being used more than once.[25] This is an inherent issue because digital information can easily be reproduced.[26] When the client is first used, the program creates a pair of cryptographic keys that are mathematically related; one is private and remains hidden on the user's computer while the other is the user's public Blockchain address that is used for transactions.[27] Nakamoto's proposed solution requires "a peer-to-peer network using proof-of-work to record a public history of transactions that quickly becomes computationally impractical for an attacker to change if honest nodes control a majority of CPU power."[28] As long as a majority of nodes do not cooperate to attack the network—which is highly unlikely—they will generate the longest chain and serve as verified proof of transactions.[29]

[20]*What Happens When Bitcoins Are Lost?*, Bitcoin, https://bitcoin.org/en/faq#is-bitcoin-anonymous (last visited November 17, 2018).

[21]Nakamoto, *supra* note 2, at 2.

[22]Doguet, *supra* note 7, at 1126.

[23]*Id.* at 1125.

[24]Aleksander Bulkin, *Explaining Blockchain—How Proof of Work Enables Trustless Consensus*, Keeping Stock, (May 3, 2016), https://keepingstock.net/explaining-blockchain-how-proof-of-work-enables-trustless-consensus-2abed27f0845.

[25]Doguet, *supra* note 7, at 1129 ("All currencies must address the problem of counterfeiting . . . . Because these coins are essentially nothing more than bits of data, the same coin may be copied and used multiple times.").

[26]*Double-Spending*, Investopedia, https://www.investopedia.com/terms/d/doublespending.asp (last visited Nov. 13, 2018).

[27]Doguet, *supra* note 7, at 1125.

[28]Nakamoto, *supra* note 2, at 8.

[29]*Id.* at 1.

Bitcoins are not owned in the traditional sense; instead, users hold the right to spend whatever amount is associated with their address.[30] In a user's "wallet" is the proof of ownership of a Bitcoin address, which allows the user to spend the Bitcoin associated with said address.[31]

The network's processes may be broken down into six steps:

1. New transactions are broadcast to all nodes.
2. Each node collects new transactions into a block.
3. Each node works on finding a difficult proof-of-work for its block.
4. When a node finds a proof-of-work, it broadcasts the block to all nodes.
5. Nodes accept the block only if all transactions in it are valid and not already spent.
6. Nodes express their acceptance of the block by working on creating the next block in the chain, using the hash of the accepted block as the previous hash.[32]

When a coin begins its transfer, it is first signed by the sender's private key; it is then sent into the network to ensure that the sender possesses the actual amount needed.[33] If the private key that made the signature correlates with the public key, the transaction is validated without anyone besides the sender knowing the origin.[34] By using a public key, anyone may see that a transaction is taking place between two parties, but it does not have information about the actual participants.[35]

Transactions in the public ledger are verified by a two-step process. The first includes individuals, or "miners," that use their computing power to find the "hash," which involves solving a computationally intense problem.[36] A hash is a mathematical equation that reduces text or data into 64-character strings.[37] Attention to detail is critical because if so much as a comma is different from the original data set, an entirely new character string will be produced.[38] This meticulousness enables miners to easily tell if anything has been changed in the hash, which leads to the transaction being confirmed if the hash has not tampered with.[39] The cryptographic puzzle is

[30]Baron, *supra* note 6, at 12.

[31]*Id.*

[32]Nakamoto, *supra* note 2, at 3.

[33]*How Do Bitcoin Transactions Work?,* CoinDesk, (last updated Jan. 28, 2018), https://www.coindesk.com/information/how-do-bitcoin-transactions-work/.

[34]*Id.*

[35]Nakamoto, *supra* note 2, at 6.

[36]Lo & Wang, *supra* note 12, at 2.

[37]*How do Bitcoin Transactions Work?, supra* note 33 ("It's not random – every time you put in that particular data set through the hash function, you'll get the same 64-character string.").

[38]*Id.*

[39]*Id.*

solved by trial and error and once a solution is found it is sent to other nodes to be re-verified.[40] To incentivize verification by miners, the first individual to solve the hash is rewarded with Bitcoin as a form of payment.[41] The first node verification reward was 50 Bitcoins, but the "amount is halved for every 210,000 blocks that are found . . . ."[42] Verification is not as difficult as it may seem. "The pre-programmed algorithm automatically adjusts the computationally difficult ([']hash rate[']) of verifying transactions in order to ensure that each transaction takes on average 10 minutes to verify."[43]

The miners' messages must be broadcast across the entire network through nodes.[44] The network selects a random assortment of nodes to assess the transactions to help bolster security; the more nodes, the more secure the network.[45] To be verified, there must be proof that at the time of the transaction a majority of nodes agree that it was the first time such coin was received.[46]

The Blockchain is reliable because tampering with it would be extremely difficult.[47] Each block includes a hash of the previous block in its data; if one of the previous blocks has been tampered with it would also affect the current hash.[48] Even if an attacker could generate an alternate chain faster than the honest chain is verified, nodes will not accept blocks containing invalid transactions.[49] In order to change the previous block, the attacker would need to redo the proof-of-work for the past block and all blocks after it, all while racing to surpass the extensive network of honest nodes.[50] This is improbable because "by the time you've reached half way, there's probably another block on top of the current one. You'd then *also* have to change that one. And so on."[51] Additionally, the incentives may help keep nodes honest.[52]

[40]Doguet, *supra* note 7, at 1127. ("Once the solution is discovered, it is forwarded to the other nodes so that its accuracy can be verified. If they are satisfied with the result, the new transactions are approved, and each node adds the block containing them to the end of their chain.").

[41]Lo & Wang, *supra* note 12, at 3.

[42]Doguet, *supra* note 7, at 1127.

[43]Lo & Wang, *supra* note 12, at 3.

[44]Daniel Cawrey, *What Are Bitcoin Nodes and Why Do We Need Them?,* CoinDesk, (last updated June 3, 2014, at 4:44 PM), https://www.coindesk.com/bitcoin-nodes-need/.

[45]*Id.*

[46]Nakamoto, *supra* note 2, at 2.

[47]*How Do Bitcoin Transactions Work?, supra* note 33.

[48]*Id.*

[49]Nakamoto, *supra* note 2, at 6.

[50]*Id.* at 3.

[51]*How Do Bitcoin Transactions Work?, supra* note 33.

[52]Nakamoto, *supra* note 2, at 4 ("[A] greedy attacker . . .would have to choose between . . . stealing back his payments, or . . . generat[ing] new coins. He ought to find it more profitable to play by the rules, . . . than to undermine the system . . . .").

II. How Should Bitcoin be Classified?

One of the principal issues in attempting to regulate cryptocurrencies is that there is "no central database to shut down and no company officers to hold accountable."[53] Additionally, the manner in which they are acquired and exchanged makes classifying them a daunting task.[54] This section will consider whether Bitcoin should fall under regulations as a currency, reserve currency, security, or commodity.

a. Should Bitcoin be a Currency?

Currency is generally accepted money that is issued by a government and circulated within an economy as a medium of exchange for goods and services.[55] Additionally, most currencies may be converted into another.[56] Money has three basic functions, to store value, act as a unit of account, and act as a medium of exchange.[57]

For over a thousand years the western world's economies were backed by tangible precious metals, such as gold or silver.[58] The first paper currency issued by a formal government in what would become the United States came in 1775 by the Continental Congress called "Continental Currency."[59] The Continental had a relatively long life in the scope of the budding country, but due to its valuation issues it was replaced in 1861 by "Demand Notes," also known as "Greenbacks."[60] The following year, "Legal Tender notes" were authorized as a new currency and remained in circulation until 1971.[61] The United States began to formally back its currency with Gold in 1900, but the American price remained at a fixed point for nearly a century.[62] The United

[53]Doguet, *supra* note 7, at 1142.

[54]*See* Kaplanov, *supra* note 10, at 145 ("Bitcoins are purchased and exchanged in a number of different manners (in person, on online exchanges, and over the Internet), and this can be interpreted in a number of ways (as a currency, an investment, or even a futures contract).").

[55]*Currency*, Investopedia https://www.investopedia.com/terms/c/currency.asp (last visited Nov. 13, 2018).

[56]*Id.*

[57]Irena Asmundson & Ceyda Oner, *What is Money? in* FINANCE & DEVELOPMENT VOL. 49, NO. 3, 52, 52 (2012), https://www.imf.org/external/pubs/ft/fandd/2012/09/pdf/fd0912.pdf.

[58]Angela Redish, *Anchors Aweigh: The Transition From Commodity Money to Fiat Money in Western Economies*, 26 CAN. J. ECON. 777, 777 (1993), https://www.jstor.org/stable/135820?seq=1#metadata_info_tab_contents ("For over a millennium western economies used a monetary system that had gold or silver as a nominal anchor, that is, where the link to gold or silver supposedly prevented arbitrary expansion of the money supply.").

[59]*See The History of American Currency*, U.S. Currency Education Program, https://www.uscurrency.gov/history (last visited Nov. 13, 2018).

[60]*Id.* ("[T]he U.S. Department of the Treasury [] issue[d] non-interest-bearing Demand Notes. These notes earn the nickname "Greenbacks" because of their color.").

[61]*Id.*

[62]Michael D. Bordo, *Gold Standard*, The Library of Economics and Liberty, https://www.econlib.org/library/Enc/GoldStandard.html (last visited Nov. 13, 2018) ("The United States . . .

States abandoned gold backing in 1971.[63] Today, the United States currency is controlled by the Federal Reserve System in an effort to maintain an efficient economy and enhance public interest.[64]

With the change from commodity-based currency[65] came the introduction of the U.S. dollar as fiat money.[66] Fiat money is declared legal tender by a government, but it is not backed by anything physical.[67] Thus, its valuation is based on supply and demand.[68] Accordingly, Bitcoin fits well into this definition.[69]

On its face, Bitcoin is not a currency in the traditional sense because it has not been issued and circulated by a central government agency.[70] However, it is quite similar to fiat money in its source

switched to gold de facto in 1834, and de jure in 1900 when Congress passed the Gold Standard Act. In 1834, the United States fixed the price of gold at $20.67 per ounce, where it remained until 1933.").

[63]*Id.* ("Finally, on August 15, 1971, President Richard M. Nixon announced that the United States would no longer redeem currency for gold. This was the final step in abandoning the gold standard.").

[64]*See* Fed. Reserve, *Overview of the Federal Reserve System*, 0, 1-2, https://www.federalreserve.gov/aboutthefed/files/pf_1.pdf (last visited Nov. 13, 2018) (stating the Federal Reserve System: controls the nation's monetary policy; promotes stability, safety, and soundness of financial institutions; fosters payment and settlement system safety and efficiency; and promotes consumer protection and community development).

[65]*See* William J. Luther, *Commodity and Commodity-Backed Currencies*, American Institute for Economic Research (July 15, 2015), https://www.aier.org/article/sound-money-project/commodity-and-commodity-backed-currencies ("Commodity monies can be contrasted with fiat monies, like the modern dollar, euro, yen, etc., which function as commonly accepted media of exchange but are not used for any non-monetary purpose. In other words, commodity monies are goods that function as money.").

[66]Naeem Aslam, *Is The End Looming For Fiat Money?*, Forbes (June 8, 2018, 10:12 AM), https://www.forbes.com/sites/naeemaslam/2018/06/08/is-the-end-looming-for-fiat-money/#24cf5bfc7078; *see also* Frank Holmes, *The Rise and Fall of the Gold Standard in the United States*, Forbes (Dec. 9, 2015, 10:44 AM), https://www.forbes.com/sites/greatspeculations/2015/12/09/the-rise-and-fall-of-the-gold-standard-in-the-united-states/#1bd5f30f6dec ("This move [from gold] [was] initially supposed to be temporary, but in 1976 the U.S. monetary system officially becomes one purely of fiat money.").

[67]*Fiat Money*, Investopedia https://www.investopedia.com/terms/f/fiatmoney.asp (Last visited Nov. 13, 2018).

[68]*Id.* ("Fiat money only has value because the government maintains that value, or because two parties agree on said value. . . . If people lose faith in a nation's paper currency, like the U.S. dollar bill, the money will no longer hold any value.").

[69]*See* Doguet, *supra* note 7, at 1119-20 ("[The] case with Bitcoin[] [is that] no government, corporation, or commodity (like gold) backs the digital currency. Practically, however, it is not very different from established fiat currencies. Bitcoin's value fluctuates . . . and [they] can be spent anywhere a merchant is willing to accept them.").

[70]Ed Howden, *The Crypto-Currency Conundrum: Regulating an Uncertain Future*, 29 EMORY INT'L L REV 741, 762 (2015).

of value and its ability to be used in transactions.[71] One of the main differences is that Bitcoin has not been declared legal tender in the United States.[72]

Aside from its uses via the Tor network, Bitcoin is already accepted by a large number of companies and the list is consistently increasing.[73] Overstock.com, the online retailer, became the first major company to accept Bitcoin.[74] This decision proved beneficial, as the company incurred "significant revenue gains, large average order sizes, and desirable customer demographics."[75] It found that accepting the crypto helped eliminate credit card transaction costs, "thus increasing [its] profit within the tight margins of e-commerce."[76] At this point, the online retailer "brings in up to $5 million annually from bitcoin."[77] Some other notable companies that accept Bitcoin are Microsoft, the DISH Network, Wikipedia, and Expedia.[78] Additionally, Starbucks, the coffee juggernaut, announced that it planned to accept Bitcoin in exchange for items in 2018.[79] In fact, Starbucks, as well as several other retailers, have started accepting Bitcoin for payment.[80]

Although Bitcoin possesses traits that fall into the classification of money,[81] Bitcoin cannot be classified as currency. In fact, the IRS stated that virtual currency is not to be treated as currency,

[71]*See* Doguet, *supra* note 7, at 1119-20.

[72]Prableen Bajpai, *Countries Where Bitcoin Is Legal & Illegal (DISH, OTSK)*, Investopedia (last updated Oct. 11, 2018, 2:22 PM), https://www.investopedia.com/articles/forex/041515/countries-where-bitcoin-legal-illegal.asp ("The [United States] Treasury has defined Bitcoin not as a currency, but as a money service business (MSB). This places it under the Bank Secrecy Act which requires exchanges and payment processors to adhere to certain responsibilities like reporting, registration, and record keeping.").

[73]Due.com, *7 Major Companies That Accept Cryptocurrency*, Nasdaq (Jan. 31, 2018, 9:56 AM), https://www.nasdaq.com/article/7-major-companies-that-accept-cryptocurrency-cm913745.

[74]Jonathan Johnson, *'Into the War Room': Overstock Looks Back on Bitcoin Embrace*, CoinDesk (last updated May 16, 2017, 6:42 PM), https://www.coindesk.com/into-the-war-room-overstock-looks-back-on-bitcoin-embrace/.

[75]Rainer Böhme et al., Bitcoin: Economics, Technology, and Governance in THE JOURNAL OF ECONOMIC PERSPECTIVES VOL.29 NO. 2, 213, 224 (2015).

[76]Johnson, *supra* note 74.

[77]Tina Mulqueen, *'Now Accepting Bitcoin': A Retailer's Guide To Digital Currencies*, Forbes (Feb. 23, 2018, 03:29 PM), https://www.forbes.com/sites/tinamulqueen/2018/02/23/now-accepting-bitcoin-a-retailers-guide-to-digital-currencies/#5f9291371ed4.

[78]Steve Fiorillo, *How to Use Bitcoin for Purchases*, TheStreet, (Apr. 18, 2018, 11:13 AM), https://www.thestreet.com/investing/bitcoin/what-can-you-buy-with-bitcoin-14556706.

[79]Emily Price, *Starbucks Will Accept Bitcoin For Lattes Later This Year*, Fortune (Aug. 3, 2018), http://fortune.com/2018/08/03/starbucks-accept-bitcoin/ ("Starbucks is working with Microsoft on technology that would allow you to pay for triple venti lattes with Bitcoin rather than cash.").
[80] Michael del Castillo, *Customers Can Spend Bitcoin At Starbucks, Nordstrom And Whole Foods, Whether They Like It Or Not*, Forbes (May 13, 2019), https://www.forbes.com/sites/michaeldelcastillo/2019/05/13/starbucks-nordstrom-and-whole-foods-now-accept-bitcoin-just-dont-ask-them/#1ef6d1742252.

[81]Asmundson & Oner, *supra* note 57.

but should be treated as property for tax purposes.[82] Any transactions that involve Bitcoin must be reported in U.S. dollars.[83] Because Bitcoin is not legal tender, there is no real reason for users to spend them as opposed to U.S. dollars.[84] Additionally, its transaction process is too inconvenient for daily use;[85] its rapid fluctuations in value negatively affect its reliability and stability.[86] The key question when assessing the store of value is whether the currency is reliable; because "storing wealth in any medium that is easily susceptible to collapse or fraud is unwise."[87] However, if Bitcoin were to be recognized as legal tender it would qualify as fiat currency.[88] In the event that Bitcoin grows strong enough to challenge the U.S. dollar, it is speculated lawmakers may ban the cryptocurrency because it could decrease the dollar's value.[89]

b. Should Bitcoin be a Security?

If Bitcoins are not actually currency, perhaps they should be classified as securities. A security is defined as "any note, stock, treasury stock, security future . . . or participation in any profit-sharing agreement . . . or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency . . . ."[90] The *Howey* test is used to determine whether an investment contract falls under the securities statutes; its focus is "whether the scheme involves

[82]I.R.S. Notice 2014-21, 2014-16 I.R.B. 938 §1 (Apr. 14, 2014) [hereinafter I.R.S. Notice] ("General tax principles applicable to property transactions apply to transactions using virtual currency.").

[83]*Id.*

[84]Doguet, *supra* note 7, at 1141.

[85]Jeffrey Dorfman, *Bitcoin Is an Asset, Not A Currency*, Forbes (May 17, 2017, 9:05 AM) https://www.forbes.com/sites/jeffreydorfman/2017/05/17/bitcoin-is-an-asset-not-a-currency/#10c618b52e5b ("Barter[ing]'s big drawback is it is inconvenient. It's hard to make change. . . . I can [use currency to] buy groceries without having to sell economic services to the supermarket. This convenience is why people moved from barter to currencies. . . .").

[86]*See* Nicholas A. Plassaras, *Regulating Digital Currencies: Bringing Bitcoin Within the Reach of the IMF*, 14 CHI. J. INT'L L. 377, 390-91 (2013) ("[T]raditional currencies are often accepted as stores of value because they are backed by governments, which, in turn, gives them a sense of legitimacy and stability in the eyes of users."); *see also* Ivana Kottasová, *Davos: Bitcoin is not a currency*, CNN (Jan. 26, 2018 9:23 AM) https://money.cnn.com/2018/01/26/technology/davos-bitcoin-currency-asset/index.html ("'[I]t's too volatile to be used as currency,' . . . Bitcoin prices, which peaked near $20,000 in December, have fallen sharply to under $11,000 after a series of exchange closures and talk of increased regulation raised concerns over the digital currency's future.").

[87]*Id.*

[88]Sarah Jane Hughes & Stephen T. Middlebrook, *Feature: Advancing a Framework for Regulating Cryptocurrency Payments Intermediaries*, 32 YALE J. REG. 495, 505 (last updated Nov. 16, 2018).

[89]Douget, *supra* note 7, at 1150 ("Some scholars have suggested that lawmakers might respond with hostility to successful digital currencies because they could eventually undermine the government's seignorage income and decrease the value of the nation's currency. . . .").

[90]15 USCA §78c(a)(10) (2012).

an investment of money in a common enterprise with profits to come solely from the efforts of others."[91] Some examples of common enterprises are companies or business ventures.[92]

Additionally, *Reves v. Ernst & Young* created the "family resemblance" test.[93] There is a rebuttable presumption that a note is a security; it may be rebutted by "a showing that the note bears a strong resemblance . . . to one of the enumerated categories of instrument(s)."[94] These categories include an evaluation of: (1) the motivation of a reasonable seller and buyer to enter into the transaction;[95] (2) the instrument's "plan of distribution" to determine if it is an instrument in common trading for investment or speculation;[96] (3) the investing public's reasonable expectations and whether it considers the instrument as a security;[97] and (4) "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Act unnecessary."[98]

Under *Howey,* it could be argued that Bitcoin should be a security because they are commonly purchased in expectation of profits.[99] Yet, the test fails because Bitcoin is not a common enterprise, so it should not be viewed as an investment contract.[100] Bitcoin also does not have to be converted to currency to complete a transaction; they are already capable of being freely exchanged on the Internet.[101]

Bitcoin also fails the *Reves* family resemblance test.[102] It is in direct contravention of the first prong.[103] A foundational element of Bitcoin is to facilitate transactions between individuals,[104] but when a note is "exchanged to facilitate the purchase and sale of a minor asset or commercial

[91]SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

[92]*Id.* at 300 (defining a "business venture" as an opportunity where "investors provide the capital and share in the earnings and profits [and] the promoters manage, control and operate the enterprise.").

[93]Reves v. Ernst & Young, 494 U.S. 56, 67 (1990).

[94]*Id.*

[95]*Id.* at 66 ("If the seller's purpose is to raise money for the general use of business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security.'").

[96]*Id.*

[97]*Id.*

[98]*Id.* at 67.

[99]Kaplanov, *supra* note 10, at 160.

[100]*Id.*

[101]*Id.*

[102]*See Reves*, 494 U.S. at 66.

[103]*Id.*

[104]*See* Nakamoto, *supra* note 2.

good . . . or to advance some other commercial or consumer purpose . . . [it] is less sensibly described as a 'security.'"[105] Further, the investing public would not reasonably expect Bitcoin to be a security because of its use as a means of exchange.[106] In regard to the fourth prong, Bitcoin has no mitigating factors to reduce risk, which explains its volatility.[107]

c. Should Bitcoin be a Commodity?

There is also the possibility that Bitcoin is a commodity. Commodities are goods sold in the market with uniform quality and value throughout the world.[108] Additionally, commodities have use value that is modified by the market's expectations.[109] A commodity's valuation is in part due to supply and demand.[110] Unlike currency, commodities are used to barter.[111] Some common examples of commodities are wheat, cotton, and livestock.[112] The CFTC is the regulatory body; it has exclusive jurisdiction over "accounts, agreements . . . and transactions involving swaps or contracts of sale of a commodity for future delivery . . . subject to regulation by the Commission. . . ."[113] A futures contract is an agreement to buy or sell a commodity at an agreed upon price for delivery on a future date.[114] Future delivery does not include the sale of any cash commodity for deferred shipment or delivery.[115]

The CFTC enforces regulations across Bitcoin exchanges that offer leveraged trading and future contracts for Bitcoin.[116] Some of these exchanges are in violation of CFTC regulations.[117] The first regulations came when TeraExchange, LLC, GTX SEF, LLC, and FTSEF LLC were approved

[105]*Reves*, 494 U.S. at 66.

[106]Kaplanov, *supra* note 10, at 160.

[107]*See generally* Kottasová, *supra* note 86.

[108]Kaplanov, *supra* note 10, at 148.

[109]George Friedman, *Why it Matters if Bitcoin is a Currency or a Commodity*, MarketWatch (Dec. 13, 2017, 4:07 PM), https://www.marketwatch.com/story/why-it-matters-if-bitcoin-is-a-currency-or-a-commodity-2017-12-13.

[110]*See* Mohammadhussein Rafieisakhaei et al., *Supply and Demand Dynamics of the Oil Market: A System Dynamics Approach*, PROCEEDINGS OF THE 34TH INTERNATIONAL CONFERENCE OF THE SYSTEM DYNAMICS SOCIETY, 3 (2016).

[111]Barter, Black's Law Dictionary (10th ed. 2014) ("the exchange of one commodity or service for another without the use of money.").

[112]*See* 7 U.S.C. §1a(9) (Supp. 2011).

[113]*See* 7 U.S.C. §2(a)(1)(A) (2015).

[114]Dunn v. Commodity Futures Trading Comm'n, 519 U.S. 465, 470 (1997).

[115]*See* 7 U.S.C. §1a(27) (Supp. 2011).

[116]Scott D. Hughes, *Cryptocurrency Regulations and Enforcement in the U.S.*, 45 W. ST. L. REV. 1, 11 (2017).

[117] *Id.*

as Swap Execution Facilities ("SEFs").[118] A swap is a derivative contract in which parties exchange financial instruments.[119] SEFs operate under the CFTC to "provide greater pre-trade and post-trade transparency to the swaps market."[120] Each of these organizations are mandated to not only comply with CFTC and Commodity Exchange Act (CEA) regulations, but also "with all representations and submissions made by it in support of its application for registration as a SEF."[121] In 2015, TeraExchange faced the threat of remedial sanctions because the CFTC discovered that it had been engaged in "wash trading," which is either a fictitious sale or used to cause an untrue price to be reported as opposed to one that is genuine.[122] The CFTC and TeraExchange reached a settlement, but the latter must ensure it complies with the trading regulations in place.[123]

Additionally, unregistered companies face CFTC enforcement.[124] Coinflip Inc. was conducting commodity transactions that did not comply with CEA regulations, to which it was met with a cease and desist of its online offerings of Bitcoin option contracts.[125] Another notable case came in June of 2016, when Bitfinex "engaged in illegal, off-exchange commodity transactions and failed to register as a futures commission merchant . . . ."[126] Like TeraExchange, it immediately settled with the CFTC.[127]

The CFTC has classified Bitcoin as a commodity.[128] It has made clear that the crypto is to be governed by the CEA.[129] This is a fitting classification because Bitcoin, like gold or oil, has a singular price across the entire world that is based on supply and demand. Bitcoin's decentralized

[118]Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Grants Registration to 3 Swap Execution Facilities [hereinafter CFTC Swap Exchange Facilities] (May 26, 2016), https://www.cftc.gov/PressRoom/PressReleases/pr7375-16.

[119]*See* Swap, Investopedia *https://www.investopedia.com/terms/s/swap.asp* (last visited Nov. 14, 2018).

[120]CFTC Swap Execution Facilities, *supra* note 118.

[121]*Id.*

[122]In re TeraExchange LLC, CFTC Docket No. 15-33, 2015 WL 5658082 (Sept. 24, 2015).

[123]Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Settles with TeraExchange LLC, a Swap Execution Facility, for Failing to Enforce Prohibitions on Wash Trading and Prearranged Trading in Bitcoin Swap (Sept. 24, 2015), https://www.cftc.gov/PressRoom/PressReleases/pr7240-15 ("As a provisionally registered SEF, Tera is required under the SEF Core Principles of the [CEA] and CFTC Regulations to enact and enforce rules prohibiting certain types of trade practices on the SEF, including wash trading and prearranged trading.").

[124]Hughes, *supra* note 116, at 12.

[125]*Id.*

[126]In re BFXNA INC. d/b/a BITFINEX, CFTC Docket No. 16-19, 2016 WL 3137612 (June 2, 2016).

[127]Hughes, *supra* note 116, at 13.

[128]Matt Clinch, *Bitcoin Now Classed as a Commodity in the US*, CNBC (last updated Sept. 18, 2015, 3:48 PM), https://www.cnbc.com/2015/09/18/bitcoin-now-classed-as-a-commodity-in-the-us.html.

[129] *Id.*

attributes allow for the same valuation to exist across the world because a central institution cannot manipulate the supply or value.[130] If Bitcoins are not currency, then any trade involving them would essentially be a barter contract,[131] which is a commodity transaction because goods are exchanged without currency. One issue with this classification is that Bitcoin's rapid verification makes it fall outside the requirement of future delivery.[132]

d. What Are Initial Coin Offerings?

An Initial Coin Offering ("ICO") is a method used by issuer to raise capital for a planned project.[133] When an ICO is conducted the project tends to be in the early stages of development; it is not uncommon for there to be no plan for real world application.[134] These offerings may include two types of coins: (1) utility coins that may be exchanged for a good or service in the future; and (2) equity coins that provide a holder ownership of the venture or interest in the revenue.[135] These coins are usually exchanged for fiat currency, but in some instances may also be exchanged for another cryptocurrency.[136]

Coins and ICOs, like any other product, are subject to the same tests to determine if they are securities. If an ICO is considered to include the offer or sale of securities, it must either be registered with the appropriate securities regulators, or find an applicable exclusion.[137] Generally, most exemptions require sales exclusively to accredited investors, which tend to be organizations or an individual with a net worth of more than $1 million.[138]

III. Enforcement Actions

The first SEC investigation into whether cryptocurrencies should be considered securities came in 2017 against The DAO, or Decentralized Autonomous Organization.[139] The DAO was created as a for-profit entity that would issue tokens to fund its projects.[140] Following an extensive

[130] *See generally* Kaplanov, *supra* note 10, at 118.

[131] *Id.*at 140.

[132] *Id.* at 162 ("[T]he delivery of bitcoins . . . is . . . well outside of the requirements for future delivery. Even so, commodities transactions in a foreign currency are also not included under the CFTC's commodity regulation. While bitcoin is not technically foreign currency, it functions in the same manner . . . .").

[133] NASAA, *Informed Investor Advisory: Initial Coin Offerings* (April 2018), http://www.nasaa.org/44836/informed-investor-advisory-initial-coin-offerings/

[134] *Id.*

[135] *Id.*

[136] *Id.*

[137] *Id.*

[138] *Id.*; *see also* 17 CFR §230.500.

[139] Report of Investigation Pursuant Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207, 1, 1 https://www.sec.gov/litigation/investreport/34-81207.pdf.

[140] *Id.* (p1).

investigation by the SEC, it was determined that DAO tokens were securities under both the 1933 and 1934 Acts. [141] This is because they meet the investment contract test under *Howey.* Token holders invested money—the cryptocurrency Etherium—in exchange for the tokens.[142] The holders of these tokens were investing in a common enterprise and expected to share in the earnings from the projects as a return on their investments.[143] These profits were also to be derived primarily from the managerial efforts of the issuers, Slock.it, the co-founders, and those who manage The DAO.[144] Any entity that offers to sell or engages in exchanging these tokens must either register for find an exemption.[145]

Following The DAO Report, there have been many more enforcement actions by the SEC. One of the early enforcement actions regarding an ICO came against the REcoin Group Foundation and DRC World, also known as Diamond Reserve Club; each of these ventures purported to reuse investments to purchase real estate and diamonds in exchange for tokens that would provide sizeable returns.[146] Another notable enforcement action came against Munchee Inc.; there, "the company and other promoters emphasized that investors could expect that efforts by the company and others would lead to an increase in value of the tokens." [147] the first cases involving civil penalties came against ParagonCoin and Airfox, also known as CarrierEQ Inc.[148] There, both companies failed to register, nor qualified for any registration exemptions.[149] Stephanie Avakian, Co-Director of the SEC's Enforcement Division stated "'[w]e have made it clear that companies that issue securities through ICOs are required to comply with existing statutes and rules governing the registration of securities[.]'" These companies agreed to return funds to their investors and register their tokens, rather than be punished by the SEC.[150]

[141] *Id.*

[142] *Id.* at 11.

[143] *Id.* at 11-12 ("Thus, a reasonable investor would have been motivated, at least in part, by the prospect of profits on their investment of ETH in The DAO.").

[144] *Id.* at 12.

[145] *Id.* at 2.

[146] Press Release, Securities Exchange Commission, SEC Exposes Two Initial Coin Offerings Purportedly Backed by Real Estate and Diamonds (Sept. 29, 2017), https://www.sec.gov/news/press-release/2017-185-0 ("the SEC's complaint, filed in federal district court in Brooklyn, N.Y., charges [], REcoin, and Diamond with violations of the anti-fraud and registration provisions of the federal securities laws.").

[147] Press Release, Securities Exchange Commission, Company Halts ICO After SEC Raises Registration Concerns (Dec. 11, 2017), https://www.sec.gov/news/press-release/2017-227.

[148] Press Release, Securities Exchange Commission, Two ICO Issuers Settle SEC Registration Charges, Agree to Register Tokens as Securities (Nov. 16, 2018), https://www.sec.gov/news/press-release/2018-264.

[149] *Id.*

[150] *Id.*

It is not just companies that have been addressed by the SEC. Most notably, professional boxer Floyd Mayweather Jr. and music producer DJ Khaled have been met with charges by the SEC.[151] Their charges related to failure to disclose promotional payments derived from ICOs.[152] Mayweather failed to disclose about $300,000 from promoting three different ICOs, while Khaled failed to disclose a $50,000 payment from one of the same companies that paid Mayweather.[153] Both stars agreed to pay disgorgement penalties plus interest, and agreed to not promote any securities for two and three years respectively.[154]

IV. State Regulations

While federal regulators are still attempting to figure out how to handle cryptocurrencies, states have begun to take action on their own. California and New York are at the forefront of these regulations because they are home to many large crypto businesses.[155] The California Society of Certified Public Accountants ("CalCPA") is seeking clarity on the status of holdings from the Financial Accounting Standards Board ("FASB") because "accounting for digital currencies is not adequately captured under existing United States Generally Accepted Accounting Principles. . . ." [156] CalCPA has urged FASB to add a project for crypto accounting to the Emerging Issues Task Force's agenda.[157] This request followed a bipartisan letter from congress to the IRS requesting guidance on how to report taxes on cryptocurrency.[158] In February 2019, California introduced the "Uniform Regulation of Virtual Currency Business Act" to the legislature, it would "prohibit a person from engaging in virtual currency business activity, or holding itself out as such, unless licensed or registered with the Department of Business Oversight, subject to a variety of exemptions."[159]

[151]Press Release, Securities Exchange Commission, Two Celebrities Charged With Unlawfully Touting Coin Offerings (Nov. 29, 2018) https://www.sec.gov/news/press-release/2018-268.

[152]*Id.*

[153]*Id.*

[154]*Id.* ("Mayweather agreed to pay $300,000 in disgorgement, a $300,000 penalty, and $14,775 in prejudgment interest. Khaled agreed to pay $50,000 in disgorgement, a $100,000 penalty, and $2,725 in prejudgment interest. In addition, Mayweather agreed not to promote any securities, digital or otherwise for three years, and Khaled agreed to a similar ban for two years.").

[155]Rakesh Sharma, *More US States May Roll Out Cryptocurrency Regulations,* Investopedia (last updated Jun 25, 2019), https://www.investopedia.com/news/majority-us-states-are-still-acknowledge-cryptocurrencies/.

[156]Ana Alexandre, *California Public Accountants Seek Clarity on Cryptocurrency Holdings*, Cointelegraph (Jun. 5, 2019), https://cointelegraph.com/news/california-public-accounts-seek-clarity-on-cryptocurrency-holdings.

[157]*Id.*

[158]*Id.*

[159][159]Matthew E. Kohen & Justin S. Wales, *State Regulations on virtual Currency and Blockchain Technologies*, Carlton Fields (Last updated Apr. 19, 2019), https://www.carltonfields.com/insights/publications/2018/state-regulations-on-virtual-currency-and-blockchain-technologies.

The New York State Department of Financial Services established "BitLicense," a regulatory framework for virtual currency businesses that requires operations relating to transactions involving any form of virtual currency to obtain a state license.[160] Prior to being issued a BitLicense, the applicant must have strict compliance and supervisory policies in place, including anti-money laundering and know-your-customer procedures.[161] Additionally, NY's legislature AB8783 creates a task force to study the impact of cryptocurrencies on NY financial markets.[162]

Another state with extensive regulations, which may come as a surprise to many people, is Wyoming.[163] In March 2018, the "Utility Token Bill" was signed into law; it exempts utility tokens from state securities laws if the token and issuer meet three requirements: (1) a notice of intent to sell the tokens is filed with the state; (2) the purpose of the tokens is consumptive; and (3) the developer or seller did not sell the token to the initial buyer as an investment.[164] Additionally, the state has also amended their Money Transmitter Act to provide an exemption for virtual currency and have also exempted cryptocurrencies from state property taxes.[165] Other states are also considering how cryptocurrency may be utilized, for example, Ohio will begin allowing businesses to pay their taxes using the cryptocurrency.[166]

V. Conclusion

Both the CFTC and SEC have signaled the need to protect consumers and combat against fraud, but laws must be adopted to directly address cryptocurrencies as a whole.[167] However, states are taking steps to advance the use of Bitcoin and other cryptocurrencies.

[160]*Id.*; *see also* 23 NYCRR 200.

[161]*Id.*

[162]*Id.*

[163]*Id.* ("Wyoming has emerged as one of the most crypto-friendly jurisdictions in the United States.").

[164]*Id.*

[165]*Id.*; *see also* H.B. 19, 2018 Budget Sess. (Wyo. 2018); S.F. 111, 2018 Budget Sess. (Wyo. 2018).

[166]Paul Vigna, *Pay Taxes With Bitcoin? Ohio Says Sure*, The Wall Street Journal (Nov. 25, 2018, 11:02 AM), https://www.wsj.com/articles/pay-taxes-with-bitcoin-ohio-says-sure-1543161720.

[167]Brendan Pierson, *Virtual Currencies Are Commodities, U.S. Judge Rules*, Reuters (Mar. 6, 2018, 6:11 PM), https://www.reuters.com/article/us-usa-cftc-bitcoin/virtual-currencies-are-commodities-u-s-judge-rules-idUSKCN1GI32C.

Framework for "Investment Contract" Analysis of Digital Assets[1]

I. Introduction

If you are considering an Initial Coin Offering, sometimes referred to as an "ICO," or otherwise engaging in the offer, sale, or distribution of a digital asset,[2] you need to consider whether the U.S. federal securities laws apply. A threshold issue is whether the digital asset is a "security" under those laws.[3] The term "security" includes an "investment contract," as well as other instruments such as stocks, bonds, and transferable shares. A digital asset should be analyzed to determine whether it has the characteristics of any product that meets the definition of "security" under the federal securities laws. In this guidance, we provide a framework for analyzing whether a digital asset has the characteristics of one particular type of security – an "investment contract."[4] Both the Commission and the federal courts frequently use the "investment contract" analysis to determine whether unique or novel instruments or arrangements, such as digital assets, are securities subject to the federal securities laws.

The U.S. Supreme Court's *Howey* case and subsequent case law have found that an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.[5] The so-called "*Howey* test" applies to any contract, scheme, or transaction, regardless of whether it has any of the characteristics of typical securities.[6] The focus of the *Howey* analysis is not only on the form and terms of the instrument itself (in this case, the digital asset) but also on the circumstances surrounding the digital asset and the manner in which it is offered, sold, or resold (which includes secondary market sales). Therefore, issuers and other persons and entities engaged in the marketing, offer, sale, resale, or distribution of any digital asset will need to analyze the relevant transactions to determine if the federal securities laws apply.

The federal securities laws require all offers and sales of securities, including those involving a digital asset, to either be registered under its provisions or to qualify for an exemption from registration. The registration provisions require persons to disclose certain information to investors, and that information must be complete and not materially misleading. This requirement for disclosure furthers the federal securities laws' goal of providing investors with the information necessary to make informed investment decisions. Among the information

that must be disclosed is information relating to the essential managerial efforts that affect the success of the enterprise.[7] This is true in the case of a corporation, for example, but also may be true for other types of enterprises regardless of their organizational structure or form.[8] Absent the disclosures required by law about those efforts and the progress and prospects of the enterprise, significant informational asymmetries may exist between the management and promoters of the enterprise on the one hand, and investors and prospective investors on the other hand. The reduction of these information asymmetries through required disclosures protects investors and is one of the primary purposes of the federal securities laws.

II. Application of *Howey* to Digital Assets

In this guidance, we provide a framework for analyzing whether a digital asset is an investment contract and whether offers and sales of a digital asset are securities transactions. As noted above, under the *Howey* test, an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. Whether a particular digital asset at the time of its offer or sale satisfies the *Howey* test depends on the specific facts and circumstances. We address each of the elements of the *Howey* test below.

A. The Investment of Money

The first prong of the *Howey* test is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real (or fiat) currency, another digital asset, or other type of consideration.[9]

B. Common Enterprise

Courts generally have analyzed a "common enterprise" as a distinct element of an investment contract.[10] In evaluating digital assets, we have found that a "common enterprise" typically exists.[11]

C. Reasonable Expectation of Profits Derived from Efforts of Others

Usually, the main issue in analyzing a digital asset under the *Howey* test is whether a purchaser has a reasonable expectation of profits (or other financial returns) derived from the efforts of others. A purchaser may expect to realize a return through participating in

distributions or through other methods of realizing appreciation on the asset, such as selling at a gain in a secondary market. When a promoter, sponsor, or other third party (or affiliated group of third parties) (each, an "Active Participant" or "AP") provides essential managerial efforts that affect the success of the enterprise, and investors reasonably expect to derive profit from those efforts, then this prong of the test is met. Relevant to this inquiry is the "economic reality"[12] of the transaction and "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."[13] The inquiry, therefore, is an objective one, focused on the transaction itself and the manner in which the digital asset is offered and sold.

The following characteristics are especially relevant in an analysis of whether the third prong of the *Howey* test is satisfied.

1. Reliance on the Efforts of Others

The inquiry into whether a purchaser is relying on the efforts of others focuses on two key issues:

- Does the purchaser reasonably expect to rely on the efforts of an AP?
- Are those efforts "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise,"[14] as opposed to efforts that are more ministerial in nature?

Although no one of the following characteristics is necessarily determinative, the stronger their presence, the more likely it is that a purchaser of a digital asset is relying on the "efforts of others":

- An AP is responsible for the development, improvement (or enhancement), operation, or promotion of the network,[15] particularly if purchasers of the digital asset expect an AP to be performing or overseeing tasks that are necessary for the network or digital asset to achieve or retain its intended purpose or functionality.[16]
    - Where the network or the digital asset is still in development and the network or digital asset is not fully functional at the time of the offer or sale, purchasers

would reasonably expect an AP to further develop the functionality of the network or digital asset (directly or indirectly). This particularly would be the case where an AP promises further developmental efforts in order for the digital asset to attain or grow in value.

- There are essential tasks or responsibilities performed and expected to be performed by an AP, rather than an unaffiliated, dispersed community of network users (commonly known as a "decentralized" network).
- An AP creates or supports a market for,[17] or the price of, the digital asset. This can include, for example, an AP that: (1) controls the creation and issuance of the digital asset; or (2) takes other actions to support a market price of the digital asset, such as by limiting supply or ensuring scarcity, through, for example, buybacks, "burning," or other activities.
- An AP has a lead or central role in the direction of the ongoing development of the network or the digital asset. In particular, an AP plays a lead or central role in deciding governance issues, code updates, or how third parties participate in the validation of transactions that occur with respect to the digital asset.
- An AP has a continuing managerial role in making decisions about or exercising judgment concerning the network or the characteristics or rights the digital asset represents including, for example:
    - Determining whether and how to compensate persons providing services to the network or to the entity or entities charged with oversight of the network.
    - Determining whether and where the digital asset will trade. For example, purchasers may reasonably rely on an AP for liquidity, such as where the AP has arranged, or promised to arrange for, the trading of the digital asset on a secondary market or platform.
    - Determining who will receive additional digital assets and under what conditions.
    - Making or contributing to managerial level business decisions, such as how to deploy funds raised from sales of the digital asset.

- Playing a leading role in the validation or confirmation of transactions on the network, or in some other way having responsibility for the ongoing security of the network.
- Making other managerial judgements or decisions that will directly or indirectly impact the success of the network or the value of the digital asset generally.

- Purchasers would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset, such as where:
  - The AP has the ability to realize capital appreciation from the value of the digital asset. This can be demonstrated, for example, if the AP retains a stake or interest in the digital asset. In these instances, purchasers would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset.
  - The AP distributes the digital asset as compensation to management or the AP's compensation is tied to the price of the digital asset in the secondary market. To the extent these facts are present, the compensated individuals can be expected to take steps to build the value of the digital asset.
  - The AP owns or controls ownership of intellectual property rights of the network or digital asset, directly or indirectly.
  - The AP monetizes the value of the digital asset, especially where the digital asset has limited functionality.

In evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales, there would be additional considerations as they relate to the "efforts of others," including but not limited to:

- Whether or not the efforts of an AP, including any successor AP, continue to be important to the value of an investment in the digital asset.
- Whether the network on which the digital asset is to function operates in such a manner that purchasers would no longer reasonably expect an AP to carry out essential managerial or entrepreneurial efforts.
- Whether the efforts of an AP are no longer affecting the enterprise's success.

2. Reasonable Expectation of Profits

An evaluation of the digital asset should also consider whether there is a reasonable expectation of profits. Profits can be, among other things, capital appreciation resulting from the development of the initial investment or business enterprise or a participation in earnings resulting from the use of purchasers' funds.[18] Price appreciation resulting ***solely*** from external market forces (such as general inflationary trends or the economy) impacting the supply and demand for an underlying asset generally is not considered "profit" under the *Howey* test.

The more the following characteristics are present, the more likely it is that there is a reasonable expectation of profit:

- The digital asset gives the holder rights to share in the enterprise's income or profits or to realize gain from capital appreciation of the digital asset.
    - The opportunity may result from appreciation in the value of the digital asset that comes, at least in part, from the operation, promotion, improvement, or other positive developments in the network, particularly if there is a secondary trading market that enables digital asset holders to resell their digital assets and realize gains.
    - This also can be the case where the digital asset gives the holder rights to dividends or distributions.
- The digital asset is transferable or traded on or through a secondary market or platform, or is expected to be in the future.[19]
- Purchasers reasonably would expect that an AP's efforts will result in capital appreciation of the digital asset and therefore be able to earn a return on their purchase.
- The digital asset is offered broadly to potential purchasers as compared to being targeted to expected users of the goods or services or those who have a need for the functionality of the network.

- The digital asset is offered and purchased in quantities indicative of investment intent instead of quantities indicative of a user of the network. For example, it is offered and purchased in quantities significantly greater than any likely user would reasonably need, or so small as to make actual use of the asset in the network impractical.

- There is little apparent correlation between the purchase/offering price of the digital asset and the market price of the particular goods or services that can be acquired in exchange for the digital asset.
- There is little apparent correlation between quantities the digital asset typically trades in (or the amounts that purchasers typically purchase) and the amount of the underlying goods or services a typical consumer would purchase for use or consumption.
- The AP has raised an amount of funds in excess of what may be needed to establish a functional network or digital asset.
- The AP is able to benefit from its efforts as a result of holding the same class of digital assets as those being distributed to the public.
- The AP continues to expend funds from proceeds or operations to enhance the functionality or value of the network or digital asset.
- The digital asset is marketed, directly or indirectly, using any of the following:
  - The expertise of an AP or its ability to build or grow the value of the network or digital asset.
  - The digital asset is marketed in terms that indicate it is an investment or that the solicited holders are investors.
  - The intended use of the proceeds from the sale of the digital asset is to develop the network or digital asset.
  - The future (and not present) functionality of the network or digital asset, and the prospect that an AP will deliver that functionality.

- The promise (implied or explicit) to build a business or operation as opposed to delivering currently available goods or services for use on an existing network.
- The ready transferability of the digital asset is a key selling feature.
- The potential profitability of the operations of the network, or the potential appreciation in the value of the digital asset, is emphasized in marketing or other promotional materials.
- The availability of a market for the trading of the digital asset, particularly where the AP implicitly or explicitly promises to create or otherwise support a trading market for the digital asset.

In evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales, there would be additional considerations as they relate to the "reasonable expectation of profits," including but not limited to:

- Purchasers of the digital asset no longer reasonably expect that continued development efforts of an AP will be a key factor for determining the value of the digital asset.
- The value of the digital asset has shown a direct and stable correlation to the value of the good or service for which it may be exchanged or redeemed.
- The trading volume for the digital asset corresponds to the level of demand for the good or service for which it may be exchanged or redeemed.
- Whether holders are then able to use the digital asset for its intended functionality, such as to acquire goods and services on or through the network or platform.
- Whether any economic benefit that may be derived from appreciation in the value of the digital asset is incidental to obtaining the right to use it for its intended functionality.
- No AP has access to material, non-public information or could otherwise be deemed to hold material inside information about the digital asset.

3. Other Relevant Considerations

When assessing whether there is a reasonable expectation of profit derived from the efforts of others, federal courts look to the economic reality of the transaction.[20] In doing so, the courts also have considered whether the instrument is offered and sold for use or consumption by purchasers.[21]

Although no one of the following characteristics of use or consumption is necessarily determinative, the stronger their presence, the less likely the *Howey* test is met:

- The distributed ledger network and digital asset are fully developed and operational.
- Holders of the digital asset are immediately able to use it for its intended functionality on the network, particularly where there are built-in incentives to encourage such use.
- The digital assets' creation and structure is designed and implemented to meet the needs of its users, rather than to feed speculation as to its value or development of its network. For example, the digital asset can only be used on the network and generally can be held or transferred only in amounts that correspond to a purchaser's expected use.
- Prospects for appreciation in the value of the digital asset are limited. For example, the design of the digital asset provides that its value will remain constant or even degrade over time, and, therefore, a reasonable purchaser would not be expected to hold the digital asset for extended periods as an investment.
- With respect to a digital asset referred to as a virtual currency, it can immediately be used to make payments in a wide variety of contexts, or acts as a substitute for real (or fiat) currency.
    - This means that it is possible to pay for goods or services with the digital asset without first having to convert it to another digital asset or real currency.
    - If it is characterized as a virtual currency, the digital asset actually operates as a store of value that can be saved, retrieved, and exchanged for something of value at a later time.

- With respect to a digital asset that represents rights to a good or service, it currently can be redeemed within a developed network or platform to acquire or otherwise use those goods or services. Relevant factors may include:
    - There is a correlation between the purchase price of the digital asset and a market price of the particular good or service for which it may be redeemed or exchanged.
    - The digital asset is available in increments that correlate with a consumptive intent versus an investment or speculative purpose.
    - An intent to consume the digital asset may also be more evident if the good or service underlying the digital asset can only be acquired, or more efficiently acquired, through the use of the digital asset on the network.
- Any economic benefit that may be derived from appreciation in the value of the digital asset is incidental to obtaining the right to use it for its intended functionality.
- The digital asset is marketed in a manner that emphasizes the functionality of the digital asset, and not the potential for the increase in market value of the digital asset.
- Potential purchasers have the ability to use the network and use (or have used) the digital asset for its intended functionality.
- Restrictions on the transferability of the digital asset are consistent with the asset's use and not facilitating a speculative market.
- If the AP facilitates the creation of a secondary market, transfers of the digital asset may only be made by and among users of the platform.

Digital assets with these types of use or consumption characteristics are less likely to be investment contracts. For example, take the case of an online retailer with a fully-developed operating business. The retailer creates a digital asset to be used by consumers to purchase products only on the retailer's network, offers the digital asset for sale in exchange for real currency, and the digital asset is redeemable for products commensurately priced in that real currency. The retailer continues to market its products to its existing customer base, advertises

its digital asset payment method as part of those efforts, and may "reward" customers with digital assets based on product purchases. Upon receipt of the digital asset, consumers immediately are able to purchase products on the network using the digital asset. The digital assets are not transferable; rather, consumers can only use them to purchase products from the retailer or sell them back to the retailer at a discount to the original purchase price. Under these facts, the digital asset would not be an investment contract.

Even in cases where a digital asset can be used to purchase goods or services on a network, where that network's or digital asset's functionality is being developed or improved, there may be securities transactions if, among other factors, the following is present: the digital asset is offered or sold to purchasers at a discount to the value of the goods or services; the digital asset is offered or sold to purchasers in quantities that exceed reasonable use; and/or there are limited or no restrictions on reselling those digital assets, particularly where an AP is continuing in its efforts to increase the value of the digital assets or has facilitated a secondary market.

III. Conclusion

The discussion above identifies some of the factors market participants should consider in assessing whether a digital asset is offered or sold as an investment contract and, therefore, is a security. It also identifies some of the factors to be considered in determining whether and when a digital asset may no longer be a security. These factors are not intended to be exhaustive in evaluating whether a digital asset is an investment contract or any other type of security, and no single factor is determinative; rather, we are providing them to assist those engaging in the offer, sale, or distribution of a digital asset, and their counsel, as they consider these issues. We encourage market participants to seek the advice of securities counsel and engage with the Staff through www.sec.gov/finhub.

[1] This framework represents the views of the Strategic Hub for Innovation and Financial Technology ("FinHub," the "Staff," or "we") of the Securities and Exchange Commission (the "Commission"). It is not a rule, regulation, or statement of the Commission, and the Commission has neither approved nor disapproved its content. Further, this framework does not replace or supersede existing case law, legal requirements, or statements or guidance from the

Commission or Staff. Rather, the framework provides additional guidance in the areas that the Commission or Staff has previously addressed. *See, e.g., Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (Exchange Act Rel. No. 81207) (July 25, 2017) ("*The DAO Report*"); William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), available at https://www.sec.gov/news/speech/speech-hinman-061418.

[2] The term "digital asset," as used in this framework, refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens."

[3] The term "security" is defined in Section 2(a)(1) of the Securities Act of 1933 (the "Securities Act"), Section 3(a)(10) of the Securities Exchange Act of 1934, Section 2(a)(36) of the Investment Company Act of 1940, and Section 202(a)(18) of the Investment Advisers Act of 1940.

[4] This framework is intended to be instructive and is based on the Staff's experiences to date and relevant law and legal precedent. It is not an exhaustive treatment of the legal and regulatory issues relevant to conducting an analysis of whether a product is a security, including an investment contract analysis with respect to digital assets generally. We expect that analysis concerning digital assets as securities may evolve over time as the digital asset market matures. Also, no one factor is necessarily dispositive as to whether or not an investment contract exists.

[5] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) ("*Howey*"). *See also United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975) ("*Forman*"); *Tcherepnin v. Knight*, 389 U.S. 332 (1967) ("*Tcherepnin*"); *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) ("*Joiner*").

[6] Whether a contract, scheme, or transaction is an investment contract is a matter of federal, not state, law and does not turn on whether there is a formal contract between parties. Rather, under the *Howey* test, "form [is] disregarded for substance and the emphasis [is] on economic reality." *Howey*, 328 U.S. at 298. The Supreme Court has further explained that that the term security "embodies a flexible rather than a static principle" in order to meet the "variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299.

[7] Issuers of digital assets, like all issuers, must provide full and fair disclosure of material information consistent with the requirements of the federal securities laws. Issuers of digital assets should be guided by the regulatory framework and concepts of materiality. What is material depends upon the nature and structure of the issuer's particular network and circumstances. *See TSC Industries v. Northway*, 426 U.S. 438, 449 (1976) (a fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision or if it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" to the shareholder).

[8] *See The DAO Report*.

[9] The lack of monetary consideration for digital assets, such as those distributed via a so-called "bounty program" does not mean that the investment of money prong is not satisfied. As the Commission explained in *The DAO Report*, "[i]n determining whether an investment contract exists, the investment of 'money' need not take the form of cash" and "in spite of *Howey's* reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract." *The DAO Report* at 11 (citation omitted). *See In re Tomahawk Exploration LLC*, Securities Act Rel. 10530 (Aug. 14, 2018) (issuance of tokens under a so-called "bounty program" constituted an offer and sale of securities because the issuer provided tokens to investors in exchange for services designed to advance the issuer's economic interests and foster a trading market for its securities). Further, the lack of monetary consideration for digital assets, such as those distributed via a so-called "air drop," does not mean that the investment of money prong is not satisfied; therefore, an airdrop may constitute a sale or distribution of securities. In a so-called "airdrop," a digital asset is distributed to holders of another digital asset, typically to promote its circulation.

[10] In order to satisfy the "common enterprise" aspect of the *Howey* test, federal courts require that there be either "horizontal commonality" or "vertical commonality." *See Revak v. SEC Realty Corp*., 18 F.3d. 81, 87-88 (2d Cir. 1994) (discussing horizontal commonality as "the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits" and two variants of vertical commonality, which focus "on the relationship between the promoter and the body of investors"). The Commission, on the other hand, does not require vertical or horizontal commonality *per se*, nor does it view a "common enterprise" as a distinct element of the term "investment contract." *In re Barkate*, 57 S.E.C. 488, 496 n.13 (Apr. 8, 2004); *see also* the Commission's Supplemental Brief at 14 in *SEC v. Edwards*, 540 U.S. 389 (2004) (on remand to the 11th Circuit).

[11] Based on our experiences to date, investments in digital assets have constituted investments in a common enterprise because the fortunes of digital asset purchasers have been linked to each other or to the success of the promoter's efforts. *See SEC v. Int'l Loan Network, Inc.*, 968 F.2d 1304, 1307 (D.C. Cir. 1992).

[12] *Howey*, 328 U.S. at 298. *See also Tcherepnin*, 389 U.S. at 336 ("in searching for the meaning and scope of the word 'security' in the [Acts], form should be disregarded for substance and the emphasis should be on economic reality.")

[13] *Joiner*, 320 U.S. at 352-53.

[14] *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973) ("*Turner*").

[15] In this guidance, we are using the term "network" broadly to encompass the various elements that comprise a digital asset's network, enterprise, platform, or application.

[16] We recognize that holders of digital assets may put forth some effort in the operations of the network, but those efforts do not negate the fact that the holders of digital assets are relying on the efforts of the AP. That a scheme assigns "nominal or limited responsibilities to the [investor] does not negate the existence of an investment contract." *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 n.15 (5th Cir. 1974) (citation and quotation marks omitted). If the AP provides efforts that are "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise," and the AP is not merely performing ministerial or routine tasks, then there likely is an investment contract. *See Turner*, 474 U.S. at 482; *see also The DAO Report* (although DAO token holders had certain voting rights, they nonetheless reasonably relied on the managerial efforts of others). Managerial and entrepreneurial efforts typically are characterized as involving expertise and decision-making that impacts the success of the business or enterprise through the application of skill and judgment.

[17] *See, e.g., Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce Fenner & Smith*, 756 F.2d 230 (2d Cir. 1985).

[18] *See Forman*, 421 U.S. at 852.

[19] Situations where the digital asset is exchangeable or redeemable solely for goods or services within the network or on a platform, and may not otherwise be transferred or sold, may more likely be a payment for a good or service in which the purchaser is motivated to use or consume the digital asset. *See* discussion of "Other Relevant Considerations."

[20] As noted above, under *Howey*, courts conduct an objective inquiry focused on the transaction itself and the manner in which it is offered.

[21] *See Forman*, 421 U.S. at 852-53 (where a purchaser is not "'attracted solely by the prospects of a return' on his investment . . . [but] is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply.").

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News Release

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Joint Statement on Broker-Dealer Custody of Digital Asset Securities

WASHINGTON – Market participants have raised questions concerning the application of the federal securities laws and the rules of the Financial Industry Regulatory Authority ("FINRA") to the potential intermediation —including custody—of digital asset securities[1] and transactions. In this statement, the staffs of the Division of Trading and Markets (the "Division") and FINRA (collectively, the "Staffs")—drawing upon key principles from their historic approach to broker-dealer regulation and investor protection—have articulated various considerations relevant to many of these questions, particularly under the SEC's Customer Protection Rule applicable to SEC-registered broker-dealers.[2]

As a threshold matter, it should be recognized by market participants that the application of the federal securities laws, FINRA rules and other bodies of laws to digital assets, digital asset securities and related innovative technologies raise novel and complex regulatory and compliance questions and challenges. For example, and as discussed in more detail below, the ability of a broker-dealer to comply with aspects of the Customer Protection Rule is greatly facilitated by established laws and practices regarding the loss or theft of a security, that may not be available or effective in the case of certain digital assets.

The Staffs are aware of, and encourage and support, efforts to address these issues such that compliance with the Customer Protection Rule and other federal securities laws and FINRA rules is reasonably practicable. In recent months, the Staffs have been engaged with industry participants regarding how industry participants believe a particular custody solution for digital asset securities would meet the possession or control standards prescribed in the SEC's Customer Protection Rule. The Staffs have found these discussions to be very informative and appreciate market participants' ongoing engagement on these issues. The Staffs encourage and support innovation and look forward to continuing our dialogue as market participants work toward developing methodologies for establishing possession or control over customers' digital asset securities. Contact information for Commission and FINRA staffs is provided at the end of this statement.

Importance of the Customer Protection Rule

Entities seeking to participate in the marketplace for digital asset securities must comply with the relevant securities laws.[3] An entity that buys, sells, or otherwise transacts or is involved in effecting transactions in digital asset securities for customers or its own account is subject to the federal securities laws, and may be required to register with the Commission as a broker-dealer and become a member of and comply with the rules of a self-regulatory organization ("SRO"), which in most cases is FINRA. Importantly, if the entity is a

broker-dealer, it must comply with broker-dealer financial responsibility rules,[4] including, as applicable, custodial requirements under Rule 15c3-3 under the Securities Exchange Act of 1934 (the "Exchange Act"), which is known as the Customer Protection Rule.

The purpose of the Customer Protection Rule is to safeguard customer securities and funds held by a broker-dealer, to prevent investor loss or harm in the event of a broker-dealer's failure, and to enhance the Commission's ability to monitor and prevent unsound business practices. Put simply, the Customer Protection Rule requires broker-dealers to safeguard customer assets and to keep customer assets separate from the firm's assets, thus increasing the likelihood that customers' securities and cash can be returned to them in the event of the broker-dealer's failure. The requirements of the Customer Protection Rule have produced a nearly fifty year track record[5] of recovery for investors when their broker-dealers have failed. This record of protecting customer assets held in custody by broker-dealers stands in contrast to recent reports of cybertheft,[6] and underscores the need to ensure broker-dealers' robust protection of customer assets, including digital asset securities.

Various unregistered entities that intend to engage in broker-dealer activities involving digital asset securities are seeking to register with the Commission and have submitted New Membership Applications ("NMAs") to FINRA. Additionally, various entities that are already registered broker-dealers and FINRA members are seeking to expand their businesses to include digital asset securities services and activities. Under FINRA rules, a firm is prohibited from materially changing its business operations (*e.g.*, engaging in material digital asset securities activities for the first time) without FINRA's prior approval of a Continuing Membership Application ("CMA").[7]

The NMAs and CMAs currently before FINRA are diverse: Some of the NMAs and CMAs cover proposed business models that would not involve the broker-dealer engaging in custody of digital asset securities. On the other hand, some NMAs and CMAs include the custodying of digital asset securities, and therefore implicate the Customer Protection Rule, among other requirements.

Some of these entities have met with the Staffs to discuss how they propose to custody digital asset securities in order to comply with the broker-dealer financial responsibility rules. These discussions have been informative. The specific circumstances where a broker-dealer could custody digital asset securities in a manner that the Staffs believe would comply with the Customer Protection Rule remain under discussion, and the Staffs stand ready to continue to engage with entities pursuing this line of business.

Noncustodial Broker-Dealer Models for Digital Asset Securities

As noted, some entities contemplate engaging in broker-dealer activities involving digital asset securities that would not involve the broker-dealer engaging in custody functions. Generally speaking, noncustodial activities involving digital asset securities do not raise the same level of concern among the Staffs, provided that the relevant securities laws, SRO rules, and other legal and regulatory requirements are followed.[8] The following are examples of some of the business activities of this type that have been presented or described to the Staffs.

- One example is where the broker-dealer sends the trade-matching details (*e.g.*, identity of the parties, price, and quantity) to the buyer and issuer of a digital asset security—similar to a traditional private placement—and the issuer settles the transaction bilaterally between the buyer and issuer, away from the broker-dealer. In this case, the broker-dealer instructs the customer to pay the issuer directly and instructs the issuer to issue the digital asset security to the customer directly (*e.g.*, the customer's "digital wallet").

- A second example is where a broker-dealer facilitates "over-the counter" secondary market transactions in digital asset securities without taking custody of or exercising control over the digital asset securities. In this example, the buyer and seller complete the transaction directly and, therefore, the securities do not pass through the broker-dealer facilitating the transaction.

- Another example is where a secondary market transaction involves a broker-dealer introducing a buyer to a seller of digital asset securities through a trading platform where the trade is settled directly between the buyer and seller. For instance, a broker-dealer that operates an alternative trading system ("ATS") could match buyers and sellers of digital asset securities and the trades would either be settled directly between the buyer and seller, or the buyer and seller would give instructions to their respective custodians to settle the transactions.[9] In either case, the ATS would not guarantee or otherwise have responsibility for settling the trades and would not at any time exercise any level of control over the digital asset securities being sold or the cash being used to make the purchase (*e.g.*, the ATS would not place a temporary hold on the seller's wallet or on the buyer's cash to ensure the transaction is completed).

Considerations for Broker-Dealer Custody of Digital Asset Securities

Whether a security is paper or digital, the same fundamental elements of the broker-dealer financial responsibility rules apply. The Staffs acknowledge that market participants wishing to custody digital asset securities may find it challenging to comply with the broker-dealer financial responsibility rules without putting in place significant technological enhancements and solutions unique to digital asset securities. As the market, infrastructure, and law applicable to digital asset securities continue to develop, the Staffs will continue their constructive engagement with market participants and to gather additional information so that they may better respond to developments in the market[10] while advancing the missions of our respective organizations: for the SEC, to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation; and for FINRA, to provide investor protection and promote market integrity.

The Customer Protection Rule

Overview

A broker-dealer seeking to custody digital asset securities must comply with the Customer Protection Rule. As noted, the rule is designed principally to protect customers of a registered broker-dealer from losses and delays in accessing their securities and cash that can occur if the firm fails. The rule requires the broker-dealer to safeguard customer securities and cash entrusted to the firm, as discussed below. If the broker-dealer fails, customer securities and cash should be readily available to be returned to customers.[11] In the event the broker-dealer were to be liquidated under SIPA, the SIPA trustee would be expected to step into the shoes of the broker-dealer and expected to be able to transfer, sell, or otherwise dispose of assets in accordance with SIPA.[12]

Among its core protections for customers, Rule 15c3-3 requires a broker-dealer to physically hold customers' fully paid and excess margin securities or maintain them free of lien at a good control location.[13] Generally, a broker-dealer may custody customer securities with a third-party custodian (*e.g.*, the Depository Trust Company or a clearing bank),[14] and uncertificated securities, such as mutual funds, may be held at the issuer or at the issuer's transfer agent.[15] In either case, there is a third party that controls the transfer of the securities. This traditional securities infrastructure (including, for example, related laws of property and security) also has processes to reverse or cancel mistaken or unauthorized transactions.

Considerations for Digital Asset Securities

There are many significant differences in the mechanics and risks associated with custodying traditional securities and digital asset securities. For instance, the manner in which digital asset securities are issued, held, and transferred may create greater risk that a broker-dealer maintaining custody of them could be victimized by fraud or theft, could lose a "private key" necessary to transfer a client's digital asset securities, or could transfer a client's digital asset securities to an unknown or unintended address without meaningful recourse to invalidate fraudulent transactions, recover or replace lost property, or correct errors. Consequently, a broker-dealer must consider how it can, in conformance with Rule 15c3-3, hold in possession or control digital asset securities.

In particular, a broker-dealer may face challenges in determining that it, or its third-party custodian, maintains custody of digital asset securities.[16] If, for example, the broker-dealer holds a private key, it may be able to transfer such securities reflected on the blockchain or distributed ledger. However, the fact that a broker-dealer (or its third party custodian) maintains the private key may not be sufficient evidence by itself that the broker-dealer has exclusive control of the digital asset security (*e.g.*, it may not be able to demonstrate that no other party has a copy of the private key and could transfer the digital asset security without the broker-dealer's consent).[17] In addition, the fact that the broker-dealer (or custodian) holds the private key may not be sufficient to allow it to reverse or cancel mistaken or unauthorized transactions. These risks could cause securities customers to suffer losses, with corresponding liabilities for the broker-dealer, imperiling the firm, its customers, and other creditors.

The Books and Records and Financial Reporting Rules

Overview

The broker-dealer recordkeeping and reporting rules[18] require a broker-dealer, among other things, to make and keep current ledgers reflecting all assets and liabilities,[19] as well as a securities record reflecting each security carried by the broker-dealer for its customers and all differences determined by the count of customer securities in the broker-dealer's possession or control compared to the result of the count with the broker-dealer's existing books and records.[20] The financial responsibility rules also require that broker-dealers routinely prepare financial statements,[21] including various supporting schedules particular to broker-dealers, such as Computation of Net Capital under Rule 15c3-1 and Information Relating to the Possession or Control Requirements under Rule 15c3-3 under the Exchange Act.[22]

The books, records, and financial reporting requirements are designed to ensure that a broker-dealer makes and maintains certain business records to assist the firm in accounting for its activities. These rules also assist securities regulators in examining for compliance with the federal securities laws and as such are an integral part of the financial responsibility program for broker-dealers.

Considerations for Digital Asset Securities

The nature of distributed ledger technology, as well as the characteristics associated with digital asset securities, may make it difficult for a broker-dealer to evidence the existence of digital asset securities for the purposes of the broker-dealer's regulatory books, records, and financial statements, including supporting schedules. The broker-dealer's difficulties in evidencing the existence of these digital asset securities may in turn create challenges for the broker-dealer's independent auditor seeking to obtain sufficient appropriate audit evidence when testing management's assertions in the financial statements during the annual broker-dealer audit.[23] We understand that some firms are considering the use of distributed ledger technology with features designed to enable firms to meet recordkeeping obligations and facilitate prompt verification of digital asset

security positions (*e.g.*, regulatory nodes or permissioned distributed ledger technologies). Broker-dealers should consider how the nature of the technology may impact their ability to comply with the broker-dealer recordkeeping and reporting rules.

Securities Investor Protection Act of 1970

Overview

Generally, a broker-dealer that fails and is unable to return the customer property that it holds would be liquidated in accordance with SIPA. Under SIPA, securities customers have a first priority claim to cash and securities held by the firm for securities customers. Customers also are eligible for up to $500,000 in protection (of which up to $250,000 can be used for cash claims) if the broker-dealer is missing customer assets. These SIPA protections apply to a "security" as defined in SIPA and cash deposited with the broker-dealer for the purpose of purchasing securities.[24] They do not apply to other types of assets, including, importantly, assets that are securities under the federal securities laws but are excluded from the definition of "security" under SIPA.[25]

Considerations for Digital Asset Securities

In the case of a digital asset security that does not meet the definition of "security" under SIPA, and in the event of the failure of a carrying broker-dealer, SIPA protection likely would not apply and holders of those digital asset securities would have only unsecured general creditor claims against the broker-dealer's estate.[26] Further, uncertainty regarding when and whether a broker-dealer holds a digital asset security in its possession or control creates greater risk for customers that their securities will not be able to be returned in the event of a broker-dealer failure.[27] The Staffs believe that such potential outcomes are likely to be inconsistent with the expectations of persons who would use a broker-dealer to custody their digital asset securities.

Control Location Applications

As a related matter, the Staffs have received inquiries from broker-dealers, including ATSs, wishing to utilize an issuer or transfer agent as a proposed "control location" for purposes of the possession or control requirements under the Customer Protection Rule. As described to the Staffs, this would involve uncertificated securities where the issuer or a transfer agent maintains a traditional single master security holder list, but also publishes as a courtesy the ownership record using distributed ledger technology. While the issuer or transfer agent may publish the distributed ledger, in these examples, the broker-dealers have asserted that the distributed ledger is not the authoritative record of share ownership. To the extent a broker-dealer contemplates an arrangement of this type, the Division will consider whether the issuer or the transfer agent can be considered a satisfactory control location pursuant to an application under paragraph (c)(7) of Rule 15c3-3.[28]

As noted, the Staffs encourage and support innovation in the securities markets and look forward to continuing to engage with investors and industry participants as the marketplace for digital asset securities develops. To contact Commission staff for assistance, please visit the Commission's FinHub webpage or contact Thomas K. McGowan, Associate Director, at (202) 551-5521 or Raymond Lombardo, Assistant Director, at (202) 551-5755. To contact FINRA staff for assistance, please visit FINRA's FinTech webpage or contact Kosha Dalal, Associate Vice President and Associate General Counsel, FINRA, (202) 728-6903.

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[1] For the purposes of this statement, the term "digital asset" refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens." A digital asset may or may not meet the definition of a "security" under the federal

securities laws. For the purposes of this statement, a digital asset that is a security is referred to as a "digital asset security."

[2] This statement represents staff views of the Division of Trading and Markets and FINRA. This statement is not a rule, regulation, guidance, or statement of the U.S. Securities and Exchange Commission ("SEC" or "Commission") or FINRA, and the Commission and FINRA's Board have neither approved nor disapproved its content. This statement does not alter or amend applicable law and has no legal force or effect.

[3] For purposes of this statement, the Staffs use the term "entities" to refer to both firms and individuals.

[4] The financial responsibility rules include Rule 15c3-1 (the net capital rule), Rule 15c3-3 (the customer protection rule), Rule 17a-3 (the record making rule), Rule 17a-4 (the record retention rule), Rule 17a-5 (the financial reporting rule), and Rule 17a-13 (the quarterly securities count rule) under the Securities Exchange Act of 1934 ("Exchange Act"). This statement does not address all federal securities laws that may be implicated by a broker-dealer seeking to maintain custody of digital asset securities. Further, this statement does not address other securities laws or rules that may apply to digital asset securities.

[5] Rule 15c3-3 was adopted by the Commission in 1972. See Broker-Dealers; Maintenance of Certain Basic Reserves, Exchange Act Release No. 9856 (Nov. 10, 1972), 37 Fed. Reg. 25224 (Nov. 29, 1972).

[6] For example, one blockchain forensic analysis firm estimated that approximately $1.7 billion worth of bitcoin and other digital assets had been stolen in 2018, of which approximately $950 million resulted from cyberattacks on bitcoin trading platforms. The estimate of total losses in 2018 is 3.6 times higher than the estimate of such losses in 2017. See CipherTrace, Cryptocurrency Anti-Money Laundering Report, 2018 Q4, at 3 (Jan. 2019) (available at: https://ciphertrace.com/crypto-aml-report-2018q4/).

[7] Firms can discuss with FINRA whether a contemplated change in business operations such as engaging in digital asset securities activities may require the filing of a CMA through the materiality consultation process.

[8] These business models and transactions must comply with other provisions of the securities laws or regulations. The Staffs offer no views about whether such business models would be in compliance with other securities laws or regulations.

[9] Entities that perform functions to facilitate the clearance and settlement of transactions in digital asset securities may be required to register as a clearing agency under Section 17A of the Exchange Act. See 15 U.S.C. 78q-1.

[10] See, *e.g.*, Statement on Digital Asset Securities Issuance and Trading, Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets, Commission (Nov. 16, 2018) (available at: https://www.sec.gov/news/public-statement/digital-asset-securites-issuuance-and-trading); see also *e.g.*, Engaging on Non-DVP Custodial Practices and Digital Assets, letter issued by staff, Division of Investment Management, Commission, dated Mar. 12, 2019 (available at: https://www.sec.gov/investment/engaging-non-dvp-custodial-practices-and-digital-assets).

[11] See Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 70072 (July 30, 2013), 78 Fed. Reg. 51824, 51826 (Aug. 21, 2013). In addition, if the broker-dealer is liquidated in a formal proceeding under the Securities Investor Protection Act of 1970 ("SIPA"), the securities and cash held by the broker-dealer for its customers would be isolated and readily identifiable as "customer property" and, consequently, available to be distributed to customers ahead of other creditors. Id.

[12] See 15 U.S.C. 78fff-1 (setting forth the powers and duties of a SIPA trustee).

[13] See paragraphs (b) and (c) of Rule 15c3-3. An entity's designation as a good control location is based, in part, on its ability to maintain exclusive control over customer securities. See, *e.g.*, paragraph (c)(5) of Rule 15c3-3 (deeming a "bank" as defined in Section 3(a)(6) of the Exchange Act to be a good control location so long as, among other things, the bank has acknowledged that customer securities "are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank" and the securities are in the custody or control of the bank).

[14] See paragraphs (c)(1) and (c)(5) of Rule 15c3-3.

[15] The Commission often receives applications under paragraph (c)(7) of Rule 15c3-3 to designate an issuer or the transfer agent of various types of uncertificated securities as a control location. The Division has delegated authority to "find and designate as control locations for purposes of Rule 15c3-3(c)(7) [under the Exchange Act] certain broker-dealer accounts which are adequate for the protection of customer securities." See 17 CFR 200.30-3(a)(10)(i). The Commission has stated that mutual funds in particular may be held at the issuer or the issuer's transfer agent. See, *e.g.*, Broker-Dealer Reports, Exchange Act Release No. 70073 (July 30, 2013), 78 Fed. Reg. 51910, 51951 (Aug. 21, 2013) (stating that "[g]enerally, mutual funds issue securities only in book-entry form. This means that the ownership of securities is not reflected on a certificate that can be transferred but rather through a journal entry on the books of the issuer maintained by the issuer's transfer agent. A broker-dealer that holds mutual funds for customers generally holds them in the broker-dealer's name on the books of the mutual fund"). See also Form Custody for Broker-Dealers, 17 CFR 249.639 (providing broker-dealers with a field to indicate that they custody mutual fund securities with a transfer agent). The Division has also previously issued no-action letters regarding the maintenance of certain other uncertificated securities at the transfer agent. See, *e.g.*, letter to Fantex Brokerage Services, LLC from Mark M. Attar, Senior Special Counsel, Division of Trading and Markets, Commission, dated Dec. 19, 2014 (providing that the staff would not recommend enforcement action if a broker-dealer treats a transfer agent for uncertificated securities as a good control location, under certain circumstances). These prior no-action letters do not address whether blockchain or distributed ledger technology, in connection with the maintenance of the single master security holder list, establishes control of uncertificated securities by the issuer (or transfer agent).

[16] See, *e.g.,* paragraph (d) of Rule 15c3-3 (requiring that, not later than the next business day, a broker-dealer, as of the close of the preceding business day, shall determine the quantity of fully paid securities and excess margin securities in its possession or control and the quantity of such securities not in its possession or control).

[17] Cf. supra note 13.

[18] See generally Rules 17a-3, 17a-4, and 17a-5.

[19] See paragraph (a)(2) of Rule 17a-3.

[20] See paragraph (a)(5) of Rule 17a-3.

[21] See generally Rule 17a-5.

[22] See paragraph (d)(2)(ii) of Rule 17a-5.

[23] See generally PCAOB Auditing Standard 1105, Audit Evidence (describing sufficient appropriate audit evidence and stating that audit evidence consists of information that supports and corroborates management's assertions regarding the financial statements and information that contradicts such assertions).

[24] The SIPA definition of "security" is different than the federal securities laws definitions. See 15 U.S.C.

78lll(14) (excluding from the SIPA definition of "security" an investment contract or interest that is not the subject of a registration statement with the Commission pursuant to the provisions of the Securities Act of 1933). This means there may be digital assets that are: (1) securities under the federal securities laws and SIPA, and thus are protected by SIPA; (2) securities under the federal securities laws, but not under SIPA, and thus not protected by SIPA; or (3) not securities under the federal securities laws and therefore not protected by SIPA.

[25] If a broker-dealer holds securities that are not protected by SIPA, the broker-dealer must nevertheless comply with the physical possession or control requirements under Rule 15c3-3 with respect to those securities.

[26] Generally, in a SIPA liquidation, assets not included in customer property (other than customer name securities) are liquidated and paid out to general creditors on a pro rata basis. See 15 U.S.C. 78fff-2(c); 15 U.S.C. 78fff(b).

[27] See supra note 16.

[28] See paragraph (c)(7) of Rule 15c3-3.

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Regulatory Notice 19-24

Digital Assets

FINRA Encourages Firms to Notify FINRA if They Engage in Activities Related to Digital Assets

Summary

Last year, FINRA took several steps to engage with members regarding their current and planned activities relating to digital assets. These efforts included the issuance of *Regulatory Notice 18-20*, which encouraged firms to keep their Regulatory Coordinator informed if the firm, or its associated persons or affiliates, engaged, or intended to engage, in activities related to digital assets, including digital assets that are non-securities.[1] *Regulatory Notice 18-20* requested that firms provide these updates to Regulatory Coordinators until July 31, 2019. FINRA appreciates members' cooperation over the past year and is encouraging firms to continue keeping their Regulatory Coordinators abreast of their activities related to digital assets until **July 31, 2020**.

Questions concerning this *Notice* may be directed to:

- Kosha Dalal, Associate Vice President & Associate General Counsel, Office of General Counsel (OGC), at (202) 728-6903 or by email at *kosha.dalal@finra.org*;
- Racquel Russell, Associate General Counsel, OGC, at (202) 728-8363 or by email at *racquel.russell@finra.org*; or
- Cara Bain, Assistant General Counsel, OGC, at (202) 728-8852 or by email at *cara.bain@finra.org*.

Background & Discussion

In 2018, FINRA undertook a multifaceted outreach initiative to engage with member firms regarding current and planned activities relating to digital assets, such as cryptocurrencies and other virtual coins and tokens.[2] FINRA requested that communication be ongoing and asked that, until July 31, 2019, each member keep its Regulatory Coordinator informed of new activities or plans regarding digital assets, including cryptocurrencies and other virtual coins and tokens (whether or not they meet the definition of "security" for the purposes of the federal securities laws and FINRA rules).[3] FINRA greatly appreciates the ongoing cooperation and outreach from members over the past year.

July 18, 2019

Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Operations
- Regulatory Reporting
- Senior Management
- Trading
- Training

Key Topics

- Blockchain
- Cryptocurrencies
- Definition of "Security"
- Digital Assets
- Distributed Ledger Technology
- Initial Coin Offerings
- Virtual Coin
- Virtual Token

Referenced Rules & Notices

- FINRA Rule 1017
- FINRA Rule 3210
- FINRA Rule 3270
- FINRA Rule 3280
- Notice to Members 00-73
- Regulation ATS
- Regulatory Notice 09-46
- Regulatory Notice 18-20
- Section 2(a)(1) of the Securities Act of 1933
- Section 3(a)(10) of the Securities Exchange Act of 1934

As securities regulators continue to provide guidance to members regarding the unique regulatory challenges presented by digital assets—*e.g.,* Joint Statement on Broker-Dealer Custody of Digital Asset Securities—FINRA believes it is important to keep the lines of communication with members open on this important topic.[4] As a result, FINRA is issuing this Notice to encourage each firm to continue to keep FINRA up to date on the firm's new and planned activities relating to digital assets not previously disclosed.

As was the case under *Regulatory Notice 18-20*, FINRA asks that each firm promptly notify its Regulatory Coordinator if it, or its associated persons (including activities under Rules 3270 and 3280),[5] or affiliates, currently engages, or intends to engage, in any activities related to digital assets.[6] As a reminder, the types of activities of interest to FINRA if undertaken (or planned) by a member, its associated persons or affiliates, include, but are not limited to:

- purchases, sales or executions of transactions in digital assets;
- purchases, sales or executions of transactions in a pooled fund investing in digital assets;
- creation of, management of, or provision of advisory services for, a pooled fund related to digital assets;
- purchases, sales or executions of transactions in derivatives (*e.g.,* futures, options) tied to digital assets;
- participation in an initial or secondary offering of digital assets (*e.g.,* ICO, pre-ICO);
- creation or management of a platform for the secondary trading of digital assets;
- custody or similar arrangement of digital assets;[7]
- acceptance of cryptocurrencies (*e.g.,* bitcoin) from customers;
- mining of cryptocurrencies;
- recommend, solicit or accept orders in cryptocurrencies and other virtual coins and tokens;
- display indications of interest or quotations in cryptocurrencies and other virtual coins and tokens;
- provide or facilitate clearance and settlement services for cryptocurrencies and other virtual coins and tokens; or
- recording cryptocurrencies and other virtual coins and tokens using distributed ledger technology or any other use of blockchain technology.[8]

Until **July 31, 2020**, FINRA encourages firms to promptly notify their Regulatory Coordinator in writing (including email) of these activities. If a firm already has submitted a continuing membership application (CMA)[9] regarding its involvement in activities related to digital assets, or has otherwise provided this information to FINRA, additional notice is not requested unless a change has occurred.

Endnotes

1. *See Regulatory Notice 18-20* (FINRA Encourages Firms to Notify FINRA if They Engage in Activities Related to Digital Assets) (July 6, 2018).

2. For purposes of this *Notice*, the term "digital asset" refers to cryptocurrencies and other virtual coins and tokens (including virtual coins and tokens offered in an initial coin offering (ICO) or pre-ICO), and any other asset that consists of, or is represented by, records in a blockchain or distributed ledger (including any securities, commodities, software, contracts, accounts, rights, intangible property, personal property, real estate or other assets that are "tokenized," "virtualized" or otherwise represented by records in a blockchain or distributed ledger).

3. Firms that engage in activities related to digital assets, whether or not they are securities, are reminded to consider all applicable FINRA rules and federal and state laws, rules and regulations. In addition, digital assets that meet the definition of an "investment contract" under Section 2(a)(1) of the Securities Act of 1933 or under Section 3(a)(10) of the Securities Exchange Act of 1934 are "securities" governed by the federal securities laws and FINRA rules, irrespective of whether or not they are labeled as "securities." On April 3, 2019, the Strategic Hub for Innovation and Financial Technology of the Commission published a framework for analyzing whether a digital asset has the characteristics of an "investment contract" and whether offers and sales of a digital asset are securities transactions. *See* Strategic Hub for Innovation and Financial Technology of the Securities and Exchange Commission, Framework for "Investment Contract" Analysis of Digital Assets (April 3, 2019) (Framework). *See also* Securities Exchange Act Release No. 81207 (July 25, 2017), Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO.

4. *See, e.g.,* Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities, Division of Trading and Markets, U.S. Securities and Exchange Commission and Office of General Counsel, Financial Industry Regulatory Authority, (July 8, 2019) (Joint Statement).

5. FINRA continues to be interested in learning how firms handle notifications regarding participation in activities related to digital assets, such as cryptocurrencies and other virtual coins and tokens. *See* FINRA Rule 3270 (Outside Business Activities of Registered Persons) and Rule 3280 (Private Securities Transactions of an Associated Person). FINRA is not requesting notification or information regarding passive investments and activities of associated persons that are subject to the requirements of Rule 3210 (Accounts at Other Broker-Dealers and Financial Institutions).

6. This notification is separate from any existing regulatory obligations under FINRA rules that may apply to a firm regarding its involvement in activities relating to digital assets (*e.g.,* trade reporting transactions in digital assets that meet the definition of a "security" or filing a new member application or continuing member application). This notification also is separate from any other regulatory obligations that may apply to a firm regarding its involvement in activities relating to digital assets, such as submitting Form ATS filings as required, including notifications of "material changes" under Regulation ATS, such as changes to the types of securities traded on a platform. *See* Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70845, 70922 (December 22, 1998) (Regulation ATS adopting release) (including changes to "the operating platform, the types of securities traded, or the types of subscribers" as examples of "material changes" that must be filed under Rule 301(b)

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(2) of Regulation ATS); *see also Regulatory Notice 09-46* (August 2009) (reminding alternative trading systems of the need to submit to FINRA duplicate copies of any filing required by Rule 301(b)(2) of Regulation ATS).

7. *See* Joint Statement (stating that "[t]he specific circumstances where a broker-dealer could custody digital asset securities in a manner that the Staffs believe would comply with the Customer Protection Rule remain under discussion, and the Staffs stand ready to continue to engage with entities pursuing this line of business.").

8. Cryptocurrencies and other virtual coins and tokens use distributed ledger technology, most commonly known as "blockchain," as the primary protocol for exchanging, storing and verifying information.

9. A material change in a firm's business operations also requires the submission and approval of a CMA. *See, e.g.*, Joint Statement, note 7 and accompanying text. For factors to consider in determining materiality, *see Notice to Members 00-73* (SEC Approves Amendments to NASD Membership Rules). *See also* FINRA Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations).

Securities Act of 1933 Section 2(a)(1) and Section 5
Securities Exchange Act of 1934 Section 3(a)(10) and Section 12(g)

April 2, 2019

VIA ELECTRONIC SUBMISSION
Office of Chief Counsel
Division of Corporation Finance
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: TurnKey Jet, Inc.

Dear Sir or Madam:

TurnKey Jet, Inc., a Delaware corporation ("TKJ"), with its principal business location in West Palm Beach, Florida, proposes to offer and sell blockchain-based digital assets in the form of "tokenized" jet cards ("Tokens"). On behalf of TKJ, I respectfully request that the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission (the "Commission") confirm that it will not recommend that the Commission take any enforcement action against TKJ if TKJ offers and sells Tokens in the manner and under the circumstances described below without registration under Section 5 of the Securities Act of 1933, as amended (the "Securities Act") and Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act," and together with the Securities Act, the "Securities Acts").

I. FACTUAL BACKGROUND

A. About TurnKey Jet, Inc. and the Proposed Token Program

TurnKey Jet, Inc. provides interstate air charter services as a licensed United States air carrier and air taxi operator. TKJ currently operates two business jets and is in the process of acquiring a third business jet. TKJ has successfully and profitably conducted flight operations since 2012. In the last two years, TKJ has operated its aircraft for at least 899 flight hours and conducted at least 643 landings for 141 customers. In that time, TKJ has had zero FAA violations or incidents and is accident-free. As discussed in more detail below, TKJ proposes to launch a Token membership program ("Program") and develop a Token platform ("Platform") to facilitate Token sales for air charter services via a private blockchain network ("Network"). TKJ will manage the Program as program manager ("Program

Manager"). Operating the Platform and Network would be within TKJ's economic authority as a federally-licensed air carrier and air taxi operator. Each user will access and use the Platform via an application ("App") that includes a wallet ("Wallet"). There will be three types of users of the Platform, depending on their role in the delivery of air charter services. Users who buy Tokens to consume air charter services are consumers ("Consumers"). Users who take part on the Platform by brokering charter flights between Consumers and carriers are brokers ("Brokers"). Users who deliver charter flights directly to Consumers via the Platform with their own fleet of planes are carriers ("Carriers"). Each type of user will have a distinct membership agreement and collectively the users of all types are members of the Program ("Members"). All Members will be required to pay membership subscription fees to take part in the Program and purchase Tokens. Consumers may be individuals or business entities. Brokers and Carriers are business entities and cannot be Consumers. Consumers will buy Tokens which TKJ will sell only at a price of one United States Dollar ("USD") per Token throughout the life of the Program. A typical transaction will involve a Consumer redeeming bought Tokens for air charter services.

B. Blockchain Technology Solves Air Charter Services Payment Settlement Problems

In supplying air charter services, TKJ faces significant transactional costs and inefficiencies, including delays, regarding payment settlement and regulatory compliance. From a customer's perspective, the delays and inefficiencies can prevent the customer from travelling. As with accepting credit cards, TKJ faces difficulties at times in accepting wire transfers for payment settlement. Further, TKJ must conduct extensive and time-consuming bookkeeping and operations records management of all transactions to meet its regulatory compliance obligations.

As discussed in more detail below, TKJ's proposed Program and Tokens for prepaid on-demand air charter services allows for settlement via blockchain which decreases the settlement time and improves the efficiencies of paying for and obtaining air charter services for both Consumers and TKJ. Consumers would be able to obtain the air charter services and leave on their trip much faster than under the current system. The advantages of utilizing blockchain technology for air charter services payment settlement include a significant reduction in financial transaction costs that financial institutions charge in payment settlement for air charter services. Transferring Tokens on the Platform and Network will significantly increase efficiencies in the delivery of air charter services. These improved efficiencies and rapid settlement of large transactions that are typical in the air charter services industry will in turn allow for faster delivery of air charter flights.

The Platform will diminish the possibility of fraudulent transactions and potential chargebacks, by relying on transparency and distribution via the Network. The Network is private to TKJ Program Members and mirrored across multiple servers, each of which verifies the validity of each transaction and keeps a copy of the entire ledger. TKJ as Program Manager will be responsible for verifying the validity of the ledger. The Platform will allow for increasing global transparency to Consumers, Brokers and Carriers by relying on the Network that will be used to record the terms of the Token contracts, manage documentation and complete transaction terms with immediate payment. This transparency will in turn provide access and insight into the clearing and settlement of the TKJ financial transactions to

prevent disputes because all participants will be able to inspect their personal Platform and Network activity and monitor settlement of their Token redemptions and delivery of air charter flights. These advantages show the utility of the proposed Tokens as an improvement to the existing air charter travel services payment settlement process.

II. PROPOSED PROGRAM AND TOKEN SALES

A. The Token Infrastructure

(i) Blockchain Platform and Network

The proposed TKJ Tokens will operate and be deployed on the Platform and Network consisting of a private, permissioned, centralized blockchain network and smart contract infrastructure operated by TKJ. TKJ will run the Platform and Network and use third-party service providers, as necessary, to meet operational requirements, including providers of internal tools for developers, user-facing app interfaces, wallets, smart contract infrastructure and private network and token management services.

TKJ will account for each TKJ Member via the Wallet that each Consumer uses to hold their Tokens. Each Wallet is part of the Platform, Network and App. TKJ will provision a Wallet to each Consumer, Broker and Carrier who will use the App and Wallet to send and receive Tokens via the Platform to TKJ, Consumers, Brokers or Carriers who are also TKJ Members on the Platform. TKJ Platform participants will be able to view their Token balance and related Platform and Network activities through a console via the App. The respective Token balances and related activities of each Member will not be public, but private to each individual Member and the TKJ Network administrators. Consumers will not satisfy the obligation to pay for air charter services. Rather, TKJ will satisfy the obligation by paying the Brokers or Carriers directly using escrow funds, which are comprised of the Token sale proceeds, upon the Consumer's redemption of Tokens. TKJ will manage payment to Brokers or Carriers but will have no contractual obligation to do so until Consumers, Brokers or Carriers transfer Tokens to TKJ for redemption.

TKJ will allow Brokers to be Members of the Platform because of antitrust legal concerns that would arise if TKJ were the sole broker of air charter services on the Platform and the Consumer user base became large. The Program attributes will incentivize Brokers to become Members and join the Platform because they will be able to transact with Consumers outside of banking hours using the Platform and App. Currently, Brokers cannot transact outside of banking hours due to the unavailability of wire transfers. Further, Brokers would need to be participants in the Program because the industry still needs their involvement in processing air charter services transactions via phone, email and fax. There is currently no automated air charter services scheduling and purchase system in place. In addition, Brokers have recently become regulated entities pursuant to 14 CFR Part 295, governing the brokerage of air charter services, and may provide air charter services as agents of Carriers or as principals with Carriers under contract to them. As such, Brokers (which may also be Carriers), as air charter services providers, Carriers (which may also be Brokers), and TKJ (which may be a Broker or

Carrier), will all be regulated entities on the Platform. TKJ will operate the Program in a manner compliant with applicable federal, state and foreign law including regulations of FinCEN, FAA, DOT and other applicable law governing the handling, custody and transmittal of funds, and other matters within their respective jurisdictions. In short, the Tokens, Platform and Network will simply be an air charter services payment debit/credit system for large financial transactions conducted inside and outside of banking hours.

(ii) <u>The Tokens Will Be Smart Contracts Between TKJ and Token Consumers and Subsequent Holders for Air Charter Services</u>

The proposed Tokens will include smart contract functionality and TKJ will create and deploy them on the Platform and Network. The Tokens will meet a token standard based on the chosen Platform technology and TKJ will develop the code for the Tokens with standard-compliant rules and methods, including transferring Tokens from TKJ to Consumers and between Network Members, reporting the balance of Tokens at a certain address, and reporting the total supply of Tokens. TKJ will be in privity of contract with each first Consumer of Tokens and the later holders of the Tokens via the Program membership agreement and the Token sales agreement embedded in the Tokens. The terms of the TKJ membership agreement will vary depending on whether the user is a Consumer, Broker or Carrier. The terms will obligate TKJ to release Token escrow funds to a Broker or Carrier to pay for the provided air charter services to a TKJ Member and holder of Tokens who exercises their right per the smart contract to redeem the Tokens at their equivalent value for those services on-demand.

TKJ, via the Platform, will update the smart contracts corresponding to each Token after each transfer of Tokens within the Platform to reflect the current holder of the transferred Tokens. The smart contracts will include the terms of service restricting transfer and setting forth that the Tokens are the prepayment of the future consumption of air charter services and there will be no return of principal or interest on the monies that are prepaid. Further, TKJ will use the smart contracts to execute the consideration for TKJ Token redemptions. Consumers will execute separately the respective TKJ Program membership agreements and Token sales agreements prior to issuance of Tokens. The agreed to terms and conditions will be embedded in the smart contract code. The smart contracts will programmatically acknowledge redemptions on the blockchain and notify TKJ of the redemptions for disbursement of the escrow funds corresponding to the Tokens to Brokers or Carriers for payment of the air charter services.

Redeemable for air charter services, the proposed Tokens in operation will be like the business jet card programs that are common in the aviation industry today. The typical jet card program operator arranges flights on behalf of their jet card clients with Carriers. In supplying the service, the air carriers keep complete operational control of the charter flights. Here, the Program Carriers will be part of the TKJ Platform. TKJ will require that all Carriers meet or exceed all FAA and TKJ safety standards.

Token issuances to Consumers will occur after they execute a Program membership agreement and Token sales agreement together with a smart contract issued on the Network that contains legally

binding terms and conditions between the Token holders and TKJ to provide air charter services equal in value to the redemption amount of the Tokens. Only Consumers will be able to buy Tokens. The Tokens will not represent a TKJ obligation to supply a specified number of flight hours regardless of cost. Rather, the Tokens will represent a TKJ obligation to supply air charter services to the Consumer/Token holder at a 1 USD:1 USD value, to allow for the variable costs of charter flights, jet fuel, catering, and other incidental costs related to each charter. When a Token enters circulation, TKJ Consumers may freely trade or exchange the Tokens in their possession between any other Consumer, Broker or Carrier within the Network. Only TKJ has the authority and capability to issue Tokens into circulation, or upon redemption remove them from circulation. In addition to the terms of the smart contracts restricting transfer of the Tokens TKJ will implement technical restrictions via the Platform and Network that restrict transfers of Tokens to TKJ Wallets only, and not to wallets external to the Platform.

A Consumer may redeem Tokens to pay for a flight directly with TKJ, which will arrange the flight using its own fleet of aircraft, a Broker or a Carrier. In that scenario, TKJ, as Program Manager, will transfer the escrow funds corresponding to the retail cost of the flight and the redeemed Tokens to itself as a Broker or Carrier and to its own bank account, deliver the flight and then pay for the costs associated with the flight using the transferred funds. In the alternative, a Consumer may transfer Tokens to a Broker or a Carrier other than TKJ to arrange and deliver the flight. In those types of transactions, the Broker or Carrier will then redeem with TKJ the Tokens that the Consumer transfers to the Broker or Carrier for the retail cost of the flight, and TKJ will then transfer the funds held in escrow directly to the Broker or Carrier for payment of the costs associated with the delivered flight. The terms stated in the Program membership agreement, Token sales agreement and each smart contract corresponding to each Token will obligate TKJ to disburse the escrow funds for the payment of air charter services when a Consumer redeems them. Further, the terms of the Program membership agreement, Token sales agreement and smart contracts for each Token will expressly state that at no time will TKJ have any discretion to do anything with the escrow funds other than disburse the funds for payment of air charter services upon redemption.

At all times, the identity of each Consumer as a TKJ Program Member will be known to TKJ in compliance with Transportation Security Administration regulations and federal law regarding TKJ's obligations to know its customers. See, e.g., 49 CFR 1540.107, governing passenger identification, which requires all passengers to provide identification using a valid verifying identity document. In addition, all passengers must provide their full name, date of birth, and gender, which is screened against the travel ban watch list in effect at the time of travel. The Tokens will be transferable only to other TKJ Program Members who are eligible to receive Tokens and become Token holders on the Platform and submit to 49 CFR 1540.107. To become a TKJ Program Member, all users must agree to the representations, terms and conditions regarding disclosure of their identity. In addition, prior to redemption and use of Tokens, all Token transferees must hold a current TKJ jet card Program membership which they can only obtain approval for after going through the TKJ application process which includes stringent KYC/AML background checks and TSA anti-terrorism watch list checks.

Construction of the TKJ Platform, Network, App and Token will be funded by TKJ through its own capital resources. At no time will TKJ utilize funds received for the purchase of Tokens to develop the TKJ Platform, Network, App or Token, and each of these will be fully developed and operational at the time any Tokens are sold. At all times, such funds will be held in escrow until redemption. At the time of their choosing, Consumers may redeem their Tokens into air charter services for the best price of those services correlated with the value of those services in the market offered directly by TKJ or by another verified and authorized Broker or Carrier that is a Program Member on the TKJ Platform. A Consumer will be able to redeem Tokens immediately after issuance for air charter services via TurnKey Jet, Inc. under its economic authority as an air carrier and air taxi operator. In addition, Consumers will be able to redeem their Tokens with any other verified and authorized Broker or Carrier that is a Program Member of the Network.

B. The Proposed Token Lifecycle and Steps of the Ongoing Token Sales

Step 1 – TKJ Consumer agrees to the terms of the Program membership agreement and Token sales agreement and deposits USD into TKJ's bank escrow account. The proceeds will be deposited into the TKJ interest-bearing escrow accounts[1] at FDIC-insured depository banks corresponding to the purchaser's Tokens, and any interest in those accounts will not be distributed to Consumers/Token holders but will be retained by TKJ.

Step 2 – TKJ creates TKJ Wallet on Platform and Network for the Consumer and credits the Consumer's Wallet with the number and value of Tokens bought. TKJ creates the smart contract and transfers the Token to the Consumer's Wallet. The Tokens are now in circulation with the Consumer as the first holder of the Tokens. The amount that the Consumer deposits equals the number of Tokens issued to the Consumer at a 1:1 ratio (i.e., 100,000 USD deposited = 100,000 Tokens issued).

Step 3 – TKJ Consumers can transfer and exchange Tokens to other Consumers, Brokers or Carriers exclusively on the TKJ Platform and Network. TKJ Consumers, Brokers and Carriers will be contractually and technically restricted from transferring Tokens outside of the TKJ Platform.

Step 4 – The Consumer deposits/transfers enough Tokens from their Wallet to TKJ, a Broker or Carrier for redemption into air charter services. The terms stated in the Program membership agreement, Token sales agreement and each smart contract corresponding to each Token obligate TKJ to disburse the escrow funds for the payment of air charter services upon redemption and TKJ has no discretion contractually to do anything else with the escrow funds.

Step 5 – TKJ, as Program Manager, will destroy the Tokens that the Consumer, Broker or Carrier redeems. Upon redemption, TKJ, as Program Manager, remits the redeemed escrow funds to itself as

[1] While the funds will be held in accounts at FDIC-insured banks, the funds in the bank escrow accounts may not be FDIC-insured in full.

Broker or Carrier, or to another Broker or Carrier. Either TKJ, via its own fleet of aircraft, or the other Broker or Carrier, supplies air charter services in the equivalent value amount of the redeemed Tokens.

TKJ plans to hold continuous, open-ended Token sales to meet demand. If a Consumer such as a corporation goes out of business, its Tokens will be assets of that corporation. Consumers may redeem their Tokens at any time of their choosing in the future. There will be no time constraints within which period the Consumers must redeem their Tokens after purchase or acquisition. Consumers will be able to receive offers and select the best offer, whether it is from TKJ directly or from one of the other verified and authorized Brokers and Carriers who are also members of the Network. At no time will Token sales include a rebate program, rewards program, or similar or otherwise allow for the monetization of an economic benefit or bonus for buying Tokens. TKJ does not expect resales of Tokens in a large amount. If TKJ offers to repurchase Tokens, it will only do so at a discount to the face value of the Tokens that the holder looks to resell to TKJ, unless a court within the United States orders TKJ to liquidate the Tokens per a forced liquidation. There should not be Token sales to others at a discount because a purchaser may buy Tokens from TKJ at 1 USD per Token, which will cause the market price to stabilize at one dollar. As a result, Consumers will not have an incentive to buy from other Token holders at a premium above one dollar per Token. In theory, a Consumer may be required to sell their Tokens at a significant discount below face value in order to liquidate its holdings, but TKJ does not anticipate that this will occur frequently because of market forces stabilizing the price near one dollar per Token, contractual and technical restrictions on transfer, and timing of purchase and use not requiring advance purchase since the Tokens are immediately redeemable after purchase.

The Tokens will be nonrefundable. Consumers will only be able to redeem their Tokens for air charter services. They will not be able to redeem their Tokens for USD. When a Consumer remits cash payment for Tokens, TKJ will follow the Patriot Act and report such purchases that are more than $10,000 per occurrence. TKJ will use its regulatory tools to identify bad actors and will reserve the right to refuse a Token sale to any such person who looks to become a Consumer as part of illegal activities such as money laundering. For international transactions, TKJ will adhere to all applicable laws and regulations for the jurisdictions that govern the transaction. Consumers who buy Tokens will be protected and will have minimal risk because TKJ will hold their prepaid funds always in escrow until the Tokens are redeemed. The United States government strictly regulates TKJ via the DOT and FAA, among others, and TKJ will hold the funds received from Token sales in bank escrow accounts at United States FDIC-insured depository banks. Hence, TKJ will hold sales proceeds in escrow as collateral to guarantee TKJ’s obligation to supply air charter services in the future.

The Tokens will be distributed to Consumers as purchasers such that they meet their on-demand air charter needs as users of the TKJ Platform. They will receive their Tokens at once after purchase and will be able to redeem their Tokens once received with no delay. Consumers will be able to transfer their Tokens in the amount needed to pay for the offered air charter services corresponding to their expected use.

C. Proof of Reserves and TKJ's Obligations to Consumers, Brokers and Carriers as Token Holders

At all times, the total number of Tokens in circulation, being TKJ liabilities, will be fully backed by an equal amount of USD held in reserve in FDIC-insured financial institution escrow accounts located in the United States. Each Token in circulation will represent one United States Dollar held in TKJ escrow reserves in a one-to-one ratio. To complement disclosure and transparency, TKJ will publish regularly in a private forum to Consumers, Brokers and Carriers an independent professional audit of the total amount of USD held in its escrow account reserves and the total number of Tokens then outstanding.

D. Representations Regarding TKJ Program Memberships and Token Sales

- TKJ will offer Program memberships and Tokens to Consumers solely as an opportunity to obtain prepaid on-demand air charter services. All marketing materials will say clearly that Consumers should buy the TKJ Program memberships and Tokens solely for the purpose of obtaining prepaid on-demand air charter services and not for investment purposes or with an expectation to earn a profit.

- The TKJ Program membership agreement, TKJ Token sale agreement and Platform terms of service will require each Consumer or later transferee holder to agree to represent, warrant and acknowledge the following prior to purchasing the Tokens:

    - The Consumer is not acquiring the membership or Tokens as an investment and has no expectation of economic benefit or profit as a TKJ Program Member or TKJ Token holder;
    - The Consumer is solely acquiring the TKJ Program membership and Tokens for the right to obtain prepaid on-demand air charter services;
    - The Consumer is acquiring the TKJ Program membership and Tokens for the Consumer's own use and not with a view to sell or otherwise distribute the Tokens to anyone else in a secondary market;
    - All funds paid to TKJ to buy TKJ Program memberships or TKJ Tokens are nonrefundable;
    - The Consumer will not have any equity or other ownership interest in TKJ or any affiliated entities; will not have any rights to dividends, distribution rights, or interest from TKJ or any affiliated entities at any time as a result of being a TKJ Program Member and TKJ Token holder; and will not have any voting rights regarding any matters relating to TKJ or any affiliated entities;
    - All transfers of TKJ Tokens will be subject to membership restrictions, TKJ Program memberships will be nontransferable, and there is no guarantee that there will exist in the future a market for the resale of TKJ Tokens, and neither TKJ nor anyone else is

obligated to create such a market. When a TKJ Token holder transfers their Tokens to another TKJ Program member, they will not represent to such prospective transferee that the Tokens or membership is an investment opportunity or an opportunity to obtain an economic benefit or profit; and

- The Consumer and subsequent Token holder will not pledge or hypothecate their Tokens.

- All TKJ Program members must execute the membership agreement providing their personal identity with proof and TKJ Token sale agreement with express terms and provisions substantially similar to the above-stated terms and conditions.

TKJ, its agents and employees will not make statements in the sales process that are in any way inconsistent with the statements and representations above, or otherwise mention profits or an investment opportunity.

III. LEGAL DISCUSSION

For the reasons set forth below, it is my opinion that the proposed sale of Tokens under the TKJ Program will not involve the sale of a "security" within the meaning of Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, and, therefore, that registration under the Securities Acts is not required. Rather, the interest represented by a Token will be a consumptive right to redeem the escrowed funds to pay for air charter services. As such, neither an "investment contract," a "note," an "evidence of indebtedness" nor another form of security is present. There is no reasonable expectation of profit derived from the efforts of others, and the Consumer's expectation will be to enter into a consumer transaction for prepayment of air charter services.

A. Howey and Forman Analyses: The Proposed TKJ Jet Card Program Tokens Fail to Satisfy the Howey Test and Thus Are Not Investment Contracts

It is my opinion that the Tokens will not be not "investment contracts," see SEC v. W.J. Howey Co., 328 U.S. 293 (1946). The United States Supreme Court in S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946) articulated the Howey test for determining whether an economic transaction is an investment contract that as such implicates the Securities Acts. The Howey test provides that an "investment contract" is present where there is: (i) an investment of money; (ii) in a common enterprise; (iii) with an expectation of profits to be derived solely from the efforts of the promoters or third parties. All elements of the Howey test must be satisfied for an instrument to be deemed a "contract, transaction or scheme" that is a security. Howey at 298–99. The focus of the Howey analysis here is on how and why the proposed Tokens fail to satisfy the third element regarding expectations of profit.

(i) Investment of Money

Since the purchase of Tokens will require the payment of funds, an investment of money under the Howey test exists here.

(ii) Common Enterprise

Since TKJ will run the Platform and Network for managing the creation and redemption of Tokens and allow for Brokers or Carriers to transfer and redeem Tokens to collectively supply air charter services in addition to TKJ as part of the Network, a common enterprise may exist here as well. Consumers, however, will not be invested in the success or failure of the TKJ Program and Platform. Rather, they are buying as consumers prepaid air charter services. As such, they are relying on TKJ to deliver the services as obligated, not to deliver a capital return or other profit on an investment.

(iii) Expectation of Profits to Be Derived Solely from the Efforts of the Promoters or Third Parties

Regarding "profit" under the Howey test, the Supreme Court means "capital appreciation" resulting from an investment of money or "participation in earnings" resulting from the usage of the investor's funds. See United Housing Foundation v. Forman, 421 U.S. at 852. While the Howey test is flexible, there must be a reasonable of expectation of profit for there to be a security.

The characteristics of the Tokens and terms and conditions of the Program demonstrate that there is no reasonable expectation of any profit that Howey recognizes on the part of any Member.[2] This is because Consumers will have no right to share in any income generated by the operation of TKJ (or any other affiliated entity). TKJ will not pay dividends, rebates, rewards, interest or other distributions to Consumers from the operation of TKJ. TKJ will make no distribution of any kind to any Consumers, other than the non-monetary provision of the air charter services using the prepaid Token sales funds held in escrow corresponding to the specific Consumers. Further, Consumers will have no reasonable expectation of profit based on capital appreciation as explained below.

A Consumer will be motivated to buy Tokens by a desire to obtain on-demand air charter services in a more efficient and faster manner than they are able to do so currently. As in Forman, the characteristics of the instrument and the manner in which they are sold indicate that Members will not buy Tokens with an expectation of profit, but rather solely with a view to use them for air charter services. In Forman, the purchasers were screened and qualified, similar to how the Consumers are

[2] In the Tuition Plan Consortium, LLP no-action letter, the Staff said that it will not recommend enforcement action where the proposed instruments represented prepaid tuition certificates, and demonstrated similar characteristics to those in Forman (purchaser received right to fixed amount of prepaid future services; provision of services not dependent on third party efforts of others to offer returns; limited transferability; the return on funds was limited to principal plus treasury rate of accrued interest). In earlier no-action letters the Staff agreed that prepayment was motivated by a desire to obtain future services for consumption and not by a desire for profit where pre-need funeral services contracts were offered. See Fleet National Bank (September 5, 1990); Michigan Funeral Directors Association (September 28, 1987). Similarly, since the TKJ memberships and Tokens do not meet the definition of a security pursuant to the Securities Acts and they will not be marketed to the public as an investment opportunity, but rather are prepayment for future air charter services, have limited transferability, and there will be no refunds, granting the requested no-action relief would be consistent with Tuition Plan Consortium, LLP and the related prepaid tuition and prepaid funeral services no-action letters.

qualified when they apply for membership in the Program (via the KYC/AML background check and TSA anti-terrorism travel ban watch list check) and subsequently execute the membership agreement and Token purchase agreement wherein, they agree to abide by Program rules and acknowledge that they are not purchasing Tokens for financial gain. Further, in Forman a purchaser could not redeem the purchase for more than the sales price, while here TKJ will not provide refunds to Consumers, and the Tokens must be consumed for air charter services within the closed Program environment.

Consumers will be motivated to purchase the Tokens in order to prepay for and consume on-demand air charter services, based on the following attributes of the Program: (i) there will be contractual and technical restrictions on transferability of Tokens, because such transfers will be subject to terms of the Token sales agreement, TKJ Program membership agreement and smart contracts that only Consumers, Brokers or Carriers may acquire and hold Tokens; (ii) the Consumers, Brokers and Carriers as Token holders will be advised that they should not acquire Tokens as an investment for profit; (iii) each prospective Consumer as buyer or holder (including transferees) will be required to represent that they are not acquiring the Tokens as an investment and has no expectation of economic benefit or profit as a Consumer; (iv) the Consumers will acknowledge and agree that they are acquiring the TKJ membership and Tokens for their own use and not with a view to sell or otherwise distribute the Tokens to anyone else in a secondary market; and (v) the Consumers will acknowledge and agree that there is no market for the Tokens, and neither TKJ nor any other person will create such a market. Hence, reasonable Consumers of the TKJ Program memberships and Tokens will not expect and TKJ will not promise any "return" on their payment, or any other "profit" from TKJ Program membership or ownership of Tokens. Similarly, Carriers' and Brokers' expectations are to receive Tokens as compensation for services rendered through the Program and not to earn "profits" for such work.

The attributes of the Program further include: (i) all marketing materials will state clearly that the TKJ Members should acquire the Tokens solely for the purpose of prepaying for and consuming prepaid on-demand air charter services; (ii) the Token and TKJ membership agreements will require each Consumer or subsequent transferee holder to agree to represent, warrant and acknowledge transfer and redemption restrictions; (iii) TKJ will hold all prepaid funds for the corresponding sold Tokens in escrow accounts; and (iv) upon redemption of Tokens, TKJ will utilize the funds held in escrow to pay for the delivery of air charter services directly to Brokers or Carriers as obligated pursuant to the Token sales agreement, smart contract embedded in each Token and Program membership agreement. Based on these attributes and the others discussed here, there would be no reasonable expectation of profit.

In the LA Fan Club, Inc. Membership Program (June 28, 2017) no-action letter, the Staff provided no-action relief relating to memberships involving personal seat licenses and ticket-related member benefits for a professional sports franchise. The terms of the memberships, among other things, provided that they had significant transfer restrictions, purchasers represented that they were obtaining the memberships for their own use and not as an investment or to profit, and they were not marketed to

the public as investments.[3] The crux of these letters is that the primary motivation of the purchasers of the seat licenses was to attend events and consume entertainment, not to profit or resell. In each case, this was demonstrated by various characteristics of the asset and the manner in which the assets were sold. This also is the case with the Tokens and the Program.

Here, TKJ has an even stronger argument since the sole purpose of buying the Tokens is to prepay for and consume air charter services. It will not be technically possible to trade and transfer Tokens from the Platform in a non-Platform secondary market at a premium. Further, it will be economically impractical to trade Tokens within the Platform in a secondary market since TKJ will offer continuous, ongoing Token sales at one USD per Token which should cause the market price of Tokens not to exceed one USD per Token. These restrictions on transfer are indicative of the consumptive nature of the Tokens. The TKJ Program memberships are non-equity memberships and will be non-transferable. The Consumers will represent that they are obtaining the TKJ memberships and Tokens for their own use and not as an investment or to profit. The TKJ memberships and Tokens will not be marketed to the public as investments. The funds that the Consumers prepay for the on-demand air charter services will be nonrefundable and will be immediately redeemable for air charter services, so no Consumer will have a reasonable expectation of profit. Thus, granting the requested no-action relief to TurnKey Jet, Inc. would be consistent with the Staff's earlier position in LA Fan Club, Inc. Membership Program and the related personal seat license no-action letters.

As explained above, it is highly unlikely that a Member would be able to buy Tokens and resell them for a financial gain. While such a financial gain is theoretically possible, it is highly unlikely, given the Program's structure, particularly that Members will be able to purchase Tokens from TKJ at the 1 USD fixed price throughout the life of the Program. Any such gain, however, would not result from the entrepreneurial or managerial efforts of TKJ and, accordingly, would not be "profit" under Howey. [4]

B. Reves Analysis: The Proposed Tokens Are Not Notes or Other Evidence of Indebtedness Because They Simply Formalize Using Blockchain Technology Open-Account Debts Incurred in the Ordinary Course of Business of TKJ

It is my opinion that the Tokens should not be viewed as a "note," as such term is used in Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, or other "evidence of indebtedness" as such term is used in Section 2(a)(1) of the Securities Act, because they will bear a strong resemblance to those instruments traditionally excluded from the definition of a security pursuant to Reves v. Ernst & Young, 494 U.S. 56 (1990). The Tokens will simply formalize using blockchain technology an open-account debt incurred in the ordinary course of business of TKJ, that is, the obligation to provide air charter services in exchange for the prepayment of those services. Such an

[3] Earlier Staff no-action letters exist involving similar circumstances involving personal seat licenses and member benefits, and non-equity memberships. See San Francisco Baseball Assocs. L.P. (February 24, 2006); Ticket Reserve, Inc. (September 11, 2003); Erica Enders Racing, LLC (November 21, 2006).

[4] See, e.g., Community Sun, LLC (August 29, 2011) (no-action recommended where solar panel condominium units could be resold by original purchasers for potential profit based on fluctuations in energy markets).

open-account debt is one of the Reves enumerated categories of instruments which are not securities.[5] Here, since the funds paid for Tokens are held in escrow, and each Token has a corresponding 1 USD in an account at an FDIC-insured financial institution available for payment for services upon redemption by the Member, they represent an open-account debt of TKJ. Further, the TKJ Program memberships and Tokens will not be marketed to the public as investments that will earn a profit. Thus, under these circumstances, granting the requested no-action relief to TurnKey Jet, Inc. would be consistent with federal case law and Staff guidance.[6]

IV. CONCLUSION

It is my opinion that the Tokens are not securities within the meaning of Section 2(a)(1) of the Securities Act or Section 3(a)(10) of the Exchange Act and the Tokens should not be viewed as the equivalent of an "investment contract," a "note," an "evidence of indebtedness" or another form of security under the analyses described in Howey, 328 U.S. 293 (1946), Forman, 421 U.S. 837 (1975) and Reves, 494 U.S. 56 (1990). For the above-mentioned reasons, I respectfully request your confirmation that the Staff will not recommend that the Commission take any enforcement action against TKJ if TKJ offers and sells Tokens in the manner and under the circumstances described above without registration under the Securities Acts.

TurnKey Jet, Inc. plans to begin offering the TKJ jet card membership Program and Tokens as soon as practical after receiving a response from the Division that grants this request. If you need more information to prepare a response, please call me at (561) 972-8222 to discuss this matter. Thank you for your assistance.

Sincerely,

James P. Curry

James P. Curry, Esquire

cc: Paul Schoen, TurnKey Jet, Inc.

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[5] See generally S.E.C. v. Thompson, 732 F.3d 1151, 1159 (10th Cir. 2013); Tr. Co. of Louisiana v. N.N.P. Inc., 104 F.3d 1478, 1489 (5th Cir. 1997)

[6] See also Poplogix, LLC (November 5, 2010) no-action letter where the Staff provided a favorable no-action response to a request arguing that certain loans and notes were not securities because, among other things, the terms of the loans and notes provided no possibility of profit or capital appreciation, and they were not marketed to the public as investments.

Securities Act of 1933
Section 2(a)(1)

April 3, 2019

Response of the Division of Corporation Finance

Re: TurnKey Jet, Inc.
Incoming letter dated April 2, 2019

Based on the facts presented, the Division will not recommend enforcement action to the Commission if, in reliance on your opinion as counsel that the Tokens are not securities, TKJ offers and sells the Tokens without registration under the Securities Act and the Exchange Act. Capitalized terms have the same meanings as defined in your letter.

In reaching this position, we particularly note that:

- TKJ will not use any funds from Token sales to develop the TKJ Platform, Network, or App, and each of these will be fully developed and operational at the time any Tokens are sold;
- the Tokens will be immediately usable for their intended functionality (purchasing air charter services) at the time they are sold;
- TKJ will restrict transfers of Tokens to TKJ Wallets only, and not to wallets external to the Platform;
- TKJ will sell Tokens at a price of one USD per Token throughout the life of the Program, and each Token will represent a TKJ obligation to supply air charter services at a value of one USD per Token;
- If TKJ offers to repurchase Tokens, it will only do so at a discount to the face value of the Tokens (one USD per Token) that the holder seeks to resell to TKJ, unless a court within the United States orders TKJ to liquidate the Tokens; and
- The Token is marketed in a manner that emphasizes the functionality of the Token, and not the potential for the increase in the market value of the Token.

This position is based on the representations made to the Division in your letter. Any different facts or conditions might require the Division to reach a different conclusion. Further, this response expresses the Divisionâ€™s position on enforcement action only and does not express any legal conclusion on the question presented.

Sincerely,

Jonathan A. Ingram
Chief Legal Advisor, FinHub
Division of Corporation Finance

Incoming Letter:

The Incoming Letter is in Acrobat format.

http://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm

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116TH CONGRESS
1ST SESSION

H. R. 2144

To amend the Securities Act of 1933 and the Securities Exchange Act of 1934 to exclude digital tokens from the definition of a security, to direct the Securities and Exchange Commission to enact certain regulatory changes regarding digital units secured through public key cryptography, to adjust taxation of virtual currencies held in individual retirement accounts, to create a tax exemption for exchanges of one virtual currency for another, to create a de minimis exemption from taxation for gains realized from the sale or exchange of virtual currency for other than cash, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

APRIL 9, 2019

Mr. DAVIDSON of Ohio (for himself, Mr. SOTO, Mr. GOTTHEIMER, Mr. BUDD, Ms. GABBARD, and Mr. PERRY) introduced the following bill; which was referred to the Committee on Financial Services, and in addition to the Committee on Ways and Means, for a period to be subsequently determined by the Speaker, in each case for consideration of such provisions as fall within the jurisdiction of the committee concerned

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A BILL

To amend the Securities Act of 1933 and the Securities Exchange Act of 1934 to exclude digital tokens from the definition of a security, to direct the Securities and Exchange Commission to enact certain regulatory changes regarding digital units secured through public key cryptography, to adjust taxation of virtual currencies held in individual retirement accounts, to create a tax exemption for exchanges of one virtual currency for another, to create a de minimis exemption from taxation

for gains realized from the sale or exchange of virtual currency for other than cash, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the ''Token Taxonomy Act of 2019''.

SEC. 2. SECURITIES ACT OF 1933.

(a) DEFINITION OF DIGITAL TOKEN.—Section 2(a) of the Securities Act of 1933 (15 U.S.C. 77b(a)) is amended by adding at the end the following:

''(20) DIGITAL TOKEN.—The term 'digital token' means a digital unit—

''(A) that is created—

''(i) in response to the verification or collection of proposed transactions;

''(ii) pursuant to rules for the digital unit's creation and supply that cannot be altered by any single person or persons under common control; or

''(iii) as an initial allocation of digital units that will otherwise be created in accordance with clause (i) or (ii);

''(B) that has a transaction history that—

''(i) is recorded in a distributed, digital ledger or digital data structure in

which consensus is achieved through a mathematically verifiable process; and

''(ii) after consensus is reached, resists modification or tampering by any single person or group of persons under common control;

''(C) that is capable of being transferred between persons without an intermediate custodian; and

''(D) that is not a representation of a financial interest in a company or partnership, including an ownership interest or revenue share.

''(21) DIGITAL UNIT.—The term 'digital unit' means a representation of economic, proprietary, or access rights that is stored in a computer-readable format.''.

(b) DEFINITION OF SECURITY.—Section 2(a)(1) of the Securities Act of 1933 (15 U.S.C. 77b(a)(1)) is amended—

(1) by inserting ''(A)'' after ''(1)''; and

(2) by adding at the end the following:

''(B) Such term does not include a digital token.''.

(c) EXEMPTION.—Section 4(a) of the Securities Act of 1933 (15 U.S.C. 77d(a)) is amended by adding at the end the following:

"(8) Transactions involving the offer, promotion, or sale of a digital unit if—

"(A) the person offering, promoting, or selling the digital unit has a reasonable and good faith belief that such digital unit is a digital token; and

"(B) within ninety days following a written notification from the Commission to such person that such digital unit has been determined by the Commission to be a security, posts public notice of such notification and takes reasonable efforts to cease all sales and return all proceeds from any sales of such digital unit, excluding funds reasonably spent on the development of technology associated with the digital unit.".

(d) PREEMPTION OF STATE LAW.—Section 18 of the Securities Act of 1933 (15 U.S.C. 77r) is amended—

(1) by redesignating subsection (d) as subsection (e); and

(2) by inserting after subsection (c) the following:

''(d) DIGITAL TOKENS.—

''(1) IN GENERAL.—No law, rule, regulation, or order, or other administrative action of any State or any political subdivision thereof—

''(A) requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a digital token;

''(B) shall directly or indirectly prohibit, limit, or impose any conditions upon the use of—

''(i) with respect to a digital token, any disclosure document concerning an offer or sale of a digital token that is prepared by or on behalf of a person developing, offering, or selling a digital token; or

''(ii) any proxy statement, report to digital token-holders, or other disclosure document relating to a digital token or a person developing, offering, or selling a digital token;

''(C) shall directly or indirectly prohibit, limit, or impose conditions, based on the merits of a digital token offering or a person devel-

oping, offering, or selling a digital token, upon the offer or sale of any digital token; or

''(D) shall directly or indirectly require the filing of any notices or other documents, or the assessment of any fees, with respect to digital tokens or digital token transactions.

''(2) PRESERVATION OF FRAUD AUTHORITY.—States and political subdivisions thereof shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by any person, in connection with digital tokens or digital token transactions.''.

SEC. 3. SECURITIES EXCHANGE ACT OF 1934.

(a) DEFINITION OF BANK.—Section 3(a)(6)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(6)(C)) is amended—

(1) by inserting ''or trust company,'' after ''Home Owners' Loan Act,''; and

(2) by striking ''receiving deposits or exercising fiduciary powers'' and inserting ''receiving deposits, providing custodial services, or exercising fiduciary powers''.

(b) DEFINITION OF SECURITY.—Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)) is amended—

(1) by inserting ''(A)'' after ''(1)''; and

(2) by adding at the end the following:

''(B) Such term does not include a digital token.''.

(c) DEFINITION OF DIGITAL TOKEN.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end the following:

''(82) DIGITAL TOKEN.—The term 'digital token' has the meaning given to it in section 2(a) of the Securities Act of 1933.''.

(d) CLERICAL AMENDMENTS.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended—

(1) by moving paragraph (79) so as to appear after paragraph (78); and

(2) by redesignating the second paragraph (80) (relating to ''Funding portal'') as paragraph (81).

SEC. 4. INVESTMENT ADVISERS ACT OF 1940.

(a) DEFINITION OF DIGITAL TOKEN.—Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)) is amended—

(1) by redesignating the second paragraph (29) as paragraph (31); and

(2) by adding at the end the following:

''(32) The term 'digital token' has the meaning given to it in section 2(a) of the Securities Act of 1933.''.

(b) DEFINITION OF SECURITY.—Section 202(a)(18) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)(18)) is amended—

(1) by inserting ''(A)'' after ''(18)''; and

(2) by adding at the end the following:

''(B) Such term does not include a digital token.''.

(c) DEFINITION OF BANK.—Section 202(a)(2)(C) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)(2)(C)) is amended by striking ''receiving deposits or exercising fiduciary powers'' and inserting ''receiving deposits, providing custodial services, or exercising fiduciary powers''.

SEC. 5. INVESTMENT COMPANY ACT OF 1940.

(a) DEFINITION OF DIGITAL TOKEN.—Section 202(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)) is amended by adding at the end the following:

''(55) The term 'digital token' has the meaning given to it in section 2(a) of the Securities Act of 1933.''.

(b) DEFINITION OF SECURITY.—Section 202(a)(36) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(36)) is amended—

(1) by inserting ''(A)'' after ''(36)''; and

(2) by adding at the end the following:

''(B) Such term does not include a digital token.''.

(c) DEFINITION OF BANK.—Section 2(a)(5) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(5)) is amended by striking ''receiving deposits or exercising fiduciary powers'' and inserting ''receiving deposits, providing custodial services, or exercising fiduciary powers''.

SEC. 6. RULE OF CONSTRUCTION WITH RESPECT TO CFTC AND FTC.

Nothing in this Act or the amendments made by this Act shall be construed to limit the application of the Commodity Exchange Act or the Federal Trade Commission Act.

SEC. 7. SATISFACTORY CONTROL LOCATION REQUIREMENT.

Not later than 90 days after the date of the enactment of this Act, the Commission shall amend section 240.15c3–3 of title 17, Code of Federal Regulations, to provide that the requirement for a satisfactory control location for any digital unit (as defined under section 2(a) of the Securities Act of 1933) that is a security is fulfilled by protecting the digital unit using public key cryptography and by following commercially reasonable cybersecurity practices to maintain the privacy and accessibility of sufficient private key material to solely be able to sign on behalf of such digital unit.

SEC. 8. INDIVIDUAL RETIREMENT ACCOUNT INVESTMENTS IN CERTAIN VIRTUAL CURRENCIES NOT TREATED AS DISTRIBUTIONS.

(a) IN GENERAL.—Section 408(m) of the Internal Revenue Code of 1986 is amended—

(1) in paragraph (3)—

(A) in the heading of the paragraph, by striking ''AND BULLION'' and inserting '', BULLION, AND VIRTUAL CURRENCIES'';

(B) in subparagraph (A)(iv), by striking ''or'';

(C) in subparagraph (B), by inserting ''or'' after ''futures contract,'';

(D) by inserting after subparagraph (B) the following:

''(C) virtual currency.''; and

(E) by striking ''if such bullion'' and inserting ''This paragraph shall only apply to bullion which''; and

(2) by adding at the end the following:

''(4) VIRTUAL CURRENCY DEFINED.—For purposes of this subsection, the term 'virtual currency' means a digital representation of value that is used as a medium of exchange and is not currency (within the meaning of section 988).''.

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to sales or exchanges on or after January 1, 2017.

SEC. 9. CERTAIN EXCHANGES OF VIRTUAL CURRENCY TREATED AS NON-TAXABLE EXCHANGES.

(a) IN GENERAL.—Section 1031 of the Internal Revenue Code of 1986 is amended—

(1) in the heading, by striking ''**REAL PROPERTY**'' and inserting ''**CERTAIN PROPERTY**''; and

(2) in subsection (a), by adding at the end the follow new paragraph:

''(4) EXCHANGE OF VIRTUAL CURRENCY.—An exchange of virtual currency (as defined under sec-

tion 408(m)) shall be treated as if such exchange were an exchange of real property under this section.''.

(b) CLERICAL AMENDMENT.—The table of parts for part III of subchapter O of chapter 1 of such Code is amended by striking ''Exchange of real property'' and inserting ''Exchange of certain property''.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to exchanges made on or after January 1, 2017.

SEC. 10. GAIN FROM SALE OR EXCHANGE OF VIRTUAL CURRENCY.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 of the Internal Revenue Code of 1986 is amended by inserting after section 139F the following new section:

''SEC. 139G. GAIN FROM SALE OR EXCHANGE OF VIRTUAL CURRENCY.

''(a) IN GENERAL.—Gross income shall not include gain from the sale or exchange of virtual currency (as defined under section 408(m)) for other than cash or cash equivalents.

''(b) LIMITATION.—

''(1) IN GENERAL.—The amount of gain excluded from gross income under subsection (a) with

respect to a sale or exchange of virtual currency shall not exceed $600.

''(2) AGGREGATION RULE.—For purposes of this subsection, all sales or exchanges which are part of the same transaction (or a series of related transactions) shall be treated as one sale or exchange.

''(c) INFLATION ADJUSTMENT.—In the case of any taxable year beginning in a calendar year after 2018, the dollar amount in subsection (b) shall be increased by an amount equal to—

''(1) such dollar amount, multiplied by

''(2) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting 'calendar year 2017' for 'calendar year 2016' in subparagraph (a)(ii) thereof.

Any increase determined under the preceding sentence shall be rounded to the nearest multiple of $50.''.

(b) CLERICAL AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 of such Code is amended by inserting after the item relating to section 139F the following new item:

''Sec. 139G. Gain from sale or exchange of virtual currency.''.

(c) REPORTING OF GAINS OR LOSSES.—The Secretary of the Treasury shall issue regulations providing for information returns on transactions in virtual currency (as

defined under section 408(m) of the Internal Revenue Code of 1986) for which gain or loss is recognized.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to transactions entered into on or after January 1, 2017.

○

"Operation Cryptosweep"
North American Securities Administrators Association (NASAA)

Beginning April 2018, NASAA's task force began a series of coordinated investigations into Initial Coin Offerings ("ICOs") and crypto-currency related investments in member states.

The following list is provided by NASAA as to the state enforcement actions taken so far. The full list and links to enforcement documents is available at: https://www.nasaa.org/policy/enforcement/operation-cryptosweep/[1]

Operation Cryptosweep

RESPONDENT	AGENCY	ACTION	NOTES
Adosia LLC	North Carolina Secretary of State – Securities Division	Consent Order	Unregistered securities offering by unregistered dealer
Advertiza Holdings (Pty) Ltd	North Dakota Securities Department	Cease & Desist Order	Unregistered securities offering by unregistered dealer
Antivolatility Coin, ZZZ Coin, Power Invest Group, Frank Bernier, William Bolduc	Autorité des marchés financiers (AMF) – QUEBEC (CANADA)	Cease & Desist Order	Offer and sale of unregistered securities; registration violations; offer and sale of derivatives; misleading and deceptive statements; offer of investments in the cryptocurrency mining pools; offer and sale of investment tied to the cryptocurrency ecosystem through multi-level marketing schemes.
AWS MINING PTY Ltd.	Texas State Securities Board	Emergency Cease & Desist Order	Registration Violations; Fraud and Misleading/Deceptive Statements
Baltic Fund	Office of Missouri Secretary of State Securities Division	Order to Cease & Desist and Order to Show Cause	Offering and selling unregistered, non-exempt securities; making an untrue statement, omitting to state material facts or engaging in an act, practice, or course of business that would operate as a fraud or deceit upon another person in connection with the offer or sale of

[1] Last accessed 07/28/19

			securities
BC Holdings and Investments LLC	Texas State Securities Board	Cease & Desist Order	Registration violations; fraud and misleading/deceptive statements
Bionic	Indiana Office of the Secretary of State, Securities Division	Cease & Desist Order	Registration violations
Bionic Coin	Colorado Division of Securities	Cease & Desist Order	Solicitation of unregistered securities
Bitcoin Trading & Cloud Mining Limited AKA BTCRUSH, Jaylon Cross, Bruce Rodgerson, Robin Lozinski and Thomas A. Johnson	Texas State Securities Board	Emergency Cease & Desist Order	Registration violations; Fraud in connection with the offer of investments in the cloud-based cryptocurrency mining program; misleading and deceptive statements
BitConnect LTD and BitConnect International PLC	North Dakota Securities Department	Cease & Desist Order	Unregistered securities offered by unregistered dealer
BitConnect	Texas State Securities Board	Emergency Cease & Desist Order	Registration violations; fraud and misleading/deceptive statements
BitConnect and BitConnectX	Office of the Georgia Secretary of State – Securities and Charities Division	Emergency Cease & Desist Order	Registration violations; fraud and misleading/deceptive statements
Blue Vase Mining	Massachusetts Securities Division	Consent Order	Selling unregistered or non-exempt securities
Broad Investments, LLC, and Guoyong Liu	Colorado Division of Securities	Cease & Desist Order and Order to Show Cause	Sale of unregistered securities
Browsers Lab, LLC	Maryland Office of the Attorney General, Securities Division	Summary Order to Cease and Desist and Order to Show Cause	Offer and Sale of Unregistered Securities; Acting as an Unregistered Broker-Dealer or Agent; Employment of Unregistered Agent for Sale of Securities; Material Misrepresentation or Omission
Bullcoin Foundation a/k/a/ Bullcoin Gold	New Jersey Bureau of Securities, Office of the New Jersey Attorney General	Summary Cease & Desist Order	Registration Violations; Omissions of Material Facts in Connection With The Offer Of Securities

Chain Group Escrow Service	Alabama Securities Commission	Cease & Desist Order	Offer and Sale of Unregistered Securities; Omission of Material Facts
Coins Miner Investment Ltd	Texas State Securities Board	Emergency Cease & Desist Order	Fraud and Misleading Statements in the Offer and Sale of Unregistered Securities
Cryptocashback c/o Kapsus Technologies Ltd.	British Columbia Securities Commission	Cease & Desist Letter	Potentially offering or promoting securities without registration
Crystal Token	North Dakota Securities Department	Cease & Desist Order	Unregistered securities offered by unregistered dealer
DasCoin	British Columbia Securities Commission	Cease & Desist Letter	Potentially offering or promoting securities without registration
DGBK Ltd., aka DigitalBank,	Texas State Securities Board	Emergency Cease & Desist Order	Registration Violations; Fraud and Misleading/Deceptive Statements
Digitalticks	British Columbia Securities Commission	Cease & Desist Letter	Potentially offering or promoting securities without registration
Disciplina*	British Columbia Securities Commission	Cease & Desist Letter	Potentially offering or promoting securities without registration **(RESOLVED per regulator)*
Doctailor	British Columbia Securities Commission	Cease & Desist Letter	Potentially offering or promoting securities without registration
Extrabit Ltd; Mack Deacon	Alabama Securities Commission	Cease & Desist Order	Offer and Sale of Unregistered Securities; Omission of Material Facts
EXY Crypto	Texas State Securities Board	Emergency Cease & Desist Order	Registration Violations; Fraud and Misleading/Deceptive Statements
Forex EA & Bitcoin Investment LLC AKA My Forex EA & Bitcoin Investment LLC AKA My Forex EA, James Butcher and Richard Dunn	Texas State Securities Board	Emergency Cease & Desist Order	Registration violations; Fraud in connection with the offer of investments in the forex and cryptocurrency mining program; misleading and deceptive statements
Forex EA & Bitcoin	Office of the Georgia	Emergency	Registration Violations;

Investment LLC a/k/a MY Forex EA, James Butcher, Richard Dunn, and CW Washington	Secretary of State – Securities and Charities Division	Cease & Desist Order	Fraud and Misleading/Deceptive Statements
Global Pay Net (aka GLPN Coin, CPN Token)	Colorado Securities Commission	Cease & Desist Order	Solicitation of Unregistered Securities
Hashkon Inc.	Alabama Securities Commission	Cease & Desist Order	Offer and Sale of Unregistered Securities; Omission of Material Facts
Krios	British Columbia Securities Commission	Cease & Desist Letter	Potentially offering or promoting securities without registration
LevelNet	Vermont Department of Financial Regulation	Cease & Desist Order	Registration Violations; Deceptive Advertising
Leverage	Alabama Securities Commission	Cease & Desist Order	Offer and Sale of Unregistered Securities; Omission of Material Facts
Life Cross Coin	North Dakota Securities Department	Cease & Desist Order	Offer and Sale of Unregistered Securities
Linda Healthcare Corporation Co. and Arturo Devesa	Colorado Division of Securities	Cease & Desist Order and Order to Show Cause	Sale of Unregistered Securities
Magma Foundation, a/k/a Magma Coin	North Dakota Securities Department	Cease & Desist Order	Unregistered Securities Offered by Unregistered Dealer
Mintage Mining	Texas State Securities Board	Cease & Desist Order	Registration Violations; Fraud and Misleading/Deceptive Statements
My Crypto Mine	Texas State Securities Board	Emergency Cease & Desist Order	Registration Violations; Fraud and Misleading/Deceptive Statements
NUI Social	Texas State Securities Board	Cease & Desist Order	Registration Violations; Fraud and Misleading/Deceptive Statements
Pension Rewards Platform	North Dakota Securities Department	Cease & Desist Order	Unregistered Securities Offered by Unregistered Dealer

Platinum Coin; Roman Dinkevich; Sergei Cherepanov, Vladimir Gorshkov, Andrey Malevanchuk, Roman Terekhin	Alabama Securities Commission	Cease & Desist Order	Offer and Sale of Unregistered Securities; Omission of Material Facts
Plexcoin	Autorité des marchés financiers (AMF) – QUEBEC (CANADA)	Cease & Desist Order	
Pooltrade; Harold Theron	Alabama Securities Commission	Cease & Desist Order	Offer and Sale of Unregistered Securities; Omission of Material Facts
Power Mining Pool	North Carolina Secretary of State – Securities Division	Permanent Cease and Desist Order	Unregistered securities offering
Roaring Investments	Pennsylvania Department of Banking and Securities	Cease & Desist Order	Registration Violations
ShipChain, Inc.*	Office of the South Carolina Attorney General, Securities Division	Administrative Cease & Desist Order	**ORDER WITHDRAWN*
Sigil Platform*	British Columbia Securities Commission	Cease & Desist Letter	Potentially offering or promoting securities without registration **(RESOLVED per regulator)*
Social Membership Network Holding LLC	Texas State Securities Board	Cease & Desist Order	Registration Violations; Fraud and Misleading/Deceptive Statements
Springcryptoinvest a/k/a Springcryptoinvest.com Ltd.	New Jersey Bureau of Securities, Office of the New Jersey Attorney General	Summary Cease & Desist Order	Registration Violations; Omissions of Material Facts in Connection With The Offer Of Securities
Sybrelabs Ltd. (aka CryptoARB)	Colorado Securities Commision	Cease & Desist Order	Solicitation of Unregistered Securities
Symatri LLC	Texas State Securities Board	Cease & Desist Order	Registration Violations; Fraud and Misleading/Deceptive Statements
Taklimakan Network	British Columbia Securities	Cease & Desist Letter	Potentially offering or promoting securities without

	Commission		registration
ThinkCoin*	British Columbia Securities Commission	Cease & Desist Letter	Potentially offering or promoting securities without registration **(RESOLVED per regulator)*
Trident d/b/a Trident Crypto Index Fund	New Jersey Bureau of Securities, Office of the New Jersey Attorney General	Summary Cease & Desist Order	Registration violations; Omissions of Material Facts in Connection With The Offer Of Securities
Tripbit*	British Columbia Securities Commission	Cease & Desist Letter	Potentially offering or promoting securities without registration **(RESOLVED per regulator)*
Ubcoin*	British Columbia Securities Commission	Cease & Desist Letter	Potentially offering or promoting securities without registration **(RESOLVED per regulator)*
Ultimate Assets LLC	Texas State Securities Board	Emergency Cease & Desist Order	Registration Violations; Fraud and Misleading/Deceptive Statements
Union Bank Payment Coin	North Dakota Securities Department	Cease & Desist Order	Promoting unregistered securities
USI-Tech	Ohio Department of Commerce – Division of Securities	Administrative Cease & Desist (Notice Order)	Registration violations; Omissions of Material Facts in Connection With The Offer Of Securities; False Representation of a Material or Relevant Fact
Wind Wide Coin Inc. AKA WWC Inc., Charles Roman, Fred Andrew and John Anny	Texas State Securities Board	Emergency Cease & Desist Order	Registration violations; Fraud in connection with the offer of investments in the cryptocurrency mining program; misleading and deceptive statements
Zanfau Ltd.	Alabama Securities Commission	Cease & Desist Order	Offer and Sale of Unregistered Securities; Omission of Material Facts

ADDITIONAL ACTIVITIES	AGENCY	ACTIVITY	
Binance Limited	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter	
BIOK	Nova Scotia Securities Commission	Investor Alert	
bitFlyer USA, Inc.	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter	
Bitstamp USA Inc.	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter	
Bittrex, Inc.	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter	
Circle Internet Financial Limited (Poloniex LLC)	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter	
Coinbase, Inc.	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter	
Elite Way Developments LLP	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter	
Gate Technology Incorporated	The Investor Protection Bureau of the Office of the New York State	Information Demand Letter	

	Attorney General	
Gemini Trust Company	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter
Huobi Global Limited	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter
iFinex Inc. (Bitfinex)	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter
itBit Trust Company	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter
Orca Alliance	Nova Scotia Securities Commission	Investor Alert
Payward, Inc. (Kraken)	The Investor Protection Bureau of the Office of the New York State Attorney General	Information Demand Letter

TRAVIS ILES
SECURITIES COMMISSIONER

CLINTON EDGAR
DEPUTY SECURITIES COMMISSIONER

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MEMBER

IN THE MATTER OF	§	
USI-TECH LIMITED,	§	**Order No.** ENF-17-CDO-1753
CLIFFORD "CLIFF" THOMAS	§	
AND MICHAEL "MIKE" RIVERA	§	

TO: USI-TECH LIMITED
PO Box 65736, Dubai, UAE, PO Box 122036, Dubai, UAE, and Fairmont Hotel, Skeikh Zayed Rd., Dubai, UAE

CLIFFORD "CLIFF" THOMAS
5708 Vernon Way, Suitland, Maryland 20746

MICHAEL "MIKE" RIVERA
4925 Westpark Drive, Los Angeles, California 91601

EMERGENCY CEASE AND DESIST ORDER

This is your OFFICIAL NOTICE of the issuance by the Securities Commissioner of the State of Texas of an EMERGENCY CEASE AND DESIST ORDER pursuant to Section 23-2 of The Securities Act, TEX. REV. CIV. STAT. ANN. arts. 581-1 to 581-45 (West 2010 & Supp. 2017).

The Staff of the Enforcement Division of the Texas State Securities Board has presented evidence sufficient for the Securities Commissioner to find that:

FINDINGS OF FACT

1. USI-TECH Limited (hereinafter referred to as "Respondent USIT") maintains last known addresses at PO Box 65736, Dubai, UAE, PO Box 122036, Dubai, UAE, Fairmont Hotel, Skeikh Zayed Rd., Dubai, UAE.

2. Clifford "Cliff" Thomas (hereinafter referred to as "Respondent Thomas") is an agent of Respondent USIT. He maintains a last known address at 5708 Vernon Way, Suitland, Maryland 20746.

3. Michael "Mike" Rivera (hereinafter referred to as "Respondent Rivera") is an agent of Respondent USIT. He maintains a last known address at 4925 Westpark Drive, Los Angeles, California 91601.

THE INVESTMENTS TIED TO BITCOIN

4. Respondents Thomas and Rivera are advertising investments issued by Respondent USIT on craigslist.org. These advertisements are directed to Texas residents.

5. The advertisement placed on craigslist.org by Respondent Thomas refers potential investors to www.cryptoauthorities.com, which redirects to cthomas.mycryptomc.com. (hereinafter referred to as the "Thomas Website"). The advertisement placed by Respondent Rivera refers potential investors to www.bitcoinlife.pro, which redirects to cryptomike.mycryptomc.com (hereinafter referred to as the "Rivera Website"). The Thomas Website and Rivera Website contain the following representations:

   a. The Thomas Website and Rivera Website explain the investment is referred to as a "BTC Package" or "BTCP."

   b. The Thomas Website and Rivera Website cite "excerpts" from "our attorney opinion letter dated August 22, 2017" to represent that BTCP "derives its value from [Respondent USIT]'s non-exclusive interest in a series of Bitcoin mining contracts."

   c. The Thomas Website and Rivera Website explain investors will receive 1% daily return independent of the value of Bitcoin.

   d. The Thomas Website and Rivera Website represent a "binding legal opinion letter" states that Respondent USIT is "a legal business in good standing (rare to find amount [sic] other Bitcoin companies in the USA)."

   e. The Thomas Website and Rivera Website also represent Respondent USIT has "certified legal products in the USA per the FTC (Federal Trade Commissions) [sic]."

6. The Thomas Website provides potential investors with contact information for Respondent Thomas. The Rivera Website provides potential investors with contact information for Respondent Rivera.

7. Respondents Thomas and Rivera are offering BTCP to potential investors who use this information to contact them.

8. Potential investors must visit a website maintained by Respondent USIT. This website is accessible by the general public at www.usitech-int.com (hereinafter referred to as the "USIT Website"). The USIT Website contains the following representations:

a. The USIT Website claims that Respondent USIT "built the world's first automated trading platform for the Bitcoin currency and even the most experienced traders are jealous of [its] results."

b. The USIT Website states that Respondent USIT has a "top-class development team" with "over 20 years of experience."

c. The USIT Website claims that its "customers have enjoyed profits of up to 150%" and "[b]y maximizing risk reduction in a highly volatile, fast-paced market environment, our software consistently provides returns of up to 150% per year."

d. The USIT Website represents that it uses "unique algorithms" and a "conservative trading strategy" to "greatly minimize the risk to... users."

e. The USIT Website informs potential investors that they can "generat[e] up to 35% commissions on 12 referral levels" through Respondent USIT's "unique referral marketing plan" that provides "above-average commissions without any qualification barriers."

9. Investors purchase investments through the USIT Website. Each investor must create an account and identify the sales agent that offered the investment to the investor. After creating an account and identifying the sales agent, investors can purchase BTCP.

REGISTRATION VIOLATIONS

10. Respondents are offering BTCP to investors in Texas who are not accredited investors. Respondents are not taking reasonable steps to verify that all purchasers are accredited investors.

11. BTCP has not been registered by qualification, notification or coordination, and no permit has been granted for its sale in Texas.

12. Respondents have not been registered with the Securities Commissioner as dealers or agents at any time material hereto.

DISCLOSURE VIOLATIONS

13. In connection with the offer of the aforementioned investments, Respondent USIT is intentionally failing to disclose material facts, including, but not limited to, the following:

a. The identity of the principals of Respondent USIT,

b. The identity of the entities or persons party to the Bitcoin mining contracts, as well information about the facilities used to mine bitcoins, the hardware used to mine bitcoins, the costs associated with their mining of bitcoins and their success in mining bitcoins,

c. The terms and conditions of the Bitcoin mining contracts, as well as the terms and conditions of Respondent USIT's non-exclusive interest in Bitcoin mining contracts,

d. Information about the assets and liabilities of Respondent USIT and any other information that indicates the means Respondent USIT will provide investors with a 1% daily return regardless of the value of Bitcoin, and

e. The risks associated with BTCP and mining bitcoins.

14. Respondents USIT, Thomas and Rivera are representing that existing investors will be paid commissions for referring new investors, which is materially misleading or otherwise likely to deceive the public because persons who offer and sell securities in Texas, including BTCP, must either be registered with the State Securities Board or otherwise exempt from registration.

15. Respondents USIT, Thomas and Rivera are representing that Respondent USIT has "certified legal products in the USA per the FTC (Federal Trade Commissions) [sic]," which is materially misleading or otherwise likely to deceive the public because:

a. The Federal Trade Commission does not regulate registration of BTCP as a security in Texas, the registration of dealers and agents offering and selling BTCP in Texas, and the disclosure of material facts in connection with the offer and sale of BTCP in Texas, and

b. The State Securities Board regulates the registration of BTCP as a security in Texas, the registration of dealers and agents offering and selling BTCP in Texas, and the disclosure of material facts in connection with the offer and sale of BTCP in Texas.

16. Respondents USIT, Thomas and Rivera are representing that a "binding legal opinion letter" states that Respondent USIT is "a legal business in good standing (rare to find amount [sic] other Bitcoin companies in the USA)," which is materially misleading or otherwise likely to deceive the public because:

a. Respondents USIT, Thomas and Rivera are violating Section 7 of the Securities Act by offering unregistered securities in the form of BTCP in Texas, and

b. Respondents USIT, Thomas and Rivera are violating Section 12 of the Securities Act by acting as or using unregistered dealers or sales agents to offer BTCP in Texas.

CONCLUSIONS OF LAW

1. BTCP is a "security" as that term is defined by Section 4.A of the Texas Securities Act.

2. Respondents are violating Section 7 of the Texas Securities Act by offering securities for sale in Texas at a time when the securities are not registered with the Securities Commissioner.

3. Respondents are violating Section 12 of the Texas Securities Act by offering securities for sale in Texas without being registered pursuant to the provisions of Section 12 of the Texas Securities Act.

4. Respondent USIT is engaging in fraud in connection with the offer for sale of securities.

5. Respondents are making offers containing statements that are materially misleading or otherwise likely to deceive the public.

6. Respondents' conduct, acts, and practices threaten immediate and irreparable public harm.

7. The foregoing violations constitute bases for the issuance of an Emergency Cease and Desist Order pursuant to Section 23-2 of the Texas Securities Act.

ORDER

1. It is therefore ORDERED that Respondents immediately CEASE AND DESIST from offering for sale any security in Texas until the security is registered with the Securities Commissioner or is offered for sale pursuant to an exemption from registration under the Texas Securities Act.

2. It is further ORDERED that Respondents immediately CEASE AND DESIST from acting as securities dealers or agents in Texas until Respondents are registered with the Securities Commissioner or are acting pursuant to an exemption from registration under the Texas Securities Act.

3. It is further ORDERED that Respondent USIT immediately CEASE AND DESIST from engaging in any fraud in connection with the offer for sale of any security in Texas.

4. It is further ORDERED that Respondents immediately CEASE AND DESIST from offering securities in Texas through an offer containing a statement that is materially misleading or otherwise likely to deceive the public.

NOTICE

Pursuant to Section 23-2 of the Texas Securities Act, you may request a hearing before the 31st day after the date you were served with this Order. The request for a hearing must be in writing, directed to the Securities Commissioner, and state the grounds for the request to set aside or modify the Order. Failure to request a hearing will result in the Order becoming final and non-appealable.

You are advised under Section 29.D of the Texas Securities Act that any knowing violation of an order issued by the Securities Commissioner under the authority of Section 23-2 of the Texas Securities Act is a criminal offense punishable by a fine of not more than $5,000, or imprisonment in the penitentiary for not more than two years, or by both such fine and imprisonment.

SIGNED AND ENTERED by the Securities Commissioner this 20th day of December, 2017.

TRAVIS J. ILES
Securities Commissioner

TRAVIS J. ILES
SECURITIES COMMISSIONER

CLINTON EDGAR
DEPUTY SECURITIES COMMISSIONER

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MIGUEL ROMANO, JR.
MEMBER

IN THE MATTER OF FXBITGLOBE AKA FX BIT GLOBE LIMITED AKA FXBITGLOBE TRADING COMPANY FKA FIDELITY TRADING COMPANY	§ § § §

Order No. ENF-19-CDO-1776

TO: FXBITGLOBE AKA FX BIT GLOBE LIMITED AKA FXBITGLOBE TRADING COMPANY FKA FIDELITY TRADING COMPANY
Space, Mies-van-der-Rohe-Strabe 8, Munchen Germany 80807, Frankfurt; 18 Baker Street, London, United Kingdom; 142 Blackfriars Road, London, United Kingdom, SE1 8EQ; and 11F Hong Kong New World Tower, 302, Huaihai Zhong Road, Luwan District, Shanghai 20002

EMERGENCY CEASE AND DESIST ORDER

This is your OFFICIAL NOTICE of the issuance by the Securities Commissioner of the State of Texas (the "Securities Commissioner") of an EMERGENCY CEASE AND DESIST ORDER pursuant to Section 23-2 of The Securities Act, TEX. REV. CIV. STAT. ANN. arts. 581-1 to 581-45 (West 2010 & Supp. 2018) (the "Securities Act").

The Enforcement Division of the State Securities Board has presented evidence sufficient for the Securities Commissioner to find that:

FINDINGS OF FACT

1. This Emergency Cease and Desist Order is brought to stop an illegal international offering of investments tied to cryptocurrencies, binary options and other products by a firm using a phony address, publishing a forged government record and misrepresenting its status as a registered broker-dealer and investment adviser.

THE RESPONDENT

2. FxBitGlobe aka Fx Bit Globe Limited aka FxBitGlobe Trading Company fka Fidelity Trading Company (hereinafter referred to as "Respondent FxBitGlobe") purports to maintain addresses at 1210 Smith Street, Houston, Texas 77002; Space, Mies-van-der-Rohe-Strabe 8, Munchen Germany 80807, Frankfurt; 18 Baker Street, London, United Kingdom; 142 Blackfriars Road, London, United Kingdom, SE1 8EQ; 11F Hong Kong New World Tower, 302, Huaihai Zhong Road, Luwan District, Shanghai 20002; and Kuala Lumpur, Malaysia.

THE INTERNET WEBSITE

3. Respondent FxBitGlobe maintains an internet website accessible by the public at fxbitglobe.com (hereinafter referred to as the "FxBitGlobe Website").

   A. The FxBitGlobe Website claims the company was founded in 2014 and is now one of the leading investment companies in the industry trading cryptocurrencies, forex, binary options, and insurance investments.

   B. Potential investors are able to use the FxBitGlobe Website as a platform to purchase investments in products tied to cryptocurrencies, forex, binary options, and insurance investments. The FxBitGlobe Website refers to the products as Service Plans.

THE SERVICE PLANS

4. Respondent FxBitGlobe, through the FxBitGlobe Website, is describing the Service Plans as follows:

   A. Investors can pay between $500.00 and $1,999.00, payable in fiat currency or cryptocurrency, to purchase an investment in the Seed Service Plan. The FxBitGlobe Website initially claims the investors purchasing an investment in the Seed Service Plan are entitled to daily profits on trades, weekly payouts, a 25% monthly return, and 30% to 40% capital insurance.

   B. Investors can pay between $2,000.00 and $9,999.00, payable in fiat currency or cryptocurrency, to purchase an investment in the Investor Service Plan. The FxBitGlobe Website initially claims the investors purchasing an investment in the Investor Service Plan are entitled to daily profits on trades, weekly payouts, a 35% monthly return, and 35% to 40% capital insurance.

   C. Investors can pay between $10,000.00 and $49,999.00, payable in fiat currency or cryptocurrency, to purchase an investment in the Premium Service Plan. The FxBitGlobe Website initially claims the investors purchasing an investment in the Premium Service Plan are entitled to daily profits on trades, weekly payouts, a 50% monthly return, and 40 to 45% capital insurance.

   D. Investors can pay $50,00.00 or more, payable in fiat currency or cryptocurrency, to purchase an investment in the Sky Service Plan. The FxBitGlobe Website initially claims the investors purchasing an investment in the Sky Service Plan are entitled to daily profits on trades, weekly payouts, a 70% monthly return, and 40% to 45% capital insurance.

5. Although the FxBitGlobe Website initially claims the Seed Service Plan pays a 25% monthly return, the Investor Service Plan pays a 35% monthly return, the Premium

Service Plan pays a 50% monthly return, and the Sky Service Plan pays a 70% monthly return, it later represents the Seed Service Plan pays a 15% monthly return, the Investor Service Plan pays a 25% monthly return, the Premium Service Plan pays a 30% monthly return, and the Sky Service Plan pays a 50% monthly return.

6. The FxBitGlobe Website does not provide any information reflecting FxBitGlobe's strategy for generating returns, other than to generally explain the investments are tied to cryptocurrencies, forex, binary options, and insurance investments.

RESPONDENT FXBITGLOBE AND ITS SCHEME TO FALSELY CREATE LEGITIMACY

7. Respondent FxBitGlobe claims to maintain a place of business at 1210 Smith Street, Houston, Texas 77002. As described herein, however, Respondent FxBitGlobe does not maintain an office at 1210 Smith Street, Houston, Texas 77002, and this address does not exist in Houston, Texas.

8. Respondent FxBitGlobe is publishing a certificate of incorporation that purports to show it registered as a private limited company with Companies House on February 25, 2017. As described herein, however, Respondent FxBitGlobe was not registered as a private limited company with Companies House on February 25, 2017, and this certificate of incorporation is a forgery.

9. Respondent FxBitGlobe claims it is a registered broker-dealer, a registered investment adviser, a member of the Financial Industry Regulatory Authority, Inc. ("FINRA"), and a member of the Securities Investor Protection Corporation (the "SIPC"). As described herein, however, Respondent FxBitGlobe is not registered as a broker-dealer with FINRA or the Securities Board, is not registered as an investment adviser with the Securities Board or the United States Securities and Exchange Commission (the "SEC"), and is not a member of FINRA or the SIPC.

10. Respondent FxBitGlobe claims it is a member of the Investors Compensation Fund, but as described herein, does not provide any information about the Investors Compensation Fund.

RESPONDENT FXBITGLOBE IS RECRUITING UNREGISTERED SALES AGENTS TO OFFER ITS SERVICE PLANS IN TEXAS

11. Respondent FxBitGlobe is recruiting unregistered sales agents to offer its investments.

12. Respondent FxBitGlobe is promising to pay unregistered sales agents a commission equal to five percent of the new client's principal investment.

REGISTRATION VIOLATIONS

13. Respondent FxBitGlobe has not been registered with the Securities Commissioner as a dealer or agent at any time material hereto.

14. The investments in the Service Plans have not been registered by qualification, notification, or coordination, and no permit has been granted for their sale in Texas.

15. Respondent FxBitGlobe is recruiting sales agents and promising to compensate sales agents to offer its investments without first verifying the sales agents are registered to offer or sell securities in Texas.

FRAUD RELATING TO THE QUALIFICATIONS AND OPERATIONS OF RESPONDENT FXBITGLOBE AND ITS STRATEGIES FOR GENERATING RETURNS

16. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is intentionally failing to disclose the following material facts relating to the identity of its principals, their qualifications, and the company's operations:

    A. The identity of its principals and their business repute, experience, and qualifications;

    B. Its assets, liabilities, and capitalization, as well as any financial information that shows it can pay a fixed rate of return to investors if it is unable to generate sufficient profit from its dealings in cryptocurrencies, forex, binary options, and insurance investments; and

    C. Respondent FxBitGlobe's relationship to Fidelity Trading Company, its experience in offering investments promising fixed rates of return as Fidelity Trading Company, and any outstanding financial obligations incurred by Respondent FxBitGlobe while operating as Fidelity Trading Company that may negatively impact its ability to pay a fixed rate of return to investors.

17. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is intentionally failing to disclose material facts relating to its strategies for generating fixed returns, including the following:

    A. The identity of traders or other personnel responsible for trading or otherwise dealing in cryptocurrencies, forex, binary options, and insurance investments;

    B. The business repute, experience, and qualifications of traders or other personnel responsible for trading or otherwise dealing in cryptocurrencies, forex, binary options, and insurance investments;

    C. Any information about the company's strategy for generating fixed returns through trading or otherwise dealing in cryptocurrencies, forex, binary options, and insurance investments; and

D. Any information about the company's strategy for reducing or minimizing the risks associated with trading or otherwise dealing in cryptocurrencies, forex, binary options and insurance investments.

18. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is representing it maintains an office at 1210 Smith Street, Houston, Texas 77002. These statements constitute misrepresentations of relevant facts because Respondent FxBitGlobe does not maintain an address at 1210 Smith Street, Houston, Texas 77002, and this address does not exist in Houston, Texas.

FRAUD RELATING TO THE LICENSURE OF RESPONDENT FXBITGLOBE AND ITS LEGAL AUTHORITY TO OFFER SERVICE PLANS

19. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is representing it is registered as a broker-dealer. This representation constitutes a misrepresentation of a relevant fact because Respondent FxBitGlobe is not registered as a broker-dealer with FINRA and is not registered as a dealer with the Securities Board.

20. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is representing it is registered as an investment adviser. This representation constitutes a misrepresentation of a relevant fact because Respondent FxBitGlobe is not registered as an investment adviser with the Securities Board or the SEC.

21. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is representing it is a member of FINRA. This representation constitutes a misrepresentation of a relevant fact because Respondent FxBitGlobe is not a member of FINRA.

22. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is representing it is a member of the SIPC. This representation constitutes a misrepresentation of a relevant fact because Respondent FxBitGlobe is not a member of the SIPC.

23. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is publishing a certificate that purports to show it registered as a private limited company with Companies House on February 25, 2017. The publication of this certificate constitutes a misrepresentation of a relevant fact because Respondent FxBitGlobe was not registered as a private limited company with Companies House on February 25, 2017, and the certificate of incorporation is a forgery.

FRAUD RELATING TO RESPONDENT FXBITGLOBE'S CONCEALMENT OF RISKS ASSOCIATED WITH THE SERVICE PLANS

24. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is telling potential investors any risks or uncertainties associated with the Service Plans are described in filings with the SEC. This statement is a misrepresentation of a relevant fact because Respondent FxBitGlobe has not filed documents relating to the sale of Service Plans with the SEC.

25. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is intentionally failing to disclose material facts relating to the risks associated with cryptocurrencies, and these risks include the following:

A. Governments may adopt legislation or regulations that may negatively impact the use, transfer, exchange, or price of cryptocurrencies;

B. Cryptocurrencies are volatile, and the price of a cryptocurrency as it relates to fiat currency may decrease over a short period of time, resulting in significant loss to purchasers or traders of the cryptocurrency;

C. A system or technical failure, or deficient source code, may negatively impact the ability to exchange cryptocurrencies and the price of cryptocurrencies;

D. A hacking incident or malicious attack may negatively impact the price of cryptocurrencies; and

E. Cryptocurrencies compete with all other cryptocurrencies, and this competition may negatively impact the price of a specific cryptocurrency.

26. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is intentionally failing to disclose material facts relating to the risks associated with investments in foreign currency, and these risks include the following:

A. Fluctuations in a country's interest rates may lead to fluctuations in a currency's value, thereby negatively impacting the ability to close a trade for a profit;

B. Fluctuations in the foreign exchange rate between the time of placing a trade and the time of closing a trade may negatively impact the price of a forex contract;

C. A system or technical failure in a platform for executing trades may negatively impact the ability to close a trade for a profit; and

D. Leveraging transactions on margin, once called, may lead to substantial losses in excess of initial investments.

27. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is intentionally failing to disclose material facts relating to the risks associated with binary options, and these risks include the following risks:

A. Traders lose the entirety of their investment when they incorrectly predict movements in the market;

B. Binary options are not liquid investments and traders must wait until the options expire before he or she can move from a position regardless of movements in the market; and

C. The over-the-counter markets are thinly regulated and as such traders must account for possibilities of fraud, deceit, or trade discrepancy.

28. In connection with the offer of investments in the Service Plans, Respondent FxBitGlobe is intentionally failing to disclose material facts relating to the risks associated with insurance investments, and these risks include the following risks:

A. A firm may lack sufficient capital or some form of reinsurance to pay amounts owed under an insurance investment;

B. A firm may contest amounts owed under an insurance contract, and investors may be reliant on a third-party to deal with the claim or litigate the matter; and

C. An insurance investment may require a party to pay premiums or satisfy some other form of recurring obligation to prevent the insurance investment from lapsing.

MISLEADING AND DECEPTIVE STATEMENTS RELATING TO RESPONDENT FXBITGLOBE'S OPERATIONS AND SERVICE PLANS

29. Respondent FxBitGlobe is telling investors the Seed Service Plan pays a 25% monthly return, the Investor Service Plan pays a 35% monthly return, the Premium Service Plan pays a 50% monthly return, and the Sky Service Plan pays a 70% monthly return. These representations are materially misleading or otherwise likely to deceive the public, because it also represents the Seed Service Plan pays a 15% monthly return, the Investor Service Plan pays a 25% monthly return, the Premium Service Plan pays a 30% monthly return, and the Sky Service Plan pays a 50% monthly return.

30. Respondent FxBitGlobe is telling investors the Service Plans feature capital insurance. These representations are materially misleading or otherwise likely to deceive the public, because it is not providing investors with any information relating to the identity of the insuring party or the terms of the capital insurance.

31. Respondent FxBitGlobe is claiming to be a member of the Investors Compensation Fund. This claim is materially misleading or otherwise likely to deceive the public,

because Respondent FxBitGlobe is not providing investors with any information relating to the Investors Compensation Fund.

32. Respondent FxBitGlobe is claiming to be a company operating from Houston, Texas, and these claims are materially misleading or otherwise likely to deceive the public because Respondent FxBitGlobe has not filed with the Texas Secretary of State and is not authorized to transact business in Texas as a domestic or foreign entity.

33. Respondent FxBitGlobe is representing it will pay commissions to sales agents who sell investments in Service Plans. These representations are materially misleading or otherwise likely to deceive the public because:

A. Persons who offer and sell securities in Texas, including the investments in the Service Plans, who are not registered as dealers or agents or otherwise exempt from registration are violating Section 12 of the Securities Act; and

B. Persons who offer and sell investments in the Service Plans in Texas are offering and selling unregistered securities in violation of Section 7 of the Securities Act.

CONCLUSIONS OF LAW

1. The investments in the Fidelity Seed Plan, the Investment Plans, and the Service Plans are "securities" as the term is defined in Section 4.A of the Securities Act.

2. Respondent FxBitGlobe is violating Section 7 of the Securities Act by offering securities for sale in Texas at a time when the securities are not registered with the Securities Commissioner.

3. Respondent FxBitGlobe is violating Section 12 of the Securities Act by offering securities for sale in Texas without being registered pursuant to the provisions of Section 12 of the Securities Act.

4. Respondent FxBitGlobe is engaging in fraud in connection with the offer for sale of securities.

5. Respondent FxBitGlobe is making offers containing statements that are materially misleading or otherwise likely to deceive the public.

6. Respondent's conduct, acts, and practices threaten immediate and irreparable harm.

7. The foregoing violations constitute bases for the issuance of an Emergency Cease and Desist Order pursuant to Section 23-2 of the Securities Act.

ORDER

1. It is therefore ORDERED that Respondent FxBitGlobe immediately CEASE AND DESIST from offering for sale any security in Texas until the security is registered with the Securities Commissioner or is offered for sale pursuant to an exemption from registration under the Texas Securities Act.

2. It is further ORDERED that Respondent FxBitGlobe immediately CEASE AND DESIST from acting as securities dealers or agents in Texas until they are registered with the Securities Commissioner or are acting pursuant to an exemption from registration under the Texas Securities Act.

3. It is further ORDERED that Respondent FxBitGlobe immediately CEASE AND DESIST from engaging in any fraud in connection with the offer for sale of any security in Texas.

4. It is further ORDERED that Respondent FxBitGlobe immediately CEASE AND DESIST from offering securities in Texas through an offer containing a statement that is materially misleading or otherwise likely to deceive the public.

NOTICE

Pursuant to Section 23-2 of the Securities Act, you may request a hearing before the 31st day after the date you were served with this Order. The request for a hearing must be in writing, directed to the Securities Commissioner, and state the grounds for the request to set aside or modify the Order. Failure to request a hearing will result in the Order becoming final and non-appealable.

You are advised under Section 29.D of the Securities Act that any knowing violation of an order issued by the Securities Commissioner under the authority of Section 23-2 of the Securities Act is a criminal offense punishable by a fine of not more than $10,000, or imprisonment in the penitentiary for two to ten years, or by both such fine and imprisonment.

SIGNED AND ENTERED by the Securities Commissioner this 9th day of April, 2019.

TRAVIS J. ILES
Securities Commissioner

TRAVIS J. ILES
SECURITIES COMMISSIONER

CLINTON EDGAR
DEPUTY SECURITIES COMMISSIONER

Mail: P.O. BOX 13167
AUSTIN, TEXAS 78711-3167

Phone: (512) 305-8300
Facsimile: (512) 305-8310

Texas State Securities Board

208 E. 10th Street, 5th Floor
Austin, Texas 78701-2407
www.ssb.texas.gov

BETH ANN BLACKWOOD
CHAIR

E. WALLY KINNEY
MEMBER

MIGUEL ROMANO, JR.
MEMBER

KENNY KONCABA
MEMBER

IN THE MATTER OF § **Order No.** ENF-19-CDO-1779
MIKHAIL RANIA SAFIYA §

TO: Mikhail Rania Safiya
40 Bank Street, 26th Floor E14 5DA, London, United Kingdom

EMERGENCY CEASE AND DESIST ORDER

This is your OFFICIAL NOTICE of the issuance by the Securities Commissioner of the State of Texas (the "Securities Commissioner") of an EMERGENCY CEASE AND DESIST ORDER pursuant to Section 23-2 of The Securities Act, TEX. REV. CIV. STAT. ANN. arts. 581-1 to 581-45 (West 2010 & Supp. 2018) (the "Securities Act").

The Enforcement Division of the Texas State Securities Board has presented evidence sufficient for the Securities Commissioner to find:

FINDINGS OF FACT

1. The price of bitcoin and the market capitalization of all cryptocurrencies have sharply increased since the start of the calendar year. From January 1, 2019, through June 24, 2019, the price of bitcoin has already increased by around 207 percent and a bitcoin is now priced at around $11,000.00 per token. During the same period of time, the market capitalization of all cryptocurrencies has increased by around 167 percent and is now valued at more than $337 billion.

2. Bad actors and other parties may attempt to capitalize on the increase in the price of bitcoin and the market capitalization of all cryptocurrencies by offering fraudulent securities schemes to the public.

3. The Enforcement Division has been dedicating significant resources to protecting Texans from illegal and fraudulent cryptocurrency investment schemes. Given the changes in the market, the Enforcement Division is now dedicating additional resources to protect the public.

4. The Enforcement Division identified promoters of recent illegal and fraudulent cryptocurrency securities schemes, including promoters using social media to broadly target Texas residents who work from home.

5. The Securities Commissioner is now entering this Emergency Cease and Desist Order to protect these Texas residents from immediate and irreparable harm.

THE RESPONDENT

6. Mikhail Rania Safiya ("Respondent Safiya") can be served at 40 Bank Street, 26th Floor E14 5DA, London, United Kingdom.

PUBLIC SOLICITATION OF TEXAS RESIDENTS WORKING FROM HOME

7. Users are posting advertisements in a public Facebook Group titled "Work From Home | Earn Money Online | San Antonio Texas."

8. The advertisements are claiming investors earn lucrative profits by investing in a bitcoin and forex trading program. They are directing potential investors to contact a promoter using WhatsApp, an end-to-end encrypted instant messaging platform.

9. Potential investors using WhatsApp to contact the promoter are being connected with Respondent Safiya.

THE BITCOIN AND FOREX TRADING PROGRAM

10. Respondent Safiya is directing potential investors to an online platform that purports to permit the trading of contracts for difference, otherwise known as CFDs, on shares, indices, forex, binary options, and cryptocurrencies.

11. Although the online platform advertises CFDs on shares, indices, forex, binary options, and cryptocurrencies, Respondent Safiya is telling investors the investment involves the trading of bitcoin and forex.

12. Respondent Safiya is encouraging potential investors to register an account through the online platform and fund the account with bitcoin.

13. Respondent Safiya is explaining she will access their bitcoin and trade their principal for a profit. She is also explaining she will collect 20% of the profits as payment for trading the principal.

14. Respondent Safiya is touting the security of the bitcoin and forex trading program, claiming the bitcoin and forex trading program is safe and investors will not lose their principal. Respondent Safiya is also claiming she is licensed to trade bitcoin and forex.

THE SCHEME PERMITS RESPONDENT SAFIYA TO ASSUME CONTROL OF INVESTOR FUNDS

15. Respondent Safiya is not providing investors with any information that shows she is employed by the online platform, affiliated with the online platform, or authorized to trade bitcoin and forex on behalf of the online platform.

16. Respondent Safiya is not using the online platform to access bitcoin deposited by investors. Instead, Respondent Safiya is telling investors they must disclose the login credentials for their accounts so Respondent Safiya can access the bitcoin and use the bitcoin to trade for a profit.

17. After users disclose their login credentials to Respondent Safiya, she can assume custody and control of the bitcoin and will be able to appropriate the bitcoin, transfer the bitcoin to her own wallet, or take other actions that will result in the loss of funds.

18. This scheme is similar to phishing, a deceptive practice where a party creates a false sense to legitimacy to encourage a person to reveal sensitive personal information, including information that permits the party to access financial accounts and take control of funds owned by others.

REGISTRATION VIOLATIONS

19. Respondent Safiya has not been registered with the Securities Commissioner as a dealer or agent at any time material hereto, and the online platform has not been registered as a dealer or agent at any time material hereto.

20. The investments in the bitcoin and forex trading program have not been registered by qualification, notification, or coordination, and no permit has been granted for their sale in Texas.

FRAUDULENT AND DECEPTIVE PRACTICES AND THE OFFER OF INVESTMENTS IN A BITCOIN AND FOREX TRADING PROGRAM

21. In connection with the offer of investments in the bitcoin and forex trading program, Respondent Safiya is intentionally failing to disclose her business repute and qualifications, and this information constitutes a material fact.

22. In connection with the offer of investments in the bitcoin and forex trading program, Respondent Safiya is intentionally failing to disclose her experience in trading or managing bitcoin and forex for a profit, and this information constitutes a material fact.

23. In connection with the offer of investments in the bitcoin and forex trading program, Respondent Safiya is intentionally failing to disclose her strategies for trading or managing cryptocurrencies, forex, and other financial instruments, and this information constitutes a material fact.

24. In connection with the offer of investments in the bitcoin trading program, Respondent Safiya is intentionally failing to disclose the addresses of her residence or principal place of business, and this information constitutes a material fact.

25. Respondent Safiya is representing her trading generates lucrative profits over a short term, and these statements are materially misleading or otherwise likely to deceive the public because she is not disclosing any risks associated with the investments.

26. Respondent Safiya is claiming she is licensed, and this statement is materially misleading or otherwise likely to deceive the public because she is not disclosing whether she is licensed with the State Securities Board, the United States Securities and Exchange Commission, the Financial Industry Regulatory Authority or any other agency.

CONCLUSIONS OF LAW

1. The investments in the bitcoin trading program are "securities" as the term is defined in Section 4.A of the Securities Act.

2. Respondent Safiya is violating Section 7 of the Securities Act by offering securities for sale in Texas at a time when the securities are not registered with or permitted by the Securities Commissioner.

3. Respondent Safiya is violating Section 12 of the Securities Act by offering securities for sale in Texas without being registered pursuant to the provisions of Section 12 of the Securities Act.

4. Respondent Safiya is engaging in fraud in connection with the offer for sale of securities.

5. Respondent Safiya is making an offer containing statements that are materially misleading or otherwise likely to deceive the public.

6. Respondent Safiya's conduct, acts, and practices threaten immediate and irreparable harm.

7. The foregoing violations constitute bases for the issuance of an Emergency Cease and Desist Order pursuant to Section 23-2 of the Securities Act.

ORDER

1. It is therefore ORDERED Respondent Safiya immediately CEASE AND DESIST from offering for sale any security in Texas until the security is registered with the Securities Commissioner or is offered for sale pursuant to an exemption from registration under the Texas Securities Act.

2. It is further ORDERED Respondent Safiya immediately CEASE AND DESIST from acting as securities dealers or agents in Texas until they are registered with the Securities Commissioner or are acting pursuant to an exemption from registration under the Texas Securities Act.

3. It is further ORDERED Respondent Safiya immediately CEASE AND DESIST from engaging in any fraud in connection with the offer for sale of any security in Texas.

4. It is further ORDERED Respondent Safiya immediately CEASE AND DESIST from offering securities in Texas through an offer containing a statement that is materially misleading or otherwise likely to deceive the public.

NOTICE

Pursuant to Section 23-2 of the Securities Act, you may request a hearing before the 31st day after the date you were served with this Order. The request for a hearing must be in writing, directed to the Securities Commissioner, and state the grounds for the request to set aside or modify the Order. Failure to request a hearing will result in the Order becoming final and non-appealable.

You are advised under Section 29.D of the Securities Act that any knowing violation of an order issued by the Securities Commissioner under the authority of Section 23-2 of the Securities Act is a criminal offense punishable by a fine of not more than $10,000, or imprisonment in the penitentiary for two to ten years or by both such fine and imprisonment.

SIGNED AND ENTERED by the Securities Commissioner this 28th day of June, 2019.

TRAVIS J. ILES
Securities Commissioner

ANATOMY OF AN ANNUITY TRIAL

FRANK J. FOX, MAJORS & FOX

Barney's Story

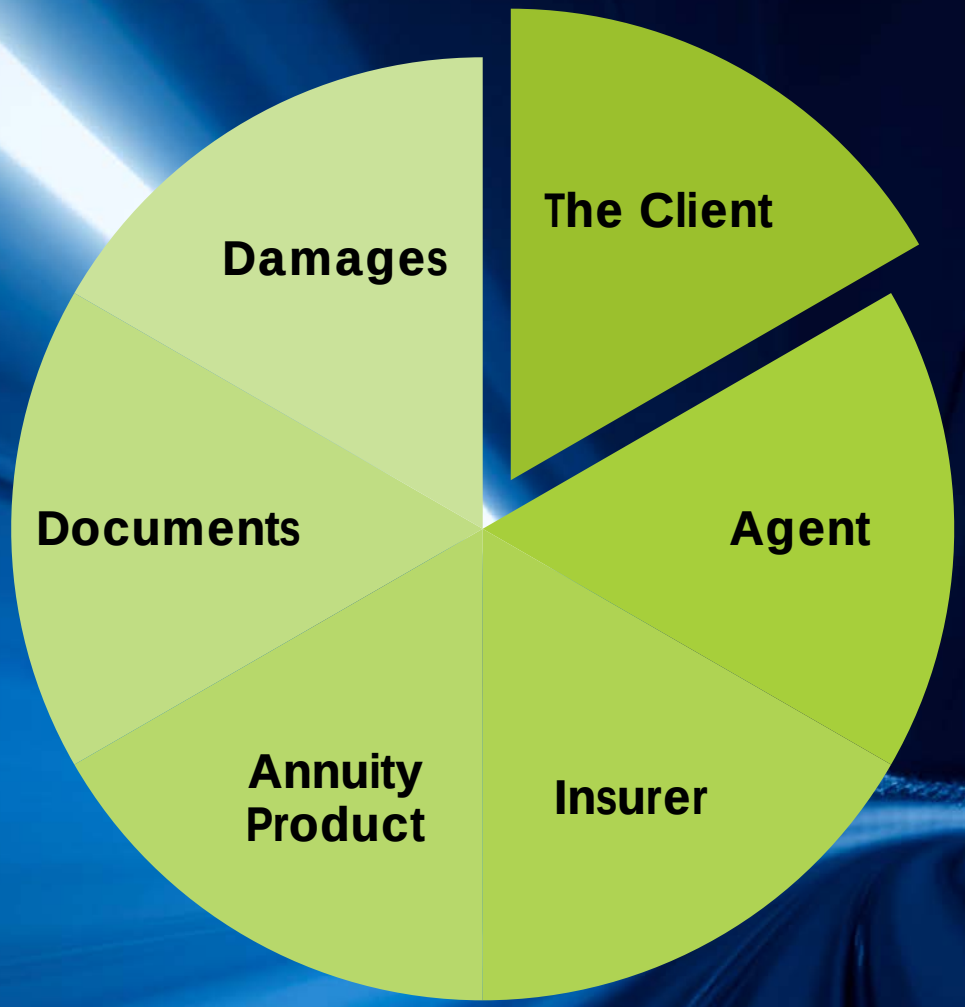
Williams v. Pantaleoni et al.

- **$18,309.41**
  Economic Loss
- **$3.1M Jury Verdict** (plus statutory attorneys' fees)

Financial Elder Abuse

- The Problem
- The Opportunity

EVALUATING THE ESSENTIAL COMPONENTS OF ANNUITY CLAIM



THE CLIENT
Discovering the Client's Story

THE CLIENT
Evaluating Client

- **Goals**
- **Financial Circumstances**

THE CLIENT
Evaluating Client's Susceptibility to UI

- **Financial Capacity**
- **Educational Background**
- **Investment Experience**

THE AGENT
Background Research

DOI Records

Enforcement Actions?

Appointments?

THE AGENT
Background Research

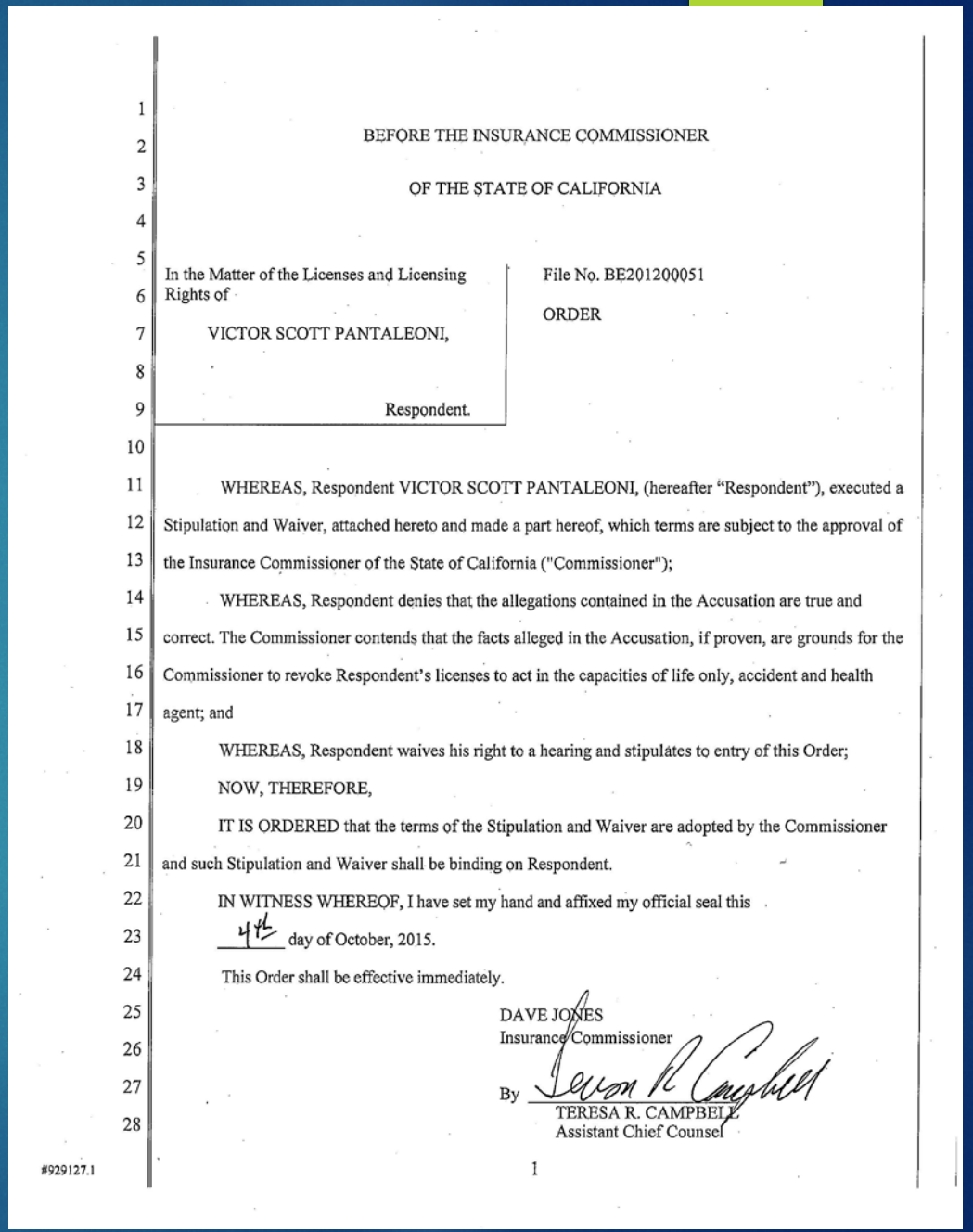
BEFORE THE INSURANCE COMMISSIONER

OF THE STATE OF CALIFORNIA

SAN FRANCISCO

In the Matter of the Licenses and Licensing Rights of VICTOR SCOTT PANTALEONI, Respondent.	File No.: BE201200051 ACCUSATION and REQUEST FOR ORDER PROHIBITING RESPONDENT FROM FURTHER PARTICPATION IN THE INSURANCE INDUSTRY (Pursuant to Insurance Code § 1748.5)

THE AGENT
Background Research



BEFORE THE INSURANCE COMMISSIONER

OF THE STATE OF CALIFORNIA

In the Matter of the Licenses and Licensing Rights of

VICTOR SCOTT PANTALEONI,

Respondent.

File No. BE201200051

ORDER

WHEREAS, Respondent VICTOR SCOTT PANTALEONI, (hereafter "Respondent"), executed a Stipulation and Waiver, attached hereto and made a part hereof, which terms are subject to the approval of the Insurance Commissioner of the State of California ("Commissioner");

WHEREAS, Respondent denies that the allegations contained in the Accusation are true and correct. The Commissioner contends that the facts alleged in the Accusation, if proven, are grounds for the Commissioner to revoke Respondent's licenses to act in the capacities of life only, accident and health agent; and

WHEREAS, Respondent waives his right to a hearing and stipulates to entry of this Order;

NOW, THEREFORE,

IT IS ORDERED that the terms of the Stipulation and Waiver are adopted by the Commissioner and such Stipulation and Waiver shall be binding on Respondent.

IN WITNESS WHEREOF, I have set my hand and affixed my official seal this 4th day of October, 2015.

This Order shall be effective immediately.

DAVE JONES
Insurance Commissioner

By _____
TERESA R. CAMPBELL
Assistant Chief Counsel

#929127.1

1

THE AGENT
Background Research

Bankruptcies?

Other Litigation?

THE AGENT
Background Research

U.S. Bankruptcy Court
District of Nevada (Reno)
Bankruptcy Petition #: 13-51544-btb
Internal Use Only

Assigned to: BRUCE T. BEESLEY
Chapter 7
Previous chapter 11
Original chapter 11
Voluntary
Asset

Date filed: 08/01/2013
Date converted: 11/06/2014
Date terminated: 04/25/2016
Debtor discharged: 05/06/2015
Joint debtor discharged: 05/06/2015
341 meeting: 12/15/2014
Deadline for objecting to discharge: 02/13/2015

Debtor disposition: Standard Discharge
Joint debtor disposition: Standard Discharge

Debtor
VICTOR S PANTALEONI
P.O. BOX 220
VERDI, NV 89439
WASHOE-NV
SSN / ITIN: 555-17-0403

represented by **MATTHEW Q. CALLISTER**
330 E. CHARLESTON BLVD.,
#100
LAS VEGAS, NV 89104
(702) 385-3343
Fax : (702) 385-2899
Email: mqc@call-law.com
TERMINATED: 09/11/2014

KEVIN A. DARBY
DARBY LAW PRACTICE, LTD.
4777 CAUGHLIN PKWY
RENO, NV 89519
(775) 322-1237
Fax : (775) 996-7290
Email: kad@darbylawpractice.com

Joint Debtor
JACQUELINE L PANTALEONI
P.O. BOX 220
VERDI, NV 89439
WASHOE-NV
SSN / ITIN: 158-58-3474

represented by **MATTHEW Q. CALLISTER**
(See above for address)
TERMINATED: 09/11/2014

KEVIN A. DARBY
(See above for address)

Trustee
C GEOFFREY WILSON
10580 N. MCCARRAN BLVD, STE 115-332
RENO, NV 89503
(775) 787-0378

U.S. Trustee
U.S. TRUSTEE - RN - 11

THE AGENT
Background Research

Businesses

Business Card

THE PRODUCT

Surrender Period

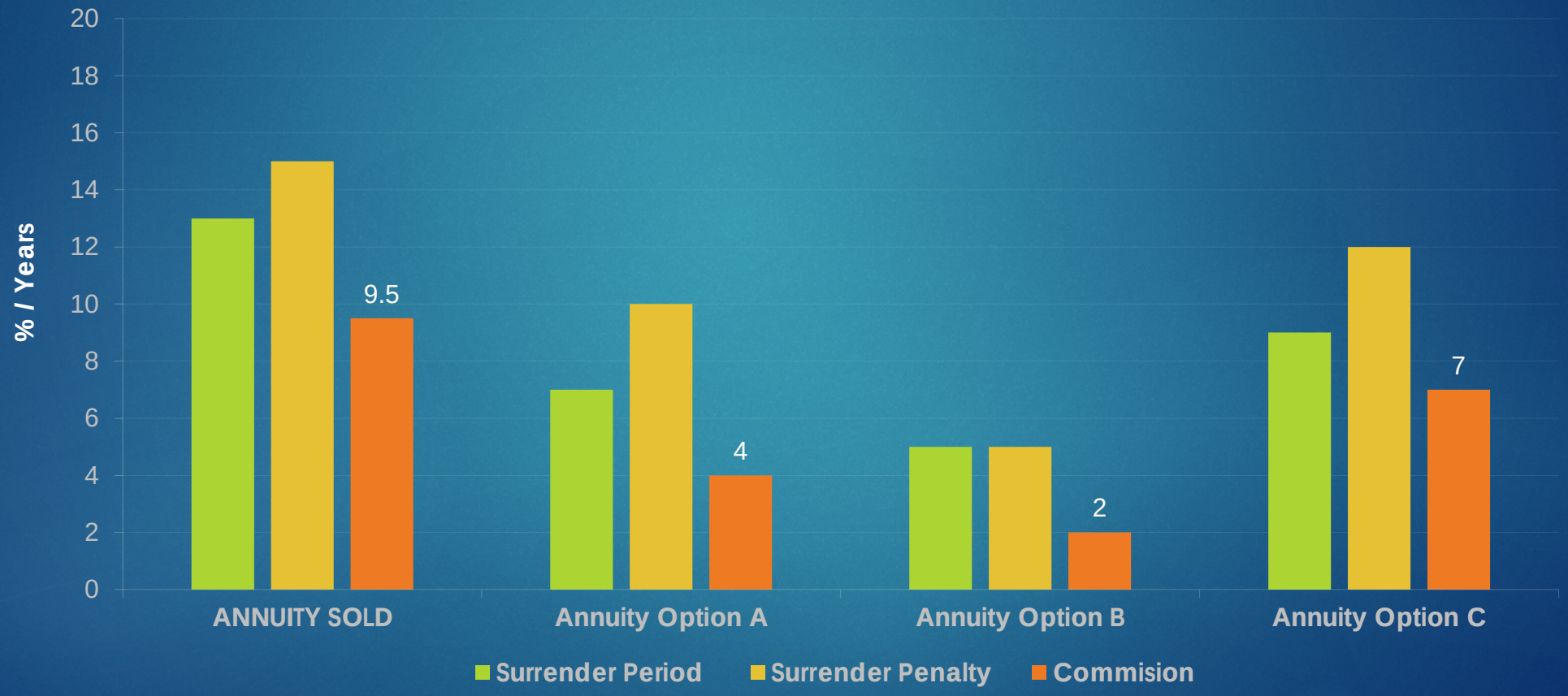
Surrender Penalty

THE PRODUCT

Commission Percentage/Amount

Illusory Benefits

THE PRODUCT
Compared to Other Annuities



TRANSACTION DOCUMENTS
The Application

Signature Valid?

Information Accurate?

TRANSACTION DOCUMENTS
Annuity Suitability Questionnaire

Questionnaire Complete?

Information Accurate (Agents trained on thresholds)

Information Consistent

TRANSACTION DOCUMENTS

NATIONAL WESTERN LIFE INSURANCE COMPANY®

ANNUITY SUITABILITY QUESTIONNAIRE FOR ALL APPLICANTS

(Please attach additional sheets as necessary)

This questionnaire is designed to elicit information about your financial needs and investment objectives so that your agent can determine which product, if any, is suitable for you. **Completion of this entire suitability questionnaire is mandatory.** This form is used by the Company to help monitor the suitability of annuity sales for the benefit of the customer. Any alterations to this form **must** be initialed by the applicant(s).

4. Approximate **Net Worth** after the purchase of this annuity ("Net Worth" means your **total** assets (excluding your primary residence and personal property, such as jewelry, furnishings, and vehicles) less your total debts (excluding mortgages on primary residence)):

☐ $0-$24,999 ☐ $25,000-$49,999 ☒ $50,000-$99,999 ☐ $100,000-$249,999

☐ $250,000-$499,999 ☐ $500,000-$999,999 ☐ $1,000,000 or higher

LIQUIDITY NEEDS AND FINANCIAL TIME HORIZON

9. What is your **Liquid Net Worth** *after* the purchase of this annuity? $ 120,000

("Liquid Net Worth" means the value of all of your assets that could readily convert to cash without imposition of fees or penalties (excluding your primary residence and personal property) less your total debts (excluding mortgages on primary residence))

ANNUITY SUITABILITY

NAIC Annuity Suitability Regulations

Statutory Annuity Suitability Requirements

ANNUITY SUITABILITY REQUIREMENTS

Prohibit Agent from recommending, and insurer from issuing, any annuity unless it is suitable based upon the applicants "Suitability Information."

ANNUITY SUITABILITY

"Suitability Information" includes (but is not limited to): Age; Annual income; Financial situation and needs; Financial experience; Financial objectives; Intended use of annuity; Financial time horizon; Existing assets; Liquidity needs; Liquid net worth; Risk tolerance; Tax status; Whether consumer has reverse mortgage or intends to apply for means-tested government benefits.

COMMON DEFENSE STRATEGIES/ARGUMENTS

- **Agent Was Plaintiff's Agent**
- **Plaintiff Failed to Consult Attorney/CPA**
- **Plaintiff Understood Transaction and Wants "Do-Over"**

COMMON DEFENSE STRATEGIES/ARGUMENTS

- **Plaintiff Has "Buyer's Remorse"**
- **Plaintiff Is Bound by Contracts He/She Signed (aka "A Deal's a Deal")**
- **The Annuity Is Beneficial**

COMMON DEFENSE STRATEGIES/ARGUMENTS

- **Agent Misled Insurer, Too**
- **Transaction Is Plaintiff's Fault (aka Plaintiff Caused His Own Damages)**

PLEADINGS
The Complaint

LEGAL THEORIES

Financial Abuse

Negligence *(Per Se)*

Breach of Fiduciary Duty

Fraud

PLEADINGS
The Complaint

OTHER CONSIDERATIONS

Civil Rights Violation

Intentional v. Negligent Conduct

PLEADINGS
The Complaint

OTHER CONSIDERATIONS

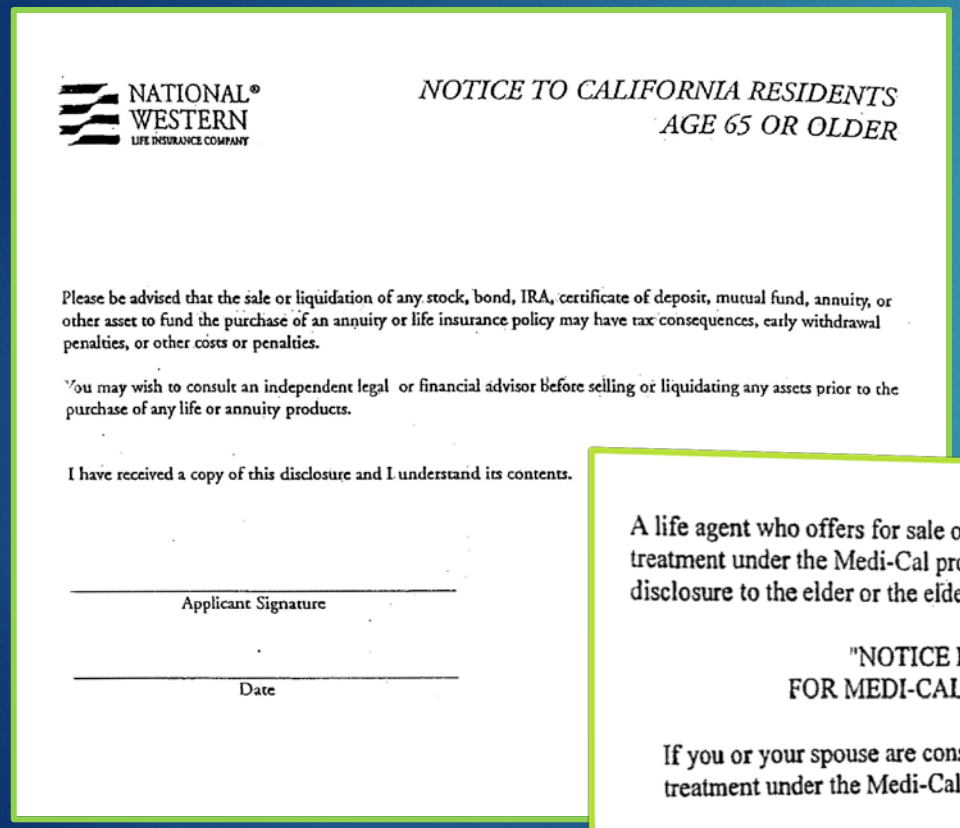
Serving the CEO/General Counsel

Ratification

DISCOVERY Documents

- Entire Agent File
- Entire Policy File
- Entire Underwriting/Suitability File
- Communications (including recorded conversations)

DISCOVERY
Documents – Required Notices



NATIONAL® WESTERN LIFE INSURANCE COMPANY

NOTICE TO CALIFORNIA RESIDENTS AGE 65 OR OLDER

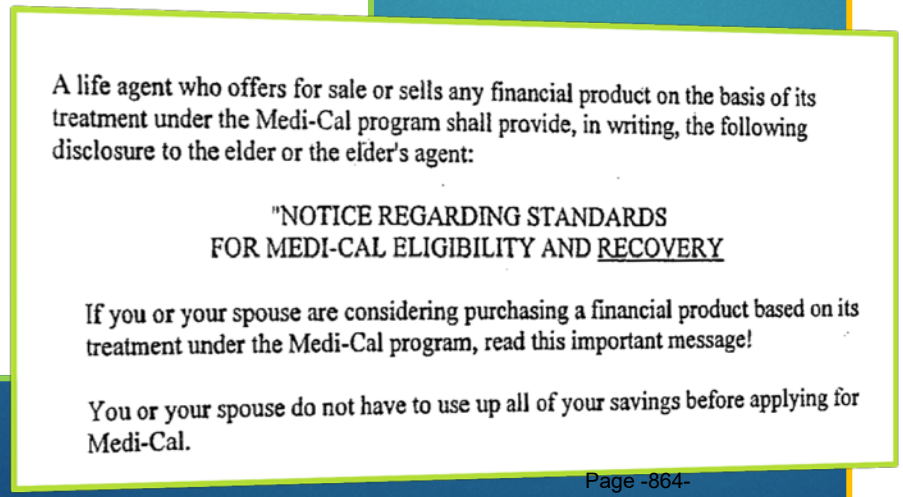
Please be advised that the sale or liquidation of any stock, bond, IRA, certificate of deposit, mutual fund, annuity, or other asset to fund the purchase of an annuity or life insurance policy may have tax consequences, early withdrawal penalties, or other costs or penalties.

You may wish to consult an independent legal or financial advisor before selling or liquidating any assets prior to the purchase of any life or annuity products.

I have received a copy of this disclosure and I understand its contents.

_____
Applicant Signature

_____
Date

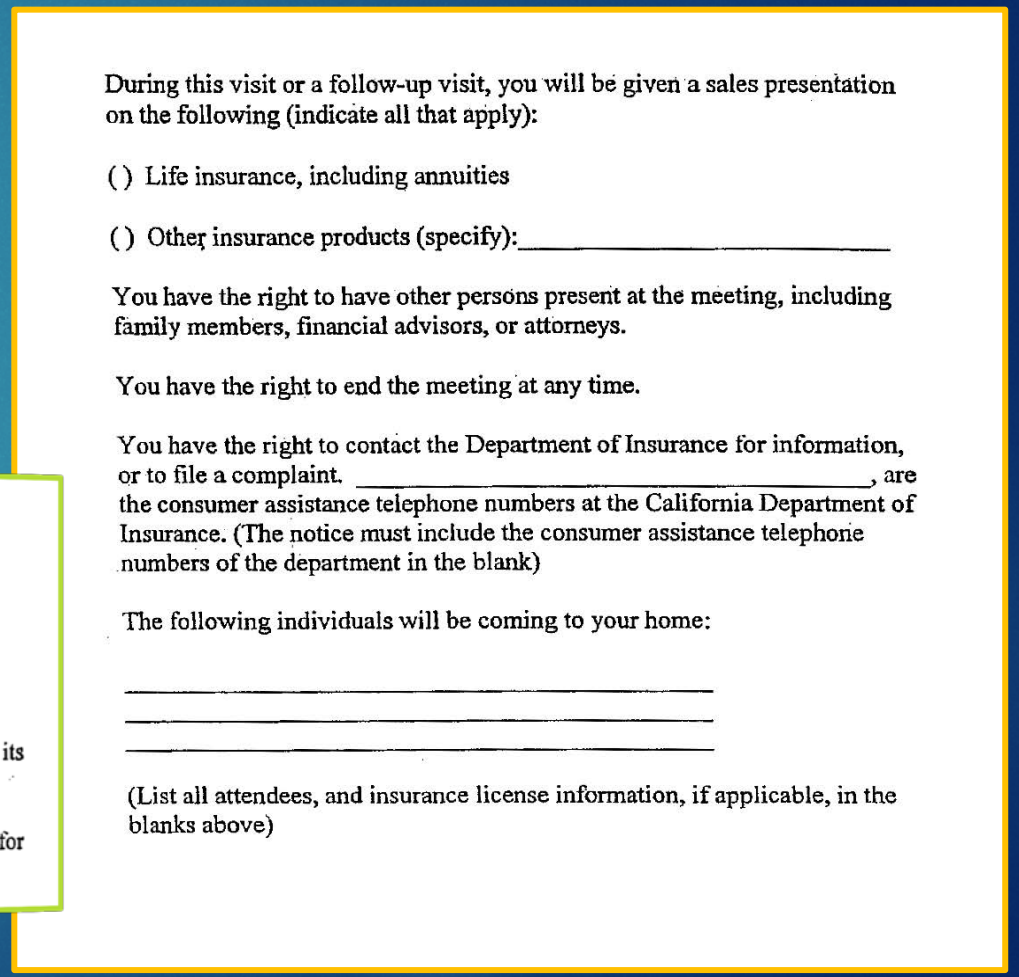


A life agent who offers for sale or sells any financial product on the basis of its treatment under the Medi-Cal program shall provide, in writing, the following disclosure to the elder or the elder's agent:

"NOTICE REGARDING STANDARDS
FOR MEDI-CAL ELIGIBILITY AND RECOVERY

If you or your spouse are considering purchasing a financial product based on its treatment under the Medi-Cal program, read this important message!

You or your spouse do not have to use up all of your savings before applying for Medi-Cal.



During this visit or a follow-up visit, you will be given a sales presentation on the following (indicate all that apply):

( ) Life insurance, including annuities

( ) Other insurance products (specify):_____

You have the right to have other persons present at the meeting, including family members, financial advisors, or attorneys.

You have the right to end the meeting at any time.

You have the right to contact the Department of Insurance for information, or to file a complaint. _____, are the consumer assistance telephone numbers at the California Department of Insurance. (The notice must include the consumer assistance telephone numbers of the department in the blank)

The following individuals will be coming to your home:

_____
_____
_____

(List all attendees, and insurance license information, if applicable, in the blanks above)

DISCOVERY
Interrogatories

- MEETINGS
- COMMUNICATIONS
- TRAINING
- COMPLAINTS
- OTHER PRODUCTS

DISCOVERY
Admission Requests

- **Authentication of Documents**
- **Transaction Facts**

DISCOVERY
Depositions

Who/Sequence/Documents

Videotape?

TRIAL STRATEGIES
Voir Dire – The Proverbial "First Impression"

- ✓ **Be Genuine**
- ✓ **Invite "Brutal Honesty"**
- ✓ **Thank ALL Contributions**
- ✓ **Address "Danger Points"**
- ✓ **Avoid Appearance of "Gamesmanship"**

TRIAL STRATEGIES
Opening Statement

- **Keep it short, simple, clear and provable**
- **Convert Defendants' arguments into your "swords"**
- **Foreshadow Closing**

TRIAL STRATEGIES
Witness Order

- Start and End Strong
- Contrast
- Avoid Repetition

TRIAL STRATEGIES
Direct Examination

- **Questions simple and present tense**
- **LISTEN to the answers**
- **Address cross-examination's "danger points"**

TRIAL STRATEGIES
Cross Examination

- **Keep it as short as possible**
- **Start and end strong**
- **Stay flexible**

TRIAL STRATEGIES
Closing Argument

- **Retell the story**
- **Review testimony highlights and key exhibits**
- **Juxtapose against jury instructions**

TRIAL STRATEGIES
Closing Argument

- **Review/Apply Key Instructions**
- **Review Special Verdict and explain answer to each question**

Thank You for What You Do!

FRANK J. FOX, ESQ. | MAJORS & FOX

3755 AVOCADO BOULEVARD, CALIFORNIA 91941

(619) 234-1000 | FJFOX@MAJORFOX.COM

Securities and Commodities Fraud: Working With the Federal Bureau of Investigation (FBI) and U.S. Commodity Futures Trading Commission (CFTC)[1]

Federal Bureau of Investigation (FBI)

The **Federal Bureau of Investigation** (**FBI**) is the domestic intelligence and security service of the United States and its principal federal law enforcement agency. Operating under the jurisdiction of the United States Department of Justice, the FBI is also a member of the U.S. Intelligence Community and reports to both the Attorney General and the Director of National Intelligence.[2] A leading U.S. counter-terrorism, counterintelligence, and criminal investigative organization, the FBI has jurisdiction over violations of more than 200 categories of federal crimes,[3] including White-Collar crimes.

Investment Fraud[4]

Investment fraud involves the illegal sale or purported sale of financial instruments. The typical investment fraud schemes are characterized by offers of low- or no-risk investments, guaranteed returns, overly-consistent returns, complex strategies, or unregistered securities. Examples of investment fraud include advance fee fraud, Ponzi schemes, pyramid schemes, and market manipulation fraud.

These schemes often seek to victimize affinity groups—such as groups with a common religion or ethnicity—to utilize the common interests to build trust to effectively operate the investment fraud against them. The perpetrators range from professional investment advisers to persons trusted and interacted with daily, such as a neighbor or sports coach. The fraudster's ability to foster trust makes these schemes so successful. Investors should use scrutiny and gather as much information as possible before entering into any new investment opportunities. Visit the FBI's White-Collar Crime webpage for additional information.

Tips for Avoiding Investment Fraud:

- Don't judge a person or company by their website; flashy websites can be set up quickly.
- Don't invest in anything you are not absolutely sure about. Do your homework on the investment and the company to ensure that they are legitimate.
- Check out other websites regarding this person/company.
- Be cautious when responding to special investment offers, especially through unsolicited e-mail.
- Be cautious when dealing with individuals/companies from outside your own country.
- Inquire about all the terms and conditions.

[1] These materials are compiled from fbi.gov and cftc.gov websites.
[2] https://en.wikipedia.org/wiki/Federal_Bureau_of_Investigation.
[3] *Id.*
[4] https://www.fbi.gov/scams-and-safety/common-fraud-schemes/investment-fraud.

Advance Fee Schemes[5]

An advance fee scheme occurs when the victim pays money to someone in anticipation of receiving something of greater value—such as a loan, contract, investment, or gift—and then receives little or nothing in return.

The variety of advance fee schemes is limited only by the imagination of the con artists who offer them. They may involve the sale of products or services, the offering of investments, lottery winnings, "found money," or many other "opportunities." Clever con artists will offer to find financing arrangements for their clients who pay a "finder's fee" in advance. They require their clients to sign contracts in which they agree to pay the fee when they are introduced to the financing source. Victims often learn that they are ineligible for financing only after they have paid the "finder" according to the contract. Such agreements may be legal unless it can be shown that the "finder" never had the intention or the ability to provide financing for the victims.

Tips for Avoiding Advanced Fee Schemes:

- If the offer of an "opportunity" appears too good to be true, it probably is. Follow common business practice. For example, legitimate business is rarely conducted in cash on a street corner.
- Know who you are dealing with. If you have not heard of a person or company that you intend to do business with, learn more about them. Depending on the amount of money that you plan on spending, you may want to visit the business location, check with the Better Business Bureau, or consult with your bank, an attorney, or the police.
- Make sure you fully understand any business agreement that you enter into. If the terms are complex, have them reviewed by a competent attorney.
- Be wary of businesses that operate out of post office boxes or mail drops and do not have a street address. Also be suspicious when dealing with persons who do not have a direct telephone line and who are never in when you call, but always return your call later.
- Be wary of business deals that require you to sign nondisclosure or non-circumvention agreements that are designed to prevent you from independently verifying the bona fides of the people with whom you intend to do business. Con artists often use non-circumvention agreements to threaten their victims with civil suit if they report their losses to law enforcement.

Ponzi Schemes[6]

"Ponzi" schemes promise high financial returns or dividends not available through traditional investments. Instead of investing the funds of victims, however, the con artist pays "dividends" to initial investors using the funds of subsequent investors. The scheme generally falls apart when the operator flees with all of the proceeds or when a sufficient number of new investors cannot be found to allow the continued payment of "dividends."

This type of fraud is named after its creator—Charles Ponzi of Boston, Massachusetts. In the early 1900s, Ponzi launched a scheme that guaranteed investors a 50 percent return on their investment in postal coupons. Although he was able to pay his initial backers, the scheme dissolved when he was unable to pay later investors.

[5] https://www.fbi.gov/scams-and-safety/common-fraud-schemes/advance-fee-schemes
[6] https://www.fbi.gov/scams-and-safety/common-fraud-schemes/ponzi-schemes

Tips for Avoiding Ponzi Schemes:

- Be careful of any investment opportunity that makes exaggerated earnings claims.
- Exercise due diligence in selecting investments and the people with whom you invest—in other words, do your homework before investing your money.
- Consult an unbiased third party—like an unconnected broker or licensed financial advisor—before investing.

Pyramid Schemes[7]

As in Ponzi schemes, the money collected from newer victims of pyramid schemes is paid to earlier victims to provide a veneer of legitimacy. In pyramid schemes, however, the victims themselves are induced to recruit further victims through the payment of recruitment commissions.

More specifically, pyramid schemes—also referred to as "franchise fraud" or "chain referral schemes"—are marketing and investment frauds in which an individual is offered a distributorship or franchise to market a particular product. The real profit is earned, not by the sale of the product, but by the sale of new distributorships. Emphasis on selling franchises rather than the product eventually leads to a point where the supply of potential investors is exhausted and the pyramid collapses. At the heart of each pyramid scheme is typically a representation that new participants can recoup their original investments by inducing two or more prospects to make the same investment. Promoters fail to tell prospective participants that this is mathematically impossible for everyone to do, since some participants drop out, while others recoup their original investments and then drop out.

Tips for Avoiding Pyramid Schemes:

- Be wary of "opportunities" to invest your money in franchises or investments that require you to bring in subsequent investors to increase your profit or recoup your initial investment.
- Independently verify the legitimacy of any franchise or investment before you invest.

Market Manipulation ("Pump and Dump") Fraud[8]

Market manipulation fraud—commonly referred to as a "pump and dump"—creates artificial buying pressure for a targeted security, generally a low-trading volume issuer in the over-the-counter securities market largely controlled by the fraud perpetrators. This artificially-increased trading volume has the effect of artificially increasing the price of the targeted security (i.e., the "pump"), which is rapidly sold off into the inflated market for the security by the fraud perpetrators (i.e., the "dump"). This results in illicit gains for the perpetrators and losses for innocent third-party investors. Typically, the increased trading volume is generated by inducing unwitting investors to purchase shares of the targeted security through false or deceptive sales practices and/or public information releases.

A modern variation on this scheme involves largely foreign-based computer criminals gaining unauthorized access to the online brokerage accounts of unsuspecting victims in the United States. These victim accounts are then utilized to engage in coordinated online purchases of the targeted security to

[7] https://www.fbi.gov/scams-and-safety/common-fraud-schemes/pyramid-schemes
[8] https://www.fbi.gov/scams-and-safety/common-fraud-schemes/market-manipulation-pump-and-dump-fraud

affect the pump portion of a manipulation, while the fraud perpetrators sell their pre-existing holdings in the targeted security into the inflated market to complete the dump.

Tips for Avoiding Market Manipulation Fraud:

- Don't believe the hype.
- Find out where the stock trades.
- Independently verify claims.
- Research the opportunity.
- Beware of high-pressure pitches.
- Always be skeptical.

White-Collar Crime[9]

Reportedly coined in 1939, the term white-collar crime is now synonymous with the full range of frauds committed by business and government professionals. These crimes are characterized by deceit, concealment, or violation of trust and are not dependent on the application or threat of physical force or violence. The motivation behind these crimes is financial—to obtain or avoid losing money, property, or services or to secure a personal or business advantage.

These are not victimless crimes. A single scam can destroy a company, devastate families by wiping out their life savings, or cost investors billions of dollars (or even all three). Today's fraud schemes are more sophisticated than ever, and the FBI is dedicated to using its skills to track down the culprits and stop scams before they start.

The FBI's white-collar crime work integrates the analysis of intelligence with its investigations of criminal activities such as public corruption, money laundering, corporate fraud, securities and commodities fraud, mortgage fraud, financial institution fraud, bank fraud and embezzlement, fraud against the government, election law violations, mass marketing fraud, and health care fraud. The FBI generally focuses on complex investigations—often with a nexus to organized crime activities—that are international, national, or regional in scope and where the FBI can bring to bear unique expertise or capabilities that increase the likelihood of successful investigations.

FBI special agents work closely with partner law enforcement and regulatory agencies such as the Securities and Exchange Commission, the Internal Revenue Service, the U.S. Postal Inspection Service, the Commodity Futures Trading Commission, and the Treasury Department's Financial Crimes Enforcement Network, among others, targeting sophisticated, multi-layered fraud cases that harm the economy.

Major Threats & Programs[10]

Corporate Fraud

Corporate fraud continues to be one of the FBI's highest criminal priorities—in addition to causing significant financial losses to investors, corporate fraud has the potential to cause immeasurable damage

[9] https://www.fbi.gov/investigate/white-collar-crime#Securities-and%20Commodities%20Fraud.
[10] https://www.fbi.gov/investigate/white-collar-crime.

to the U.S. economy and investor confidence. As the lead agency investigating corporate fraud, the Bureau focuses its efforts on cases that involve accounting schemes, self-dealing by corporate executives, and obstruction of justice.

The majority of corporate fraud cases pursued by the FBI involve accounting schemes designed to deceive investors, auditors, and analysts about the true financial condition of a corporation or business entity. Through the manipulation of financial data, the share price, or other valuation measurements of a corporation, financial performance may remain artificially inflated based on fictitious performance indicators provided to the investing public.

The FBI's corporate fraud investigations primarily focus on the following activities:

Falsification of financial information

- False accounting entries and/or misrepresentations of financial condition;
- Fraudulent trades designed to inflate profits or hide losses; and
- Illicit transactions designed to evade regulatory oversight.

Self-dealing by corporate insiders

- Insider trading (trading based on material, non-public information);
  Kickbacks;
- Misuse of corporate property for personal gain; and
- Individual tax violations related to self-dealing.

Fraud in connection with an otherwise legitimately operated mutual hedge fund

- Late trading;
- Certain market timing schemes; and
- Falsification of net asset values.

Obstruction of justice designed to conceal any of the above-noted types of criminal conduct, particularly when the obstruction impedes the inquiries of the U.S. Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), other regulatory agencies, and/or law enforcement agencies.

The FBI has formed partnerships with numerous agencies to capitalize on their experience in specific areas such as securities, taxes, pensions, energy, and commodities. The Bureau has placed greater emphasis on investigating allegations of these frauds by working closely with the SEC, CFTC, Financial Industry Regulatory Authority, Internal Revenue Service, Department of Labor, Federal Energy Regulatory Commission, and the U.S. Postal Inspection Service.

Money Laundering

Money laundering is the process by which criminals conceal or disguise their proceeds and make them appear to have come from legitimate sources.

Money laundering allows criminals to hide and accumulate wealth, avoid prosecution, evade taxes, increase profits through reinvestment, and fund further criminal activity.

While many definitions for money laundering exist, it can be defined very simply as turning "dirty" money into "clean" money. And it's a significant crime—money laundering can undermine the integrity and stability of financial institutions and systems, discourage foreign investment, and distort international capital flows.

The FBI focuses its efforts on money laundering facilitation, targeting professional money launderers, key facilitators, gatekeepers, and complicit financial institutions, among others.

Money laundering is usually associated with crimes that provide a financial gain, and criminals who engage in money laundering derive their proceeds in many ways. Some of their crimes include:

- Complex financial crimes
- Health care fraud
- Human trafficking
- International and domestic public corruption
- Narcotics trafficking
- Terrorism

The number and variety of methods used by criminals to launder money makes it difficult to provide a complete listing, but here are a few of the ways through which criminals launder their illicit proceeds:

- Financial institutions
- International trade
- Precious metals
- Real estate
- Third party service providers
- Virtual currency

There are three steps in the money laundering process—placement, layering, and integration. Placement represents the initial entry of the criminal's proceeds into the financial system. Layering is the most complex and often entails the international movement of funds. Layering separates the criminal's proceeds from their original source and creates a complex audit trail through a series of financial transactions. And integration occurs when the criminal's proceeds are returned to the criminal from what appear to be legitimate sources.

Detection and Deterrence

Money laundering is a massive and evolving challenge that requires collaboration on every level. The FBI regularly coordinates with:

- Other federal, state, and local law enforcement agencies to detect and deter the money laundering threat in the U.S.;
- Our international partners to help address the increasingly complex global financial system, the cross-border nature of many financial transactions, and the increased sophistication of many money laundering operations; and

- All aspects of industry touched by the money laundering efforts of criminals.

Securities and Commodities Fraud

The continuing integration of global capital markets has created unprecedented opportunities for U.S. businesses to access capital and investors to diversify their portfolios. Whether through individual brokerage accounts, college savings plans, or retirement accounts, more and more Americans are choosing to invest in the U.S. securities and commodities markets. This growth has led to a corresponding rise in the amount of fraud and misconduct seen in these markets. The creation of complex investment vehicles and the tremendous increase in the amount of money being invested have created greater opportunities for individuals and businesses to perpetrate fraudulent investment schemes.

The following are the most prevalent types of securities and commodities fraud schemes:

- **Investment fraud**: These schemes—sometimes referred to as "high-yield investment fraud"—involve the illegal sale or purported sale of financial instruments. The typical investment fraud schemes are characterized by offers of low- or no-risk investments, guaranteed returns, overly-consistent returns, complex strategies, or unregistered securities. These schemes often seek to victimize affinity groups—such as groups with a common religion or ethnicity—to utilize the common interests to build trust to effectively operate the investment fraud against them. The perpetrators range from professional investment advisers to persons trusted and interacted with daily, such as a neighbor or sports coach. The fraudster's ability to foster trust makes these schemes so successful. Investors should use scrutiny and gather as much information as possible before entering into any new investment opportunities. Here are some examples of the most common types of investment fraud schemes:

    - **Ponzi schemes:** These schemes involve the payment of purported returns to existing investors from funds contributed by new investors. Ponzi schemes often share common characteristics, such as offering overly consistent returns, unregistered investments, high returns with little or no risk, or secretive or complex strategies.

    - **Pyramid schemes:** In these schemes, as in Ponzi schemes, money collected from new participants is paid to earlier participants. In pyramid schemes, however, participants receive commissions for recruiting new participants into the scheme. Pyramid schemes are frequently disguised as multi-level marketing programs.

    - **Prime bank investment fraud/trading program fraud:** In these schemes, perpetrators claim to have access to a secret trading program endorsed by large financial institutions such as the Federal Reserve Bank, Treasury Department, World Bank, International Monetary Fund, etc. Victims are often drawn into prime bank investment frauds because the criminals use sophisticated terms and legal-looking documents, and also claim that the investments are insured against loss.

    - **Advance fee fraud:** Advance fee schemes require victims to pay upfront fees in the hope of realizing much larger gains. Typically, victims are told that in order to participate in a lucrative investment program or receive the prize from a lottery/sweepstakes, they must first send funds to cover a cost, often disguised as a tax or participation fee. After the first payment, the perpetrator will request additional funds for other "unanticipated" costs.

- **Promissory note fraud:** These are generally short-term debt instruments issued by little-known or nonexistent companies. The notes typically promise a high rate of return with little or no risk. Fraudsters may use promissory notes in an effort to avoid regulatory scrutiny; however, most promissory notes are securities and need to be registered with the Securities and Exchange Commission and the states in which they are being sold.

- **Commodities fraud:** Commodities fraud is the illegal sale or purported sale of raw materials or semi-finished goods that are relatively uniform in nature and are sold on an exchange (e.g., gold, pork bellies, orange juice, and coffee). The perpetrators of commodities fraud entice investors through false claims and high-pressure sales tactics. Often in these frauds, the perpetrators create artificial account statements that reflect purported investments when, in reality, no such investments have been made. Instead, the money has been diverted for the perpetrators' use. Additionally, they may trade excessively merely to generate commissions for themselves (known as "churning"). Two common types of commodities fraud include investments in the foreign currency exchange (Forex) and into precious metals (e.g., gold and silver).

- **Broker embezzlement:** These schemes involve illicit and unauthorized actions by brokers to steal directly from their clients. Such schemes may be facilitated by the forging of client documents, doctoring of account statements, unauthorized trading/funds transfer activities, or other conduct in breach of the broker's fiduciary responsibilities to the victim client.

- **Market manipulation:** These "pump and dump" schemes are based on the manipulation of lower-volume stocks on small over-the-counter markets. The basic goal of market manipulation frauds is to artificially inflate the price of the penny stocks so that the conspirators can sell their shares at a large profit. The "pump" involves recruiting unwitting investors through false or deceptive sales practices, public information, or corporate filings. Many of these schemes use boiler room methods where brokers—who are bribed by the conspirators—use high pressure sale tactics to increase the number of investors and, as a result, raise the price of the stock. Once the target price is achieved, the perpetrators "dump" their shares at a huge profit and leave innocent investors to foot the bill.

The FBI anticipates that the variety of securities and commodities fraud schemes will continue to grow as investors remain susceptible to the uncertainty of the global economy. To investigate and help prevent fraudulent activity in the financial markets, the Bureau continues to work closely with various governmental and private entities. For example:

- FBI field offices operate task forces and working groups with other law enforcement and regulatory agencies, including, the Securities and Exchange Commission, U.S. Attorney's Offices, Commodity Futures Trading Commission, Financial Industry Regulatory Authority, U.S. Postal Inspection Service, and the Internal Revenue Service;
- And nationally, the FBI participates in several working groups and task forces such as the Financial Fraud Enforcement Task Force, which coordinates the efforts of the Department of Justice at all levels of government to disrupt and dismantle significant large-scale criminal enterprises.

For more information regarding the what the FBI investigates, visit FBI.gov.

U.S. Commodity Futures Trading Commission (CFTC)

The U.S. Commodity Futures Trading Commission (CFTC) is an independent agency of the US government created in 1974, that regulates futures and option markets.[11]

The Commodities Exchange Act ("CEA"), 7 U.S.C. § 1 *et seq.*, prohibits fraudulent conduct in the trading of futures contracts. The stated mission of the CFTC is to foster open, transparent, competitive, and financially sound markets, to avoid systemic risk, and to protect the market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act. After the Financial crisis of 2007–2008 and since 2010 with the Dodd–Frank Wall Street Reform and Consumer Protection Act, CFTC has been transitioning to bring more transparency and stricter regulation to the multitrillion dollar swaps market.[12]

CFTC Overview[13]

The U.S. Commodity Futures Trading Commission is an independent U.S. government agency that regulates the U.S. derivatives markets, including futures, options, and swaps. The mission of the CFTC is to foster open, transparent, competitive, and financially sound markets; detect and reduce systemic risk; promote market integrity; and protect the market users, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act.

In carrying out this mission, the Commission polices the derivatives markets for various abuses and works to ensure the protection of customer funds. Further, the agency seeks to reduce the risk of the futures and swaps markets to protect the economy and the public.

To fulfill these roles, the Commission oversees designated contract markets, swap execution facilities, derivatives clearing organizations, swap data repositories, swap dealers, futures commission merchants, commodity pool operators, and other intermediaries.

The markets overseen by the Commission profoundly affect the U.S. economy and the prices individuals in the United States pay for food, energy, transportation, and most other goods and services bought each day. A wide variety of businesses—such as manufacturers, retailers, farmers, and ranchers—uses these markets to manage routine commercial risk. For example, derivatives enable farmers to lock in a price for their crops, and utility companies or airlines to hedge the costs of fuel. Derivatives also enable exporters and importers to manage fluctuations in foreign currency exchange rates, and businesses of all types to lock in their borrowing costs. In the simplest terms, derivatives markets enable businesses of all kinds to manage risk. For more information about the Commission and what it does, please visit the CFTC website.

[11] https://en.wikipedia.org/wiki/Commodity_Futures_Trading_Commission.
[12] *Id.*
[13] https://www.whistleblower.gov/aboutcftc.

CFTC Enforcement Overview[14]

The Commission, through its Division of Enforcement, investigates violations of the Commodity Exchange Act (CEA) and the CFTC Regulations. Violations can be certain actions or behavior in connection with futures, options, and swaps and in connection for a contract of sale of any commodity in interstate commerce. In general, violations of the CEA include, among other things:

- Fraud (for example, fraudulent solicitation, misappropriation of customer funds, issuing false customer account statements, mishandling customer funds, Ponzi schemes, affinity schemes)

- Market manipulation, including attempted market manipulation and disruptive trading practices (for example, fictitious and non-competitive transactions, illicit trading strategies designed to manipulate or attempt to manipulate prices, and spoofing, which is defined as entering an order with the intent to cancel it before it is consummated in a complete transaction)

- Trade practice violations (for example, wash sales, fictitious sales, noncompetitive transactions, violation of position limits, noncompetitive exchange of futures for physical transactions opposite each other, unauthorized swap transactions, inadequate oversight of traders, undercapitalization, improper controls and supervision, improper handling and/or segregation of customer funds, failing to comply with applicable record-keeping and audit trail rules, and creating after the fact trading records containing fictitious information that were submitted for clearing)

The Commission regularly investigates matters involving violations described above. Some examples of the context in which the Commission has brought successful enforcement actions include, but are not limited to:

- Manipulation or fixing of benchmark rates such as LIBOR, ISDAFIX and global foreign exchange rates

- Illegal, off-exchange precious metals transactions

- Disruptive trading of futures or swaps, including spoofing—bidding or offering with the intent to cancel the bid or offer before execution

- False statements to the CFTC or the National Futures Association

- Forex trading scams

- Violating prior CFTC orders

The Commission also engages in cooperative enforcement work with state, federal and international regulatory and criminal authorities. The CFTC has enforcement teams in Washington, D.C., New York, Kansas City, and Chicago.

The Division of Enforcement bases investigations on information it receives from members of the public, including tips and complaints submitted to the Commission; other divisions of the Commission; industry

[14] *Id.*

self-regulatory associations; state, federal, and international authorities; and information it develops independently. For more information about CFTC Enforcement, please visit the Enforcement Actions page on the CFTC website.

What the Regulators Do[15]

The CFTC is the Federal agency with the primary responsibility for overseeing the commodities markets, including foreign currency trading. Many state securities regulators also have the right under their state laws to take action against illegal commodities investments. Sometimes the CFTC and the states work together on cases. Examples include:

In 2005, the CFTC and the Commissioner of Corporations of the State of California sued National Investment Consultants, Inc., and others in U.S. District Court for the Northern District of California for engaging in a forex scam involving approximately $2 million in customer funds. In 2006, the Court ordered restitution and fines amounting to $3.4 million.

Also in 2005, the CFTC and the Texas State Securities Board (TSSB) engaged in a cooperative enforcement effort against Premium Income Corp. (PIC) and its principals. The CFTC and Securities and Exchange Commission (SEC) filed an action in U.S. District Court for the Northern District of Texas and the TSSB filed an administrative action charging PIC and its principals with engaging in an illegal $11 million forex operation. To date, the federal court has found three corporate defendants liable to pay restitution of $12 million and each was assessed a fine of $37 million. The State of Texas also has obtained cease and desist orders along with various criminal indictments and convictions. PIC's president is currently incarcerated on charges stemming from his forex scam.

In 2004, Gregory Blake Baldwin of Utah pleaded guilty to fraud after his firm, Sunstar Funding, accepted $228,500 from 33 investors for placement into the foreign currency market. The investors' money was not placed in the foreign currency market but was used to pay some past investors and for personal expenses of Baldwin.

In 2003, the CFTC and the State of Oregon Department of Consumer and Business Services sued Orion International, Inc., and its principals in U.S. District Court for the District of Oregon for fraudulently soliciting over $40 million to participate in a purported forex fund. Orion, and its president Russell Cline, misappropriated virtually all the customer funds. In 2006, the Court entered fines and restitution orders against the defendants totaling almost $150 million. Cline is currently incarcerated on charges stemming from his forex scam.

In 2002, the CFTC, the SEC and the State of Utah filed an action against a company known as "4NExchange" for violations of state and Federal laws as the firm's principals illegally offered foreign currency contracts through an alleged Ponzi scheme that cost investors nearly $15 million.

15 https://www.cftc.gov/ConsumerProtection/FraudAwarenessPrevention/ForeignCurrencyTrading/cftcnasaaforexalert.html

Division of Enforcement[16]

The Division of Enforcement investigates and prosecutes alleged violations of the Commodity Exchange Act (CEA or Act) and Commission regulations. For example, the Division brings enforcement actions against: individuals and firms registered with the Commission; those who violate these laws in connection with their trading commodity futures and options on designated domestic exchanges; those who improperly market futures and options contracts to retail investors or perpetrate Ponzi schemes; those who use manipulative or deceptive schemes in connection with commodities, futures or swaps; and those who engage in disruptive trading practices. The Division undertakes these activities under the management and direction of the Office of the Director.[17]

Type of Fraud

Foreign Currency Trading

On September 10, 2010, the CFTC published in the Federal Register final regulations concerning off-exchange retail foreign currency transactions. (75 Fed. Reg. 55410.) The rules implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Food, Conservation, and Energy Act of 2008, which, together, provide the CFTC with broad authority to register and regulate entities wishing to serve as counterparties to, or to intermediate, retail foreign exchange (forex) transactions. The final rules become effective October 18, 2010.

The final forex rules put in place requirements for, among other things, registration, disclosure, recordkeeping, financial reporting, minimum capital and other business conduct and operational standards. Specifically, the regulations require the registration of counterparties offering retail foreign currency contracts as either futures commission merchants (FCMs) or retail foreign exchange dealers (RFEDs), a new category of registrant. Persons who solicit orders, exercise discretionary trading authority or operate pools with respect to retail forex also will be required to register, either as introducing brokers, commodity trading advisors, commodity pool operators (as appropriate) or as associated persons of such entities. "Otherwise regulated" entities, such as financial institutions and SEC-registered brokers or dealers, remain able to serve as counterparties in such transactions under the oversight of their primary regulators.

The final rules include financial requirements designed to ensure the financial integrity of firms engaging in retail forex transactions and robust customer protections. For example, FCMs and RFEDs are required to maintain net capital of $20 million plus 5 percent of the amount, if any, by which liabilities to retail forex customers exceed $10 million. Leverage in retail forex customer accounts will be subject to a security deposit requirement to be set by the National Futures Association within limits provided by the Commission. All retail forex counterparties and intermediaries are required to distribute forex-specific risk disclosure statements to customers and comply with comprehensive recordkeeping and reporting requirements.

In 2001, 2002, and 2007 – prior to the release of the proposed and final rules – the Commission and Division of Clearing and Intermediary Oversight had issued a number of advisories regarding foreign currency trading by retail customers. These advisories are superseded and no longer effective.

[16] https://www.cftc.gov/LawRegulation/Enforcement/index.htm.
[17] *Id.*

The CFTC's regulatory jurisdiction does not extend to fraudulent activities in connection with using U.S. dollars to purchase foreign currency for its actual physical delivery.

Gold and Other Precious Metals[18]

Gold and other precious metals, such as silver and platinum may not be as safe as some promoters make them out to be. Claims sometimes suggest that gold or silver are safe havens that can protect one against economic or political uncertainty. While precious metals can offer additional diversification to an investment portfolio, they are subject to the same pressures of supply and demand as other commodities.

Here are three common ways you can invest in gold or other precious metals, and all of them involve some risk:

Futures contracts. When you speculate in the futures markets, you have the ability to purchase contracts on margin. This means you can control a large amount of metal at a fraction of its value. Leverage can amplify returns and risk. Small price swings in either direction could mean significant gains, or you could lose significantly more than you initially invested.

Precious metals securities. These can range from shares in publicly traded mining companies to exchange traded funds (ETFs) that buy physical metal or trade metal futures contracts. Like other securities, metals securities and ETFs are subject to trading commissions, fees, and market risk.

Physical metal. You can buy bullion or coins from a bank or other dealer. You will pay the current or "spot" price plus a markup or "premium." You'll want to compare premiums from multiple sellers to make sure you're getting the best value. For you to make a profit, the spot price needs to increase enough to cover the premium plus any other costs associated with selling the metal. Also, consider the cost of storage over time. If you keep the metal at home, it may not be covered by your homeowners insurance. If you store it with a bank or other facility, you will likely pay fees.

Other Types of Offers[19]

Investors should be cautious of offers to buy bullion or coins and store the metal in secured facilities rather than deliver it to you. If the seller is not registered with the CFTC and the sale involves financing or buying the metal on margin, it could be operating illegally. In most cases, it is against the law for a non-registered entity to sell any commodity "over the counter" using credit or margin, unless the buyer receives delivery within 28 days of the purchase.

The CFTC has brought enforcement actions against several companies that operated illegally. In some cases, the CFTC charged the companies with fraud for selling gold and other precious metals that didn't exist. These frauds also charged victims for:

- Storing the nonexistent metal
- Insurance premiums

[18] The CTFC brochure, *The Risks of Buying Gold, Silver & Platinum*, is available at https://www.cftc.gov/sites/default/files/idc/groups/public/@cpfraudawarenessandprotection/documents/file/cppreciousmetalsfraudbrochure.pdf

[19] *Id.*

• Shipping fees
• Interest on loans

Commodity Pool Fraud

Commodity pool operators are persons or firms that raise funds and pool them together to trade commodity futures and options. Most fraudulent commodity pools involve unregistered operators. Many commodity pool operators advertise and solicit investors based on false claims of high profits and low risk. In fraudulent commodity pools, the funds are often misused and spent on improper expenses.

Signs of a Possible Fraudulent sales Pitch –

- Leading the customer to believe one can profit from current news already known to the public. "As a result of that hurricane, the price of oil futures will increase substantially."
- Made through word of mouth referrals or emails from friends, relatives, members of churches or social groups—one fraudulent pool operator even solicited his cancer support group.
- Claiming to know unique market trends or to have a record of highly profitable trading.
- Promising quick, large and guaranteed returns.
- Contacting the customer asking for personal information such as full name, phone number, email or home address.
- Requesting cash immediately.

Whistleblower Program[20]

History of the Whistleblower Program

The CFTC's Whistleblower Program was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which amended the CEA by adding a new Section 23, titled "Commodity Whistleblower Incentives and Protection."

Section 23 of the CEA, along with the rules and regulations issued by the CFTC to implement the provisions of the section (the Whistleblower Rules - 17 C.F.R.pt.165), governs the Whistleblower Program and provides detailed procedures and requirements about the program and process for obtaining a whistleblower award. The Whistleblower Rules became effective in October 2011 and were amended in July 2017.

Under the Whistleblower Program:[21]

[20] https://www.whistleblower.gov/overview.
[21] *Id.*

The CFTC pays monetary awards to eligible whistleblowers who voluntarily provide the CFTC with original information about violations of the Commodity Exchange Act (CEA) that leads the CFTC to bring a successful enforcement action resulting in monetary sanctions exceeding $1,000,000.
The CFTC pays monetary awards to eligible whistleblowers whose information leads to the successful enforcement of a Related Action brought by another governmental entity and certain other entities that is based on original information voluntarily submitted by a whistleblower to the CFTC that led to the successful enforcement of an action brought by the CFTC.

The total amount of an award for an eligible enforcement action is between 10% and 30% of the amount of monetary sanctions collected in the CFTC's enforcement action or a Related Action. If multiple whistleblowers are granted awards in an action, the total award amount is still limited to between 10% and 30% of the amount of the monetary sanctions collected.

Whistleblowers have certain protections regarding confidentiality of their identity. Employers may not take any action to impede would-be whistleblowers from communicating directly with the Commission's staff about possible violations of the Commodity Exchange Act (CEA), including by enforcing, or threatening to enforce, a confidentiality agreement or predispute arbitration agreement with respect to such communications. Nor may employers retaliate against whistleblowers for reporting violations of the CEA—as through discharge, demotion, suspension, threats, harassment, direct or indirect, or any other discrimination against a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower.

A whistleblower who has been retaliated against has the right to sue an employer in federal court. In addition, the CFTC has authority to enforce the anti-retaliation provisions of the CEA by bringing an enforcement action or proceeding against an offending employer.

Information provided could lead the Commission to open a new investigation, re-open a closed investigation, or pursue a new line of inquiry in an ongoing investigation. This could result in a successful enforcement action and may make one be eligible for an award if the information matches certain criteria. More information is available under Submit a Tip.

Submitting a tip alone will not be sufficient to obtain an award. In order to be considered for an award, a whistleblower must also submit an award application when the Whistleblower Office releases a Notice of Covered Action, or when a judgment is issued in a Related Action.

Who Can Be A Whistleblower Eligible for An Award[22]

A whistleblower eligible for an award can be any individual who sends the Commission a Form TCR containing information about a potential violation of the Commodity Exchange Act. Examples range from a corporate officer or insider, to a trader or market observer, to an investor or fraud victim. A company or another entity is not eligible to be a whistleblower. Rules 165.2(p), 165.

However, not every person who files a TCR will be eligible for an award. To be eligible, a whistleblower must "voluntarily" provide the Commission with "original information" about a violation. Those terms are explained in these FAQs. Also, certain persons – including certain government and self-regulatory personnel, and persons convicted of a crime related to the conduct at issue in the whistleblower matter – are ineligible for an award. Rules 165.5(a), 165.6.

[22] https://www.whistleblower.gov/overview/submitatip/#becomewhistleblower.

How to Become a Whistleblower Eligible for Award[23]

The first step to becoming eligible for a whistleblower award is for an individual or group of individuals to submit a tip, complaint, or referral on a Form TCR that contains information about a potential violation of the CEA. Whistleblowers can be anyone: corporate insiders, market observers, investors, customers, and fraud victims. A whistleblower need not be a company insider. But entities cannot be eligible for awards themselves, and not every whistleblower will be eligible for an award.

Information provided by a whistleblower could lead the Commission to open a new investigation, re-open a closed investigation, pursue a new line of inquiry in an ongoing investigation, or significantly contribute to the success of an enforcement action. This could result in a successful enforcement action or a Related Action, which could be brought by another governmental authority. Only those whistleblowers who submit information before the CFTC contacts them will be eligible for an award. In order for information to be voluntarily submitted, it must be submitted before the CFTC or certain other authorities request, inquire, or demand information from the whistleblower related to the original information being provided.

Individuals can submit a tip anonymously, with or without a lawyer's help. Because the CFTC may need to contact a whistleblower for more information, individuals should provide some means of contact, such as an email address or telephone number. Likewise, there are detailed requirements for submitting an award application anonymously. If you have any questions about submitting anonymously, you are encouraged to contact the Whistleblower Office before you file.

Whether or not an individual submits anonymously, the CFTC is committed to protecting the identities of whistleblowers. The CFTC treats information learned during the course of an investigation—including the identity of sources—as non-public and confidential.

The exception to this policy is that in an administrative or court proceeding, the CFTC may be required to produce documents or other information which would reveal a whistleblower's identity. Likewise, the CFTC may also provide the information provided by whistleblowers, subject to confidentiality requirements, to other government or regulatory entities.

For more information regarding CFTC oversight, enforcement and the Whistleblower Program, visit CFTC.gov.

[23] *Id.*