2022

SECURITIES LAW SEMINAR

Public Investors Advocate Bar Association
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2022 PIABA Securities Law Seminar

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2022 PIABA Securities Law Seminar Speaker Biographies

Melanie Cherdack, Esq.
University of Miami School of Law
Investor Rights Clinic
Coral Gables, Florida

Melanie Cherdack is the Acting Associate Director of the Investor Rights Clinic at the University of Miami School of La. She is also of counsel in the Miami, Florida office of Genovese Joblove & Battista, P.A. Earlier in her career, she served as Assistant General Counsel in the litigation department of PaineWebber Inc. (now UBS). Melanie graduated with honors from the University of Florida College of Law where she was a Senior Editor on the Florida Law Review. She has published numerous articles and has lectured before many legal and professional organizations on issues related to securities arbitration. She is an editor of the PIABA Bar Journal and co- authors the Recent Awards section of that publication.

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

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

Scott Eichhorn, Esq.
University of Miami Investor Rights Clinic
Coral Gables, Florida

Scott Eichhorn is the Acting Director of the University of Miami School of Law Investor Rights Clinic, where he teaches the substantive law and practical skills of securities arbitration claims and supervises Clinic representation of investors of modest means in claims for investment losses and FINRA arbitration proceedings. Mr. Eichhorn is a regular participant on panels and contributor to written materials for securities-related conferences. He currently serves as co-chair of the PIABA Securities Law Seminar Committee.

Prior to joining the University of Miami, he was in private practice at Fowler White Burnett, P.A., practicing in commercial litigation and specializing in securities litigation in state and federal courts and FINRA arbitration. Mr. Eichhorn received his J.D. from Northwestern University Pritzker School of Law and his B.S. in Journalism from the University of Florida.

Elissa J. Germaine, Esq.
Fairbridge Investor Rights Clinic
Elisabeth Haub School of Law
Pace University
White Plains, New York

Elissa Germaine is the Director of the Fairbridge Investor Rights Clinic at the Elisabeth Haub School of Law at Pace University. The Investor Rights Clinic represents investors of modest means, who are unable to obtain legal representation because of the small amount of their claims, in disputes with their brokers in FINRA arbitration. She is also the Executive Director of John Jay Legal Services, which operates the law school's clinic and externship programs. She serves on the SEC's Investor Advisory Committee and as a public member of FINRA's National Arbitration and Mediation Committee.

Professor Germaine previously taught in the legal skills and legal writing programs at Pace Law and New York Law School. Before entering legal education, she practiced securities litigation, white collar defense and investigations, and complex commercial litigation at Latham & Watkins LLP in San Francisco. She served as a law clerk for the Honorable John S. Rhoades, Sr. in the United States District Court, Southern District of California.

She received her JD from Northwestern University Pritzker School of Law and her BA from Dartmouth College.

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

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

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

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

William A. Jacobson, Esq.
Director, Cornell Securities Law School
Ithaca, New York

William A. Jacobson, Esq., is a Clinical Professor of Law at Cornell Law School, and Director of the Cornell Securities Law Clinic, which he founded in 2008. He is a 1981 graduate of Hamilton College, and a 1984 graduate of Harvard Law School. Prior to joining Cornell, Prof. Jacobson practiced law in NYC (1985-1993) and Providence, RI (1994-2007). He has been a PIABA member since 1995, and he is a former member of the PIABA Board of Directors. His full biography, including his many reported cases, is available at the Cornell Law School website.

Bryan Jacoutot, Esq.
Taylor English Duma LLP
Atlanta, Georgia

Bryan's multifaceted legal practice centers on commercial litigation and election law. He also leads the firm's Bitcoin practice team, which offers a full suite of legal services for Bitcoin-focused companies dealing with a wide range of challenges unique to the Bitcoin industry.

Bryan also works frequently with t|e Decisions, the government affairs arm of Taylor English. Through his work with Decisions, Bryan represents legislators and industry groups in complex litigation as well as legislative drafting.

In addition to the law, Bryan devotes significant time to studying and writing about economics, history, technology, and public policy. This diverse cross-section of subject matters aids in his holistic view of election law and compliments his legal expertise in the Bitcoin industry.

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

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

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

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

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

Melanie Lubin, Esq.
Maryland Securities Commissioner
Maryland Division of Securities
Baltimore, Maryland

Melanie Senter Lubin joined the Maryland Division of Securities within the Office of the Maryland Attorney General early in her career and was appointed Maryland Securities Commissioner in 1998.

Throughout her years as a Maryland securities regulator, Commissioner Lubin has also held numerous leadership positions with the North American Securities Administrators Association (NASAA).

Commissioner Lubin began serving her term as President of NASAA in September 2021. Prior to her NASAA presidency, Lubin has served on the NASAA Board of Directors as a Director, Secretary, and Treasurer, and has chaired the organization's Central Registration Depository/Investment Adviser Registration Depository Steering Committee, as well as the Investment Adviser Section Committee and the Corporation Finance Section Committee. Commissioner Lubin has also served on various NASAA committees including the Federal Legislation Committee, Senior Issues/Diminished Capacity Committee, Electronic Filing Depository Steering Committee, and Regulation Best Interest Implementation Committee.

In 2015, Commissioner Lubin was appointed by NASAA's Board to serve as the association's representative to the Financial Stability Oversight Council. She has also represented NASAA in testimony before the U.S. House Financial Services Committee. In these roles, she has helped shape NASAA's approach to a broad range of regulatory issues important to America's capital markets and retail investors.

John O. McGinnis, Esq.
George C. Dix Professor in Constitutional Law
Chicago, Illinois

John O. McGinnis is a graduate of Harvard College and Harvard Law School where he was an editor of the Harvard Law Review. He also has an MA degree from Balliol College, Oxford, in philosophy and theology. Professor McGinnis clerked on the U.S. Court of Appeals for the District of Columbia. From 1987 to 1991, he was deputy assistant attorney general in the Office of Legal Counsel at the Department of Justice. He is the author of *Accelerating Democracy: Transforming Government Through Technology* (Princeton 2013) and *Originalism and the Good Constitution* (Harvard 2013) (with M.

Rappaport). He is a past winner of the Paul Bator award given by the Federalist Society to an outstanding academic under 40. He has been listed by the United States on the roster of panelists who may be called upon to decide World Trade Organization Disputes.

Joe Rotunda, Esq.
Securities Board, State Director
Enforcement Division

Joe Rotunda is Director of Enforcement at the Texas State Securities Board. He manages a diverse team of more than thirty attorneys, examiners and other personnel responsible for protecting investors. They are dedicated to uncovering and investigating illegal securities offerings and pursuing appropriate administrative, civil and criminal enforcement actions. They often coordinate with district attorney's offices and frequently serve as special prosecutors to assist in the successful prosecution of complex white-collar offenses.

Joe currently serves as Vice-Chair of the Enforcement Section of the North American Securities Administrators Association. He was previously employed as an Assistant District Attorney at the Travis County District Attorney's Office, and was assigned to the Felony Trial Division and the Public Integrity Unity, Insurance Fraud Division.

Joe graduated from Trinity University in San Antonio, Texas, with a degree in political science. He received his juris doctorate from the University of Kansas School of Law in Lawrence, Kansas, and is licensed to practice law in Texas.

Jeffery E. Schaff
Ardor Fiduciary Services, Ltd.
Northfield, Illinois

Jeffery Schaff is a principal shareholder of and consultant for the Ardor group of companies, independent, fee-only financial consulting practices specializing in the needs of fiduciaries. The private boutique collectively offers fiduciary, investment and financial consulting services to attorneys and fiduciaries, in tandem with private clients, trusts and companies.

Jeffery's investment management background began in 1987 while he was a college student. Initially a financial planner, his career path included becoming a stockbroker, managing a brokerage branch with over fifty stockbrokers and then forming an independent business with his own brokerage branch and registered investment advisory. In 2000, Jeffery dropped his brokerage licenses and founded a fee-only registered investment advisory firm.

Prior to developing the advisory practice, Jeffery augmented his investment management skills and experiences by earning the Certified Investment Management Consultant accreditation. To bolster an expertise in investment fiduciary responsibilities, Jeffery earned the Certified Fiduciary Auditor credential as a graduate of the inaugural program of the Center for Fiduciary Studies. This credential was later expanded and replaced by the Accredited Investment Fiduciary Analyst™, which Jeffery also earned in its inaugural program.

When Ardor expanded to offer fiduciary support and litigation support services, Jeffery's professional role expanded to include assisting attorneys with litigation proceedings and helping fiduciaries with their responsibilities and litigation mitigation. As an expert in securities regulations, investment advisor duties, portfolio management and investment fiduciary duties, Jeffery works with plaintiff/claimant clients as well as defendant/respondent clients in mediation, arbitration and court proceedings.

Geraldine Walsh, Esq.
Senior Vice President of Investor Education, FINRA
President, FINRA Investor Education Foundation

Gerri Walsh is Senior Vice President of Investor Education at the Financial Industry Regulatory Authority (FINRA). In this capacity, she is responsible for the development and operations of FINRA's investor education program. She is also President of the FINRA Investor Education Foundation, where she manages the Foundation's strategic initiatives to educate and protect investors and to foster financial capability for all Americans, especially underserved audiences. She joined FINRA in May 2006. Prior to joining FINRA, Ms. Walsh was Deputy Director of the Securities and Exchange Commission's Office of Investor Education and Assistance (OIEA) and, before that, Special Counsel to the Director of OIEA. She also served as a senior attorney in the SEC's Division of Enforcement, investigating and prosecuting violators of the federal securities laws. Before that, she practiced law as an associate with Hogan Lovells in Washington, D.C. Ms. Walsh was the founding executive sponsor of FINRA's Military Community Employee Resource Group and leads FINRA's Corporate Social Responsibility efforts. She serves on the Advisory Council to the Stanford Center on Longevity and

represents FINRA on IOSCO's standing policy committee on retail investor education, the Jump$tart Coalition for Personal Financial Literacy, NASAA's Senior Investor Advisory Council and the Wharton Pension Research Council. Ms. Walsh received her J.D. from N.Y.U. School of Law and her B.A., magna cum laude, from Amherst College. She is a member of the New York and District of Columbia bars.

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

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

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

Mr. Aidikoff has served on the faculty of the Practicing Law Institute (1996, 1997, 2002), NASD Fall Securities Conference (2002, 2004, 2005, 2006), NASAA Enforcement Conference (2002, 2004), NASAA Attorney/Investigator Training Conference (2006), University of Cincinnati School of Law Symposium-Twenty Years after Shearson v. McMahon (2007), SCMA Conference (2005), NERA Securities Litigation Seminar (2004), New York City Bar Securities Arbitration program (2002), Los Angeles County Bar Association Securities Arbitration program (2006, 2011, 2013 and 2015), the NASD faculty for training of discovery arbitrators, and on the JAMS faculty for training of securities arbitrators. He was a member of the NASD Neutral Roster Task Force (2005-2006), the FINRA Arbitrator Training Task Force (2009- 2010), FINRA Discovery Guide Task Force (2010–2013) and National Roundtable on Consumer and Employment Dispute Resolution, Pepperdine University 2012. He has appeared on CNBC, CNN/fn, PBS Nightly Business Report, National Public Radio, CBS Radio, and the Business Channel addressing investor rights topics, and has been quoted on securities matters in the Wall Street Journal, the Dow Jones News Service, Newsweek, Reuters, Fortune Magazine, Business Week, Money Magazine, Bloomberg News Service, Forbes, Medical Economics, Registered Representative, The New York Times, USA Today, The Los Angeles Times, The Washington Post and other national and local press. For five years he wrote a weekly column in the Palm Springs Desert Sun on issues of interest to investors. (www.securitiesarbitration.com)

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

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

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

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

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

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

Bar Memberships
Oregon, Washington.

Other
Finra Arbitrator Since 1989
Arbitration Services of Portland Arbitrator

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

CASE LAW UPDATES: 2021 – 2022

Mackenzie S. P. Connick and Christine Lazaro[1]

This article will summarize recent decisions impacting arbitration and securities law in both the federal and state courts.

Supreme Court Cases

Morgan v. Sundance, Inc., 142 S. Ct. 1708, 1711, 212 L. Ed. 2d 753 (2022)

This case involves Robyn Morgan, petitioner, an hourly Taco Bell employee, and Sundance, respondent, franchise owner of that Taco Bell. As is the case at many corporations, when she was hired, Morgan was required to sign an agreement to use arbitration for any employment dispute. However, Morgan filed a collective action against Sundance in court for violating the Fair Labor Standards Act (FLSA) regarding overtime pay. Sundance proceeded with the lawsuit and did not raise the arbitration agreement in its motion to dismiss or its answer. About eight months after the lawsuit was filed, and after an unsuccessful mediation attempt, Sundance moved to stay the litigation and compel arbitration under the Federal Arbitration Act (FAA).

Under the FLSA, "employers must pay overtime to … employees who work more than 40 hours in a week."[2] Morgan claims that Sundance would move employees' hours to other weeks to appear as if the extra hours were not overtime hours. Sundance originally moved to dismiss the case, claiming it was duplicative of another collective action. The motion was denied, and Sundance answered Morgan's complaint with 14 affirmative defenses, none of which included mention of the arbitration agreement. Following a joint mediation with the other collective action, that case settled but this case did not. Shortly after, Sundance moved to stay Morgan's litigation and compel arbitration under Sections 3 and 4 of the FAA.

The courts below relied on Eighth Circuit precedent, which was consistent with eight other circuits: under the strong federal policy favoring arbitration, "a party waives its contractual right to arbitration if it knew of the right; acted inconsistently with that right; and—critical here—prejudiced the other party by its inconsistent action."[3] The federal rule of waiver generally does not require the other party to be prejudiced.

In its holding, the Court considered whether the courts may create arbitration specific variants of federal procedural rules. The Court held that the Eighth Circuit erred in requiring a showing of prejudice in assessing waiver. In any other context, a waiver is "the intentional relinquishment or abandonment of a known right."[4] A court would therefore focus on the actions of the party holding that right, not the effects on other parties.

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[1] Mackenzie S. P. Connick is a second year law student at St. John's University School of Law. Christine Lazaro is a Professor of Clinical Legal Education at St. John's Law School.

[2] 142 S. Ct. 1708, 1711 (citing to 29 U.S.C. § 207(a)).

[3] *Id.* at 1712 (internal quotations omitted).

[4] *Id.* at 1713.

The Court found that the FAA does not authorize courts to "invent special, arbitration-preferring procedural rules."[5] Rather, the policy should put arbitration agreements on the same footing as other contracts, not tilt the field in favor of or against arbitration.

The Court vacated the judgment and remanded it for further proceedings. The question for the lower courts now being: Did Sundance act inconsistently with its right to arbitrate thereby knowingly relinquishing its right?

Badgerow v. Walters, 142 S. Ct. 1310 (2022)

While the FAA permits parties to petition a federal court for several types of relief, it does not convey subject matter jurisdiction, causing some problems during litigation. *Vaden v. Discover Bank*, 556 U.S. 49, held that Section 4 of the FAA explicitly instructs the courts to look through to the underlying controversy to determine whether there is subject matter jurisdiction. The issue in *Badgerow v. Walters*, however, is whether the same approach applies to applications under Sections 9 and 10 of the FAA to confirm or vacate arbitral awards. The Court held that the look-through test applied in *Vaden* does not apply here, reversing and remanding the case.

Petitioner, Denise Badgerow, began arbitration against her employers, alleging unlawful termination. Badgerow worked for REJ Properties, a firm run by Greg Walters, Thomas Meyer, and Ray Trosclair. Her employment contract required claims to be arbitrated. Badgerow initially arbitrated but had her claims dismissed. She then sued in Louisiana state court to vacate the arbitration decision, alleging fraud. Respondents removed the case to federal court, prompting Petitioner to move to remand the case, arguing that the federal court lacked jurisdiction. The District Court followed *Vaden*, determining that the federal court did have jurisdiction by looking through to the underlying arbitration claim, which included a federal-law claim. The United States Court of Appeals for the Fifth Circuit then affirmed the decision, relying on a "principle of uniformity"[6] in relation to the look-through provision stated in Section 4.

The Supreme Court, however, explains that because of the long-standing precedents surrounding the principles of statutory construction, the absence of the language in Sections 9 and 10 that is used in Section 4 (which instructs courts to "look through") implies intentionality. Because of this presumed intentional omission, the language allowing the look-through test in Section 4 applies to Section 4 *only*. Permitting the use of such a test when looking at petitions under section 9 or 10 would be overbroad and improper.

Additionally, Respondents' policy arguments, while valid, do not override the decision. The Court notes that "[e]ven the most formidable policy arguments cannot overcome a clear statutory directive."[7] All other arguments by the Respondents are swiftly dismissed by the Court.

As such, the Court held that the test applied in *Vaden* does not apply here and no federal jurisdiction exists, thereby reversing the Fifth Circuit decision and remanding the case for further review.

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[5] *Id.*

[6] 142 S. Ct. 1310, 1314.

[7] *Id.* at 1321.

Federal District Court Cases

Jarkesy v. Sec. & Exch. Comm'n, 34 F.4th 446 (5th Cir. 2022)

The Fifth Circuit reviewed the constitutionality of an administrative enforcement action brought by the SEC against Petitioners, George R. Jarkesy, Jr. and Patriot28, LLC (collectively, "Petitioners"). The Court vacated the SEC's decision and remanded the case for further proceedings.

The SEC brought an administrative enforcement action against Petitioners alleging that they committed fraud under the Securities Act, Securities Exchange Act, and the Advisers Act by (1) misrepresenting who served as the prime broker and as the auditor; (2) misrepresenting the fund's investment parameters and safeguards; and (3) overvaluing the funds' assets to increase the fees that they could charge investors. Petitioners sought to enjoin the action in the U.S. District Court for the District of Columbia on the basis that the proceedings infringed on their constitutional rights. The courts refused to issue an injunction, finding that Petitioners had not exhausted their administrative remedies.

The enforcement action proceeded before an Administrative Law Judge, who determined that Petitioners had committed securities fraud. Petitioners then sought review by the SEC, which affirmed the ALJ's decision. The Commission ordered Petitioners to cease and desist from committing further violations and imposed a civil penalty of $300,000, and disgorgement of nearly $685,000 in ill-gotten gains. Jarkesy was also individually barred from various securities-related activities.

Petitioners appealed to the Fifth Circuit, raising several constitutional challenges to the SEC proceedings. First, Petitioners argued they were deprived of their Seventh Amendment right to a jury trial. The Court agreed, finding that the SEC's enforcement action "is akin to traditional actions at law to which the jury-trial right attaches." The Court considered first whether the claim arises under common law and determined that it did since it was a fraud claim. The Court then considered whether it was a "public-rights case," which permit congressional reassignment to agency adjudication without a jury trial. The Court determined that securities fraud actions were not properly assigned to agency adjudication because they were not new actions unknown to common law, and the jury trials would not dismantle the statutory scheme or impede swift resolution of enforcement claims. The Court further pointed out that these cases have historically been heard in court.

Petitioners also argued that Congress unconstitutionally delegated legislative power to the SEC when it gave the SEC discretion over bringing enforcement actions in Article III courts or administratively within the agency. The Court held that because Congress failed to provide the SEC with an intelligible principle to guide its use of the delegated power, the delegation was unconstitutional.

Last, Petitioners argued that the statutory removal restrictions for the SEC ALJs were unconstitutional. The Court held that SEC ALJs perform substantial executive functions, and therefore, the President must retain control over the performance of their functions. The ALJs have two levels of protection because first, there are restrictions on their removal. Second, they are subject to oversight by the SEC commissioners, and there are restrictions on the removal of the commissioners. Because there are two layers of removal protection, the restrictions are unconstitutional.

Accordingly, the Court agreed with Petitioners that the SEC proceedings were unconstitutional on multiple grounds and vacated the SEC's decision.

In re Jan. 2021 Short Squeeze Trading Litig., No. 21-2989-MDL, 2022 WL 1522054 (S.D. Fla. May 12, 2022)

This case concerns a Consolidated Class Action Complaint containing both antitrust claims and federal securities claims. In May 2022, the Court dismissed the Amended Antitrust Tranche Complaint.

The case focuses on the conduct of Robinhood and other market participants in January and February 2021. The complaint was brought by investors who suffered losses as a result of Robinhood's and Citadel Securities' response to a "short squeeze that occurred in January 2021." Plaintiffs allege that Citadel pressured Robinhood to restrict trading on its platform to drive down the prices of the relevant securities.

Retail investors using apps such as Robinhood often exchange information about stocks on online discussion forums, including the WallStreetBets thread on Reddit. The participants on WallStreetBets are known for the use of memes when discussing investments, hence the term "meme stock" was coined.

In January 2021, investors began investing in the relevant securities, each of which were discussed as being undervalued in the market. Individual retail investors began purchasing long positions and out of the money call options. This demand drove the prices of the securities up. As the prices rose, those holding short positions, including Citadel, were caught in a "short squeeze." They were facing exposure to significant losses as the prices of the securities increased because eventually the short sellers have to buy back the securities.

On January 28, 2021, at around 1am, Robinhood announced that Gamestop and AMC options with expirations of January 29, 2021 would be set to closing transactions only. Investors were prevented from making new options investments in these securities. Early that same morning, Robinhood received a message from National Securities Clearing Corp. (NSCC), which settles and clears trades, that it had a collateral requirement deficit of over $3 billion. Robinhood negotiated to reduce the margin requirement, and was able to satisfy the revised requirement shortly after 9am.

Before the markets opened that morning, Robinhood moved the rest of the relevant securities to "Position Close Only" ("PCO"), meaning investors could only sell the affected securities, but could not place orders to purchase them. Robinhood also cancelled overnight purchase orders of the relevant securities. Robinhood announced via Twitter that it had restricted trading because of market volatility. The purchase restrictions led to a massive selloff in the relevant securities, depressing their prices. This allowed short sellers, including Citadel, to close out their short positions at artificially reduced prices.

Plaintiffs allege that Robinhood and Citadel colluded to limit buy-side trading in the relevant securities so that Citadel could recover losses resulting from the rise in the stocks' prices.

In this order, the Court considered the allegations of Sherman Act violations, and determined that the complaint should be dismissed for two reasons: (i) Plaintiffs failed to plausibly allege the existence of an agreement to restrict trade between Robinhood and Citadel; and (ii) even if

Plaintiffs did allege an agreement, they failed to plausibly allege an unreasonable restraint on trade.

To allege an agreement to restrict trade, Plaintiffs must establish a plausible common motive to conspire. While Plaintiffs allege that Citadel benefitted from the trading restrictions, Plaintiffs fail to assert a plausible motivation for Robinhood to conspire. Plaintiffs point to Robinhood's reliance on revenue stemming from its relationship with Citadel[8] and its hope of preserving that relationship as Robinhood's motivation. While the Court found that motivation possible, the Court did not find it plausible, especially given the obvious alternative theory for the trading restrictions – Robinhood's own liquidity concerns. Therefore, the Plaintiffs did not adequately allege an agreement to restrict trade.

The Court considered whether, even if there was such an agreement, there was a restraint on trade. To establish a restraint, Plaintiffs must demonstrate that the alleged restraint had an anticompetitive effect on the market. Here, the Plaintiff did not adequately define the market, and therefore could not adequately allege an anticompetitive effect.

Accordingly, the Court granted Defendant's motion to dismiss the Amended Antitrust Tranche Complaint.

In re Jan. 2021 Short Squeeze Trading Litig., No. 21-2989-MDL (S.D. Fla. Aug. 11, 2022)

In this Order, the Court considered the Defendants' Motion to Dismiss the Federal Securities Tranche Complaint. The Court granted the motion in part and denied it in part.

Plaintiffs alleged market manipulation claims under sections 9(a)(2) and 10(b) of the Securities Exchange Act of 1934, and a misrepresentation claim under section 9(a)(4).

There are five elements to a 9(a)(2) claim: (1) a series of transactions in a security creating actual or apparent trading in that security or raising or depressing the price of that security, (2) carried out with scienter, (3) for the purpose of inducing the security's sale or purchase by others, [that] (4) was relied on by the plaintiff; (5) and affected plaintiff's purchase or selling price.

The Court begins with examining whether there were any transactions satisfying the first element. Plaintiff alleged that canceling purchase orders, closing out options, restricting purchases, and liquidating customers' shares of the Affected Stocks after raising capital requirements constitute transactions. The Court held that in instituting PCO (Position Close Only), Robinhood did not engage in any transactions. However, canceling purchase orders, closing out options, and liquidating positions were all transactions sufficient to establish the first element.

With respect to scienter, the Court determined whether Robinhood "intended to deceive investors by artificially affecting the market price of securities." The Court found that there was a particularized inference of scienter from two alleged facts: (i) that Robinhood benefited; and (ii) that Robinhood employees knowingly made inaccurate and harmful statements. The Court considered Robinhood's financial desperation in conjunction with the misleading statements by Robinhood's founder that Robinhood was not having any liquidity issues, as well as the evidence that Robinhood was aware its trading restrictions would decrease the Affected Stock's prices. The

[8] Revenue came from Payment for Order Flow (PFOF). Citadel was responsible for 43% of Robinhood's PFOF revenue for the first quarter of 2021. 2022 WL 1522054, at *8.

Court found that there was an inference that Robinhood acted willfully to lower the prices of the Affected Stocks. With respect to whether Robinhood acted with the purpose of inducing the purchase or sale of securities by others, the Court found that there was an inference that Robinhood sought to induce its customers to sell the Affected Stocks to lower their share prices. Accordingly, the Court found that the 9(a)(2) claim could proceed.

With respect to the 9(a)(4) claim, the Plaintiffs must prove a: "(1) misstatement or omission (2) of material fact (3) made with scienter (4) for the purpose of inducing a sale or purchase of a security (5) on which the plaintiff relied (6) that affected plaintiff's purchase or selling price." In terms of the misstatement or omission, Plaintiffs point to Robinhood's failure to state that it could not meet the NSCC's collateral requirements as well as Robinhood's statements that it did not have any liquidity issues. The Court found that Plaintiffs did not sufficiently allege that the misstatements and omissions were made for the purpose of inducing investors to sell their shares. Rather, it was more likely Robinhood made the misstatements and omissions for the purpose of retaining its customers. Accordingly, the Court dismissed the section 9(a)(4) claims.

To assert a market manipulation claim under section 10(b), Plaintiff must allege "(1) manipulative acts; (2) damage (3) caused by reliance on an assumption of an efficient market free of manipulation; (4) scienter; (5) in connection with the purchase or sale of securities; (6) furthered by the defendant's use of the mails or any facility of a national securities exchange." The Court discussed that for a manipulation claim, one need not assert a transaction so long as there is alleged a device or contrivance. The Court held that restricting the sales of the Affected Stocks could be deemed to be a device or contrivance. Further, Robinhood misled investors about the reasoning for the restrictions. While it did disclose the restrictions, it premised the need for the restrictions on market volatility rather than its own liquidity issues. Accordingly, the section 10(b) claims may proceed.

In conclusion, the Court dismissed the section 9(a)(4) claims but denied the motion to dismiss with respect to the section 9(a)(2) and 10(b) claims.

State Court Cases

Legacy Consulting Grp., LLC v. Gutzman, 636 S.W.3d 447 (Ky. 2021)

Kentucky law provides that arbitration agreements that are validly entered into are generally enforceable, except those within insurance contracts. The issue in *Legacy Consulting Grp. v. Gutzman* is whether the annuity contract at issue was a security or an insurance contract.

In 2009 Ms. McGaughey, the trustee of the William A. McGaughey Non-Marital Trust, purchased a variable annuity, under advice from David W. Hudson of Legacy Consulting Group, LLC. The contract contained an arbitration clause. In December 2015, Ms. McGaughey signed forms electing the income option, which provided for monthly payments via a fixed annuitization. In March 2017 following Ms. McGaughey's death, Brenda Gutzman, her daughter, was appointed Executrix. Ms. Gutzman brought a claim in state court alleging breach of fiduciary duty, breach of contract, violation of the common law duty of good faith, violation of the implied duty of good faith and fair dealing, and violation of Kentucky's Consumer Protection Act against the Money Concepts Capital Corp., a broker-dealer, its successor Legacy Consulting Group, LLC, and the annuity issuer, Jackson National Life Ins. Co. Money Concepts and Legacy Consulting moved to compel arbitration, in accordance with the arbitration clause included in the 2009 annuity contract. Following a hearing on the motions, the court denied the motion to compel arbitration.

To determine the validity of the arbitration agreement, the Court asks a "simple" question: was the annuity contract "insurance" as defined by KRS 304-1.030? If so, the arbitration agreement is unenforceable. Appellants argued that the annuity contract was a variable annuity. Appellee (Ms. Gutzman) argued that following the income option election, the annuity was for a fixed account with regular payments, making it an insurance contract. After discussing the differences between fixed, fixed index, and variable annuities, the Court agreed with Gutzman and finds that following the income option election, the annuity was an insurance product rather than a securities product, and therefore, the arbitration clause was unenforceable. The Court affirmed the lower court's order denying the motion to compel arbitration.

Park Plus, Inc. v. Palisades of Towson, LLC, 478 Md. 35, 272 A.3d 309 (2022)

During the construction of a luxury apartment building, appellees, Palisades of Towson and Encore Development Corporation (collectively, "Palisades"), entered into a contract with appellant, Park Plus, Inc. ("Park Plus"). This contract required Park Plus to furnish and install an automated parking system. The contract contained a one-year warranty period, and an arbitration clause. Problems arose immediately after the system began to be used in October 2010.

In September 2014, Palisades sent Park Plus a demand for arbitration. After a number of delays, Palisades filed a petition in the Circuit Court for Baltimore County, Maryland, to enforce the arbitration agreement. Park Plus challenged the petition to enforce arbitration, claiming that Palisades failed to bring the claim within the three-year statutory period under CJ § 5-101. Palisades argued that the contract did not contain a deadline to demand arbitration, and that CJ § 5-101 did not apply to arbitration. The Circuit Court held that the demand was timely and ordered Park Plus to submit to arbitration.

The issue in *Park Plus, Inc. v. Palisades of Towson, LLC* is whether CJ § 5-101 applies to arbitration claims. The Court holds that it applies to "civil actions at law," which do not include arbitrations.

The Court reviews its powers under the Maryland Uniform Arbitration Act (the "MUAA"). The MUAA confers jurisdiction on the court to enforce an arbitration agreement and to enter judgment on an arbitration award. Therefore, if an arbitration agreement exists, the courts must enforce it and order arbitration of the claims regardless of whether the court believes the claim lacks merit or whether a valid basis for the claim sought has been made.

Park Place argued that because Palisades did not demand arbitration within the statute of limitations, it has extinguished its right to arbitrate. The Court concluded that timeliness is a waiver issue if the contract sets forth a time period within which the parties must demand arbitration. The contract at issue contained no such limitation. Park Place then argued that CJ § 5-101 applies if the contract is silent. The Court disagrees. The Court holds that the history and text of CJ § 5-101 indicates that it does not apply to the remedy sought by Palisades, that is, enforcing the contractual right to arbitration. CJ § 5-101 applies to "civil actions at law" and a petition to compel arbitration is not that. Therefore, the Court holds that a petition to compel arbitration is not subject to a defense under CJ § 5-101.

Wells Fargo Clearing Servs., LLC v. Leggett, No. A22A1149, 2022 WL 3038377 (Ga. Ct. App. Aug. 2, 2022)

Brian Leggett and Bryson Holdings, LLC (collectively, "Leggett") filed an arbitration claim against Wells Fargo Clearing Services, LLC and Jay Windsor Pickett III (collectively, "Wells Fargo").[9] The arbitration panel issued an award in Wells Fargo's favor, and ordered that Leggett pay costs to Wells Fargo in the amount of $50,000. Leggett then moved to vacate the award in Georgia state court.[10]

Leggett alleged that there was a series of issues with the arbitration that warranted vacatur. After the arbitrator rankings were sent to the parties, Wells Fargo asked that FINRA remove one of the arbitrators from the list, citing an agreement the attorney had with FINRA that the specific arbitrator would never appear when this attorney was involved in a case. After briefing by both sides, FINRA granted the request to remove the arbitrator and the ranking proceeded. After the panel was constituted, Wells then sought removal of an arbitrator whose firm was suing Wells Fargo. After briefing, FINRA removed the arbitrator. Approximately two weeks before the hearing was set to begin, Leggett moved to adjourn it on the grounds that they needed additional time to review the approximately 2,000 pages of discovery which had just been produced. The panel denied the adjournment request, and the hearing commence. The hearing was then adjourned when the Wells Fargo attorney had a medical emergency.

Once the hearing resumed, the panel denied a request by Leggett to call a witness, which was to rebut testimony by Leggett's expert witness. Leggett also objected to the introduction of an exhibit by Wells Fargo; however, the panel allowed the evidence to be admitted. Leggett sought to call a witness about the new exhibit, but the panel limited Leggett's questioning to Wells Fargo's expert. Leggett also alleged that the testimony of the broker was perjured as it changed between the first hearing dates and the recommenced hearing. Finally, Leggett challenged the panel's ability to award costs to Wells Fargo after it denied Wells Fargo's motion to amend its answer to seek attorney's fees and costs.

The state court vacated the award on several grounds. It held that (i) the arbitrator selection process violated 9 U.S.C. § 10(a)(4); (ii) the arbitrator's refusal to postpone the hearing violated 9 U.S.C. § 10(a)(3); (iii) the arbitrator's refusal to allow Leggett to call the rebuttal witness and restricting Leggett's cross examination of Wells Fargo's expert witnesses also violated 9 U.S.C. § 10(a)(3); (iv) the award was procured by fraud in violation of 9 U.S.C. § 10(a)(1) and; (v) the panel violated 9 U.S.C. § 10(a)(3) by imposing costs and hearing session fees against the investors.

Wells Fargo appealed the decision to the Georgia State Court of Appeals.[11] The Court reversed the state court decision and confirmed the award. The Court found that Wells Fargo had not manipulated the arbitrator selection process, and that FINRA had not exceeded its authority in exercising its discretion to remove the two arbitrators. Therefore, there was no basis for vacatur

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[9] *In the Matter of Arbitration Between Brian Leggett and Bryson Holdings, LLC v. Wells Fargo Clearing Services, LLC and Jay Windsor Pickett III*; FINRA Case No. 17-01077 (July 31, 2019).

[10] *Leggett v. Wells Fargo Clearing Services, LLC*, No. 2019CV328949, 2022 WL 1522096 (Ga.Super. Jan. 25, 2022).

[11] *Wells Fargo Clearing Services, LLC et al v. Brian Leggett et al*, Case No. A22A1149 (Court of Appeals of the State of GA) (Aug. 2, 2022).

under 9 U.S.C. § 10(a)(4). The Court agreed that the panel acted improperly in failing to continue the hearing when requested by Leggett. However, the hearing was continued following the medical emergency, and the Court found that Leggett did not establish that they were prejudiced by the initial refusal to postpone the hearing. Next, the Court found that Leggett did not establish that the panel acted in bad faith in refusing to hear the rebuttal witness. With respect to Leggett's claims that their cross examination of Wells Fargo's expert was curtailed, the Court pointed to the fact that the record did not contain a full transcript of the arbitration hearing. The excerpts that were included did not support Leggett's claims that the examination was curtailed.

The Court also pointed to the missing record when considering the claim that the award was procured by fraud through perjured testimony. The record did not include the transcript from the first set of hearing dates, and therefore there was no evidence that the broker's testimony had actually changed. Further, Leggett raised these allegations during the hearing itself, so the Court found there was no evidence of fraud. Lastly, the Court found that the arbitrators did have authority to allocate costs.

The state court decision prompted FINRA to retain a law firm to conduct an independent review of how FINRA had followed its rules, policies, and procedures for arbitrator selection in the Leggett arbitration.[12] FINRA then published the report of the independent counsel.[13] The report concluded that there was no evidence of any agreement between FINRA and the attorney for Wells Fargo. The report further concluded that FINRA generally adhered to the applicable policies and procedures, although the report did make several recommendations to further enhance FINRA Dispute Resolution.

Robinhood Fin., LLC v. Galvin, No. 2184CV00884, 2022 WL 1720131 (Mass. Super. Mar. 30, 2022)

Robinhood filed an action for injunctive and declaratory relief against the Massachusetts Securities Division (the "Secretary"). The Secretary has brought an administrative enforcement action against Robinhood, alleging violation of Massachusetts's newly adopted Fiduciary Duty Rule, 950 C.M.R. § 207 (1)(a) (the "Fiduciary Duty Rule"). The Fiduciary Duty Rule deems it an "'unethical or dishonest conduct or practice' for purposes of an enforcement action . . . for a broker-dealer . . . to 'fail[] to act in accordance with a fiduciary duty to a customer when providing investment advice.'" Robinhood challenged the validity of the Fiduciary Duty Rule, contending it was invalid on its face and as it applied to Robinhood. Robinhood argued that the Fiduciary Duty Rule unlawfully overrides Massachusetts common law; that the Secretary lacked the authority to adopt the Fiduciary Duty Rule; and that the Fiduciary Duty Rule is preempted by Regulation Best Interest.

The Court considered the SEC's adoption of Regulation Best Interest, and Massachusetts's adoption of the Fiduciary Duty Rule. The Secretary proceeded with the rulemaking under the statute that vested authority in the Secretary to adopt rules defining "unethical business conduct or practice." The Court examined *Patsos v. First Albany Corp.*, 433 Mass. 323 (MA Sup. Jud. Ct.

[12] FINRA, *FINRA Hires Firm to Conduct Independent Review of Arbitrator Selection Process* (Feb. 18, 2022), https://www.finra.org/media-center/newsreleases/2022/finra-hires-firm-conduct-independent-review-arbitrator-selection.

[13] FINRA, *FINRA Published Independent Counsel's Report on Arbitrator Selection Process* (June 29, 2022), https://www.finra.org/media-center/newsreleases/2022/finra-publishes-independent-counsels-report-arbitrator-selection.

2001), which set out the scope of a brokerage firm's fiduciary obligations, if any, to its customers. Robinhood contended that the Secretary had re-defined unethical and dishonest conduct to include non-fiduciary activities by a brokerage firm that were permissible under *Patsos*. The Court considered whether the Secretary had the authority to interpret the statute in a way that would contradict the Supreme Judicial Court's interpretation of the statute. Because the rulemaking overrides the common law as set forth in *Patsos*, the Secretary acted without authority. Accordingly, the Court granted Robinhood's motion and declared the Fiduciary Duty Rule to be unlawful.

WHAT MAKES SPACS SO SPECIAL?

Scott Eichhorn[1]

I. Introduction

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

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

The initial wave of SPACs included only 14 IPOs between 1993 and 1996.[7] SPACs initially traded on the over-the-counter (OTC) markets until AMEX became the first exchange to accept SPACs for listing in 2005.[8] SPACs later experienced a brief surge in IPOs in 2006 and 2007 ending when the overall market for IPOs declined following the 2008 financial crisis. In 2008, the NYSE and

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[2] MURRAY, JAMES S., THE REGULATION AND PRICING OF SPECIAL PURPOSE ACQUISITION CORPORATION IPOS 2 (2014).

[3] *Id.*

[4] *Id.* at 5.

[5] *Id.*

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

[7] MURRAY, *supra* note 1, at 5.

[8] *Id.* at 7.

NASDAQ exchanges also began to accept SPACs for listing, subject to satisfaction of certain listing standards.[9] SPACs emerged in their current form in 2009.[10] Only in recent years, however, have SPACs seen a dramatic rise in IPOs.

During 2020, 248 SPAC IPOs raised a whopping $75.3 billion, more than all previous years combined.[11] SPAC IPOs outnumbered traditional IPOs at the end of 2020 and beginning of 2021.[12] SPACs continued to proliferate with 447 IPOs in the first three quarters of 2021.[13] At the height of the SPAC mania, celebrities from Serena Williams to Leonardo DiCaprio became involved as managers or advisors promoting SPACs, prompting the SEC to release an Investor Alert cautioning against investing in SPAC 's based on such celebrity endorsements.[14] Since their soaring popularity in late 2020 and early 2021, the market for SPAC IPOs has cooled. SPAC IPOs dropped from 298 in the first quarter of 2021 to 55 in the first quarter of 2022, falling to 15 in the second quarter of 2022.[15] In June 2022, business magazine Forbes and online ticket dealer SeatGeek announced termination of their respective SPAC deals.[16] In addition, companies that have gone public in recent SPAC mergers have not fared well. Online media publisher BuzzFeed lost one-third of its value by June 2022 since going public through a SPAC earlier this year.[17] A $32.6 billion SPAC deal reached in June 2022—one of the largest in SPAC history—lost 90% of its value in the days following its merger.[18]

In part, unsettled market and economic conditions have blunted investor and target company demand for SPACs. In addition, regulatory announcements have also cooled market participation.

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[9] *Id.* at 8-9.

[10] KLAUSNER, MICHAEL, A SOBER LOOK AT SPACs 78 (2022).

[11] GAHNG, MINMO, SPACS 1 (2022).

[12] Preston Brewer, *Analysis: IPOs Fall to Earth; A Requiem for SPACs?*, BLOOMBERG LAW ANALYSIS (July 8, 2022, 5:00 AM), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-ipos-fall-to-earth-a-requiem-for-spacs.

[13] GAHNG, *supra* note 10, at 3.

[14] *Celebrity Involvement with SPACs — Investor Alert*, SEC (Mar. 10, 2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert#:~:text=The%20SEC's%20Office%20of%20Investor,variety%20of%20products%20and%20services.; Bailey Lipschultz, *Celebrity SPACs Leave Famous Winners Looking More Like Losers*, BLOOMBERG (Dec. 16, 2021, 8:53am), https://www.bloomberg.com/news/articles/2021-12-16/celebrity-spacs-leave-famous-winners-looking-more-like-losers.

[15] Brewer, *supra* note 11.

[16] *Forbes, SeatGeek Terminate Blank-Check Deals as SPAC Boom Fizzles* Out, REUTERS (June 1, 2022, 11:48 AM), https://www.reuters.com/business/media-telecom/forbes-seatgeek-terminate-blank-check-deals-spac-boom-fizzles-out-2022-06-01/.

[17] *Id.*

[18] Dan Roe, *Miami Lawyer John Ruiz Made $2 Billion in the Final Days of SPAC Fever. Can He Keep It?*, THE AMERICAN LAWYER (June 9, 2022, 11:09 AM), https://www.law.com/americanlawyer/2022/06/09/miami-lawyer-john-ruiz-made-2-billion-in-the-final-days-of-spac-fever-can-he-keep-it/.

SPAC market participants have long believed that the regulations applicable to business combination—or deSPAC—transactions provide a safe harbor for forward-looking statements that is not available under traditional IPO laws.[19] However, John Coates, Acting Director of the SEC Division of Corporation Finance, released a statement in April 2021 expressing the view that the safe harbor in the PSLRA may not in fact cover SPACs.[20] Another SEC statement that month also suggested that some SPACs improperly accounted for warrants, resulting in companies like Virgin Galactic reporting an additional $49 million in expenses in 2021.[21] Both of these statements gave market participants pause to reconsider raising capital through SPACs. The SEC also warned in May 2021 that attractive business combinations may become scarcer as more SPACs became active.[22] Most recently, in May 2022, the SEC proposed an overhaul of regulations governing SPACs to align SPAC regulation more closely with traditional IPO regulation.[23]

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

II. What is a SPAC?

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

[19] GAHNG, *supra* note 10, at 6.

[20] John Coates, *SPACs, IPOs and Liability Risk under the Securities Laws*, SEC (Apr. 8, 2021), https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.

[21] NEWMAN, NEAL, SPECIAL PURPOSE ACQUISITION COMPANIES (SPACS) AND THE SEC 16 (2021).; John Coates & Paul Munter, *Staff Statememt on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs")*, SEC (Apr. 12, 2021). https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs.

[22] *What You Need to Know*, *supra* note 5.

[23] Special Purpose Acquisition Companies, Shell Companies, and Projections, 87 Fed. Reg. 29458 (proposed May 13, 2022) [hereinafter "SEC Release"].

[24] *What You Need to Know*, *supra* note 5.

[25] *Id.*

[26] *Id.*

[27] *Id.*

following the transaction is publicly traded, taking the SPAC's place on an exchange and continuing the target company's business.[28] At the time of the merger, the SPAC will change its ticker symbol to align with the target company.[29] Thus, the SPAC process entails two separate transactions: the IPO of the SPAC itself and the merger with the private company, or deSPAC transaction.[30]

a. SPAC Structure and Process

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

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

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[28] *Id.*

[29] NEWMAN, *supra* note 20, at 7.

[30] KLAUSNER, *supra* note 9, at 10.

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] GAHNG, *supra* note 10, at 2; *See* Lionheart III Corp., Registration Statement (Form S-!) (Mar. 19, 2021) [hereinafter "Lionheart"].

[36] *Id.*

[37] *Id.*

i. SPAC IPOs

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

In a traditional IPO, an issuer hires one or more underwriters to conduct thorough due diligence on the company going public.[45] As noted by the SEC in its release of the proposed new rules governing SPACs, underwriters play a critical role as gatekeepers to the public markets as intermediaries between issuers and the investing public.[46] Although SPACs work with underwriters in their initial offerings, the role of the underwriter in investigating and evaluating a SPAC IPO is far more limited than the underwriter's role in a traditional IPO. This is because a SPAC has no business operations other than seeking a target company. Financial statements in the SPAC's registration statement will be minimal, including balance sheets showing shares issued to sponsors, nominal consideration paid for sponsor shares, any initial financing transactions, and other nominal operating expenses incurred to that point.[47] Other disclosures in the SPAC offering document should include conflicts of interest between shareholders and sponsors and the structure and timelines of the SPAC.[48] Most SPACs pay underwriters a fee of 5.5%, with 2% paid at the IPO and 3.5% paid at the time of a successful business combination.

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[38] *Id.* at 1.

[39] *What You Need to Know*, *supra* note 5.

[40] *Id.*

[41] *Id.*; GANHG, *supra* note 10, at 1.

[42] *What You Need to Know*, *supra* note 5 (SPACs will file an 8-K to notify investors when separate trading may commence).

[43] MURRAY, *supra* note 1, at 6.

[44] Lionheart, *supra* note 34, at 14.

[45] FINRA, REGULATORY NOTICE 08-54 3.

[46] SEC Release, pp. 20, 88

[47] NEWMAN, *supra* note 20, at 39-40.

[48] *Id.* at 40-41.

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

A. Sponsor's Role Following the SPAC IPO

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

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[49] *What You Need to Know*, *supra* note 5.

[50] NEWMAN, *supra* note 20, at 22.

[51] *Id.*

[52] *What You Need to Know*, *supra* note 5.

[53] NEWMAN, *supra* note 20, at 33-34.

[54] KLAUSNER, *supra* note 9, at 17.

[55] *Id.* at 18.

[56] NEWMAN, *supra* note 20, at 42.

[57] LIN, CHEN ET AL., SPAC IPOS AND SPONSOR NETWORK CENTRALITY (2021).

[58] KLAUSNER, *supra* note 9, at 31.

[59] GANHG, *supra* note 10, at 11.

[60] KLAUSNER, *supra* note 9, at 3.

500 companies as sponsors are more successful in attracting and retaining public and private funding.[61]

At the time of the IPO, the sponsor acquires "sponsor" or "founder" shares, usually 20 percent of the shares outstanding after the merger, for a nominal sum.[62] This form of compensation is known as the sponsor "promote." For example, a SPAC may raise $200,000,000 in IPO funds through the issuance of 20,000,000 shares at $10 per share and set the sponsor's promote at the standard 20 percent of the total outstanding shares in exchange for a nominal payment of $25,000.[63] Here, the sponsor purchases 5,000,000 sponsor shares for $25,000, or $0.005 per share.[64] Thus, the IPO investors contributed 99.9 percent of the funding for 80 percent of the total outstanding shares, while the sponsor contributed 0.01 percent of the funding for 20 percent of the total outstanding shares. The significant discount that sponsors pay for their equity stakes dilutes value for public shareholders in SPACs that successfully merge.[65] Commentators have observed that this hidden cost represents an "exorbitant fee" paid to sponsors by public shareholders and have questioned why investors accept such high compensation to sponsors.[66]

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

The promote, in effect, compensates the sponsor for organizing the SPAC and supporting its management while the SPAC seeks a business combination.[71] Some SPACs add proceeds from

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[61] *Id.* at 30.

[62] NEWMAN, *supra* note 20, at 24.

[63] Lionheart, *supra* note 34, at 15-16.

[64] *Id.*

[65] KLAUSNER, *supra* note 9, at 22.

[66] NEWMAN, *supra* note 20, at 30.

[67] GANHG, *supra* note 10, at 1.

[68] KLAUSNER, *supra* note 9, at 23.

[69] *Id.* at 11.

[70] *Id.* at 23.

[71] *Id.* at 11.

additional sponsor investment to the trust.[72] In 2010, many sponsors began to purchase private placement warrants or units at the fair market value at the time of the IPO.[73] This additional funding of millions of dollars was used to cover upfront underwriting fees and future operating expenses of the SPAC while it sought a target company, assuring that the IPO capital held in trust did not pay those expenses.[74] This resulted in each public investor share of the trust having an initial value at or near $10.00, rather than $9.80 net of underwriting fees.[75] Such steps help to ensure that IPO investors receive a return of at least their full investment when they redeem shares or the SPAC liquidates, including interest accrued in the trust account.[76] Other SPACs may pay expenses using interest generated in the trust account.[77] Exchange rules and SPAC charters generally require that SPACs retain in trust a minimum percent of IPO proceeds for use in a business combination.[78] For example, the minimum percent required by NASDAQ is 90% of IPO proceeds, although in practice, most SPACs that are eligible to be listed on an exchange deposit more than 90% of the IPO proceeds into the trust.[79] NASDAQ rules also require that SPACs complete a business combination with a fair market value of at least 80% of the value of the trust account at the time of signing a definitive merger agreement.[80]

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

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[72] *Id.*

[73] GANHG, *supra* note 10, at 12.

[74] *Id.* at 1.; KLAUSNER, *supra* note 9, at 11.

[75] GANHG, *supra* note 10, at 1.

[76] KLAUSNER, *supra* note 9, at 11-12.

[77] FINRA, *supra* note 44, at 4.

[78] MURRAY, *supra* note 1, at 9.

[79] *Id.*

[80] Lionheart, *supra* note 34, at 8.

[81] *What You Need to Know*, *supra* note 5.

[82] *Id.*

[83] *Id.*

ii. SPAC Mergers

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

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

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

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[84] GANHG, *supra* note 10, at 11.

[85] NEWMAN, *supra* note 20, at 23.

[86] GANHG, *supra* note 10, at 3.

[87] *Id.*

[88] KLAUSNER, *supra* note 9, at 10.

[89] GANHG, *supra* note 10, at 12.

[90] *Id.*

[91] NEWMAN, *supra* note 20, at 19.

[92] KLAUSNER, *supra* note 9, at 12.

[93] *Id.*

[94] *Id.* at 13.

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

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

b. Conflicts of Interest and SPAC Performance

The structure of SPACs encourages their formation by sponsors. The sponsor promote structure assures that the sponsor will receive generous compensation in any merger, regardless of whether the merger is good for shareholders. Moreover, the sponsor has an incentive to characterize a merger proposal as favorable in investor presentations and the SPAC's public filings, both to encourage shareholder approval of the merger and to bolster the premerger value

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[95] GANHG, *supra* note 10, at 10.

[96] *Id.* at 2.

[97] *Id.*

[98] *Id.*

[99] NEWMAN, *supra* note 20, at 33.

[100] *Id.*

[101] *Id.* at 34-35.

[102] SEC Release, *supra* note 22, at 97.

[103] KLAUSNER, *supra* note 9, at 14.

[104] NEWMAN, *supra* note 20, at 7.

of SPAC shares to encourage sales instead of redemptions of shares.[105] This incentivizes sponsors to not fully disclose details regarding a merger to shareholders.[106] Likewise, because 3.5% of its 5.5% underwriting fee is conditioned on a successful merger, underwriters have an incentive to gain the approval of shareholders.[107]

While the merger deadline for SPACs helps to limit IPO investors' illiquidity costs, it also creates a misaligned incentive for the sponsor to pursue unattractive business combinations.[108] For the sponsor, a merger that is bad for shareholders is still better than no merger at all, which results in a loss of the sponsor's entire 20% equity stake.[109] Unpromising merger proposals may also result in higher redemptions, enhancing the need for PIPE funding to meet minimum cash per share requirements negotiated by the target company.[110] Although the difficulties posed by high rates of redemptions—including the prospects that a sponsor may need to forfeit part of its promote or to inject its own additional capital in order to meet minimum cash per share requirements—may discourage sponsors from proposing bad deals, at least one analysis has found poorer deSPAC returns associated with higher redemptions and shorter time periods until the merger deadline. This finding suggests that sponsors propose more unfavorable mergers under pressure to consummate any business combination rather than lose their promote in a liquidation of the SPAC.[111]

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

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[105] KLAUSNER, *supra* note 9, at 8.

[106] *Id.* at 23.

[107] SEC Release, *supra* note 22, at 97.; KLAUSNER, *supra* note 9, at 28.

[108] GANHG, *supra* note 10, at 6.

[109] KLAUSNER, *supra* note 9, at 23.

[110] *Id.* at 30.

[111] GANHG, *supra* note 10, at 11.

[112] KLAUSNER, *supra* note 9, at 19.

[113] *Id.* at 21.

[114] Id. at 17.

[115] *Id.* at 22.

[116] Coates, *supra* note 19, at 4.

seem to serve the role of funding the creation of a public company that will later bring a private company public through a merger funded with investment from entirely new shareholders.[117]

A recent study showed that SPAC period investors earned an average annualized return of almost 16 percent for SPAC IPOs between 2010 and 2019, reflecting the benefits of redemption rights and retention of warrants.[118] Meanwhile, deSPAC period investors, measured from the first day of trading of the merged company, earned average returns of -8.1 percent, or -24.6% worse than an overall market value-weighted index.[119] Measured another way, among shareholders for all 47 SPACs that merged between January 2019 and June 2020, the average market-adjusted return of nonredeeming shareholders was -64%.[120] Why are deSPAC and nonredeeming shareholder returns so low? The value of a SPAC is its cash, and the amount of net cash per share delivered by the SPAC is in effect the price at which the target company will sell its shares, providing a reference point for estimating the valuation of the company.[121] SPACs typically deliver less than $10 of cash per share to the target company due to high redemptions, underwriting fees, and the promote, even after PIPE investments.[122] In fact, researchers found that the median SPAC, in a sample from January 2019 to June 2020, delivered only $5.70 in cash per share in its merger transaction.[123] In addition, outstanding warrants are dilutive when a merged company is successful, resulting in a drag on deSPAC upside returns.[124] Thus, public shareholders who choose not to redeem experience dilution through the sponsor promote, redemptions by other public shareholders, and PIPE investments.[125]

Proponents of SPACs cite their lower costs and greater efficiencies for target companies compared to IPOs. Skeptics note that the common SPAC structure leads to conflicts of interest for the sponsor of the SPAC and disadvantages non-redeeming IPO shareholders through dilution and costs. In his April 2021 statement, the SEC's former Acting Director of the Division of Corporation Finance described SPAC mergers as functional equivalents of introductions to the market of traditional IPOs, noting the importance of "developing law around economic substance over form."[126] Commentators have also observed that there is no policy reason to treat a SPAC

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[117] KLAUSNER, *supra* note 9, at 22.

[118] GANHG, *supra* note 10, at 3.

[119] *Id.* at 4.

[120] KLAUSNER, *supra* note 9, at 7.

[121] *Id.* at 57, 72.

[122] GANHG, *supra* note 10, at 4.

[123] KLAUSNER, *supra* note 9, at 7 (researchers have attributed the difference between $10 and the net cash per share to costs embedded in the SPAC structure: extraction of compensation paid to sponsor, IPO investors, underwriters, and other advisors in the merger).

[124] GANHG, *supra* note 10, at 4.

[125] NEWMAN, *supra* note 20, at 38.

[126] Coates, *supra* note 19, at 3.

merger differently than an IPO and that differing treatment of them has encouraged companies seeking to go public to engage in regulatory arbitrage.[127]

c. Current Regulations Governing SPACs

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

Once a SPAC has completed the negotiation of an agreement with the target company, it announces the agreement and prepares and files a Form S-4 registration statement.[134] A Form S-4 is the form required to be filed by a company seeking to publicly issue new securities pursuant to a merger and, like a Form S-1, is governed by Regulations S-K and S-X.[135] SPACs typically require shareholder approval of a merger and will schedule a shareholder vote and provide shareholders with a proxy statement.[136] The proxy statement contains information regarding the target company and the capital structure of the merger, including financial statements of the target and conflicts of interest among parties to the transaction, including the sponsor.[137] SPACs are also required to file written communications regarding proposed business combinations pursuant

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[127] KLAUSNER, *supra* note 9, at 68;. GANHG, *supra* note 10, at 15.

[128] NEWMAN, *supra* note 20, at 21.

[129] 17 C.F.R. § 229 (2022).

[130] 17 C.F.R. § 210 (2022).

[131] NEWMAN, *supra* note 20, at 22.

[132] *Id.* at 21-22.

[133] *See* Lionheart, *supra* note 34.

[134] GANHG, *supra* note 10, at 14.

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

[136] *What You Need to Know*, *supra* note 5 (Some SPACs do not require approval from public shareholders because the sponsor and affiliated individuals and entities hold sufficient votes to approve the transaction. In that case, the SPAC will provide an information statement to its shareholders. *Id.* If a SPAC is not required to obtain shareholder approval at all, it will provide a tender offer statement to its shareholders. *Id.*).; NEWMAN, *supra* note 20, at 29.

[137] FINRA, *supra* note 44, at 3.

to Rule 425 of the Securities Act and may use Form 8-K to provide that information.[138] In connection with the shareholder vote on the proposed merger, SPACs are required to file a proxy statement using Form 14A.[139]

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

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

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

A few years before enactment of the PSLRA, the SEC defined "blank check company" under Rule 419 as "a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies" and is issuing "penny stock" as defined in Rule 3a51-1(503).[146] SPAC predecessors known as "blind pools" had negative associations connected with penny-stock fraud.[147] However, because SPACs being issued in the 1990s did not meet the definition of

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[138] 17 C.F.R. § 230.425; See, e.g., Lionheart Acquisition Corp. II, 8-K

[139] SEC Release, *supra* note 22, at 11.

[140] GANHG, *supra* note 10, at 13.

[141] *Id.* at 14.

[142] KLAUSNER, *supra* note 9, at 52.

[143] 15 U.S.C. § 78u-5 (2018).

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

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

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

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

issuers of penny stock, they were not considered to be "blank check companies" for purposes of the safe harbor exclusion. A SPAC that raises more than $5 million in an IPO is not selling "penny stock" and therefore is not a "blank check company" as the SEC currently defines those terms.[148] Thus, SPACs are not subject to liability for forward-looking statements or projections that turn out to be false (if accompanied by "meaningful cautionary language") unless the person making the statement knew it was false at the time it was made.[149] While this view is widely held among SPAC market participants, at least some legislative history of the PSLRA indicates that Congress may not have been aware of the SEC definition and intended that the safe harbor would not apply to "blank check companies" regardless of whether they are issuing penny stock.[150] Nonetheless, SPACs and target companies routinely disclose projections and other forward-looking statements in investor presentations and registration statement filings.[151] Companies seeking to bridge information gaps with potential investors may find it beneficial to have the ability to make forward-looking statements.[152] Similarly, low-revenue or "pre-revenue" SPAC targets may only have future projections to share with investors.[153]

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

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

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

With respect to SPAC IPO disclosures, the proposed rule would require certain disclosures on the prospectus cover page in plain English, including the time frame for a SPAC to reach a merger,

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[148] SEC Release, *supra* note 22, at 83.

[149] KLAUSNER, *supra* note 9, at 53.

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

[151] *Id.* at 53.

[152] *Id.*

[153] *Id.*

[154] FINRA, *supra* note 44, at 3.

[155] SEC Release, *supra* note 22, at 89.

[156] *Id.*

terms of redemptions, sponsor compensation, dilution, and conflicts of interest.[157] As to SPAC merger disclosures, the proposed rule would require disclosures regarding the fairness of the deSPAC transaction, material financing transactions, sponsor compensation and dilution, and conflicts of interest on the cover page in plain English.[158] The proposed rule would also require enhanced disclosures in the prospectus summary at both the SPAC IPO and the SPAC merger stages, including the process for identifying and merging with a target company, material terms of the trust and redemption rights, the class of shares held by the sponsor, plans for additional financing, material terms and fairness of the deSPAC transaction, financing transactions for the SPAC merger, redemption, sponsor compensation, dilution, and conflicts of interest.[159]

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

Underwriters for SPACs would also face increased liability under the proposed rule. Citing underwriters' critical role as "gatekeepers" in the offering and distribution of securities, the proposed rule would subject underwriters to Section 11 liability in the deSPAC transaction under new Rule 140a of the Securities Exchange Act.[165] Specifically, the proposed new rule would provide that an underwriter involved in the SPAC IPO and the deSPAC transaction, or related financing transactions, would be deemed to have engaged in the distribution of securities of the combined public company for purposes of the Securities Exchange Act.[166] The clarification of the status of underwriters in deSPAC transactions would subject them to civil liability under Section

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[157] *Id.* at 42.

[158] *Id.*

[159] *Id.* at 43-44.

[160] *Id.* at 84.

[161] 17 C.F.R. § 230.419; SEC Release, *supra* note 22, at 83.

[162] SEC Release, *supra* note 22, at 84.

[163] *Id.* at 85.

[164] *Id.* at 84.

[165] *Id.* at 96.

[166] *Id.*

11.[167] This would restore the "due diligence" obligations of underwriters as an intermediary in the distribution of securities, requiring them to show as a defense to civil liability that it exercised reasonable care in verifying statements in the registration statement and had reasonable ground to believe and did believe that those statements were true and that there was no omission to state a material fact required to be stated or necessary to make the statements not misleading.[168] In support of the proposed rule, the SEC cites the financial incentive that underwriters have in seeking shareholder approval of business combinations, given that 3.5% of underwriting fees is deferred to, and conditioned upon, the completion of a merger.[169]

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

IV. FINRA Regulation of SPACs

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

In 2008, FINRA released a regulatory notice providing an overview of SPACs and SPAC processes, as well as identifying risks that firms must consider at various stages when recommending SPACs to their customers.[174] Those risks included that SPAC sponsors may be "unqualified or incompetent" and that underwriters may not perform the same level of diligence on SPAC acquisition targets as they do on companies going public in an IPO.[175] At that time, FINRA stated that firms must ensure that their brokers understand the features of SPACs and

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[167] *Id.*

[168] SEC Release, *supra* note 22, at 90.

[169] *Id.* at 97.

[170] *Id.* at 112.

[171] *Id.*

[172] *Id.* at 116.

[173] *Id.*

[174] FINRA, *supra* note 44.

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

that their customers understand the risks of SPACs.[176] FINRA also noted that firms should consider adoption of special suitability guidelines for SPACs.[177] In October 2021, FINRA conducted a targeted examination—also known as a sweep—regarding activities and procedures of member firms relating to services provided to SPACs as well as SPAC retail sales practices.[178]

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

a. Brokers' Duties When Recommending SPACs Under Reg BI

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

With respect to the care obligation, Reg BI requires a broker making a recommendation to "[u]nderstand the potential risks, rewards, and costs associated with the recommendation" and to "[h]ave a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer."[183] Because a SPAC that has not yet announced a merger has no business operations—other than its search for a target company—a broker recommending the purchase of SPAC shares at this stage has very little information available upon which to evaluate whether the recommendation is in the best interest of the customer. The information available on a pre-merger SPAC is generally limited to the background of the SPAC's management, plans for the use of offering proceeds to purchase an unidentified company, and disclosures and balance sheets relating to the operations of the SPAC. A broker recommending a SPAC at this stage likewise has little to no information on the company (or type of company) that a SPAC will acquire or the terms of the merger. Given this absence of information, it may not be possible to understand

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[176] *Id.* at 4.

[177] *Id.*

[178] *Special Purpose Acquisition Companies ("SPACs")*, FINRA (Oct. 2021), https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/special-purpose-acquisition-companies-spacs.

[179] NEWMAN, *supra* note 20, at 38.

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

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

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

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

risks, rewards, and costs associated with a SPAC recommendation sufficiently to determine a SPAC to be in a customer's best interest for all but the most speculative investor profiles. As part of the obligation to understand a security before recommending it, the SEC specified "characteristics (including any special or unusual features)" as factor that brokers and firms should consider.[184] One characteristic of SPACs that is special or unusual is the redemption feature, which firms and brokers should therefore consider, understand, and explain when recommending a SPAC to a customer. Even then, the conflicts of interest, costs, and share dilution of SPACs may complicate or frustrate compliance with Reg. BI, and the broker or firm will not have any basis at the time of the initial recommendation for determining whether the eventual redemption decision is in the best interest of the customer.

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

V. Conclusion

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

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

CRYPTOCURRENCY HISTORY, RISKS AND REGULATION

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The purpose of this paper is to provide an introduction and overview of the major risks associated with cryptocurrencies and the corresponding regulatory framework that seeks to mitigate those risks. Our approach is confined to trends in the United States. The content is a broad survey of the cryptocurrency landscape rather than an in-depth dissection of a particular type of cryptocurrency or regulatory agency. We also examine the current market crash and how it relates to concomitant changes in regulations and laws surrounding the coins.

I. INTRODUCTION – AN OVERVIEW OF THE MARKET AND THE REGULATORY LANDSCAPE

a. History of Cryptocurrencies

The first, and perhaps most well-known, cryptocurrency was Bitcoin.[1] An individual named Satoshi Nakamoto created Bitcoin in 2008, but the identity of this individual is unknown.[2] Bitcoin, and most cryptocurrencies, run on a blockchain.[3] A blockchain is a decentralized database that stores data in blocks.[4] Once a block is full, the data within it cannot be changed, making it allegedly more secure than a traditional database.[5]

Some cryptocurrencies run on their own blockchains (such as Bitcoin), but others run on existing blockchains.[6] For example, the cryptocurrency Ethereum runs on the Ethereum blockchain, but

[1] Eric Rosenberg, *History of Cryptocurrency*, THE BALANCE (Mar. 3, 2022), https://www.thebalance.com/history-of-cryptocurrency-5119511.

[2] *Id*.

[3] Adam Hayes, *Blockchain Explained*, INVESTOPEDIA (Mar. 5, 2022), https://www.investopedia.com/terms/b/blockchain.asp.

[4] *Id*.

[5] *Id.*

[6] *Id*.

there are many other coins that also run on the Ethereum blockchain.[7] The Ethereum blockchain allows other coins to run on it through what are called smart contracts.[8] A smart contract is a collection of code that executes upon the satisfaction of a certain condition.[9]

As of 2022, there are over 10,000 different cryptocurrencies.[10] However, the top twenty cryptocurrencies make up nearly ninety percent of the entire market. Cryptocurrencies can be bought on an exchange.[11] Centralized exchanges (CEXs), such as Coinbase, operate like a traditional stock exchange.[12] Decentralized exchanges (DEXs), such as Uniswap, use smart contracts to remove the need for a middleman.[13] In a DEX, the equivalent of a market maker can input certain pairs of coins into what is called a "liquidity pool." For example, someone who owns one Bitcoin and seventeen Ethereum can deposit the coins in a Bitcoin/Ethereum liquidity pool. Then, someone who wants to swap his or her Ethereum for Bitcoin (or vice versa) can do so via a smart contract in the DEX.[14]

Once one buys or receives a cryptocurrency, a record of the transaction is stored on the respective blockchain.[15] To facilitate access to the coins, they must be stored in what is called a "wallet." There are both hardware and software wallets, and each wallet contains a public key and a private key. The public key is the "address" one uses to send crypto to a specific wallet. The private key is the password one uses to access his or her own wallet.[16]

b. Major Risks and the Crypto Crash

What makes the risks associated with cryptocurrencies special is that many of the risks are intentional. In other words, the decentralized nature of the coins means that transactions are not reversible, and no central bank governs them. So, in exchange for privacy and security, there is a substantial risk of loss.

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[7] *Id*.

[8] Joseph Cook, *Introduction to Smart Contracts*, ETHEREUM (May 6, 2022), https://ethereum.org/en/developers/docs/smart-contracts/.

[9] *What is a Smart Contract,* CHAINLINK (Sept. 14, 2021), https://chain.link/education/smart-contracts.

[10] Raynor de Best, *Number of Cryptocurrencies Worldwide From 2013 to February 2022, STATISTA,* https://www.statista.com/statistics/863917/number-crypto-coins-tokens/.

[11] Sajjad Hussain, *Top Ten Centralized and Decentralized Crypto Exchanges*, MEDIUM (Nov. 12, 2021), https://medium.com/cryptocurrencies-ups-and-down/top-ten-centralized-and-decentralized-crypto-exchanges-c0d0b8bd83d4.

[12] *Id*.

[13] Benedict George, *What is a DEX? How Decentralized Crypto Exchanges Work*, COINDESK, https://www.coindesk.com/learn/what-is-a-dex-how-decentralized-crypto-exchanges-work/.

[14] *Id*.

[15] *Storing and Securing Cryptocurrencies*, FINRA (Nov. 29, 2018), https://www.finra.org/investors/insights/cryptocurrency-storage.

[16] *Id*.

A traditional source of risk with crypto relates to the private key. Due to the potential for hackers stealing the coins in one's wallet, it is up to the owner of the wallet to remember his or her private key. In other words, there is no "forget password" option with wallets. If one forgets the password to his or her wallet, the crypto in that wallet is theoretically lost (as no one can access those coins on the blockchain).[17]

Alternatively, if one creates an account with a CEX, the exchange will store the private key for the user.[18] Now, the user must remember his or her login to the CEX, but there is always the "forget password" option as the CEX operates like any other website. The risk here is that if someone hacks the CEX, he or she could access one's crypto.[19]

An additional risk with crypto is that transactions are irreversible.[20] So, for example, if an individual sends crypto to the wrong address, it is impossible to retrieve the crypto (unless the receiver sends it back). This reality of the digital coins also means that if one accidentally puts an extra zero at the end of a transaction, there could be catastrophic losses.

The digital nature of the coins lends itself to a through network of scammers, phishers, and other forms of thievery.[21] The internet is ripe with those looking to steal coins from others, especially novice investors who do not understand the unlimited risks of cryptocurrencies.

There are many risks of a market economy that consumers have forgotten in the modern regulatory state. For example, the FDIC backs a certain amount of money someone loses in a banking account if the bank declares bankruptcy or the money is otherwise lost. The FDIC, however, does not guarantee crypto wallets.[22]

The FDIC issue is particularly relevant as many crypto exchanges have filed for bankruptcy in the preceding months in the midst of crypto prices collapsing.[23] In the absence of regulations, many of these exchanges have planted clauses in their terms of service that vest ownership of the coins to the exchange while a user deposits them on the platform.[24] For example, crypto

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[17] *What is a Private Key?,* COINBASE, https://www.coinbase.com/learn/crypto-basics/what-is-a-private-key.

[18] Cryptopedia Staff, *The State of Centralized Exchanges*, GEMINI (Apr. 6, 2021), https://www.gemini.com/cryptopedia/centralized-exchanges-crypto.

[19] *DeFi Hacks Shift Security Narrative in Favor of CEXs,* CRYPTO BRIEFING (Sept. 2, 2021), https://cryptobriefing.com/defi-hacks-shift-security-narrative-in-favor-of-cexs/.

[20] *What to Know About Cryptocurrency and Scams*, FEDERAL TRADE COMMISSION (last visited July 19, 2022), https://consumer.ftc.gov/articles/what-know-about-cryptocurrency-and-scams. While a transaction is pending, it is sometimes possible to cancel the transaction. However, once the payment clears, the sender cannot unilaterally recover the money.

[21] *See id*.

[22] *See id*.

[23] Nizan Geslevich Packin, *Bankruptcy and Crypto*, FORBES (July 15, 2022, 8:44 PM EDT), https://www.forbes.com/sites/nizangpackin/2022/07/15/bankruptcy-and-cypto/?sh=5d3b474f7df5.

[24] *Id*.

bank Cesius, which recently initiated Chapter 11 bankruptcy proceedings, states in its terms of use that bankruptcy may lead to "total loss of any and all Digital Assets."[25]

Alternatively, consider the necessity of calling one's bank to dispute a fraudulent transaction. With a crypto wallet, there is no bank to call. If a hacker accesses someone's wallet, all the money in that wallet is lost with absolutely no recourse.[26]

All of these aforementioned risks are notwithstanding the inherent risks in holding cryptocurrency as an investment or as currency. Bitcoin, the so-called gold standard of crypto, has fluctuated wildly in the past two years alone.[27] Between March 2020 (the COVID crash in the markets) and November 2021, Bitcoin skyrocketed over 1,200%.[28] Between November 2021 and July 2022, it subsequently fell over 70%.[29]

Coins like Bitcoin, Dogecoin, and Ethereum, however, are merely the most popular coins that are often in the news. There are thousands of coins with absolutely no inherent value that pump and dump in a manner akin to penny stock frauds. Indeed, some traders actually call these coins "penny cryptos."[30]

Perhaps the cruelest irony of the current crash of major coins is that so-called experts once touted Bitcoin as a hedge against inflation.[31] However, Bitcoin has not had a test against inflation until now, when inflation rates are spiking.

Unfortunately, Bitcoin has been following a similar price trajectory to the overall stock market.[32] Finally, while not an individual risk, crypto has created a widespread net of money laundering.[33] In reality, coins like Bitcoin have some protections against anonymity that resist money laundering attempts. For example, transactions running on the Ethereum blockchain are publicly

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[25] *Id*.

[26] *What to Know About Cryptocurrency and Scams, supra* note 21.

[27] *Bitcoin USD*, YAHOO! FINANCE (last visited July 19, 2022), https://finance.yahoo.com/quote/BTC-USD?p=BTC-USD&.tsrc=fin-srch.

[28] *Id*.

[29] *Id*.

[30] Dawn Allcot, *8 of the Best Penny Cryptocurrencies to Buy*, NASDAQ (July 18, 2022, 4:05 PM EDT), https://www.nasdaq.com/articles/8-of-the-best-penny-cryptocurrencies-to-buy.

[31] David Z. Morris, *Why is Bitcoin Dropping if it's an Inflation Hedge?,* YAHOO! FINANCE (Dec. 10, 2021), https://finance.yahoo.com/news/why-bitcoin-dropping-inflation-hedge-180633263.html.

[32] Mike Winters, *Bitcoin Was Supposed to Hedge Against Inflation*, CNBC (July 8, 2022, 3:57 PM EDT), https://www.cnbc.com/2022/07/08/why-bitcoin-doesnt-seem-to-be-a-hedge-against-inflation.html.

[33] Tom Wilson, *Explainer: "Privacy Coin" Monero Offers Near Total Anonymity*, REUTERS (May 15, 2019, at 7:06 AM), https://www.reuters.com/article/us-crypto-currencies-altcoins-explainer-idUSKCN1SL0F0.

broadcast on a site called Etherscan.[34] While an individual's name is not attached to transactions, the wallet addresses of both the sender and receiver are publicly available.

However, a popular coin called Monero prides itself on being completely anonymous.[35] Wallet addresses associated with transactions are not publicly available.[36] The FBI itself has cited concerns with tracking Monero transactions.[37]

Nevertheless, the proclivity for criminals to use cryptocurrencies illicitly is unclear in comparison to traditional fiat currency. After all, it's not as though USD is resistant to usage in illegal transactions. Furthermore, the United States has already adapted to tracking certain crypto transactions. For example, in early 2022, the DOJ succeeded in tracking two individuals behind billions of dollars in Bitcoin laundering.[38]

II. FEDERAL CRYPTO REGULATIONS

Three U.S. agencies—the Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency—issued a joint statement in late 2021 stating that they aimed to provide clarity on laws and regulations surrounding cryptocurrencies in 2022.[39]

Most crypto regulations arise from traditional frameworks for securities, commodities, and property.

a. The SEC and Crypto as Securities

The SEC views many cryptocurrencies as securities.[40] Technically, to qualify as a security, the SEC concedes that a token must meet the Supreme Court's test from *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).[41] According to the Howey Test, an asset is a security if there is (1) the

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[34] *The Ethereum Blockchain Explorer*, ETHERSCAN (last visited July 19, 2022), https://etherscan.io/.

[35] Wilson, *supra* note 34.

[36] *Id*.

[37] Michael del Castillo, *The FBI is Worried Criminals Might Use the Private Cryptocurrency Monero,* COINDESK (Jan. 31, 2017, 6:00 AM EST), https://www.coindesk.com/markets/2017/01/31/the-fbi-is-worried-criminals-might-use-the-private-cryptocurrency-monero/.

[38] Andy Greenberg, *The DOJ's $3.6B Bitcoin Seizure Shows How Hard It Is to Launder Crypto,* WIRED (Feb. 9, 2022, 6:16 PM), https://www.wired.com/story/bitcoin-seizure-record-doj-crypto-tracing-monero/.

[39] *Exhibit 1*, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20211123a.htm.

[40] John Hyatt, *Decoding Crypto: Are There Regulations in the U.S. For Cryptocurrency?*, NASDAQ (Aug. 19, 2021), https://www.nasdaq.com/articles/decoding-crypto%3A-are-there-regulations-in-the-u.s.-for-cryptocurrency.

[41] Roger E. Barton et al., *Are Cryptocurrencies Securities? The SEC is Answering the Question*, REUTERS, https://www.reuters.com/legal/transactional/are-cryptocurrencies-securities-sec-is-answering-question-2022-03-21/.

investment of money (2) in a common enterprise (3) with a reasonable expectation of profits to be derived from the efforts of others.[42]

SEC Chair Gary Gensler stated in a CNBC interview that most crypto coins satisfy the test.[43] When cryptocurrencies are securities, the SEC applies existing securities laws to them.[44]

The SEC has already begun prosecuting several companies for unauthorized crypto offerings.[45] Perhaps the most notable case is one against Ripple Labs, Inc. regarding its unregistered securities offering of the coin XRP.[46]

The case is currently being adjudicated in the Southern District of New York.[47] XRP is one of the largest cryptocurrencies by market cap, so the case's outcome will be important in determining the authority of the SEC to treat cryptocurrencies under traditional securities regulations.[48] The case has been in court for several years and is still progressing through the discovery phase.[49]

Another notable SEC case involved crypto lender BlockFi, which resulted in a $100,000,000 settlement.[50] BlockFi was one of several companies to offer high-yield savings accounts for cryptocurrencies.[51] For example, Binance, another popular cryptocurrency exchange, touts a yield of up to 35% APY for holding certain coins on the platform.[52]

With cryptocurrency, there are two processes that lead to these high yields: lending (both peer-to-peer and traditional lending) and staking (how Binance offers such high yields). Some

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[42] *Id.*

[43] *CNBC Exclusive: CNBC Transcript: SEC Chair Gary Gensler Speaks With CNBC's 'Squawk Box' Today*, CNBC (Aug. 4, 2021, 9:39 AM), https://www.cnbc.com/2021/08/04/cnbc-exclusive-cnbc-transcript-sec-chair-gary-gensler-speaks-with-cnbcs-squawk-box-today.html.

[44] Hyatt, *supra* note. 41.

[45] *Exhibit 2*, https://www.sec.gov/spotlight/cybersecurity-enforcement-actions.

[46] *SEC Charges Ripple and Two Executives with Conducting $1.3 Billion Unregistered Securities Offering*, SEC (Dec. 22, 2020), https://www/sec.gov/news/press-release/2020-338.

[47] *See Exhibit 3*.

[48] *The SEC v. Ripple Lawsuit—Where Are We Now?*, HART DAVID CARSON (Jan. 4, 2022), https://www.hartdavidcarson.com/news/sec-ripple-lawsuit/.

[49] *See SEC v. Ripple Labs, Inc.*, No. 20-CV-10832 (AT) (SN), 2022 U.S. Dist. LEXIS 123141 (S.D.N.Y. July 12, 2022).

[50] Matt Robinson et al., *Crypto Lender BlockFi to Pay $100 Million in Settlement With SEC, States,* BLOOMBERG (Feb. 11, 2022, 8:14 PM EST), https://www.bloomberg.com/news/articles/2022-02-12/blockfi-to-pay-100-million-to-sec-states-over-crypto-lending.

[51] *Buy, Sell, and Earn Crypto*, BLOCKFI (last visited July 1, 2022), https://blockfi.com/.

[52] *Grow Your Crypto Faster*, BINANCE (last visited July 2, 2022), https://www.binance.com/en/event/earn-crypto.

websites, like MyConstant, allow users to lend cryptocurrency to others directly in exchange for high yields.[53] Others, like BlockFi, have accounts that behave like traditional savings accounts.[54] Staking is another way of earning interest on cryptocurrency that involves the more technical aspects of blockchain technology.[55] Regardless, the SEC fined BlockFi for failing to register these accounts as securities.[56] The SEC also warned Coinbase that if it began issuing its own lending accounts, the SEC would sue the company.[57]

Companies like Binance still offer staking rewards, however, and peer-to-peer lending on MyConstant exists today. There are also certain decentralized lending exchanges, such as Compound.

Earlier this year, the SEC changed the name of its Cyber Unit to the Crypto Assets and Cyber Unit.[58] The SEC nearly doubled the size of the unit and aims to protect investors in the crypto markets.[59]

In June 2022, the SEC announced it was investigating the collapse of Terraform Labs' Terra (UST) and Luna cryptocurrencies.[60] The meltdown of these two cryptocurrencies resulted in billions of dollars of losses by coin holders.[61] Founder and Stanford graduate Do Kwon's algorithm for the coins malfunctioned and completely devalued the coins.

b. The Commodities Future Trading Commission and Crypto as Commodities

The Commodities Future Trading Commission ("CFTC") views many cryptocurrencies as commodities.[62] The CFTC claims jurisdiction over cryptocurrencies (or what it calls "virtual

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[53] *Invest in Global Peer-to-Peer (P2P) Lending with USD or Crypto*, MYCONSTANT (last visited July 1, 2022), https://www.myconstant.com/.

[54] Robinson, *supra* note 51.

[55] *What is Staking?,* COINBASE (last visited July 1, 2022), https://www.coinbase.com/learn/crypto-basics/what-is-staking. Some coins, like Bitcoin, operate on a Proof of Work system. Others, like Tezos, operation on a Proof of Stake system. By "staking" one's coins (lending them to the blockchain to validate transactions), the user receives more of those coins in return.

[56] Robinson, *supra* note 51.

[57] *Id*.

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

[59] *Id*.

[60] Kevin Helms, *U.S. SEC Investigating Do Kwon's Terraform Labs and UST Collapse*, BITCOIN.COM (June 9, 2022), https://news.bitcoin.com/us-sec-investigating-do-kwons-terraform-labs-and-ust-collapse/.

[61] Christopher H. Loo, *What Happened With the Terra Luna Collapse and What It Means for Stable Coins Going Forwards*, MEDIUM (May 16, 2022), https://medium.com/coinmonks/what-happened-with-the-terra-luna-collapse-and-what-it-means-for-stable-coins-going-forwards-104c0e28ae44.

[62] *Exhibit 4*, https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/oceo_bitc

currencies") used in derivatives contracts and whenever "there is fraud or manipulation involving a virtual currency traded in interstate commerce."[63]

The CFTC claims this jurisdiction as an extension of the Commodity Exchange Act, which established the organization in 1936.[64] The CFTC has been active in filing complaints involving cryptocurrency.[65] For example, the agency recently settled a dispute with the cryptocurrency exchange BitMEX for $100,000,000.[66] The CFTC had charged BitMEX with offering unlicensed crypto products and lacking know- your-customer and anti-money laundering systems to protect consumers.[67]

Commissioners of the CFTC have been vocal in the need for the CFTC's involvement in crypto disputes.[68] According to Commissioner Caroline Pham, the CFTC has already brought over 50 enforcement actions with roughly $750,000,000 in penalties.[69]

Most recently, on May 24, the CFTC settled with a Swiss commodity trading and mining firm for over $1,100,000,000.[70]

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oinbasics0218.pdf.

[63] *Id*.

[64] *Id.; see* 7 U.S.C. §§ 1-27(f) (codifying the Commodity Exchange Act); Dawn D. Stump, *Digital Assets: Clarifying CFTC Regulatory Authority*, CFTC (Aug. 23, 2021), https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement082321.

[65] *See, e.g., CFTC v. Reynolds*, No. 1:19-cv-05631-MKV, 2021 U.S. Dist. LEXIS 38896 (S.D.N.Y. Mar. 2, 2021)(holding that cryptocurrency *is* a commodity under the Commodity Exchange Act); *CFTC v. Garcia,* Civil Action No. 4:20-cv-03185, 2021 U.S. Dist. LEXIS 179724 (S.D. Tex. Sep. 21, 2021) (issuing final judgment by default against individuals who fraudulently solicited others to invest in Bitcoin); *Exhibit 5* (approving consent decree between CFTC and Cryptocurrency exchange).

[66] *See Exhibit 5* at *17; Dan M. Berkovitz, *Statement of Commissioner Dan M. Berkovitz on the $100 Million BitMEX Crypto Trading Fine*, CFTC (Aug. 10, 2021), https://www.cftc.gov/PressRoom/SpeechesTestimony/bertovitzstatement081021.

[67] Nikhilesh De & Danny Nelson, *BitMEX Announces $100M CFTC, FinCEN Settlement*, COINDESK (Aug. 10, 2021, 2:24 PM EDT), https://www.coindesk.com/markets/2021/08/10/bitmex-announces-100m-cftc-fincen-settlement/.

[68] *See* Berkovitz, *supra* note 67; *CFTC Commissioner Pham Discusses Crypto Regulation and Customer Protections with CNBC and Yahoo! Finance*, CFTC (May 31, 2022), https://www.cftc.gov/PressRoom/PressReleases/8538-22.

[69] *Id*.

[70] *Glencore Entered Guilty Pleas to Foreign Bribery and Market Manipulation Schemes*, DOJ (May 24, 2022), https://www.justice.gov/opa/pr/glencore-entered-guilty-pleas-foreign-bribery-and-market-manipulation-schemes.

c. The Department of the Treasury and the IRS

The U.S. Department of the Treasury classifies cryptocurrencies as currencies.[71] The department has issued some of its own regulations, but the rules are relatively light.[72]

In March 2022, Biden signed an executive order on cryptocurrencies which included a requirement that Treasury Secretary Janet Yellen produce a report "on the future of money and payment systems."[73]
Finally, crypto exchanges in the United States must register with and abide by regulations of the Financial Crimes Enforcement Network (FinCEN), a bureau of the Department of the Treasury.[74]

The IRS, on the other hand, classifies cryptocurrency as property.[75] For example, purchasers and sellers of cryptocurrency must report capital gains and losses, and taxpayers must record cryptocurrency as income if the individual performed a service in exchange for it.[76]

III. CONGRESSIONAL LEGISLATION

In addition to legislation creating the aforementioned agencies, other past legislation has been expanded to cover cryptocurrencies.[77] For example, cryptocurrency exchanges must abide by the Bank Secrecy Act as well as anti- money laundering (AML) and combating the financing of terrorism (CFT) requirements.[78]

Senators Kirsten Gillibrand (D-NY) and Cynthia Lummis (R-WY) introduced the most recent bill

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[71] Timothy Smith, *Cryptocurrency Regulations Around the World*, INVESTOPEDIA (May 9, 2022), https://www.investopedia.com/cryptocurrency-regulations-around-the-world-5202122,

[72] *See, e.g.,* Kevin Helms, *U.S. Treasury Unveils Stifling Crypto Wallet Regulation*, BITCOIN.COM (Dec. 19, 2020), https://news.bitcoin.com/us-treasury-cryptocurrency-wallet-regulation-experts-break-down-rules/; Nikhilesh De, *U.S. Treasury Department Formally Adds Crypto Rules to Russian Sanctions Guidance*, COINDESK (Feb. 28, 2022), https://www.coindesk.com/policy/2022/02/28/us-treasury-department-formally-adds-crypto-rules-to-russian-sanctions-guidance/; Christy Bieber, *U.S. Treasury Rushing to Regulate Crypto Markets*, THE MOTLEY FOOL (Oct. 11, 2021), https://www.fool.com/the-ascent/cryptocurency/articles/us-treasury-rushing-to-regulate-crypto-markets/.

[73] Kevin Helms, *Biden Signs Executive Order Establishing National Crypto Policy Across 6 Key Priorities*, BITCOIN.COM (Mar. 9, 2022), https://news.bitcoin.com/biden-signs-executive-order-establishing-national-crypto-policy-across-6-key-priorities/.

[74] Smith, *supra* note 72.

[75] *Frequently Asked Questions on Virtual Currency Transactions*, IRS (last visited June 10, 2022), https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions.

[76] *Id*.

[77] Smith, *supra* note 72.

[78] *Id*.

on cryptocurrency regulation in the form of S.4356.[79] The bill is called the Responsible Financial Innovation Act and is currently in the Committee on Finance.[80]

According to Gillibrand, the Act would "establish a regulatory framework that spurs innovation, develops clear standards, defines appropriate jurisdictional boundaries and protects consumers."[81]
Before S.4356, members of Congress had introduced several bills on cryptocurrency that died or are in limbo.[82]

Overall, Congress has been less involved in cryptocurrency legislation compared to regulatory agency activity.[83]

IV. STATE LEGISLATION

State legislation, like federal legislation and regulatory action, has mainly involved extending existing laws and regulatory frameworks to cryptocurrency.[84]

The most active area of state legislation involves regulating money transmitters.[85] Money transmitters are companies like payment processors that accept cryptocurrency from a customer, convert it to fiat currency, and pay the merchant.[86]

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[79] *Exhibit 6*.

[80] *Id*.

[81] Theo Wayt, *Pro-Cryptocurrency Regulatory Bill Introduced by Sens. Gillibrand, Lummis*, NEW YORK POST (June 7, 2022), https://nypost.com/2022/06/07/pro-cryptocurrency-regulatory-bill-introduced-by-sens-gillibrand-lummis/.

[82] *See, e.g.,* Cryptocurrency Tax Reform Act, H.R. 5083, 117th Cong. (2021); Cryptocurrency Accountability Act, H.R. 7862, 117th Cong. (2022); Russian Digital Asset Sanctions Compliance Act of 2022, H.R. 7429, 117th Cong. (2022); *Cryptocurrency Laws and Regulations by State*, BL (May 26, 2022), https://pro.bloomberglaw.com/brief/cryptocurrency-laws-and-regulations-by-state/.

[83] *Cryptocurrency Laws and Regulations by State*, *supra* note 83.

[84] *See, e.g., id*.; Exhibit 7*,* https://www.ncsl.org/research/financial-services-and-commerce/cryptocurrency-2022-legislation.aspx.

[85] *Cryptocurrency Laws and Regulations by State, supra* note 83.

[86] Marco Santori, *What is Money Transmission and Why Does it Matter?,* COIN CENTER (Apr. 7, 2015), https://www.coincenter.org/education/policy-and-regulation/money-transmission/.

Under these laws, money transmitters have to apply for a license from the state to perform cryptocurrency transactions.[87] In most states, the traditional regulatory framework for money transmitters has simply been extended to cover cryptocurrency rather than revised in any manner.[88]

Other state statutes have authorized legal agreements via smart contracts, allowed campaign donations via cryptocurrency, and permitted corporations to use blockchain technology to maintain corporate records.[89]

The most extensive and burdensome state regulations are in New York.[90] With the exception of a few types of cryptocurrency businesses, most of these businesses must apply for a BitLicense from the New York State Department of Financial Services (NYSDFS).[91]

A business must obtain a license regardless of its place of incorporation to serve customers in New York.[92] For money transmitters, these companies must also apply for a separate money transmitter license.[93] Companies that act as fiduciaries for their clients must apply for a Limited Purpose Trust Charter from both the NYSDFS and the New York Banking Board.[94]

BitLicenses are hard to obtain; between 2014 and 2019, the NYSDFS only issued 18 BitLicenses.[95] Notoriously, international cryptocurrency exchange Kraken stopped serving customers in New York due to the cost and difficulty of obtaining a BitLicense.[96]

Nevertheless, the story of Kraken highlights the battle between New York, the least crypto-friendly state, and Wyoming, the most crypto-friendly state. In the United States, national banks are exempt from needing money transmitter licenses in any individual state.[97] In 2019, Wyoming passed legislation that created a type of bank called a Special Purpose Depository

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[87] *Id*.

[88] *Id*.

[89] *An Overview of U.S. Crypto Regulations,* CRYPTOPEDIA (Dec. 7, 2021), https://www.gemini.com/cryptopedia/us-crypto-regulations-laws.

[90] *Crypto Regulation in New York: A Benchmark for Progress*, CRYPTOPEDIA (Dec. 2, 2021), https:www.gemini.com/cryptopedia/new-york-cryptocurrency-regulations; *Exhibit 8*.

[91] *Crypto Regulation in New York, supra* note 91.

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[92] *Id*.

[93] *Id*.

[94] *Id*.

[95] Ian Allison, *Wyoming's New Crypto Banking Law Could Defang New York's BitLicense*, COINDESK (Nov. 14, 2019, 4:05 PM EST), https://www.coindesk.com/markets/2019/11/14/wyomings-new-crypto-banking-law-could-defang-new-yorks-bitlicense/.

[96] *Farewell, New York*, KRAKEN (Aug. 9, 2015), https://blog.kraken.com/post/253/farewell-new-york/.

[97] Allison, *supra* note 96.

Institution (SPDI; pronounced "speedy").[98] These banks, which focus on virtual currencies, would then theoretically be exempt from other state money transmitter laws.[99]

The idea of the SPDI was to attempt to find a loophole around the BitLicense.[100] A SPDI still has to seek approval from the Federal Reserve to become a national bank, however.[101] Kraken became a Wyoming SPDI in 2020, but the Federal Reserve has refused to process its application to receive a master account with the Federal Reserve—a prerequisite to becoming a national bank.[102] Therefore, New York residents still cannot use Kraken.[103] The only other state where Kraken does not operate is the state of Washington.[104] Kraken cited operating costs in Washington as the reason for its exit from the state.[105] Washington does not have any irregular regulations, so presumably its money transmitter requirements led to the exile.[106]

V. CONCLUSION

The SEC has recovered millions in fines from cryptocurrency companies and is continuing to sue large companies like Ripple Labs, Inc. The CFTC has also been active in suing cryptocurrency companies, such as its $100,000,000 settlement with cryptocurrency exchange BitMEX.

States, like the federal government, have mostly been expanding existing regulatory frameworks to cover cryptocurrencies. This phenomenon is especially notable with money transmission licenses.

The most active states are New York and Wyoming. New York's BitLicenses are required for most cryptocurrency businesses serving customers in the state, regardless of the company's place of incorporation. Wyoming is friendly to cryptocurrency firms, allowing some to become SPDIs, operating as a type of bank.

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[98] *Exhibit 9*, https://wyomingbankingdivision.wyo.gov/banks-and-trust-companies/special-purpose-depository-institutions.

[99] Allison, *supra* note 96.

[100] *Id*.

[101] Jeff John Roberts, *Fed Chair Defends Blocking Wyoming Crypto Banks, Including Kraken,* DECRYPT (Jan. 11, 2022), https://decrypt.co/90186/powell-lummis-spdi-kraken-wyoming.

[102] *Id*.

[103] *Where Can I Use Kraken?*, KRAKEN (last visited July 1, 2022), https://support.kraken.com/hc/en-us/articles/360001368823-Where-can-I-use-Kraken.

[104] *Id*.

[105] Drew Atkins, *New Bitcoin Regulations Shake Up Washington State's Cryptocurrency Industry*, GEEKWIRE (Aug. 1, 2017), https://www.geekwire.com/2017/new-bitcoin-regulations-shake-washington-states-cryptocurrency-industry/.

[106] *See id.*

This year would seem to be the time for more extensive cryptocurrency regulations. In the midst of a larger economic downturn, cryptocurrencies have fallen from all- time-highs toward all-time-lows. Bitcoin itself has fallen by over 70% since its all- time-high in November 2021.

Senators Gillibrand and Lummis introduced S.4356 in the Senate, though it is currently in the Committee on Finance. Therefore, amidst many bills at the national and state levels, cryptocurrency regulations still mainly consist of an adapted regulatory framework from the past rather than a new regime to fit the peculiarities of these modern currencies.

EXHIBIT 1

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Agencies Issue Joint Statement on Crypto-Asset Policy Initiative and Next Steps, FEDERAL RESERVE (Nov. 23, 2021), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20211123a.htm

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Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

November 23, 2021

Joint Statement on Crypto-Asset Policy Sprint Initiative and Next Steps

The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency (collectively, agencies) recognize that the emerging crypto-asset sector presents potential opportunities and risks for banking organizations, their customers, and the overall financial system.[1] As supervised institutions seek to engage in crypto-asset-related activities, it is important that the agencies provide coordinated and timely clarity where appropriate to promote safety and soundness, consumer protection, and compliance with applicable laws and regulations, including anti-money laundering and illicit finance statutes and rules.

To that end, the agencies recently conducted a series of interagency "policy sprints" focused on crypto-assets. Similar to a "tech sprint" model, agency staff with various backgrounds and relevant subject matter expertise conducted preliminary analysis on various issues regarding crypto-assets. This joint statement summarizes the work undertaken during the policy sprints and provides a roadmap of future planned work.

Agency staff focused on quickly advancing and building on the agencies' combined knowledge and understanding related to banking organizations' potential involvement in crypto-asset-related activities. The focus of the sprint work included:

- Developing a commonly understood vocabulary using consistent terms regarding the use of crypto-assets by banking organizations.
- Identifying and assessing key risks, including those related to safety and soundness, consumer protection, and compliance, and considering legal permissibility related to potential crypto-asset activities conducted by banking organizations.[2]
- Analyzing the applicability of existing regulations and guidance and identifying areas that may benefit from additional clarification.

To place the sprint work in context, staff reviewed and analyzed a number of crypto-asset activities in which banking organizations may be interested in engaging including:

- Crypto-asset custody.
- Facilitation of customer purchases and sales of crypto-assets.
- Loans collateralized by crypto-assets.
- Activities involving payments, including stablecoins.

[1] By "crypto-asset," the agencies refer generally to any digital asset implemented using cryptographic techniques.
[2] To assist in identifying key risks, agency staff reviewed comment letters submitted in response to the FDIC's Request for Information on Digital Assets.

- Activities that may result in the holding of crypto-assets on a banking organization's balance sheet.

Based on this preliminary and foundational staff-level work, the agencies have identified a number of areas where additional public clarity is warranted. As a result, the agencies have developed a crypto-asset roadmap that is summarized below.

Throughout 2022, the agencies plan to provide greater clarity on whether certain activities related to crypto-assets conducted by banking organizations are legally permissible, and expectations for safety and soundness, consumer protection, and compliance with existing laws and regulations related to:

- Crypto-asset safekeeping and traditional custody services.[3]
- Ancillary custody services.[4]
- Facilitation of customer purchases and sales of crypto-assets.
- Loans collateralized by crypto-assets.
- Issuance and distribution of stablecoins.
- Activities involving the holding of crypto-assets on balance sheet.

The agencies also will evaluate the application of bank capital and liquidity standards to crypto-assets for activities involving U.S. banking organizations and will continue to engage with the Basel Committee on Banking Supervision on its consultative process in this area.

The agencies continue to monitor developments in crypto-assets and may address other issues as the market evolves. Further, the agencies will continue to engage and collaborate with other relevant authorities, as appropriate, on issues arising from activities involving crypto-assets.

[3] Traditional custody services in this context include facilitating the customer's exchange of crypto-assets and fiat currency, transaction settlement, trade execution, recordkeeping, valuation, tax services, and reporting.
[4] Ancillary custody services could potentially include staking, facilitating crypto-asset lending, and distributed ledger technology governance services. The agencies may seek additional information on these activities through a request for information, prior to providing any further clarity on these activities.

EXHIBIT 2

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Crypto Assets and Cyber Enforcement Actions, SEC (last visited May 31, 2022), https://www.sec.gov/spotlight/cybersecurity-enforcement-actions

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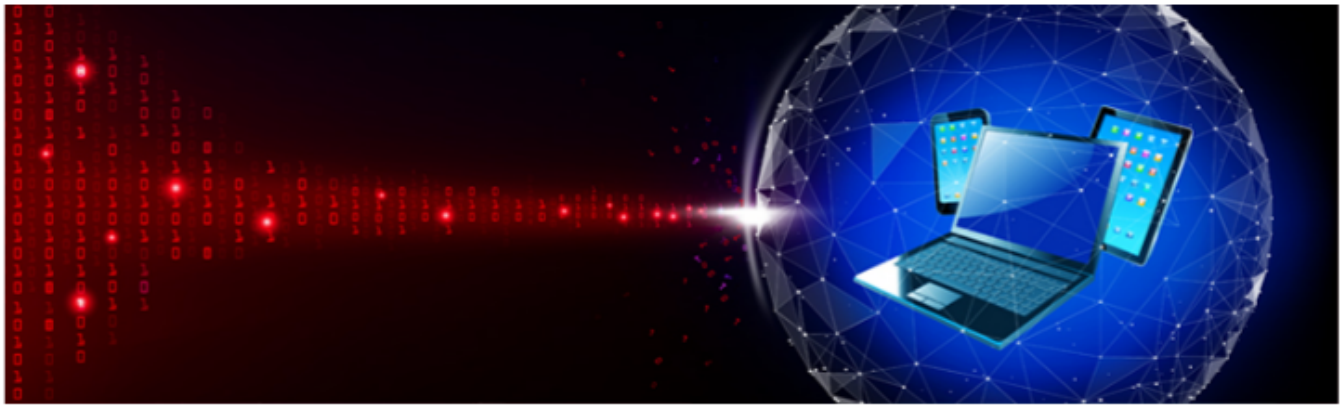
Crypto Assets and Cyber Enforcement Actions



Crypto Assets

Action Name	Description	Date Filed
SEC v. Okhotnikov, et al.	The Securities and Exchange Commission charged 11 individuals for their roles in creating and promoting Forsage, a fraudulent crypto pyramid and Ponzi scheme that raised more than $300 million from millions of retail investors worldwide, including in the United States. Those charged include the four founders of Forsage, who were last known to be living in Russia, the Republic of Georgia, and Indonesia, as well as three U.S.-based promoters engaged by the founders to endorse Forsage on its website and social media platforms, and several members of the so-called Crypto Crusaders—the largest promotional group for the scheme that operated in the United States from at least five different states.	8/1/2022
SEC v. Wahi, et al.	The Securities and Exchange Commission brought insider trading charges against a former Coinbase product manager, his brother, and his friend for perpetrating a scheme to trade ahead of multiple announcements regarding certain crypto assets that would be made available for trading on the Coinbase platform.	7/21/2022
SEC v. Chiang, et al.	The Securities and Exchange Commission charged Steven Chiang a/k/a Cyrus Kong, Eric Tippetts, James Hardy, and Ma[illegible]utch" Chelliah for their roles in	4/28/2022

	raising over $10 million through two fraudulent and unregistered digital asset securities offerings.	
SEC v. Block Bits Capital, LLC, et al.	The Securities and Exchange Commission charged Block Bits Capital, LLC, Block Bits Capital GP I, LLC and their co-founders Japheth Dillman and David Mata, with conducting a fraudulent unregistered securities offering.	4/28/2022
SEC v. MCC International Corp., et al.	The Securities and Exchange Commission brought fraud charges against MCC International Corp., which does business as Mining Capital Coin Corp., its founders Luiz Carlos Capuci, Jr. and Emerson Souza Pires, and two other entities controlled by Capuci, CPTLCoin Corp. and Bitchain Exchanges, in connection with the unregistered offerings and fraudulent sales of investment plans called mining packages to thousands of investors.	4/7/2022
SEC v. Barksdale, et al.	The Securities and Exchange Commission charged siblings John and JonAtina (Tina) Barksdale with defrauding thousands of retail investors out of more than $124 million through two unregistered fraudulent offerings of securities involving a digital token called "Ormeus Coin."	3/8/2022
BlockFi Lending LLC	The Securities and Exchange Commission charged BlockFi Lending LLC with failing to register the offers and sales of its retail crypto lending product, and also charged BlockFi with violating the registration provisions of the Investment Company Act of 1940.	2/14/2022
SEC v. Garcia	The Securities and Exchange Commission charged Paul A. Garcia of Severance, Colorado, for allegedly defrauding investors by stealing approximately one quarter of investor funds raised for Gold Hawgs Development Corp., a failed cryptocurrency venture.	1/18/2022
SEC v. Crowd Machine, Inc., et al.	The Securities and Exchange Commission charged Australian citizen Craig Sproule and two companies he founded, Crowd Machine, Inc. and Metavine, Inc., for making materially false and misleading statements in connection with an unregistered offer and sale of digital asset securities.	1/6/2022

EXCERPTED FROM: https://www.sec.gov/spotlight/cybersecurity-enforcement-actions

EXHIBIT 3

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SEC v. Ripple Labs, Inc., No. 20-CV-10832 (AT)(SN), 2021 U.S. Dist. LEXIS 69563 (S.D.N.Y. Apr. 9,2021)

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SEC v. Ripple Labs, Inc.

United States District Court for the Southern District of New York

April 9, 2021, Decided; April 9, 2021, Filed

20-CV-10832 (AT)(SN)

Reporter
2021 U.S. Dist. LEXIS 69563 *; 2021 WL 1335918

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, -against-RIPPLE LABS, INC., et al., Defendants.

Subsequent History: Motion granted by, in part, Motion denied by, in part SEC v. Ripple Labs, 2021 U.S. Dist. LEXIS 89783, 2021 WL 1814771 (S.D.N.Y., May 6, 2021)

Motion denied by SEC v. Ripple Labs, Inc., 540 F. Supp. 3d 409, 2021 U.S. Dist. LEXIS 95328, 2021 WL 2069782 (S.D.N.Y., May 19, 2021)

Motion denied by SEC v. Ripple Labs, Inc., 2021 U.S. Dist. LEXIS 102002, 2021 WL 2323089 (S.D.N.Y., May 30, 2021)

Motion granted by, in part, Motion denied by, in part, Request denied by, Without prejudice, Request denied by SEC v. Ripple Labs, Inc., 2021 U.S. Dist. LEXIS 112010 (S.D.N.Y., June 15, 2021)

Motion denied by, Request denied by SEC v. Ripple Labs, Inc., 2021 U.S. Dist. LEXIS 180033, 2021 WL 4296650 (S.D.N.Y., Sept. 21, 2021)

Motion denied by SEC v. Ripple Labs, Inc., 2021 U.S. Dist. LEXIS 190855, 2021 WL 4555352 (S.D.N.Y., Oct. 4, 2021)

Motion granted by, in part, Motion denied by, in part, Without prejudice, Motion granted by, Motion denied by, in part, Motion granted by, in part SEC v. Ripple Labs, Inc., 2021 U.S. Dist. LEXIS 203566, 2021 WL 5336970 (S.D.N.Y., Oct. 21, 2021)

Motion granted by, in part, Motion denied by, in part SEC v. Ripple Labs, Inc., 2022 U.S. Dist. LEXIS 6999, 2022 WL 123590 (S.D.N.Y., Jan. 13, 2022)

Motion granted by, in part, Motion denied by, in part SEC v. Ripple Labs, 2022 U.S. Dist. LEXIS 21936, 2022 WL 329211 (S.D.N.Y., Feb. 3, 2022)

Motion denied by SEC v. Ripple Labs, Inc., 2022 U.S. Dist. LEXIS 43537, 2022 WL 748150 (S.D.N.Y., Mar. 11, 2022)

Motion denied by SEC v. Ripple Labs, Inc., 2022 U.S. Dist. LEXIS 43497 (S.D.N.Y., Mar. 11, 2022)

Motion denied by SEC v. Ripple Labs, Inc., 2022 U.S. Dist. LEXIS 71938, 2022 WL 1154348 (S.D.N.Y., Apr. 19, 2022)

Motion granted by, in part, Motion denied by, in part SEC v. Ripple Labs, Inc., 2022 U.S. Dist. LEXIS 122155 (S.D.N.Y., July 11, 2022)

Motion denied by SEC v. Ripple Labs, Inc., 2022 U.S. Dist. LEXIS 123141 (S.D.N.Y., July 12, 2022)

Counsel: [*1] For Securities and Exchange Commission, Plaintiff: Jorge Gerardo Tenreiro, LEAD ATTORNEY, Securities and Exchange Commission(NYC), New York, NY; Dugan William Edward Bliss, U.S. Securities and Exchange Commission (NY), New York, NY; Richard R. Best, U.S. Securities and Exchange Commission, New York, NY.

Judges: Sarah Netburn, United States Magistrate Judge.

Opinion by: Sarah Netburn

Opinion

OPINION & ORDER

SARAH NETBURN, United States Magistrate Judge:

The Securities and Exchange Commission has sued

Ripple Labs, Inc., Bradley Garlinghouse and Christian A. Larsen for violations of *Sections 5(a)* and *5(c)* of the *Securities Act of 1933* by engaging in the unlawful offer and sale of unregistered securities. The amended complaint further alleges that Garlinghouse and Larsen aided and abetted Ripple in its violations. See ECF No. 46 at ¶¶ 9, 10; *15 U.S.C. §§ 77e(a)*, *77e(c)*.

As part of civil discovery, the SEC seeks eight years of personal financial information of Garlinghouse and Larsen from them directly and through subpoenas served upon financial institutions with which they or their family members hold accounts. Garlinghouse and Larsen move for a protective order to avoid their discovery obligation and to quash the subpoenas served upon SVB Financial Group, First [*2] Republic Bank, the Federal Reserve Bank of New York, Silver Lake Bank, Silvergate Bank, and Citibank, N.A. The motion is GRANTED.

BACKGROUND

XRP is a digital asset (or "cryptocurrency") that can be issued or transferred using a distributed ledger—a peer-to-peer database spread across a network of computers that records all transactions publicly.[1] There are many such ledgers, some of which have "native" digital assets, perhaps with the best-known example being the Bitcoin, the native digital asset to the Bitcoin Ledger.[2] XRP is the native asset to the XRP Ledger. See ECF No. 46 at ¶¶ 32-37.

The SEC alleges that in approximately late 2011 or early 2012, Larsen and another co-founder began to work on the idea and code for what would become the XRP Ledger. In September 2012, Larsen (with others) founded Ripple Labs, Inc. Id. at ¶ 44. Upon completion of the XRP Ledger in December 2012, and as its software was deployed on the first computer servers on which it runs, its development team created a fixed supply of 100 billion XRP. Id. at ¶ 45. The development team then transferred 80 billion XRP to Ripple and 9 billion to Larsen as compensation.[3] Id. [*3] at ¶ 46. Garlinghouse joined Ripple in 2015, and subsequently received at least 357 million XRP from Ripple as compensation. See id. at ¶¶ 74, 87. The SEC claims that from 2013 to the present, the Individual Defendants offered or sold a portion of their individual holdings of XRP to the public in exchange for hundreds of millions of dollars (1.7 billion XRP netting $450 million for Larsen and his wife; 375 million XRP netting $159 million for Garlinghouse). See id. at ¶¶ 86-88.

I. The SEC's Burden in this Case

Sections 5(a) and *5(c) of the Securities Act* require that whenever an issuer of securities, its control persons, or affiliates offers or sells securities to the public, those securities must first be registered with the SEC, absent certain exemptions. See *15 U.S.C. §§ 77e(a)*, *77e(c)*. The SEC claims that XRP is an investment contract, and therefore a security. Accordingly, the SEC claims that the Individual Defendants violated *Section 5* by offering and selling their XRP into the public market without first registering those offers and sales, and that they aided and abetted Ripple's violations as well. See ECF No. 9.

To prevail, the SEC will need to show that XRP is an investment contract under the Howey test. See *S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298-99, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946)* (holding that an [*4] "investment contract . . . means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party. . ."); *S.E.C. v. Aqua-Sonic Products Corp., 687 F.2d 577, 582 (2d Cir. 1982)* (finding that the Supreme Court had moved away from a literal interpretation of "solely" in the Howey test, and toward an economic realities and totality of the circumstances view of the alleged scheme); *Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027, 1034 (2d Cir. 1974)* ("The question therefore becomes whether . . . in light of the economic reality and the totality of circumstances . . . the customers were making an investment . . . ."). Furthermore, in order to prove its allegations that the Individual Defendants aided and abetted Ripple in offering or selling unregistered securities, the SEC must show that the Individual

[1] A number of technical details, distinctions, and operational nuances are absent from these descriptions of XRP and the XRP Ledger that may prove critical in the ultimate determination of whether the Defendants are liable for offering and selling unregistered securities. Without expressing a view on that issue for now, I seek to provide only the necessary facts to place the present dispute in context.

[2] See Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System, Bitcoin.org, https://bitcoin.org/bitcoin.pdf.

[3] The remaining 11 billion XRP was transferred to another co-founder and development team member who are not parties to the case. See ECF No. 46 at ¶ 46.

Defendants knew or recklessly disregarded that Ripple's offerings and sales of XRP required registration as securities and that those transactions were improper. See *15 U.S.C. § 77o(b)*; *S.E.C. v. Apuzzo, 689 F.3d 204, 206 (2d Cir. 2011)*; *S.E.C. v. Espuelas, 905 F. Supp. 2d 507, 518 (S.D.N.Y. 2012)*.

DISCUSSION

The SEC has served the Individual Defendants with Requests for Production seeking their personal financial records over an eight-year period. See ECF. No. 59, Exs. A, B. It also issued third-party subpoenas to several financial institutions [*5] at which the Individual Defendants maintain accounts, seeking similar records. See id. at Exs. C—H. The Individual Defendants have moved to prevent the SEC's attempts to obtain these records. See id.

I. The Parties' Burdens Under the Federal Rules

Rule 26(b) limits discovery to "any nonprivileged matter that is relevant to any party's claim or defense and proportional to the needs of the case." *Fed. R. Civ. P. 26(b)*. "The party seeking discovery bears the initial burden of proving the discovery is relevant." *Citizens Union of City of N.Y. v. Att'y Gen. of N.Y., 269 F. Supp. 3d 124, 139 (S.D.N.Y. 2017)*. In considering whether a discovery request poses an undue burden, the court should consider if it is "unreasonably cumulative or duplicative"; if it "can be obtained from some other source that is more convenient, less burdensome, or less expensive"; if "the party seeking discovery has had ample opportunity to obtain the information by discovery in the action"; and if "the proposed discovery is outside the scope permitted by *Rule 26(b)(1)*." *Fed. R. Civ. P. 26(b)(1)-(2)*.

Furthermore, subpoenas "issued under *Rule 45 of the Federal Rules of Civil Procedure* are subject to *Rule 26(b)(1)*'s overriding relevance requirement." *During v. City Univ. of N.Y., No. 05-cv-06992 (RCC), 2006 U.S. Dist. LEXIS 53684, 2006 WL 2192843, at *2 (S.D.N.Y. Aug. 1, 2006)*. If the party issuing the subpoena establishes the relevance of the materials sought, the party moving to quash must demonstrate that it poses an [*6] undue burden. See *Griffith v. United States, No. M8-85 (JFK), 2007 U.S. Dist. LEXIS 36672, 2007 WL 1222586, at *2 (S.D.N.Y. Apr. 25, 2007)*. "Whether a subpoena imposes an undue burden depends upon such factors as relevance, the need of the party for the documents, the breadth of the documents, the time period covered by it, the particularity with which the documents are described and the burden imposed." *Night Hawk Ltd. v. Briarpatch Ltd., No. 03-cv-01382 (RWS), 2003 U.S. Dist. LEXIS 23179, 2003 WL 23018833, at *8 (S.D.N.Y. Dec. 23, 2003)*. Trial courts have broad discretion to determine if a subpoena imposes an undue burden. See *Jones v. Hirschfeld, 219 F.R.D. 71, 74 (S.D.N.Y. 2003)*.

II. Application

The SEC argues that the Individual Defendants' personal financial records are relevant to its claims because, under *Section 5 of the Securities Act*, "each sale of a security must either be made pursuant to a registration statement or fall under a registration exemption"—making *each* of the Individual Defendants' sales of XRP a possible *Section 5* violation. See ECF No. 72 at 3 (quoting *SEC v. Cavanagh, 155 F.3d 129, 133 (2d Cir. 1998)*) (cleaned up). The SEC claims that the Individual Defendants' personal financial statements would show deposits from cryptocurrency exchanges,[4] representing the "simplest and most reliable way to deanonymize [the] Individual Defendants' XRP transactions." ECF No. 72 at 3. The Individual Defendants counter that they have already agreed to produce [*7] (and have begun to produce) all of the trading records relating to the sales and transfer of their XRP holdings, as well as any financial records concerning compensation they received from Ripple—as XRP or otherwise.

To the extent that the Individual Defendants' personal financial records contain relevant information showing that the Individual Defendants transferred or sold XRP, the Defendants have already agreed to provide such records to the SEC. The SEC's Requests for Production and third-party subpoenas make broader requests, however, that would result in the disclosure of an

[4] Cryptocurrency exchanges are businesses that allow customers to trade cryptocurrencies for other assets, such as fiat money or other digital assets. See, e.g., What is a Crypto Wallet?, Coinbase.com, https://www.coinbase.com/learn/tips-and-tutorials/how-to-send-crypto. Exchanges often host users'"crypto wallets," containing a public and a private key that, through a complex mathematical process, allows only that user to transfer cryptocurrency from the wallet. See What is a Private Key?, Coinbase.com, https://www.coinbase.com/learn/crypto-basics/what-is-a-private-key.

immense trove of private financial information with no relevance to whether the Individual Defendants offered or sold XRP into the public market or promoted its sale to potential investors. And although the SEC argues that it has no interest in the individual Defendants' private transactions unrelated to XRP (e.g., grocery receipts), and that it is willing to further limit its requests, the proposed limited requests are not before the Court.

Insofar as the SEC seeks the personal financial records to verify that the records the Individual Defendants [*8] agreed to provide are complete, the Court finds no evidence to suggest that such a verification is necessary or appropriate. The SEC does not allege that the Individual Defendants have misrepresented their records, and it has not shown that the records that have been promised are lacking the information necessary to support its claims in any meaningful way. Indeed, this case is in its beginning stages, and the SEC's rush to serve requests and subpoenas seeking duplicative information of records already promised is premature at best.

The most compelling reason the SEC provides for why these banking records are necessary to prove *Section 5* violations is that the Individual Defendants may have moved the XRP from the identifiable digital addresses (or "crypto wallets") linked to their banking or cryptocurrency exchange accounts, into other pseudonymous or anonymous crypto wallets. It argues that the Individual Defendants could use such pseudonymous accounts to make offers or sales of XRP to the public undetected. See Mar. 19, 2021 Hearing Transcript ("Tr.") 41:10-42:11. The SEC reasons that, because the records the Individual Defendants have agreed to share would not show sales from pseudonymous [*9] or anonymous accounts necessarily, the only way to verify such sales is by tracing their proceeds back to the Individual Defendants. The SEC argues that, because such proceeds must be converted into fiat currency to be of use to the Individual Defendants, they would need to transfer them from cryptocurrency exchanges into their bank accounts, which would show a deposit date, amount, and the name of the depositing exchange. See Tr. 37:18-39:08. The SEC argues that such deposits are the most reliable record of individual offers or sales of XRP.

The SEC's argument presents several problems. First, the Individual Defendant's bank records might reflect a given deposit from a cryptocurrency exchange (e.g., Coinbase) on a certain date—but, by the SEC's own admission, that is all it would show.[5] It would not detail whether that deposit was the result of XRP sales, Bitcoin sales, sales of some other type of cryptocurrency, or even a withdrawal of U.S. dollars previously deposited into that Coinbase account. Furthermore, unless the Individual Defendant's bank deposits from Coinbase listed a particular XRP wallet address, it would be impossible from the bank records alone to determine whether the [*10] Coinbase transfer came from the Individual Defendant's known XRP wallet or from the presumed pseudonymous wallet. Perhaps most importantly, without more information from Coinbase, the SEC could not determine if the deposit was the result of one or more XRP transactions. Accordingly, the Court is not convinced that the personal banking records would show (or even could show) what the SEC claims they would—individual violations of *Section 5*.

Second, the SEC's "stress-test" argument assumes facts that have not yet been established. The SEC has not presented any evidence the Individual Defendants have hidden transactions or that the documents produced support an inference of hidden transactions. Furthermore, Defendant Larsen's counsel stated at oral argument that if the SEC "has a problem identifying . . . a transaction" on the XRP Ledger, that he would be "glad to explain it." See Tr. at 68:24-69:07. The SEC's belief that the Individual Defendants' banking records might show evidence of a speculative transaction that could have occurred (and that the Individual Defendants are not providing in their XRP transaction records) is not a foundation on which to order expansive discovery into personal [*11] financial accounts.

Additionally, the SEC argues that the personal financial records at issue are relevant to showing the extent to which the Individual Defendants personally funded efforts to promote a "reasonable expectation of profit" for XRP's investors, necessary to prove the alleged *Section 5* violations. See *Howey, 328 U.S. at 298-99*. Citing an unpublished order in which Judge Castel did not present his reasoning, the SEC proposes that the Individual Defendants should be compelled to provide their personal bank records as evidence of such promotion efforts. See S.E.C. v. Telegram Grp., Inc.,

[5] The SEC named Coinbase, a popular cryptocurrency exchange, at oral argument, though it alleges that the Individual Defendants used several different crypto exchanges for their transactions. For clarity, Coinbase is used as the hypothetical exchange, without any factual significance attached. See Tr. at 38:07-38:24.

No. 19-cv-09439, ECF No. 67 (S.D.N.Y. Jan. 13, 2020). The Court finds that Telegram is distinguishable, however, especially in light of the Individual Defendants' willingness to provide the SEC with records of their XRP transactions and sales in this case, whereas the Telegram defendant claimed that foreign privacy laws shielded its records from disclosure. See id. at ECF No. 61. Furthermore, the Court agrees with the Individual Defendants that the disclosure of corporate bank records at issue in Telegram was of a different character than the personal financial records at issue here.

Finally, the SEC contends that it is entitled [*12] to obtain the Individual Defendants' personal financial records to prove that they had a personal financial motive to aid and abet Ripple in offering or selling unregistered securities. Relying on S.E.C. v. Am. Growth Funding II, LLC, it argues that these personal financial records showing "what proportion of the Individual Defendant's income was comprised of proceeds from XRP sales" could help a factfinder assess whether the Individual Defendants sold their XRP holdings in good faith, or whether they had a motive to purposefully ignore evidence that XRP may be considered a security. See *No. 16-cv-00828 (KMW), 2019 U.S. Dist. LEXIS 67421, 2019 WL 1748186, at *4 (S.D.N.Y. Apr. 19, 2019)*; ECF No. 72 at *4.

The Court is not persuaded that the SEC should be entitled to obtain the entirety of the Individual Defendants' personal financial records over an eight-year period for the purpose of bolstering its "proportional" financial motive argument. The SEC has alleged that the Individual Defendants gained more than half a billion dollars from their sales of XRP. See, e.g., ECF No. 46 at ¶ 6. Such an extraordinary sum surely is great enough to make the same "motive" argument, regardless of whether it represented 95% or 5% of the Individual Defendants' wealth.

Additionally, [*13] the Court finds that the Individual Defendants distinguished the authorities upon which the SEC relies from the case at hand, noting that they involved individuals and businesses who were accused of intent to defraud, unlike here. See, e.g., *S.E.C. v. eSmart Tech, No. 11-cv-00895, 63 A.3d 572, 2013 WL 1233681, at *2 (D.D.C. Oct. 24, 2013)* (granting SEC motion to compel bank records as relevant to scienter where the defendant was accused of diverting funds raised from investors to her personal bank account). The SEC argues that it cited these authorities only for the principle that bank records have been used as circumstantial evidence to support an inference of scienter. See Tr. 47:01-17. But it can be true that personal financial records provide evidence of scienter *in a fraud case* (the fact that investor funds were improperly transferred to a personal bank account) but would provide little insight into whether or not the Individual Defendants acted in good faith that XRP was not a security or did so knowingly or recklessly.

CONCLUSION

Accordingly, the Court finds that the SEC's requests for the Individual Defendants' personal financial records, apart from those records of XRP transactions that are already promised, are not relevant or proportional [*14] to the needs of the case. Accordingly, the Individual Defendants' motion is GRANTED. The SEC shall withdraw its Requests for Production seeking the Individual Defendants' personal financial records and withdraw its third-party subpoenas seeking the same. If, as discovery progresses, the SEC uncovers evidence that the Individual Defendants have not been forthcoming with records of their XRP transactions, it may provide such evidence to the Court and renew its application.

SO ORDERED.

/s/ Sarah Netburn

Sarah Netburn

United States Magistrate Judge

DATED: April 9, 2021

New York, New York

End of Document

EXHIBIT 4

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U.S. COMMODITY FUTURES TRADING COMMISSION, BITCOIN BASICS (2018), https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/oceo_bitcoinbasics0218.pdf.

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BITCOIN BASICS

What is Bitcoin?

Bitcoin is a convertible virtual currency. Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.

Is Bitcoin a commodity?

Yes, virtual currencies, such as Bitcoin, have been determined to be commodities under the Commodity Exchange Act (CEA).

Does the CFTC oversee Bitcoin?

The U.S. Commodity Futures Trading Commission's (CFTC) jurisdiction is implicated when a virtual currency is used in a derivatives contract, or if there is fraud or manipulation involving a virtual currency traded in interstate commerce.

What risks come with virtual currencies?

While virtual currencies have potential benefits, the market overall is largely unregulated, so beware. Virtual currencies:

- Are commonly targeted by hackers and fraudsters
- Have no assurance of recourse if stolen
- Involve e-wallets or storage that present cybersecurity risks
- Carry speculative risk plus fraud and manipulation risks

What do I do if I suspect fraud?

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How can I learn more?

Find the latest information and ways to protect yourself at: www.cftc.gov/bitcoin.

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EXHIBIT 5

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CFTC v. Hdr Glob. Trading Ltd., No. 1:20-cv-08132, 2022 U.S. Dist. LEXIS 82960 (S.D.N.Y. May 5, 2022)

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CFTC v. Hdr Global Trading Ltd.

United States District Court for the Southern District of New York

May 5, 2022, Decided; May 5, 2022, Filed

Case No. 1:20-cv-08132

Reporter
2022 U.S. Dist. LEXIS 82960 *; 2022 WL 1421479

COMMODITY FUTURES TRADING COMMISSION, Plaintiff v. HDR GLOBAL TRADING LIMITED, 100x HOLDINGS LIMITED, ABS GLOBAL TRADING LIMITED, SHINE EFFORT INC LIMITED, HDR GLOBAL SERVICES (BERMUDA) LIMITED, ARTHUR HAYES, BENJAMIN DELO, and SAMUEL REED, Defendants

Counsel: [*1] For Commodity Futures Trading Commission, Plaintiff: Elizabeth N Pendleton, U.S. Commodity Futures Trading Commission (IL), Chicago, IL; Joseph Curtis Platt, U.S. CFTC, Chicago, IL; Scott Robert Williamson, Commodity Futures Trading Commission, Chicago, IL; Carlin Metzger, U.S. Commodity Futures Trading Commission, Chicago, IL.

For HDR Global Trading Limited, 100x Holdings Limited, ABS Global Trading Limited, Shine Effort Inc Limited, HDR Global Services (Bermuda) Limited, Defendants: Kenneth M. Raisler, LEAD ATTORNEY, Kathleen Suzanne McArthur, Sullivan & Cromwell, LLP (NYC), New York, NY; Anthony Lewis, Sullivan and Cromwell(Los Angeles), Los Angeles, CA; Suniti Navin Mehta, Sullivan & Cromwell LLP, New York, NY.

For Arthur Hayes, Defendant: James Joseph Benjamin , Jr, LEAD ATTORNEY, Akin Gump Strauss Hauer & Feld LLP (NYC), New York, NY; Katherine Rachel Goldstein, Akin Gump Strauss Hauer & Feld LLP, New York, NY; Peter Ian Altman, Akin Gump Strauss Hauer & Feld, Los Angeles, CA.

For Samuel Reed, Defendant: Douglas Kent Yatter, LEAD ATTORNEY, Latham & Watkins LLP (NY), New York, NY; Jack McNeily, Latham & Watkins, Chicago, IL.

For United States Attorney - SDNY, Intervenor: Samuel Raymond, [*2] LEAD ATTORNEY, United States Attorney's Office, New York, NY.

Judges: Hon. Laura Taylor Swain, UNITED STATES DISTRICT JUDGE.

Opinion by: Laura Taylor Swain

Opinion

CONSENT ORDER FOR PERMANENT INJUNCTION, CIVIL MONETARY PENALTY, AND OTHER EQUITABLE RELIEF AGAINST DEFENDANT ARTHUR HAYES

I. INTRODUCTION

On October 1, 2020, Plaintiff Commodity Futures Trading Commission ("Commission" or "CFTC") filed a Complaint against Defendants HDR Global Trading Limited ("HDR"), 100x Holdings Limited (100x"), ABS Global Trading Limited ("ABS"), Shine Effort Inc Limited ("Shine"), and HDR Global Services (Bermuda) Limited ("HDR Services"), all doing business as "BitMEX" (collectively "BitMEX"), as well as BitMEX's co-founders Arthur Hayes ("Hayes"), Benjamin Delo ("Delo"), and Samuel Reed ("Reed"), (collectively "Defendants"), seeking injunctive and other equitable relief, as well as the imposition of civil penalties, for violations of the *Commodity Exchange Act ("Act")*, *7 U.S.C. §§ 1-26*, and the Commission's Regulations ("Regulations") promulgated thereunder, 17 C.F.R. pts. 1-190 (2021). ("Complaint," ECF No. 1.)[1] On August 10, 2021, the

[1] On October 1, 2020, the U.S. Attorney's Office for the Southern District of New York charged Hayes, Delo, and Reed, along with Greg Dwyer, with: (1) willfully causing a financial institution to violate the *Bank Secrecy Act*, in violation of *31 U.S.C. §§ 5318(h)(1)* and *(l)*, *5322(a)* and *(c)*; *31 C.F.R. §§ 1026.210* and *1026.220*; and *18 U.S.C. § 2*; and (2) conspiracy to commit the same offense, in violation of *18 U.S.C. § 371*. *United States v. Hayes, et al.*, 20 CR 500 (JGK) (S.D.N.Y.). On February 24, 2022, Hayes entered a guilty plea to Count One of the indictment. Delo and Reed have also

district court entered a consent order of permanent injunction against the five defendant companies doing business as BitMEX (ECF No. 62), leaving the action [*3] pending against the three individual defendants, Hayes, Delo and Reed.

II. CONSENTS AND AGREEMENTS

To effect settlement of all charges alleged in the Complaint against Defendant Arthur Hayes ("Hayes") without a trial on the merits or any further judicial proceedings, Hayes:

1. Consents to the entry of this Consent Order for Permanent Injunction, Civil Monetary Penalty, and Other Equitable Relief ("Consent Order");

2. Affirms that he has read and agreed to this Consent Order voluntarily, and that no promise, other than as specifically contained herein, or threat, has been made by the CFTC or any member, officer, agent, or representative thereof, or by any other person, to induce consent to this Consent Order;

3. Acknowledges proper service of the summons and Complaint;

4. Admits the jurisdiction of this Court over him for purposes of this settlement, and the subject matter of this action pursuant to *Section 6c* of the Act, *7 U.S.C. § 13a-1*;

5. Admits the jurisdiction of the Commission over the conduct and transactions at issue in this action pursuant to the Act;

6. Admits that venue properly lies with this Court pursuant to *7 U.S.C. § 13a-1(e)*;

7. Waives:

(a) Any and all claims that he may possess under the [*4] *Equal Access to Justice Act, 5 U.S.C. § 504* and *28 U.S.C. § 2412*, and/or the rules promulgated by the Commission in conformity therewith, Part 148 of the Regulations, 17 C.F.R. pt. 148 (2021), relating to, or arising from, this action;

(b) Any and all claims that he may possess under the Small Business Regulatory Enforcement Fairness Act of 1996, *Pub. L. No. 104-121, tit. II, §§ 201-253, 110 Stat. 847, 857-74* (codified as amended at *28 U.S.C. § 2412* and in scattered sections of 5 U.S.C. and 15 U.S.C.), relating to, or arising from, this action;

(c) Any claim of Double Jeopardy based upon the institution of this action or the entry in this action of any order imposing a civil monetary penalty or any other relief, including this Consent Order; and

(d) Any and all rights of appeal from this action;

8. Consents to the continued jurisdiction of this Court over him for the purpose of implementing and enforcing the terms and conditions of this Consent Order and for any other purpose relevant to this action, even if Hayes now or in the future resides outside this judicial district;

9. Agrees that he will not oppose enforcement of this Consent Order on the ground, if any exists, that it fails to comply with *Rule 65(d) of the Federal Rules of Civil Procedure* and hereby waives any objection based thereon;

10. Agrees that neither he nor any of his agents or employees under his authority or control shall take any action or make any public statement denying, [*5] directly or indirectly, any allegation in the Complaint or the Findings of Fact or Conclusions of Law in this Consent Order, or creating or tending to create the impression that the Complaint and/or this Consent Order is without a factual basis; provided, however, that nothing in this provision shall affect his: (a) testimonial obligations, or (b) right to take positions in other proceedings to which the Commission is not a party. Hayes shall comply with this agreement, and shall undertake all steps necessary to ensure that all of his agents and/or employees under his authority or control understand and comply with this agreement;

11. By consenting to the entry of this Consent Order, neither admits nor denies the allegations of the Complaint or any Findings of Fact or Conclusions of Law in this Consent Order, except the admissions in Paragraphs 4 and 5 above;

12. Admits the facts set forth during his February 24, 2022 plea allocution in *United States v. Hayes et al.*, 20 CR 500 (JGK) (S.D.N.Y.), a copy of which is attached to the parties' Joint Motion for Entry of Consent Order;

13. Consents to the use of the Findings of Fact or Conclusions of Law in this Consent Order in this proceeding [*6] and in any other proceeding brought by

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entered guilty pleas to Count One of the indictment. Hayes is scheduled to be sentenced on May 18, 2022. The criminal case remains pending against Dwyer as of the date of this Consent Order.

the Commission or to which the Commission is a party or claimant, and agrees that they shall be taken as true and correct and be given preclusive effect therein, without further proof;

14. Does not consent, however, to the use of this Consent Order, or the Findings of Fact or Conclusions of Law herein, as the sole basis for any other proceeding, including a proceeding in which the registration of any Defendant may be affected, brought by the Commission or to which the Commission is a party other than a: proceeding in bankruptcy or receivership; or proceeding to enforce the terms of this Consent Order;

15. Does not consent to the use of this Consent Order, or the Findings of Fact or Conclusions of Law herein, by any other party in any other proceeding; and

16. Agrees that no provision of this Consent Order shall in any way limit or impair the ability of any other person or entity to seek any legal or equitable remedy, if there is a basis in law and fact to do so, against Hayes in any other proceeding; provided, however, that Hayes does not agree that any provision of this Consent Order inures to the benefit of, or confers rights on, any other person [*7] or entity to seek any legal or equitable remedy that does not exist independently of this Consent Order, or that this Consent Order or any provision herein is admissible in any proceeding not involving the Commission.

III. FINDINGS OF FACT AND CONCLUSIONS OF LAW

The Court, being fully advised in the premises, finds that there is good cause for the entry of this Consent Order and that there is no just reason for delay. The Court therefore directs the entry of the following Findings of Fact, Conclusions of Law, permanent injunction, and equitable relief pursuant to *Section 6c* of the Act, *7 U.S.C. § 13a-1*, as set forth herein. The findings and conclusions in this Consent Order are not binding on any other party to this action.

A. Findings of Fact

The Parties to this Consent Order

17. Plaintiff **Commodity Futures Trading Commission** is the independent federal regulatory agency that is charged by Congress with administering and enforcing the Act and the Regulations.

18. Defendant **Arthur Hayes** is a co-founder and co-owner of BitMEX. Hayes has never been registered with the Commission in any capacity.

The BitMEX Trading Platform and Products

19. BitMEX is a peer-to-peer "crypto-products platform" that offers the trading of [*8] cryptocurrency derivatives, including derivatives on bitcoin, ether, and litecoin.

20. From November 2014 to October 1, 2020 (the "Relevant Period"), BitMEX operated as a common enterprise through a number of affiliated entities, including HDR, 100x, ABS, Shine, and HDR Services, acting through their officers, agents, or employees.

21. During the Relevant Period, BitMEX offered leveraged trading of cryptocurrency derivatives to retail (non-eligible contract participants ("non-ECPs")) and institutional customers through BitMEX's website, www.bitmex.com, and by direct connection to its trading engine servers via the BitMEX application programming interface ("API"). Customers in the U.S. placed orders to buy or sell contracts directly through BitMEX's user interfaces, including the website and API. During the Relevant Period, BitMEX acted as the counterparty to certain transactions on its platform.

22. On May 13, 2016, BitMEX launched its first swap product, a "perpetual bitcoin U.S. dollar leveraged swap product." On its website, BitMEX has described its "Perpetual Contract" (or "perpetual swap contract") as "a product similar to a traditional Futures Contract in how it trades."

23. During [*9] the Relevant Period, BitMEX conducted certain components of its business and maintained a presence in the U.S., including maintaining an office in New York from late 2017 until early 2019 and establishing a San Francisco office in 2017.

24. During the Relevant Period, BitMEX solicited orders from U.S.-based customers for futures, options, and swaps through its website and on social media that were available to and accessed by U.S.-based customers.

25. Throughout the Relevant Period, BitMEX's U.S. customers were able to access the BitMEX platform from the U.S.—either via API or through the BitMEX

website accessed on customers' own computers located in the U.S. via a virtual private network ("VPN"). BitMEX was aware that U.S. customers used VPNs to access the BitMEX platform.

26. During the Relevant Period, BitMEX offered, entered into, confirmed the execution of, and otherwise conducted activities relating to commodity option transactions in interstate commerce. These transactions were not executed on any registered board of trade, nor was BitMEX registered as a foreign board of trade.

27. During the Relevant Period, BitMEX solicited or accepted orders for the purchase or sale of commodities [*10] for future delivery; engaged in soliciting or accepting orders for swaps; engaged in soliciting or accepting orders for retail commodity transactions, and/or acted as a counterparty to those transactions; and, in connection with these activities, accepted money, securities, or property, including bitcoin, to margin, guarantee, or secure resulting trades on the BitMEX platform. In accordance with *Section 1(a)(47)(iii)* and *(vi)* of the Act, *7 U.S.C. §§ 1a(47) (iii)*, *(vi)*, the swaps solicited or accepted by BitMEX included "perpetual swaps" or "perpetual contracts" on bitcoin, ether, and litecoin. During the Relevant Period, BitMEX operated a facility for the trading of swaps—that is, a trading system or platform in which more than one market participant has the ability to execute or trade swaps with more than one other market participant on the system or platform—on digital assets including bitcoin, ether, and litecoin without registering with the CFTC as a designated contract market or a swap execution facility.

28. During the Relevant Period, BitMEX employed an inadequate supervisory system and failed to perform its supervisory duties diligently. Among other things, BitMEX failed to implement a customer identification program ("CIP"), [*11] including know-your-customer ("KYC") procedures to identify U.S. persons using the BitMEX platform—or determine the true identity of the vast majority of its customers, whether from the U.S. or elsewhere. BitMEX also failed to implement an adequate anti-money laundering ("AML") program, which is required to prevent or detect, among other things, terrorist financing or other criminal activity, and failed to implement procedures to determine whether a customer appears on lists of known or suspected terrorists or terrorist organizations such as those issued by the Treasury Department's Office of Foreign Assets Control ("OFAC").

Hayes' Control Over BitMEX

29. During the Relevant Period, Hayes, along with others, controlled the operations of BitMEX. Hayes was one of three co-founders of BitMEX and he was a co-owner of BitMEX. Hayes served as BitMEX's Chief Executive Officer and was primarily responsible for strategic decisions, business development, marketing, and management of the BitMEX enterprise.

30. Hayes, along with others, was involved in decisions concerning whether to pursue regulatory approval for the platform and whether to implement KYC or AML policies and procedures.

31. During [*12] the Relevant Period, employees managing BitMEX's business ultimately acted under the direction and control of Hayes, along with others.

B. Conclusions of Law

Jurisdiction and Venue

32. This Court possesses jurisdiction over this action pursuant to *28 U.S.C. § 1331* (codifying federal question jurisdiction) and *28 U.S.C. § 1345* (providing that U.S. district courts have original jurisdiction over civil actions commenced by the United States or by any agency expressly authorized to sue by Act of Congress). *Section 6c(a)* of the Act, *7 U.S.C. § 13a-1(a)*, provides that the Commission may bring actions for injunctive relief or to enforce compliance with the Act or any rule, regulation, or order thereunder in the proper district court of the United States whenever it shall appear to the Commission that any person has engaged, is engaging, or is about to engage in any act or practice constituting a violation of any provision of the Act or any rule, regulation, or order thereunder.

33. Venue properly lies with this Court pursuant to *7 U.S.C. § 13a-1(e)*.

Violations of the Act by BitMEX and Hayes

34. As set forth in the Order entered by this Court on August 10, 2021 (ECF No. 62), by the conduct described above, Defendants HDR, 100x, ABS, Shine, and HDR Services, all acting as a common [*13] enterprise and doing business as BitMEX:

a. offered to enter into, entered into, executed or confirmed the execution of transactions involving commodities for future delivery on its platform that was not designated as a contract market and thus violated *Section 4(a)* of the Act, *7 U.S.C. § 6(a)*;

b. offered to enter into, entered into, confirmed the execution of, maintained a position in, or otherwise conducted activity related to any transaction in interstate commerce that is a commodity option transaction not in compliance with and subject to the provisions of this Act, including any Commission rule, regulation, or order thereunder and thus violated Section 4c(b) of the Act, *7 U.S.C. § 6c(b)*, and *Regulation 32.2*, *17 C.F.R. § 32.2 (2021)*;

c. acted as an FCM without being registered with the Commission as required under the Act and thus violated Section 4d of the Act, *7 U.S.C. § 6d*;

d. operated a facility for the trading or processing of swaps without being registered as a swap execution facility or as a designated contract market and thus violated Section 5h(a)(1) of the Act, *7 U.S.C. § 7b-3(1)*, and *Regulation 37.3(a)(1)*, *17 C.F.R. § 37.3(a)(1) (2021)*;

e. failed to diligently supervise the handling by its officers, employees and agents of all commodity interest accounts carried by BitMEX and all other activities relating to its business as a registrant and thus violated [*14] *Regulation 166.3*, *17 C.F.R. § 166.3 (2021)*; and

f. failed to comply with the *Bank Secrecy Act* and certain related regulations which require that a customer identification program be adopted as part of a firm's *Bank Secrecy Act* compliance program and thus violated Regulation 42.2, *17 C.F.R. § 42.2 (2021)*.

35. Hayes is liable as a control person of BitMEX for these violations. Hayes controlled BitMEX, directly or indirectly, and did not act in good faith or knowingly induced, directly or indirectly, the foregoing acts of BitMEX in violation of the Act; therefore, pursuant to Section 13(b) of the Act, *7 U.S.C. § 13c(b)*, Hayes is liable for these violations by BitMEX.

IV. PERMANENT INJUNCTION

IT IS HEREBY ORDERED THAT:

36. Based upon and in connection with the foregoing conduct, pursuant to *Section 6c* of the Act, *7 U.S.C. § 13a-1*, Hayes is permanently restrained, enjoined, and prohibited from directly or indirectly:

a. offering to enter into retail commodity transactions, or contracts for the purchase or sale of bitcoin, litecoin, and ether for future delivery; entering into retail commodity transactions, or contracts for the purchase or sale of bitcoin, litecoin, and ether for future delivery; confirming the execution of retail commodity transactions, or contracts for the purchase or sale of bitcoin, litecoin, [*15] and ether for future delivery; and conducting an office or business in the U.S. for the purpose of soliciting, or accepting any order for, or otherwise dealing in, any transaction in, or in connection with, retail commodity transactions or contracts for the purchase or sale of bitcoin, litecoin, and ether for future delivery without conducting such futures transactions on or subject to the rules of a board of trade that is designated or registered by the CFTC as a contract market, in violation of Section 4(a) of the Act, *7 U.S.C. § 6(a)*.

b. offering to enter into, entering into, confirming the execution of, maintaining positions in, or otherwise conducting activities relating to commodity option transactions in interstate commerce which do not comply with the Act or any Regulations, in violation of Section 4c(b) of the Act, *7 U.S.C. § 6c(b)*, and *Regulation 32.2*, *17 C.F.R. § 32.2 (2021)*.

c. engaging in soliciting or accepting orders for the purchase or sale of commodities for future delivery, engaging in soliciting or accepting orders for swaps, engaging in soliciting or accepting orders for agreements, contracts or transactions described in Section 2(c)(2)(D)(i) of the Act, *7 U.S.C. § 2(c)(2)(D)(i)* (retail commodity transactions), and/or acting as a counterparty in agreements, contracts, or [*16] transactions described in *7 U.S.C. § 2(C)(2)(D)(i)*, and, in connection with these activities, accepting money, securities, or property (or extended credit in lieu thereof) to margin, guarantee, or secure resulting trades, in violation of Section 4d of the Act, *7 U.S.C. § 6d*.

d. operating a facility for the trading of swaps—that is, a trading system or platform in which more than one market participant has the ability to execute or

trade swaps with more than one other market participant on the system or platform— on digital assets including bitcoin, ether, and litecoin without registering with the CFTC as a designated contract market or a swap execution facility in violation of Section 5h(a)(1) of the Act, *7 U.S.C. § 7b-3(1)*, and *Regulation 37.3(a)(1)*, *17 C.F.R. § 37.3(a)(1) (2021)*.

e. failing to perform supervisory duties diligently, in particular by failing to implement a Customer Identification Program, failing to implement and conduct Know-Your-Customer procedures, failing to implement Anti-Money Laundering procedures, and by failing to ensure that his partners, officers, employees, and agents lawfully and appropriately handle all commodity interest accounts, in violation of *Regulation 166.3*, *17 C.F.R. § 166.3 (2021)*.

f. failing to implement a Customer Identification Program, failing to implement Know-Your-Customer policies and procedures, [*17] failing to implement an Anti-Money Laundering program, failing to retain required customer information, and failing to implement procedures to determine whether a customer appears on lists of known or suspected terrorists or terrorist organizations such as those issued by the OFAC, in violation of Regulation 42.2, *17 C.F.R. § 42.2 (2021)*.

V. MONETARY AND OTHER EQUITABLE RELIEF

A. Civil Monetary Penalty

37. Hayes shall pay a civil monetary penalty in the amount of Ten Million Dollars ($10,000,000) ("CMP Obligation"). If the CMP Obligation is not paid within ten business days of the date of entry of this Consent Order, then post-judgment interest shall accrue on the CMP Obligation beginning on the date of entry of this Consent Order and shall be determined by using the Treasury Bill rate prevailing on the date of entry of this Consent Order pursuant to *28 U.S.C. § 1961*.

38. Hayes shall pay the CMP Obligation, as well as any post-judgment interest, by electronic funds transfer, U.S. postal money order, certified check, bank cashier's check, or bank money order. If payment is to be made other than by electronic funds transfer, then the payment shall be made payable to the Commodity Futures Trading Commission and sent [*18] to the address below:

MMAC/ESC/AMK326
Commodity Futures Trading Commission
6500 S. MacArthur Blvd.
HQ Room 266
Oklahoma City, OK 73169
9-amc-ar-cftc@faa.gov

If payment by electronic funds transfer is chosen, Hayes or his agent shall contact Tonia King or her successor at the address above to receive payment instructions and shall fully comply with those instructions. Hayes or his agent shall accompany payment of the CMP Obligation with a cover letter that identifies him as payor and the name and docket number of this proceeding. Hayes or his agent shall simultaneously transmit copies of the cover letter and the form of payment to the Chief Financial Officer, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581.

B. Provisions Related to Monetary Sanctions

39. Partial Satisfaction: Acceptance by the Commission of any partial payment of Hayes' CMP Obligation shall not be deemed a waiver of his obligation to make further payments pursuant to this Consent Order, or a waiver of the Commission's right to seek to compel payment of any remaining balance.

VI. MISCELLANEOUS PROVISIONS

40. Until such time as Hayes satisfies in full his CMP Obligation, [*19] this Consent Order, upon the commencement by or against Hayes of insolvency, receivership or bankruptcy proceedings or any other proceedings for the settlement of any of Hayes' debts, all notices to creditors required to be furnished to the Commission under Title 11 of the United States Code or other applicable law with respect to such insolvency, receivership bankruptcy or other proceedings, shall be sent to the address below:

Secretary of the Commission
Legal Division
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street N.W.
Washington, DC 20581

41. Notice: All notices and certifications required to be given by any provision in this Consent Order, except as set forth in paragraph 40, above, shall be sent by email

and by certified mail as follows:

Notice to Commission:
Robert T. Howell, Deputy Director
Commodity Futures Trading Commission, Chicago Regional Office
Metcalfe Federal Building
77 W. Jackson Blvd., Suite 800
Chicago, IL 60604
RHowell@cftc.gov
Notice to Hayes:
James J. Benjamin Jr.
Akin Gump Strauss Hauer & Feld LLP
One Bryant Park
Bank of America Tower
New York, NY 10036-6745
JBenjamin@AkinGump.com

All such notices to the Commission shall reference the name and docket [*20] number of this action.

42. Change of Address/Phone: Until such time as Hayes satisfies in full his CMP Obligation as set forth in this Consent Order, Hayes shall provide written notice to the Commission by certified mail of any change to his telephone number and mailing address within ten calendar days of the change.

43. Entire Agreement and Amendments: This Consent Order incorporates all of the terms and conditions of the settlement among the parties hereto to date. Nothing shall serve to amend or modify this Consent Order in any respect whatsoever, unless: (a) reduced to writing; (b) signed by all parties hereto; and (c) approved by order of this Court.

44. Invalidation: If any provision of this Consent Order or if the application of any provision or circumstance is held invalid, then the remainder of this Consent Order and the application of the provision to any other person or circumstance shall not be affected by the holding.

45. Waiver: The failure of any party to this Consent Order at any time to require performance of any provision of this Consent Order shall in no manner affect the right of the party at a later time to enforce the same or any other provision of this Consent Order. [*21] No waiver in one or more instances of the breach of any provision contained in this Consent Order shall be deemed to be or construed as a further or continuing waiver of such breach or waiver of the breach of any other provision of this Consent Order.

46. Continuing Jurisdiction of this Court: This Court shall retain jurisdiction of this action to ensure compliance with this Consent Order and for all other purposes related to this action, including any motion by Hayes to modify or for relief from the terms of this Consent Order.

47. Injunctive and Equitable Relief Provisions: The injunctive and equitable relief provisions of this Consent Order shall be binding upon Hayes, upon any person under his authority or control, and upon any person who receives actual notice of this Consent Order, by personal service, e-mail, facsimile, or otherwise insofar as he or she is acting in active concert or participation with Hayes.

48. Counterparts and Facsimile Execution: This Consent Order may be executed in two or more counterparts, all of which shall be considered one and the same agreement and shall become effective when one or more counterparts have been signed by each of the parties hereto and [*22] delivered (by facsimile, e-mail, or otherwise) to the other party, it being understood that all parties need not sign the same counterpart. Any counterpart or other signature to this Consent Order that is delivered by any means shall be deemed for all purposes as constituting good and valid execution and delivery by such party of this Consent Order.

49. Contempt: Hayes understands that the terms of the Consent Order are enforceable through contempt proceedings, and that, in any such proceedings he may not challenge the validity of this Consent Order.

50. Agreements and Undertakings: Hayes shall comply with all of the undertakings and agreements set forth in this Consent Order.

There being no just reason for delay, the Clerk of the Court is hereby ordered to enter this *Consent Order for Injunctive Relief, Civil Monetary Penalty, and Other Equitable Relief Against Defendant Arthur Hayes* forthwith and without further notice.

IT IS SO ORDERED on this 5th day of May, 2022.

/s/ Laura Taylor Swain

UNITED STATES DISTRICT JUDGE

End of Document

EXHIBIT 6

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Responsible Financial Innovation Act, S. 4356, 117th Cong. (2022)

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S.4356 - Lummis-Gillibrand Responsible Financial Innovation Act

117th Congress (2021-2022) | Get alerts

BILL Hide Overview

Sponsor: Sen. Lummis, Cynthia M. [R-WY] (Introduced 06/07/2022)

Committees: Senate - Finance

Committee Meetings: 07/28/22 10:00AM

Latest Action: Senate - 07/28/2022 Committee on Banking, Housing, and Urban Affairs. Hearings held. (All Actions)

Tracker: Introduced | Passed Senate | Passed House | To President | Became Law

More on This Bill

CBO Cost Estimates [0]

Subject — Policy Area:

Finance and Financial Sector

View subjects »

Give Feedback on This Bill

Contact Your Member

Summary (0) | Text (1) | Actions (2) | Titles (2) | Amendments (0) | Cosponsors (1) | Committees (2) | Related Bills (0)

Summary: S.4356 — 117th Congress (2021-2022)

All Information (Except Text)

A summary is in progress.

EXHIBIT 7

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Heather Morton, *Cryptocurrency 2022 Legislation*, NCSL (June 7, 2022), https://www.ncsl.org/research/financial-services-and-commerce/cryptocurrency-2022-legislation.aspx

****

Legislation

6/7/2022 Heather Morton

Digital or virtual currencies are a medium of exchange but are not regular money.

Unlike dollar bills and coins, cryptocurrencies are not issued or backed by the U.S. government or any other government or central bank. The lack of a physical token to count and hold may confuse some. Rather, Bitcoin and other cryptocurrencies are a form of digital currency used in electronic payment transactions—no coins, paper money or banks are involved; there are zero to minimal transaction fees; transactions are fast and not bound by geography; and, similar to using cash, transactions are anonymous.

Digital currencies are stored in digital wallets, which are software or apps installed by users on their computer or mobile device.

Each digital wallet contains encrypted information, called public and private keys, that is used to send and receive the digital currency. All digital currency transactions are recorded in a virtual public ledger called the "blockchain," which is maintained by digital currency "miners." These miners can be anyone, anywhere in the world, who is willing to invest in the specialized computer hardware needed to rapidly process complex computations. Miners are awarded digital currency, like Bitcoin, Ripple, Dogecoin, and Litecoin, in exchange for verifying each transaction and adding it to the blockchain.

Thirty-seven states have addressed legislation regarding cryptocurrency, digital or virtual currencies and other digital assets in the 20[illegible] legislative session.

currencies and other digital assets in the 2022 legislative session.

Examples of enacted legislation include:

- Connecticut required the Board of Regents for Higher Education to develop seminar programs to assist small businesses with adapting to the business environment in the aftermath of the COVID-19 pandemic through courses in subject areas, including, but not limited to, electronic commerce, social media, cybersecurity and virtual currency.
- Indiana enacted legislation adding a new chapter to the Uniform Commercial Code (UCC) that governs transactions involving controllable electronic records.
- South Dakota required a licensee transmitting virtual currencies shall hold like-kind virtual currencies of the same volume as that held by the licensee but that is obligated to consumers, in lieu of the permissible investments otherwise required.
- Washington and West Virginia updated their unclaimed property laws to include virtual currencies.
- Wyoming amended statutory provisions regulating decentralized autonomous organizations.

EXCERPTED FROM: https://www.ncsl.org/research/financial-services-and-commerce/cryptocurrency-2022-legislation.aspx

EXHIBIT 8

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N.Y. COMP. CODES R. & REGS. tit. 20, §§ 200.1–200.22

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23 NYCRR Part 200 Notes

This document reflects those changes received from the NY Bill Drafting Commission through July 8, 2022

NY - New York Codes, Rules and Regulations > TITLE 23. DEPARTMENT OF FINANCIAL SERVICES > CHAPTER I. REGULATIONS OF THE SUPERINTENDENT OF FINANCIAL SERVICES > PART 200. VIRTUAL CURRENCIES

Part 200 Notes

Statutory Authority

Statutory Authority:

Financial Services Law, sections 102, 104, 201, 206, 301, 302, 309, and 408

History

Added Part 200 on 6/24/15.

NEW YORK CODES, RULES AND REGULATIONS

End of Document

23 NYCRR § 200.1

This document reflects those changes received from the NY Bill Drafting Commission through July 8, 2022

NY - New York Codes, Rules and Regulations > TITLE 23. DEPARTMENT OF FINANCIAL SERVICES > CHAPTER I. REGULATIONS OF THE SUPERINTENDENT OF FINANCIAL SERVICES > PART 200. VIRTUAL CURRENCIES

§ 200.1 Introduction

This Part contains regulations relating to the conduct of business involving Virtual Currency, as defined herein, in accordance with the superintendent's powers pursuant to the above-stated authority.

History

Added 200.1 on 6/24/15.

NEW YORK CODES, RULES AND REGULATIONS

End of Document

23 NYCRR § 200.2

This document reflects those changes received from the NY Bill Drafting Commission through July 8, 2022

NY - New York Codes, Rules and Regulations > TITLE 23. DEPARTMENT OF FINANCIAL SERVICES > CHAPTER I. REGULATIONS OF THE SUPERINTENDENT OF FINANCIAL SERVICES > PART 200. VIRTUAL CURRENCIES

§ 200.2 Definitions

For purposes of this Part only, the following definitions shall apply:

(a) Affiliate means any Person that directly or indirectly controls, is controlled by, or is under common control with, another Person;

(b) Cyber Security Event means any act or attempt, successful or unsuccessful, to gain unauthorized access to, disrupt, or misuse a Licensee's electronic systems or information stored on such systems;

(c) Department means the New York State Department of Financial Services;

(d) Exchange Service means the conversion or exchange of Fiat Currency or other value into Virtual Currency, the conversion or exchange of Virtual Currency into Fiat Currency or other value, or the conversion or exchange of one form of Virtual Currency into another form of Virtual Currency;

(e) Fiat Currency means government-issued currency that is designated as legal tender in its country of issuance through government decree, regulation, or law;

(f) Licensee means any Person duly licensed by the superintendent pursuant to this Part;

(g) New York means the State of New York;

(h) New York Resident means any Person that resides, is located, has a place of business, or is conducting business in New York;

(i) Person means an individual, partnership, corporation, association, joint stock association, trust, or other entity, however organized;

(j) Prepaid Card means an electronic payment device that: (i) is usable at a single merchant or an affiliated group of merchants that share the same name, mark, or logo, or is usable at multiple, unaffiliated merchants or service providers; (ii) is issued in and for a specified amount of Fiat Currency; (iii) can be reloaded in and for only Fiat Currency, if at all; (iv) is issued and/or reloaded on a prepaid basis for the future purchase or delivery of goods or services; (v) is honored upon presentation; and (vi) can be redeemed in and for only Fiat Currency, if at all;

(k) Principal Officer means an executive officer of an entity, including, but not limited to, the chief executive, financial, operating, and compliance officers, president, general counsel, managing partner, general partner, controlling partner, and trustee, as applicable;

(l) Principal Stockholder means any Person that directly or indirectly owns, controls, or holds with power to vote ten percent or more of any class of outstanding capital stock or other equity interest of an entity or possesses the power to direct or cause the direction of the management or policies of the entity;

(m) Principal Beneficiary means any Person entitled to ten percent or more of the benefits of a trust;

(n) Qualified Custodian means a bank, trust company, national bank, savings bank, savings and loan association, federal savings association, credit union, or federal credit union in the State of New York,

subject to the prior approval of the superintendent. To the extent applicable, terms used in this definition shall have the meaning ascribed by the Banking Law;

(o) Transmission means the transfer, by or through a third party, of Virtual Currency from a Person to a Person, including the transfer from the account or storage repository of a Person to the account or storage repository of a Person;

(p) Virtual Currency means any type of digital unit that is used as a medium of exchange or a form of digitally stored value. Virtual Currency shall be broadly construed to include digital units of exchange that (i) have a centralized repository or administrator; (ii) are decentralized and have no centralized repository or administrator; or (iii) may be created or obtained by computing or manufacturing effort. Virtual Currency shall not be construed to include any of the following:

(1) digital units that (i) are used solely within online gaming platforms, (ii) have no market or application outside of those gaming platforms, (iii) cannot be converted into, or redeemed for, Fiat Currency or Virtual Currency, and (iv) may or may not be redeemable for real-world goods, services, discounts, or purchases.

(2) digital units that can be redeemed for goods, services, discounts, or purchases as part of a customer affinity or rewards program with the issuer and/or other designated merchants or can be redeemed for digital units in another customer affinity or rewards program, but cannot be converted into, or redeemed for, Fiat Currency or Virtual Currency; or

(3) digital units used as part of Prepaid Cards;

(q) Virtual Currency Business Activity means the conduct of any one of the following types of activities involving New York or a New York Resident:

(1) receiving Virtual Currency for Transmission or Transmitting Virtual Currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of Virtual Currency;

(2) storing, holding, or maintaining custody or control of Virtual Currency on behalf of others;

(3) buying and selling Virtual Currency as a customer business;

(4) performing Exchange Services as a customer business; or

(5) controlling, administering, or issuing a Virtual Currency. The development and dissemination of software in and of itself does not constitute Virtual Currency Business Activity.

History

Added 200.2 on 6/24/15.

23 NYCRR § 200.3

This document reflects those changes received from the NY Bill Drafting Commission through July 8, 2022

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§ 200.3 License

(a) License required. No Person shall, without a license obtained from the superintendent as provided in this Part, engage in any Virtual Currency Business Activity. Licensees are not authorized to exercise fiduciary powers, as defined under *section 100 of the Banking Law*.

(b) Unlicensed agents prohibited. Each Licensee is prohibited from conducting any Virtual Currency Business Activity through an agent or agency arrangement when the agent is not a Licensee.

(c) Exemption from licensing requirements. The following Persons are exempt from the licensing requirements otherwise applicable under this Part:

(1) Persons that are chartered under the New York Banking Law and are approved by the superintendent to engage in Virtual Currency Business Activity; and

(2) merchants and consumers that utilize Virtual Currency solely for the purchase or sale of goods or services or for investment purposes.

History

Added 200.3 on 6/24/15.

NEW YORK CODES, RULES AND REGULATIONS

End of Document

§ 200.4 Application

(a) Application for a license required under this Part shall be in writing, under oath, and in a form prescribed by the superintendent, and shall contain the following:

(1) the exact name of the applicant, including any doing business as name, the form of organization, the date of organization, and the jurisdiction where organized or incorporated;

(2) a list of all of the applicant's Affiliates and an organization chart illustrating the relationship among the applicant and such Affiliates;

(3) a list of, and detailed biographical information for, each individual applicant and each director, Principal Officer, Principal Stockholder, and Principal Beneficiary of the applicant, as applicable, including such individual's name, physical and mailing addresses, and information and documentation regarding such individual's personal history, experience, and qualification, which shall be accompanied by a form of authority, executed by such individual, to release information to the department;

(4) a background report prepared by an independent investigatory agency acceptable to the superintendent for each individual applicant, and each Principal Officer, Principal Stockholder, and Principal Beneficiary of the applicant, as applicable;

(5) for each individual applicant; for each Principal Officer, Principal Stockholder, and Principal Beneficiary of the applicant, as applicable; and for all individuals to be employed by the applicant who have access to any customer funds, whether denominated in Fiat Currency or Virtual Currency: (i) a set of completed fingerprints, or a receipt indicating the vendor (which vendor must be acceptable to the superintendent) at which, and the date when, the fingerprints were taken, for submission to the State Division of Criminal Justice Services and the Federal Bureau of Investigation; (ii) if applicable, such processing fees as prescribed by the superintendent; and (iii) two portrait-style photographs of the individuals measuring not more than two inches by two inches;

(6) an organization chart of the applicant and its management structure, including its Principal Officers or senior management, indicating lines of authority and the allocation of duties among its Principal Officers or senior management;

(7) a current financial statement for the applicant and each Principal Officer, Principal Stockholder, and Principal Beneficiary of the applicant, as applicable, and a projected balance sheet and income statement for the following year of the applicant's operation;

(8) a description of the proposed, current, and historical business of the applicant, including detail on the products and services provided and to be provided, all associated website addresses, the jurisdictions in which the applicant is engaged in business, the principal place of business, the primary market of operation, the projected customer base, any specific marketing targets, and the physical address of any operation in New York;

(9) details of all banking arrangements;

(10) all written policies and procedures required by, or related to, the requirements of this Part;

(11) an affidavit describing any pending or threatened administrative, civil, or criminal action, litigation, or proceeding before any governmental agency, court, or arbitration tribunal against the applicant or any of its directors, Principal Officers, Principal Stockholders, and Principal Beneficiaries, as applicable, including the names of the parties, the nature of the proceeding, and the current status of the proceeding;

(12) verification from the New York State Department of Taxation and Finance that the applicant is compliant with all New York State tax obligations in a form acceptable to the superintendent;

(13) if applicable, a copy of any insurance policies maintained for the benefit of the applicant, its directors or officers, or its customers;

(14) an explanation of the methodologies used to calculate the value of Virtual Currency in Fiat Currency; and

(15) such other additional information as the superintendent may require.

(b) As part of such application, the applicant shall demonstrate that it will be compliant with all of the requirements of this Part upon licensing.

(c) Notwithstanding subdivision (b) of this section, the superintendent may in his or her sole discretion and consistent with the purposes and intent of the Financial Services Law and this Part approve an application by granting a conditional license.

(1) A conditional license may be issued to an applicant that does not satisfy all of the regulatory requirements upon licensing.

(2) A Licensee that holds a conditional license may be subject to heightened review, whether in regard to the scope and frequency of examination or otherwise.

(3) Unless the superintendent removes the conditional status of or renews a conditional license, said license shall expire two years after its date of issuance.

(i) The superintendent may in his or her sole discretion and consistent with the purposes and intent of the Financial Services Law and this Part:

(A) renew a conditional license for an additional length of time; or

(B) remove the conditional status from a conditional license.

(4) A conditional license may be suspended or revoked pursuant to section 200.6 of this Part.

(5) A conditional license may impose any reasonable condition or conditions, as determined by the superintendent in his or her sole discretion.

(6) The superintendent may remove any condition or conditions from a conditional license that has been issued.

(7) In determining whether to issue a conditional license, renew or remove the conditional status of a conditional license, or impose or remove any specific conditions on a conditional license, the superintendent may consider any relevant factor or factors. Relevant factors may include but are not limited to:

(i) the nature and scope of the applicant's or Licensee's business;

(ii) the anticipated volume of business to be transacted by the applicant or Licensee;

(iii) the nature and scope of the risks that the applicant's or Licensee's business presents to consumers, Virtual Currency markets, financial markets, and the general public;

(iv) the measures which the applicant or Licensee has taken to limit or mitigate the risks its business presents;

(v) whether the applicant or Licensee is registered with FinCEN;

(vi) whether the applicant or Licensee is licensed, registered, or otherwise authorized by any governmental or self-regulatory authority to engage in financial services or other business activities;

(vii) the applicant's or Licensee's financial services or other business experience; and

(viii) the Licensee's history as a holder of a conditional license issued by the superintendent.

(d) The superintendent may permit that any application for a license under this Part, or any other submission required by this Part, be made or executed by electronic means.

History

Added 200.4 on 6/24/15.

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23 NYCRR § 200.5

This document reflects those changes received from the NY Bill Drafting Commission through July 8, 2022

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§ 200.5 Application fees

As part of an application for licensing under this Part, each applicant must submit an initial application fee, in the amount of five thousand dollars, to cover the cost of processing the application, reviewing application materials, and investigating the financial condition and responsibility, financial and business experience, and character and general fitness of the applicant. If the application is denied or withdrawn, such fee shall not be refunded. Each Licensee may be required to pay fees to the department to process additional applications related to the license.

History

Added 200.5 on 6/24/15.

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This document reflects those changes received from the NY Bill Drafting Commission through July 8, 2022

§ 200.6 Action by superintendent

(a) Generally. Upon the filing of an application for licensing under this Part, payment of the required fee, and demonstration by the applicant of its ability to comply with the provisions of this Part upon licensing, the superintendent shall investigate the financial condition and responsibility, financial and business experience, and character and general fitness of the applicant. If the superintendent finds these qualities are such as to warrant the belief that the applicant's business will be conducted honestly, fairly, equitably, carefully, and efficiently within the purposes and intent of this Part, and in a manner commanding the confidence and trust of the community, the superintendent shall advise the applicant in writing of his or her approval of the application, and shall issue to the applicant a license to conduct Virtual Currency Business Activity, subject to the provisions of this Part and such other conditions as the superintendent shall deem appropriate; or the superintendent may deny the application.

(b) Approval or denial of application. The superintendent shall approve or deny every application for a license hereunder within 90 days from the filing of an application deemed by the superintendent to be complete. Such period of 90 days may be extended at the discretion of the superintendent for such additional reasonable period of time as may be required to enable compliance with this Part. A license issued pursuant to this Part shall remain in full force and effect until it is surrendered by the Licensee, is revoked or suspended, or expires as provided in this Part.

(c) Suspension or revocation of license. The superintendent may suspend or revoke a license issued under this Part on any ground on which the superintendent might refuse to issue an original license, for a violation of any provision of this Part, for good cause shown, or for failure of the Licensee to pay a judgment, recovered in any court, within or without this State, by a claimant or creditor in an action arising out of, or relating to, the Licensee's Virtual Currency Business Activity, within thirty days after the judgment becomes final or within thirty days after expiration or termination of a stay of execution thereon; provided, however, that if execution on the judgment is stayed, by court order or operation of law or otherwise, then proceedings to suspend or revoke the license (for failure of the Licensee to pay such judgment) may not be commenced by the superintendent during the time of such stay, and for thirty days thereafter. "Good cause" shall exist when a Licensee has defaulted or is likely to default in performing its obligations or financial engagements or engages in unlawful, dishonest, wrongful, or inequitable conduct or practices that may cause harm to the public.

(d) Hearing. No license issued under this Part shall be revoked or suspended except after a hearing thereon. The superintendent shall give a Licensee no less than ten days' written notice of the time and place of such hearing by registered or certified mail addressed to the principal place of business of such Licensee. Any order of the superintendent suspending or revoking such license shall state the grounds upon which it is based and be sent by registered or certified mail to the Licensee at its principal place of business as shown in the records of the department.

(e) Preliminary injunction. The superintendent may, when deemed by the superintendent to be in the public interest, seek a preliminary injunction to restrain a Licensee from continuing to perform acts that violate any provision of this Part, the Financial Services Law, Banking Law, or Insurance Law.

(f) Preservation of powers. Nothing in this Part shall be construed as limiting any power granted to the superintendent under any other provision of the Financial Services Law, Banking Law, or Insurance Law, including any power to investigate possible violations of law, rule, or regulation or to impose penalties or take any other action against any Person for violation of such laws, rules, or regulations.

History

Added 200.6 on 6/24/15.

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23 NYCRR § 200.7

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§ 200.7 Compliance

(a) Generally. Each Licensee is required to comply with all applicable federal and state laws, rules, and regulations.

(b) Compliance officer. Each Licensee shall designate a qualified individual or individuals responsible for coordinating and monitoring compliance with this Part and all other applicable federal and state laws, rules, and regulations.

(c) Compliance policy. Each Licensee shall maintain and enforce written compliance policies, including policies with respect to anti-fraud, anti-money laundering, cyber security, privacy and information security, and any other policy required under this Part, which must be reviewed and approved by the Licensee's board of directors or an equivalent governing body.

History

Added 200.7 on 6/24/15.

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23 NYCRR § 200.8

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§ 200.8 Capital requirements

(a) Each Licensee shall maintain at all times such capital in an amount and form as the superintendent determines is sufficient to ensure the financial integrity of the Licensee and its ongoing operations based on an assessment of the specific risks applicable to each Licensee. In determining the minimum amount of capital that must be maintained by a Licensee, the superintendent may consider a variety of factors, including but not limited to:

(1) the composition of the Licensee's total assets, including the position, size, liquidity, risk exposure, and price volatility of each type of asset;

(2) the composition of the Licensee's total liabilities, including the size and repayment timing of each type of liability;

(3) the actual and expected volume of the Licensee's Virtual Currency Business Activity;

(4) whether the Licensee is already licensed or regulated by the superintendent under the Financial Services Law, Banking Law, or Insurance Law, or otherwise subject to such laws as a provider of a financial product or service, and whether the Licensee is in good standing in such capacity;

(5) the amount of leverage employed by the Licensee;

(6) the liquidity position of the Licensee;

(7) the financial protection that the Licensee provides for its customers through its trust account or bond;

(8) the types of entities to be serviced by the Licensee; and

(9) the types of products or services to be offered by the Licensee.

(b) Each Licensee shall hold capital required to be maintained in accordance with this section in the form of cash, virtual currency, or high-quality, highly liquid, investment-grade assets, in such proportions as are acceptable to the superintendent.

History

Added 200.8 on 6/24/15.

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23 NYCRR § 200.9

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§ 200.9 Custody and protection of customer assets

(a) Each Licensee shall maintain a surety bond or trust account in United States dollars for the benefit of its customers in such form and amount as is acceptable to the superintendent for the protection of the Licensee's customers. To the extent a Licensee maintains a trust account in accordance with this section, such trust account must be maintained with a Qualified Custodian.

(b) To the extent a Licensee stores, holds, or maintains custody or control of Virtual Currency on behalf of another Person, such Licensee shall hold Virtual Currency of the same type and amount as that which is owed or obligated to such other Person.

(c) Each Licensee is prohibited from selling, transferring, assigning, lending, hypothecating, pledging, or otherwise using or encumbering assets, including Virtual Currency, stored, held, or maintained by, or under the custody or control of, such Licensee on behalf of another Person except for the sale, transfer, or assignment of such assets at the direction of such other Person.

History

Added 200.9 on 6/24/15.

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23 NYCRR § 200.10

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§ 200.10 Material change to business

(a) Each Licensee must obtain the superintendent's prior written approval for any plan or proposal to introduce or offer a materially new product, service, or activity, or to make a material change to an existing product, service, or activity, involving New York or New York Residents.

(b) A "materially new product, service, or activity" or a "material change" may occur where:

(1) the proposed new product, service, or activity, or the proposed change may raise a legal or regulatory issue about the permissibility of the product, service, or activity;

(2) the proposed new product, service, or activity, or the proposed change may raise safety and soundness or operational concerns; or

(3) a change is proposed to an existing product, service, or activity that may cause such product, service, or activity to be materially different from that previously listed on the application for licensing by the superintendent.

(c) The Licensee shall submit a written plan describing the proposed materially new product, service, or activity, or the proposed material change, including a detailed description of the business operations, compliance policies, and the impact on the overall business of the Licensee, as well as such other information as requested by the superintendent.

(d) If a Licensee has any questions about the materiality of any proposed new product, service, or activity, or of any proposed change, the Licensee may seek clarification from the department prior to introducing or offering that new product, service, or activity or making that change.

History

Added 200.10 on 6/24/15.

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§ 200.11 Change of control; mergers and acquisitions

(a) Change of Control. No action shall be taken, except with the prior written approval of the superintendent, that may result in a change of control of a Licensee.

(1) Prior to any change of control, the Person seeking to acquire control of a Licensee shall submit a written application to the superintendent in a form and substance acceptable to the superintendent, including but not limited to detailed information about the applicant and all directors, Principal Officers, Principal Stockholders, and Principal Beneficiaries of the applicant, as applicable.

(2) For purposes of this section, the term "control" means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a Licensee whether through the ownership of stock of such Licensee, the stock of any Person that possesses such power, or otherwise. Control shall be presumed to exist if a Person, directly or indirectly, owns, controls, or holds with power to vote ten percent or more of the voting stock of a Licensee or of any Person that owns, controls, or holds with power to vote ten percent or more of the voting stock of such Licensee. No Person shall be deemed to control another Person solely by reason of his being an officer or director of such other Person.

(3) The superintendent may determine upon application that any Person does not or will not upon the taking of some proposed action control another Person. Such determination shall be made within 30 days or such further period as the superintendent may prescribe. The filing of an application pursuant to this subdivision in good faith by any Person shall relieve the applicant from any obligation or liability imposed by this section with respect to the subject of the application until the superintendent has acted upon the application. The superintendent may revoke or modify his or her determination, after notice and opportunity to be heard, whenever in his or her judgment revocation or modification is consistent with this Part. The superintendent may consider the following factors in making such a determination:

(i) whether such Person's purchase of common stock is made solely for investment purposes and not to acquire control over the Licensee;

(ii) whether such Person could direct, or cause the direction of, the management or policies of the Licensee;

(iii) whether such Person could propose directors in opposition to nominees proposed by the management or board of directors of the Licensee;

(iv) whether such Person could seek or accept representation on the board of directors of the Licensee;

(v) whether such Person could solicit or participate in soliciting proxy votes with respect to any matter presented to the shareholders of the Licensee; or

(vi) any other factor that indicates such Person would or would not exercise control of the Licensee.

(4) The superintendent shall approve or deny every application for a change of control of a Licensee hereunder within 120 days from the filing of an application deemed by the superintendent to be complete. Such period of 120 days may be extended by the superintendent, for good cause shown, for such additional reasonable period of time as may be required to enable compliance with the requirements and conditions of this Part.

(5) In determining whether to approve a proposed change of control, the superintendent shall, among other factors, take into consideration the public interest and the needs and convenience of the public.

(b) Mergers and Acquisitions. No action shall be taken, except with the prior written approval of the superintendent, that may result in a merger or acquisition of all or a substantial part of the assets of a Licensee.

(1) Prior to any such merger or acquisition, an application containing a written plan of merger or acquisition shall be submitted to the superintendent by the entities that are to merge or by the acquiring entity, as applicable. Such plan shall be in form and substance satisfactory to the superintendent, and shall specify each entity to be merged, the surviving entity, or the entity acquiring all or substantially all of the assets of the Licensee, as applicable, and shall describe the terms and conditions of the merger or acquisition and the mode of carrying it into effect.

(2) The superintendent shall approve or deny a proposed merger or a proposed acquisition of all or a substantial part of the assets of a Licensee within 120 days after the filing of an application that contains a written plan of merger or acquisition and is deemed by the superintendent to be complete. Such period of 120 days may be extended by the superintendent, for good cause shown, for such additional reasonable period of time as may be required to enable compliance with the requirements and conditions of this Part.

(3) In determining whether to so approve a proposed merger or acquisition, the superintendent shall, among other factors, take into consideration the public interest and the needs and convenience of the public.

History

Added 200.11 on 6/24/15.

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23 NYCRR § 200.12

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§ 200.12 Books and records

(a) Each Licensee shall, in connection with its Virtual Currency Business Activity, make, keep, and preserve all of its books and records in their original form or native file format for a period of at least seven years from the date of their creation and in a condition that will allow the superintendent to determine whether the Licensee is complying with all applicable laws, rules, and regulations. The books and records maintained by each Licensee shall, without limitation, include:

(1) for each transaction, the amount, date, and precise time of the transaction, any payment instructions, the total amount of fees and charges received and paid to, by, or on behalf of the Licensee, and the names, account numbers, and physical addresses of (i) the party or parties to the transaction that are customers or accountholders of the Licensee; and (ii) to the extent practicable, any other parties to the transaction;

(2) a general ledger containing all asset, liability, ownership equity, income, and expense accounts;

(3) bank statements and bank reconciliation records;

(4) any statements or valuations sent or provided to customers and counterparties;

(5) records or minutes of meetings of the board of directors or an equivalent governing body;

(6) records demonstrating compliance with applicable state and federal anti-money laundering laws, rules, and regulations, including customer identification and verification documents, records linking customers to their respective accounts and balances, and a record of all compliance breaches;

(7) communications and documentation related to investigations of customer complaints and transaction error resolution or concerning facts giving rise to possible violations of laws, rules, or regulations;

(8) all other records required to be maintained in accordance with this Part; and

(9) all other records as the superintendent may require.

(b) Each Licensee shall provide the department, upon request, immediate access to all facilities, books, records, documents, or other information maintained by the Licensee or its Affiliates, wherever located.

(c) Records of non-completed, outstanding, or inactive Virtual Currency accounts or transactions shall be maintained for at least five years after the time when any such Virtual Currency has been deemed, under the Abandoned Property Law, to be abandoned property.

History

Added 200.12 on 6/24/15.

End of Document

23 NYCRR § 200.13

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§ 200.13 Examinations

(a) Each Licensee shall permit and assist the superintendent to examine the Licensee whenever in the superintendent's judgment such examination is necessary or advisable, but not less than once every two calendar years, including, without limitation, to determine:

(1) the financial condition of the Licensee;

(2) the safety and soundness of the conduct of its business;

(3) the policies of its management;

(4) whether the Licensee has complied with the requirements of laws, rules, and regulations; and

(5) such other matters as the superintendent may determine, including, but not limited to, any activities of the Licensee outside the State of New York if in the opinion of the superintendent such activities may affect the Licensee's Virtual Currency Business Activity.

(b) Each Licensee shall permit and assist the superintendent at any time to examine all of the Licensee's books, records, accounts, documents, and other information.

(c) Each Licensee shall permit and assist the superintendent to make such special investigations as the superintendent shall deem necessary to determine whether a Licensee has violated any provision of the applicable laws, rules, or regulations and to the extent necessary shall permit and assist the superintendent to examine all relevant facilities, books, records, accounts, documents, and other information.

(d) For the purpose of determining the financial condition of the Licensee, its safety and soundness practices, or whether it has complied with the requirements of laws, rules, and regulations, the Licensee shall permit and assist the superintendent, when in the superintendent's judgment it is necessary or advisable, to examine an Affiliate of the Licensee.

History

Added 200.13 on 6/24/15.

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23 NYCRR § 200.14

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§ 200.14 Reports and financial disclosures

(a) Each Licensee shall submit to the superintendent quarterly financial statements within 45 days following the close of the Licensee's fiscal quarter in the form, and containing such information, as the superintendent shall prescribe, including without limitation, the following information:

(1) a statement of the financial condition of the Licensee, including a balance sheet, income statement, statement of comprehensive income, statement of change in ownership equity, cash flow statement, and statement of net liquid assets;

(2) a statement demonstrating compliance with any financial requirements established under this Part;

(3) financial projections and strategic business plans;

(4) a list of all off-balance sheet items;

(5) a chart of accounts, including a description of each account; and

(6) a report of permissible investments by the Licensee as permitted under this Part.

(b) Each Licensee shall submit audited annual financial statements, together with an opinion and an attestation by an independent certified public accountant regarding the effectiveness of the Licensee's internal control structure. All such annual financial statements shall include:

(1) a statement of management's responsibilities for preparing the Licensee's annual financial statements, establishing and maintaining adequate internal controls and procedures for financial reporting, and complying with all applicable laws, rules, and regulations;

(2) an assessment by management of the Licensee's compliance with such applicable laws, rules, and regulations during the fiscal year covered by the financial statements; and

(3) certification of the financial statements by an officer or director of the Licensee attesting to the truth and correctness of those statements.

(c) Each Licensee shall notify the superintendent in writing of any criminal action or insolvency proceeding against the Licensee or any of its directors, Principal Stockholders, Principal Officers, and Principal Beneficiaries, as applicable, immediately after the commencement of any such action or proceeding.

(d) Each Licensee shall notify the superintendent in writing of any proposed change to the methodology used to calculate the value of Virtual Currency in Fiat Currency that was submitted to the department in accordance with section 200.4 or this section.

(e) Each Licensee shall submit a report to the superintendent immediately upon the discovery of any violation or breach of law, rule, or regulation related to the conduct of activity licensed under this Part.

(f) Each Licensee shall make additional special reports to the superintendent, at such times and in such form, as the superintendent may request.

History

Added 200.14 on 6/24/15.

NEW YORK CODES, RULES AND REGULATIONS

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§ 200.15 Anti-money laundering program

(a) All values in United States dollars referenced in this section must be calculated using the methodology to determine the value of Virtual Currency in Fiat Currency that was provided to the department under this Part.

(b) Each Licensee shall conduct an initial risk assessment that will consider legal, compliance, financial, and reputational risks associated with the Licensee's activities, services, customers, counterparties, and geographic location and shall establish, maintain, and enforce an anti-money laundering program based thereon. The Licensee shall conduct additional assessments on an annual basis, or more frequently as risks change, and shall modify its anti-money laundering program as appropriate to reflect any such changes.

(c) The anti-money laundering program shall, at a minimum:

(1) provide for a system of internal controls, policies, and procedures designed to ensure ongoing compliance with all applicable anti-money laundering laws, rules, and regulations;

(2) provide for independent testing for compliance with, and the effectiveness of, the anti-money laundering program to be conducted by qualified internal personnel of the Licensee, who are not responsible for the design, installation, maintenance, or operation of the anti-money laundering program, or the policies and procedures that guide its operation, or a qualified external party, at least annually, the findings of which shall be summarized in a written report submitted to the superintendent;

(3) designate a qualified individual or individuals in compliance responsible for coordinating and monitoring day-to-day compliance with the anti-money laundering program; and

(4) provide ongoing training for appropriate personnel to ensure they have a fulsome understanding of anti-money laundering requirements and to enable them to identify transactions required to be reported and maintain records required to be kept in accordance with this Part.

(d) The anti-money laundering program shall include a written anti-money laundering policy reviewed and approved by the Licensee's board of directors or equivalent governing body.

(e) Each Licensee, as part of its anti-money laundering program, shall maintain records and make reports in the manner set forth below.

(1) Records of Virtual Currency transactions. Each Licensee shall maintain the following information for all Virtual Currency transactions involving the payment, receipt, exchange or conversion, purchase, sale, transfer, or transmission of Virtual Currency:

(i) the identity and physical addresses of the party or parties to the transaction that are customers or accountholders of the Licensee and, to the extent practicable, any other parties to the transaction;

(ii) the amount or value of the transaction, including in what denomination purchased, sold, or transferred;

(iii) the method of payment;

(iv) the date or dates on which the transaction was initiated and completed; and

(v) a description of the transaction.

(2) Reports on transactions. When a Licensee is involved in a Virtual Currency to Virtual Currency transaction or series of Virtual Currency to Virtual Currency transactions that are not subject to currency transaction reporting requirements under federal law, including transactions for the payment, receipt, exchange, conversion, purchase, sale, transfer, or transmission of Virtual Currency, in an aggregate amount exceeding the United States dollar value of $ 10,000 in one day, by one Person, the Licensee shall notify the department, in a manner prescribed by the superintendent, within 24 hours.

(3) Monitoring for suspicious activity. Each Licensee shall monitor for transactions that might signify money laundering, tax evasion, or other illegal or criminal activity.

(i) Each Licensee shall file Suspicious Activity Reports ("SARs") in accordance with applicable federal laws, rules, and regulations.

(ii) Each Licensee that is not subject to suspicious activity reporting requirements under federal law shall file with the superintendent, in a form prescribed by the superintendent, reports of transactions that indicate a possible violation of law or regulation within 30 days from the detection of the facts that constitute a need for filing. Continuing suspicious activity shall be reviewed on an ongoing basis and a suspicious activity report shall be filed within 120 days of the last filing describing continuing activity.

(f) No Licensee shall structure transactions, or assist in the structuring of transactions, to evade reporting requirements under this Part.

(g) No Licensee shall engage in, facilitate, or knowingly allow the transfer or transmission of Virtual Currency when such action will obfuscate or conceal the identity of an individual customer or counterparty. Nothing in this section, however, shall be construed to require a Licensee to make available to the general public the fact or nature of the movement of Virtual Currency by individual customers or counterparties.

(h) Each Licensee shall also maintain, as part of its anti-money laundering program, a customer identification program.

(1) Identification and verification of account holders. When opening an account for, or establishing a service relationship with, a customer, each Licensee must, at a minimum, verify the customer's identity, to the extent reasonable and practicable, maintain records of the information used to verify such identity, including name, physical address, and other identifying information, and check customers against the Specially Designated Nationals ("SDNs") list maintained by the Office of Foreign Asset Control ("OFAC"), a part of the U.S. Treasury Department. Enhanced due diligence may be required based on additional factors, such as for high risk customers, high-volume accounts, or accounts on which a suspicious activity report has been filed.

(2) Enhanced due diligence for accounts involving foreign entities. Licensees that maintain accounts for non-U.S. Persons and non-U.S. Licensees must establish enhanced due diligence policies, procedures, and controls to detect money laundering, including assessing the risk presented by such accounts based on the nature of the foreign business, the type and purpose of the activity, and the anti-money laundering and supervisory regime of the foreign jurisdiction.

(3) Prohibition on accounts with foreign shell entities. Licensees are prohibited from maintaining relationships of any type in connection with their Virtual Currency Business Activity with entities that do not have a physical presence in any country.

(4) Identification required for large transactions. Each Licensee must require verification of the identity of any accountholder initiating a transaction with a value greater than $ 3,000.

(i) Each Licensee shall demonstrate that it has risk-based policies, procedures, and practices to ensure, to the maximum extent practicable, compliance with applicable regulations issued by OFAC.

(j) Each Licensee shall have in place appropriate policies and procedures to block or reject specific or impermissible transactions that violate federal or state laws, rules, or regulations.

(k) The individual or individuals designated by the Licensee, pursuant to paragraph 200.15(c)(3), shall be responsible for day-to-day operations of the anti-money laundering program and shall, at a minimum:

(1) Monitor changes in anti-money laundering laws, including updated OFAC and SDN lists, and update the program accordingly;

(2) Maintain all records required to be maintained under this section;

(3) Review all filings required under this section before submission;

(4) Escalate matters to the board of directors, senior management, or appropriate governing body and seek outside counsel, as appropriate;

(5) Provide periodic reporting, at least annually, to the board of directors, senior management, or appropriate governing body; and

(6) Ensure compliance with relevant training requirements.

History

Added 200.15 on 6/24/15.

NEW YORK CODES, RULES AND REGULATIONS

End of Document

23 NYCRR § 200.16

This document reflects those changes received from the NY Bill Drafting Commission through July 8, 2022

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§ 200.16 Cyber security program

(a) Generally. Each Licensee shall establish and maintain an effective cyber security program to ensure the availability and functionality of the Licensee's electronic systems and to protect those systems and any sensitive data stored on those systems from unauthorized access, use, or tampering. The cyber security program shall be designed to perform the following five core cyber security functions:

(1) identify internal and external cyber risks by, at a minimum, identifying the information stored on the Licensee's systems, the sensitivity of such information, and how and by whom such information may be accessed;

(2) protect the Licensee's electronic systems, and the information stored on those systems, from unauthorized access, use, or other malicious acts through the use of defensive infrastructure and the implementation of policies and procedures;

(3) detect systems intrusions, data breaches, unauthorized access to systems or information, malware, and other Cyber Security Events;

(4) respond to detected Cyber Security Events to mitigate any negative effects; and

(5) recover from Cyber Security Events and restore normal operations and services.

(b) Policy. Each Licensee shall implement a written cyber security policy setting forth the Licensee's policies and procedures for the protection of its electronic systems and customer and counterparty data stored on those systems, which shall be reviewed and approved by the Licensee's board of directors or equivalent governing body at least annually. The cyber security policy must address the following areas:

(1) information security;

(2) data governance and classification;

(3) access controls;

(4) business continuity and disaster recovery planning and resources;

(5) capacity and performance planning;

(6) systems operations and availability concerns;

(7) systems and network security;

(8) systems and application development and quality assurance;

(9) physical security and environmental controls;

(10) customer data privacy;

(11) vendor and third-party service provider management;

(12) monitoring and implementing changes to core protocols not directly controlled by the Licensee, as applicable; and

(13) incident response.

(c) Chief Information Security Officer. Each Licensee shall designate a qualified employee to serve as the Licensee's Chief Information Security Officer ("CISO") responsible for overseeing and implementing the Licensee's cyber security program and enforcing its cyber security policy.

(d) Reporting. Each Licensee shall submit to the department a report, prepared by the CISO and presented to the Licensee's board of directors or equivalent governing body, at least annually, assessing the availability, functionality, and integrity of the Licensee's electronic systems, identifying relevant cyber risks to the Licensee, assessing the Licensee's cyber security program, and proposing steps for the redress of any inadequacies identified therein.

(e) Audit. Each Licensee's cyber security program shall, at a minimum, include audit functions as set forth below.

(1) Penetration testing. Each Licensee shall conduct penetration testing of its electronic systems, at least annually, and vulnerability assessment of those systems, at least quarterly.

(2) Audit trail. Each Licensee shall maintain audit trail systems that:

(i) track and maintain data that allows for the complete and accurate reconstruction of all financial transactions and accounting;

(ii) protect the integrity of data stored and maintained as part of the audit trail from alteration or tampering;

(iii) protect the integrity of hardware from alteration or tampering, including by limiting electronic and physical access permissions to hardware and maintaining logs of physical access to hardware that allows for event reconstruction;

(iv) log system events including, at minimum, access and alterations made to the audit trail systems by the systems or by an authorized user, and all system administrator functions performed on the systems; and

(v) maintain records produced as part of the audit trail in accordance with the recordkeeping requirements set forth in this Part.

(f) Application Security. Each Licensee's cyber security program shall, at minimum, include written procedures, guidelines, and standards reasonably designed to ensure the security of all applications utilized by the Licensee. All such procedures, guidelines, and standards shall be reviewed, assessed, and updated by the Licensee's CISO at least annually.

(g) Personnel and Intelligence. Each Licensee shall:

(1) employ cyber security personnel adequate to manage the Licensee's cyber security risks and to perform the core cyber security functions specified in paragraphs 200.16(a)(1)-(5);

(2) provide and require cyber security personnel to attend regular cyber security update and training sessions; and

(3) require key cyber security personnel to take steps to stay abreast of changing cyber security threats and countermeasures.

History

Added 200.16 on 6/24/15.

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23 NYCRR § 200.17

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§ 200.17 Business continuity and disaster recovery

(a) Each Licensee shall establish and maintain a written business continuity and disaster recovery ("BCDR") plan reasonably designed to ensure the availability and functionality of the Licensee's services in the event of an emergency or other disruption to the Licensee's normal business activities. The BCDR plan, at minimum, shall:

(1) identify documents, data, facilities, infrastructure, personnel, and competencies essential to the continued operations of the Licensee's business;

(2) identify the supervisory personnel responsible for implementing each aspect of the BCDR plan;

(3) include a plan to communicate with essential Persons in the event of an emergency or other disruption to the operations of the Licensee, including employees, counterparties, regulatory authorities, data and communication providers, disaster recovery specialists, and any other Persons essential to the recovery of documentation and data and the resumption of operations;

(4) include procedures for the maintenance of back-up facilities, systems, and infrastructure as well as alternative staffing and other resources to enable the timely recovery of data and documentation and to resume operations as soon as reasonably possible following a disruption to normal business activities;

(5) include procedures for the back-up or copying, with sufficient frequency, of documents and data essential to the operations of the Licensee and storing of the information off-site; and

(6) identify third parties that are necessary to the continued operations of the Licensee's business.

(b) Each Licensee shall distribute a copy of the BCDR plan, and any revisions thereto, to all relevant employees and shall maintain copies of the BCDR plan at one or more accessible off-site locations.

(c) Each Licensee shall provide relevant training to all employees responsible for implementing the BCDR plan regarding their roles and responsibilities.

(d) Each Licensee shall promptly notify the superintendent of any emergency or other disruption to its operations that may affect its ability to fulfill regulatory obligations or that may have a significant adverse effect on the Licensee, its counterparties, or the market.

(e) The BCDR plan shall be tested at least annually by qualified, independent internal personnel or a qualified third party, and revised accordingly.

History

Added 200.17 on 6/24/15.

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End of Document

23 NYCRR § 200.18

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§ 200.18 Advertising and marketing

(a) Each Licensee engaged in Virtual Currency Business Activity shall not advertise its products, services, or activities in New York or to New York Residents without including the name of the Licensee and the legend that such Licensee is "Licensed to engage in Virtual Currency Business Activity by the New York State Department of Financial Services."

(b) Each Licensee shall maintain, for examination by the superintendent, all advertising and marketing materials for a period of at least seven years from the date of their creation, including but not limited to print media, internet media (including websites), radio and television advertising, road show materials, presentations, and brochures. Each Licensee shall maintain hard copy, website captures of material changes to internet advertising and marketing, and audio and video scripts of its advertising and marketing materials, as applicable.

(c) In all advertising and marketing materials, each Licensee shall comply with all disclosure requirements under federal and state laws, rules, and regulations.

(d) In all advertising and marketing materials, each Licensee and any person or entity acting on its behalf, shall not, directly or by implication, make any false, misleading, or deceptive representations or omissions.

History

Added 200.18 on 6/24/15.

NEW YORK CODES, RULES AND REGULATIONS

End of Document

§ 200.19 Consumer protection

(a) Disclosure of material risks. As part of establishing a relationship with a customer, and prior to entering into an initial transaction for, on behalf of, or with such customer, each Licensee shall disclose in clear, conspicuous, and legible writing in the English language and in any other predominant language spoken by the customers of the Licensee, all material risks associated with its products, services, and activities and Virtual Currency generally, including at a minimum, the following:

(1) Virtual Currency is not legal tender, is not backed by the government, and accounts and value balances are not subject to Federal Deposit Insurance Corporation or Securities Investor Protection Corporation protections;

(2) legislative and regulatory changes or actions at the state, federal, or international level may adversely affect the use, transfer, exchange, and value of Virtual Currency;

(3) transactions in Virtual Currency may be irreversible, and, accordingly, losses due to fraudulent or accidental transactions may not be recoverable;

(4) some Virtual Currency transactions shall be deemed to be made when recorded on a public ledger, which is not necessarily the date or time that the customer initiates the transaction;

(5) the value of Virtual Currency may be derived from the continued willingness of market participants to exchange Fiat Currency for Virtual Currency, which may result in the potential for permanent and total loss of value of a particular Virtual Currency should the market for that Virtual Currency disappear;

(6) there is no assurance that a Person who accepts a Virtual Currency as payment today will continue to do so in the future;

(7) the volatility and unpredictability of the price of Virtual Currency relative to Fiat Currency may result in significant loss over a short period of time;

(8) the nature of Virtual Currency may lead to an increased risk of fraud or cyber attack;

(9) the nature of Virtual Currency means that any technological difficulties experienced by the Licensee may prevent the access or use of a customer's Virtual Currency; and

(10) any bond or trust account maintained by the Licensee for the benefit of its customers may not be sufficient to cover all losses incurred by customers.

(b) Disclosure of general terms and conditions. When opening an account for a new customer, and prior to entering into an initial transaction for, on behalf of, or with such customer, each Licensee shall disclose in clear, conspicuous, and legible writing in the English language and in any other predominant language spoken by the customers of the Licensee, all relevant terms and conditions associated with its products, services, and activities and Virtual Currency generally, including at a minimum, the following, as applicable:

(1) the customer's liability for unauthorized Virtual Currency transactions;

(2) the customer's right to stop payment of a preauthorized Virtual Currency transfer and the procedure to initiate such a stop-payment order;

(3) under what circumstances the Licensee will, absent a court or government order, disclose information concerning the customer's account to third parties;

(4) the customer's right to receive periodic account statements and valuations from the Licensee;

(5) the customer's right to receive a receipt, trade ticket, or other evidence of a transaction;

(6) the customer's right to prior notice of a change in the Licensee's rules or policies; and

(7) such other disclosures as are customarily given in connection with the opening of customer accounts.

(c) Disclosures of the terms of transactions. Prior to each transaction in Virtual Currency, for, on behalf of, or with a customer, each Licensee shall furnish to each such customer a written disclosure in clear, conspicuous, and legible writing in the English language and in any other predominant language spoken by the customers of the Licensee, containing the terms and conditions of the transaction, which shall include, at a minimum, to the extent applicable:

(1) the amount of the transaction;

(2) any fees, expenses, and charges borne by the customer, including applicable exchange rates;

(3) the type and nature of the Virtual Currency transaction;

(4) a warning that once executed the transaction may not be undone, if applicable; and

(5) such other disclosures as are customarily given in connection with a transaction of this nature.

(d) Acknowledgement of disclosures. Each Licensee shall ensure that all disclosures required in this section are acknowledged as received by customers.

(e) Receipts. Upon completion of any transaction, each Licensee shall provide to a customer a receipt containing the following information:

(1) the name and contact information of the Licensee, including a telephone number established by the Licensee to answer questions and register complaints;

(2) the type, value, date, and precise time of the transaction;

(3) the fee charged;

(4) the exchange rate, if applicable;

(5) a statement of the liability of the Licensee for non-delivery or delayed delivery;

(6) a statement of the refund policy of the Licensee; and

(7) any additional information the superintendent may require.

(f) Each Licensee shall make available to the department, upon request, the form of the receipts it is required to provide to customers in accordance with subdivision 200.19(e).

(g) Prevention of fraud. Licensees are prohibited from engaging in fraudulent activity. Additionally, each Licensee shall take reasonable steps to detect and prevent fraud, including by establishing and maintaining a written anti-fraud policy. The anti-fraud policy shall, at a minimum, include:

(1) the identification and assessment of fraud-related risk areas;

(2) procedures and controls to protect against identified risks;

(3) allocation of responsibility for monitoring risks; and

(4) procedures for the periodic evaluation and revision of the anti-fraud procedures, controls, and monitoring mechanisms.

History

Added 200.19 on 6/24/15.

NEW YORK CODES, RULES AND REGULATIONS

End of Document

23 NYCRR § 200.20

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§ 200.20 Complaints

(a) Each Licensee shall establish and maintain written policies and procedures to fairly and timely resolve complaints.

(b) Each Licensee must provide, in a clear and conspicuous manner, on its website or websites, in all physical locations, and in any other location as the superintendent may prescribe, the following disclosures:

(1) the Licensee's mailing address, email address, and telephone number for the receipt of complaints;

(2) a statement that the complainant may also bring his or her complaint to the attention of the department;

(3) the department's mailing address, website, and telephone number; and

(4) such other information as the superintendent may require.

(c) Each Licensee shall report to the superintendent any change in the Licensee's complaint policies or procedures within seven days.

History

Added 200.20 on 6/24/15.

NEW YORK CODES, RULES AND REGULATIONS

End of Document

23 NYCRR § 200.21

This document reflects those changes received from the NY Bill Drafting Commission through July 8, 2022

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§ 200.21 Transitional period

A Person already engaged in Virtual Currency Business Activity must apply for a license in accordance with this Part within 45 days of the effective date of this regulation. In doing so, such applicant shall be deemed in compliance with the licensure requirements of this Part until it has been notified by the superintendent that its application has been denied, in which case it shall immediately cease operating in this state and doing business with New York State Residents. Any Person engaged in Virtual Currency Business Activity that fails to submit an application for a license within 45 days of the effective date of this regulation shall be deemed to be conducting unlicensed Virtual Currency Business Activity.

History

Added 200.21 on 6/24/15.

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23 NYCRR § 200.22

This document reflects those changes received from the NY Bill Drafting Commission through July 8, 2022

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§ 200.22 Severability

If any provision of this Part or the application thereof to any Person or circumstance is adjudged invalid by a court of competent jurisdiction, such judgment shall not affect or impair the validity of the other provisions of this Part or the application thereof to other Persons or circumstances.

History

Added 200.22 on 6/24/15.

NEW YORK CODES, RULES AND REGULATIONS

End of Document

EXHIBIT 9

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Special Purpose Depository Institutions, WYOMING DIVISION OF BANKING (last visited July 1, 2022), https://wyomingbankingdivision.wyo.gov/banks-and-trust-companies/special-purpose-depository-institutions.

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Special Purpose Depository Institutions

Wyoming-chartered special purpose depository institutions ("SPDIs") are banks that receive deposits and conduct other activity incidental to the business of banking, including custody, asset servicing, fiduciary asset management, and related activities.

SPDIs will likely focus on digital assets, such as virtual currencies, digital securities and digital consumer assets. For example, SPDIs may elect to provide custodial services for digital assets and, in accordance with customer instructions, undertake authorized transactions on behalf of customers. SPDIs may also conduct activity under Wyoming regulations tailored to digital assets, which address issues such as technology controls, transaction handling, and custody operations for digital assets. As a final example, SPDIs operate under Wyoming law that defines digital assets in conjunction with the Wyoming Uniform Commercial Code and describes, among things, perfection and priority of security interests in digital assets.

SPDIs may focus on traditional assets as well. They also may serve as a vehicle for business cash management, operational accounts, and any other purpose permitted under applicable law. However, SPDIs are generally prohibited from making loans with customer deposits of fiat currency and they must at all times maintain unencumbered level 1 high-quality liquid assets valued at 100% or more of their depository liabilities. Given this, SPDIs are not required to obtain insurance from the Federal Deposit Insurance Corporation—though they may do so.

SPDIs may resemble custody banks because they will likely be predominantly engaged in custody, safekeeping, and asset servicing activities. The role of a custody bank is focused on safekeeping assets, fiduciary management, transaction processing and settlement, and providing an "on/off" ramp to securities markets, commodities markets and customer bank accounts.

Wyoming first authorized SPDI charters with the enactment of House Bill 74 in 2019, which created the Special Purpose Depository Institutions Act ("SPDI Act") at Wyo. Stat. § 13-12-101, et seq. Wyoming also created its digital asset law at Wyo. Stat. § 34-29-101, et seq. with the enactment of Senate File 125 in 2019. Since then, Wyoming amended the SPDI Act in 2020 and amended its digital asset law in 2021, with the latter becoming effective July 1, 2021. The Division of Banking also promulgated new SPDI and digital asset regulations in 2020. It also adopted amendments to the SPDI and digital asset regulations in 2021.

Wyoming's statutes, rules, guidance, and other information related to SPDIs and digital assets may be found below.

The Division has been accepting SPDI applications since October 1, 2019. The Wyoming Banking Board has approved four SPDI charters thus far. Application materials and background information may be found below. If you are considering applying for a SPDI charter, please contact the Division at (307) 777-7797 or at wyomingbankingdivision@wyo.gov.

Charter Applications- Rules.pdf

Digital Asset Custody Rules (05-21).pdf

Digital Asset Statutes (07-21).pdf

Procedure for Application Hearings- Rules.pdf

SPDI Application Process Overview (05-20).pdf

SPDI Bank Charter Application (11-21).docx

SPDI Biographical & Financial Report (06-20).docx

SPDI Rules (05-21).pdf

SPDI Statutes (7-21).pdf

SPDI Updated Capital Guidance (07-21).pdf

SPDI Examination Manual v1 2021 (pdf)

THE SEC AND THE COMING CRYPTO CRACKDOWN: WHY BITCOIN REMAINS THE OUTLIER

Bryan F. Jacoutot

An ominous cloud looming over the cryptocurrency industry today—and one of the most hotly contested legal questions—is whether the ever-expanding class of crypto tokens and related digital assets should be classified as securities under applicable law.[1] Beginning about a decade ago, crypto clients began trickling into law offices seeking advice on how to launch these tokens without drawing scrutiny from the Securities and Exchange Commission ("SEC"). What started as a trickle, however, has now become a steady stream. For the most part, these clients either had a preexisting business they hoped could benefit from launching a cryptocurrency token, or they simply had an idea for a cryptocurrency project they wanted to build a business around.[2]

But in recent years, another type of client is coming to increasing prominence in law offices across the country: the (often disgruntled) token investor. Many eager investors entering the cryptocurrency space are quickly met with enticing promises from highly effective marketers and technologists. But these initial moments of wonder and expectation often run headlong into the sobering reality that the broader crypto space has a penchant for making promises it simply cannot deliver.

Whether looking at it from the perspective of the token issuer or the token investor, though, the trouble is that the success of most cryptocurrency projects hinges on a financial instrument that looks an awful lot like the sale of an investment contract under the *Howey*[3] test. As a result, both eager investors and intrepid entrepreneurs should exercise caution before getting swept up in the emotion and promise of what feels like a once-in-a-lifetime opportunity. And while there are many prudent questions worth asking when experimenting in the cryptocurrency space, the salient one for our purposes is determining whether the crypto token or digital asset involved is a security.

In exploring this timely question, we must first understand how crypto tokens are usually created. In doing so, only passing attention is paid to the often overused and largely misunderstood term, "blockchain." The term has become confusing and no longer lends itself to easy definition. And most novice or casual onlookers seem to view it as equivalent to an un-hackable database. But the numberless hacks and thefts of so-called blockchain projects and crypto assets should have disabused the reader of that fanciful notion by now. More importantly, from a securities perspective, the fact that some asset purports to utilize a blockchain is not really all that significant

[1] 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.

[2] There is a very prominent third type, as well: individuals or teams that have *already* launched a cryptocurrency sale and now somewhat belatedly need to determine whether they've violated any laws.

[3] The *Howey* test arose out of the seminal Supreme Court case, *Securities and Exchange Commission v. W.J. Howey, Co.,* 328 U.S. 293 (1946), which established a four-factor inquiry for determining whether a transaction constituted an investment contract subject to the regulatory authority of the SEC. Under the *Howey* test, a transaction is an investment contract if 1) it constitutes an investment of money (or other thing of value); 2) there is an expectation of profit from the investment; 3) the investment of money is in a common enterprise; and 4) any profit comes from the efforts of others.

except to the extent its apparent technological sophistication confuses many into thinking blockchains are beyond the reach of traditional legal systems.[4]

Once we establish how token creation and issuance generally occurs today, focus shifts to the world's first decentralized cryptocurrency, Bitcoin, to contrast critical elements of the Bitcoin story from the tens of thousands of alternative cryptocurrencies that followed. In so doing, several unique attributes surrounding the formation and operation of Bitcoin are explained. Considering these attributes against the backdrop of the *Howey* test, we can see how Bitcoin is demonstrably distinct from the more than 20,000 currently circulating cryptocurrencies. Perhaps more importantly, we can identify what potential token issuers and prospective token buyers need to consider when deciding whether a particular cryptocurrency project suits them.

Cryptocurrency token creation

Although Bitcoin first emerged in 2009, there was lengthy period where the cryptocurrency scene remained relatively modest. Indeed, prior to 2015, creating a new cryptocurrency token usually required the arduous task of spinning up an entirely new blockchain.[5] And while some sporadic experimentation of building tokens "on top of" existing blockchains like Bitcoin had occurred, [6] the launch of Ethereum in 2015 following an initial coin offering ("ICO")[7] radically changed the cryptocurrency landscape.[8]

Not long after Ethereum launched, developers leveraged its robust programming language and ruleset to advance what became known as the ERC-20 protocol.[9] This streamlined the process

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[4] Both the SEC and the courts look to the "economic realities underlying a transaction," *United Housing Found., Inc. v. Forman,* 421 U.S. 837, 849 (1975), so merely stating that your token "uses a blockchain" will not, without more, save it from SEC scrutiny. *See also Reves v. Ernst & Young,* 494 U.S. 56, 61 (1990) ("Congress' purpose in enacting the securities laws was to regulate investments, ***in whatever form they are made and by whatever name they are called***," (emphasis added)).

[5] The XRP Ledger, for example, launched in 2012 using its own native Ripple Consensus Ledger, and underlying token, XRP. The Ripple ledger is entirely separate and distinct from Bitcoin. *See, e.g.,* https://xrpl.org/history.html

[6] An early secondary layer token, Mastercoin, was built on top of Bitcoin in 2013 and led by J.R. Willett, who had been pitching the idea to the Bitcoin community with limited success. *See* Laura Shin, Here's The Man Who Created ICOs And This Is The New Token He's Backing, FORBES, (Sep. 21, 2017, 12:06 PM), https://www.forbes.com/sites/laurashin/2017/09/21/heres-the-man-who-created-icos-and-this-is-the-new-token-hes-backing/?sh=7b3b44591183 (last visited August 11, 2022).

[7] ICO's, like their traditional finance namesake, IPOs, "entail the issuance of assets whose value depends on the success of a business venture, and… are offered to so-called retail investors." Shaanan Cohney, et al., *Coin-Operated Capitalism*, 119 Col. L. Rev. 591, 609 (2019).

[8] The History of Ethereum, https://ethereum.org/en/history (last updated August 9, 2022)

[9] See Fabian Vogelsteller & Vitalik Buterin, ERC-20 Token Standard, GitHub, https://github.com/ethereum/EIPs/blob/master/EIPS/eip-20.md [https://perma.cc/4GZA- EFMP] (last visited August 10, 2022). The acronym "ERC" means "Ethereum Request for Comment." Chris Dannen, Introducing Ethereum and Soldity: Foundations of Cryptocurrency and Blockchain Programming for Beginners 106 (2017). The Ethereum community uses these requests to develop standards for smart contract design. *Id.* at 111.

of token creation and made it possible for even those with comparatively rudimentary technical experience to quickly launch a token of their own.[10] With just a few simple steps, these tokens could use the persisting Ethereum protocol in order to enforce their own discrete cryptocurrency ruleset.[11] Around the same time, appetite grew among some developers and investors for leaving Bitcoin behind, which they argued was too resistant to experimentation to remain valuable in the fast-paced and dynamic world of cryptocurrency.[12] The phrase "blockchain, not Bitcoin" became relatively commonplace, particularly in the corporate and venture capital spheres and, unsurprisingly, an explosion in cryptocurrencies followed suit.[13]

From 2017-2018, alongside a strong Bitcoin bull market, a new investor "boom" found its footing with the ICO forming its backbone.[14] Over that period, more than a thousand projects offered early investment opportunities to buy their "native token." A speculative fervor around the blockchain space grew and an eager public wanting to avail itself of the "new internet" gold rush was happy to oblige project founders pitching blockchain ideas and accompanying token offerings for everything from supply chain management[15] to dental visits.[16] Speculation swelled and, perhaps due to the sheer number of tokens being created, it seemed the SEC had given tacit permission for these offerings through its perceived inaction.[17]

But over time, the SEC began ramping up enforcement actions against token issuers.[18] Currently, the SEC is suing Ripple, Inc.—the company responsible for what at one time was the third largest

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[10] Cohney, et al., *supra* note 7, at 605.

[11] *Id.,* (describing how the ERC-20 standard "establishes a simple template to create… and operate entirely new crypto assets within the Ethereum system.")

[12] *See, e.g.,* Alex Hern, Bitcoin's Forked: Chief Scientist Launches Alternative Proposal For The Currency, THE GUARDIAN, (Aug. 17, 2015, 6:57 AM) https://www.theguardian.com/technology/2015/aug/17/bitcoin-xt-alternative-cryptocurrency-chief-scientist (last visited August 11, 2022)

[13] *See,* Cohney, et al., *supra* note 7, at 594-95 ("In 2017—the year that ICOs entered popular consciousness—453 ICOs raised an estimated $6.58 billion. By July 1, 2018, an additional 684 ICOs had raised an estimated $17.47 billion.")

[14] *Id.*

[15] Stephen Laaper & Joseph Fitzgerald, Using blockchain to drive supply chain transparency, DELOITTE, https://www2.deloitte.com/us/en/pages/operations/articles/blockchain-supply-chain-innovation.html (last visited August 11, 2022)

[16] Dentacoin, the blockchain solution for oral health, https://dentacoin.com/assets/uploads/dentacoin-company-introduction.pdf (last visited August 11, 2022).

[17] There also was confusion about the actions the SEC did undertake related to unregistered securities in the blockchain space. For example, the SEC issued the "DAO Report," investigating a massive token sale involving a Decentralized Autonomous Organization ("DAO") built using smart contracts on the Ethereum blockchain. *See,* Securities and Exchange Commission, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Release No. 81207 (Jul. 25, 2017). Though the report found the token issued was an unregistered security, the Commission did not pursue any action against the issuers. *Id.*

[18] *See,* Alex Sunnarborg, The Incoming Wave of ICO Regulation (Yes, It's Coming), COINDESK (Nov. 2, 2018), https://www.coindesk.com/the-incoming-wave-of-ico-regulation-yes-its-coming (last visited Aug. 11, 2022)

cryptocurrency platform by market cap--and its co-founders in federal court for allegedly violating securities laws.[19] A decision in the case has not yet been reached. But similar actions have been filed against relatively small token issuers and sellers, suggesting the SEC is intent on curbing the *practice* of unregistered ICOs, as well as other token sales and purchases. Not just punishing those who are unusually successful.[20]

To understand why the cryptocurrency landscape is broadly vulnerable to SEC enforcement actions, it helps to compare the core attributes of Bitcoin against those of a typical alternative cryptocurrency.

What makes Bitcoin different under *Howey*?

For several reasons, Bitcoin is perhaps the only—or at least the clearest—exception to the current securities conundrum faced by most of the cryptocurrency industry.[21] [22] We will first take a high-level look at the reasons for this, and then explore each of Bitcoin's relevant attributes in detail.

First, Bitcoin had what has been described as a "fair launch," meaning there was no pre-launch sale of Bitcoin to an investing public. This makes it difficult for regulators to allege under *Howey* that Bitcoin was conceived and offered to the public with the "expectation of profit." Second, there is no identifiable leadership team because the person or persons responsible for its creation disappeared more than a decade ago.[23] This makes regulators unlikely to find that any profit resulting from acquiring bitcoin comes primarily through "the efforts of others," as the *Howey* test requires. Third, Bitcoin enjoyed an extended period following its launch in which it freely circulated among enthusiasts without having any monetary value at all.[24] Again, this suggests there was no "expectation of profit" at the time of launch. Finally, Bitcoin has a high degree of decentralization, meaning that there are users running the software all around the world.[25] Because of this, there

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[19] *Securities and Exchange Commission v. Ripple Labs, Inc., et al.,* No. 1:20-cv-10832 (S.D.N.Y. Dec. 20, 2020)

[20] *Securities and Exchange Commission v. Ishan Wahi, Nikhil Wahi, and Sameer Ramani,* No. 2:22-cv-01009 (S.D.N.Y. Jul. 21, 2022)

[21] The Bitcoin network has been "hard forked" on multiple occasions, a process that maintains the original coin distribution as it existed at the time of the fork, but ultimately changes the network rules in a way that is incompatible with the broader Bitcoin network. These forks, to the extent they still exist, at least initially enjoy many of the attributes that shield Bitcoin from a securities classification and so they, too, might not be securities. But that depends on how the network operates going forward, and merely forking from Bitcoin will not guarantee a non-security classification in perpetuity.

[22] This article does not attempt to divine what might come from a more favorable regulatory regime. It only attempts to describe the regulatory reality as it exists today, and why most cryptocurrencies—even with their perceived complexity—likely fail to comply with it.

[23] Sophie Bearman, Bitcoin's creator may be worth $6 billion—but people still don't know who it is, CNBC https://www.cnbc.com/2017/10/27/bitcoins-origin-story-remains-shrouded-in-mystery-heres-why-it-matters.html

[24] Benjamin Wallace, The Rise and Fall of Bitcoin, WIRED, (Nov. 23, 2011, 2:52 PM) https://www.wired.com/2011/11/mf-bitcoin/ (last visited August 9, 2022).

are no top-down directives from a privileged class within the Bitcoin network that might exercise outsized influence over the protocol.[26] This both creates practical enforcement problems and further diminishes any claim that pecuniary gains associated with Bitcoin are secured through "the efforts of others" or the result of an identifiable "common enterprise" under *Howey.*

The fair launch

When pseudonymous creator, Satoshi Nakamoto, "mined" the first Bitcoin block—known as the Genesis Block[27]—the Bitcoin White Paper describing the structure of the protocol had already been circulating for several months.[28] Moreover, unlike most cryptocurrency launches today, no tokens were created in advance of the launch to be sold to eager investors or hoarded by founders with the goal of bootstrapping the project. To the contrary, bitcoin is exclusively created through the Bitcoin mining process, with just a handful being released each time a new block of transactions is added to the chain. And the first fifty bitcoins generated by the Genesis Block—as well as many tens of thousands generated thereafter—had *no market value.*[29] Instead, they essentially operated as a proof-of-concept.

But the network their issuance started persists to this day, with each new block adding more (though progressively fewer[30]) bitcoin to the network.[31] And while today it may be difficult to imagine a bitcoin circulating freely with no price, that's exactly what these early bitcoin did.[32] And

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[25] See, Bitnodes, https://bitnodes.io. *Note:* These are users that go beyond merely opening a wallet on Coinbase or some other pubic exchange and trading the underlying token. These are users that run "full node" software, personally downloading and independently verifying the state of the Bitcoin blockchain in real time, as well as enforce the Bitcoin ruleset and agree to (or deny) periodic upgrades to the rules. It is also difficult to determine the exact number of nodes operational on the Bitcoin network at any given time because, for a variety of reasons, users may be utilizing techniques to mask the appearance of their node.

[26] See generally, Jonathan Bier, The Blocksize War: The Battle Over Who Controls Bitcoin's Protocol Rules (2021)

[27] See Blockchain.com, Block 1, https://www.blockchain.com/btc/block/1 (last visited August 11, 2022)

[28] Satoshi Nakamoto Institute, Bitcoin: A Peer-to-Peer Electronic Cash System, https://nakamotoinstitute.org/bitcoin/ (last visited, August 11, 2022)

[29] See, *infra,* Section on "Valueless Circulation"

[30] The Bitcoin block reward gradually decreases over time in what can be compared to an atomic half-life. Every 210,000 blocks (approximately four years), the reward is programmatically cut in half. This process—colloquially termed the "halving" or "halvening"—continues with each roughly four-year epoch, eventually reaching zero sometime around the year 2140. Because of Bitcoin's half-life, the block reward has already been diminished from the original 50 bitcoin to just 6.25 bitcoin per block at the time of publication.

[31] For an in-depth but still non-technical explanation on the process of Bitcoin mining, see Bryan F. Jacoutot, Understanding Bitcoin Mining, (Nov. 29, 2020), https://jacoutotonlaw.com/2020/11/understanding-bitcoin-mining/ (last visited August 11, 2022).

[32] There is some uncertainty about when a price for Bitcoin was first established. In October of 2009, about nine months after the Genesis Block, a now defunct entity known as the New Liberty Exchange

as the network of computers utilizing the Bitcoin protocol grew, new blocks continued to generate new bitcoin. Thus, a steady stream of initially valueless bitcoin slowly seeped into the world, largely sent among hobbyists or hoarded among the initial miners.[33] Because they had no value, many were lost forever through carelessness or neglect.[34]

This "fair launch" is very different from what occurs with the launch of a typical cryptocurrency.

For example, as earlier mentioned, Ethereum founders opted for the now-commonplace technique of a pre-launch ICO, in which the initial developers and investors staged a "pre-mine"[35] event resulting in a privileged allocation of a large amount of the platform's native token, Eth, accruing to select investors before or immediately after launch. These tokens were either allocated back to the project founders to retain or distribute at their discretion, or sold to the investing public. [36] And while the Ethereum protocol currently employs a mechanism similar to the Bitcoin block reward distribution,[37] the initial pre-mine represented the vast majority of tokens circulating at the time of launch and for a long time thereafter.[38]

When we compare the two launches in the context of the *Howey* test, it's relatively clear that the launch path taken by Ethereum and the many similarly situated crypto tokens potentially run afoul of the four-prong test, and Bitcoin does not. This is not to say that all necessarily *will* be classified as a security. In fact, individual members of the SEC have indicated (unofficially) at various times that Ethereum may enjoy a non-security designation alongside Bitcoin.[39] Nevertheless, the

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calculated a proposed price for a bitcoin based on the energy expenditure and computing power necessary to mine a block. https://web.archive.org/web/20100427033445/http://newlibertystandard.wetpaint.com/page/Exchange+Rate. But many people credit the purchase of two Papa John's pizzas for 10,000 bitcoin on May 22, 2010 as the date in which a market price for bitcoin was truly established. *See,* Francisco Memoria, The First Bitcoin Transactions: From a Test to the Famous Pizza Purchase, CRYPTOCOMPARE (Oct. 7, 2021), https://www.cryptocompare.com/coins/guides/the-first-bitcoin-transactions-from-a-test-to-the-famous-pizza-purchase-1/.

[33] *Id.*

[34] Jeff John Roberts and Nicholas Rapp, Exclusive: Nearly 4 Million Bitcoins Gone Forever, New Study Says, FORTUNE, Nov. 25, 2017 https://fortune.com/2017/11/25/lost-bitcoins/ (last accessed Aug. 11, 2022).

[35] Camilla Russo, Sale of The Century: The Inside Story of Ethereum's 2014 Pre-Mine, COINDESK, Jul. 11, 2020 https://www.coindesk.com/markets/2020/07/11/sale-of-the-century-the-inside-story-of-ethereums-2014-premine/ (last accessed Aug. 11, 2022)

[36] Russo, *supra* note 35.

[37] *Id*.

[38] *Id*.

[39] William Hinman, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418 (last visited Aug. 12, 2022) ("If the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract.")

question is obviously a close call, and the SEC has not made an official pronouncement either way.

Valueless circulation

Because Bitcoin was the first leaderless cryptocurrency,[40] early users faced the thorny question of how to value it. Early on, it required trivial computing power to mine and operated mostly as a kind of science project for the intellectually curious. Despite this phase of tinkering, Satoshi's code promised to eliminate the need for a central currency issuer, an attribute long possessed by commodity monies like gold or silver, but never quite replicated by synthetic or fiat monies. And while Austrian and Keynesian economists continue to grapple with the origins of the value of commodity money,[41] the value of Bitcoin needed to come from a more abstract source: consensus. This has proven difficult.

Even now, Bitcoin's seemingly insurmountable price volatility is proof the market continues to grapple with this question. Nevertheless, during the first year and a half of its life, Bitcoin circulated with no price.[42] To date, no other cryptocurrency has replicated this free circulation period. And it would be difficult to do at this stage because there are now throngs of willing speculators hoping for privileged early access to anything claiming to be "the next bitcoin."

No leadership team

The vast majority of cryptocurrencies today have a clear leader or leadership team. These leadership teams are often supported by seed investors, or venture capitalists and hedge funds, who in turn hope to raise money and profit on a secondary market from increasing token value. Ethereum, for example, has been helmed by Vitalik Buterin and Joseph Lubin since its inception, as well as the Ethereum Foundation and other key players.

These identifiable leaders create potential problems for cryptocurrency projects under *Howey,* because their contributions to the project may be deemed the "efforts of others" and "common enterprise" with which the SEC and courts concern themselves when making a securities determination.

To be sure, Bitcoin has a founder but it has no leader. And that distinction is crucial. Today, while there are many influential persons in the Bitcoin space, it exists exclusively on its own inertia and on a participatory basis. The same cannot be said for the vast majority of cryptocurrency projects.

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[40] Even if we accept that Bitcoin had a founder in Satoshi Nakamoto, this individual was only ever the protocol's nominal "leader." Because as a practical matter, Satoshi exercised only as much influence over the protocol as his computers had the power to generate, and his ideas had the power to persuade.

[41] *Compare,* Ludwig von Mises*, The Theory of Money and Credit* (J.E. Batson trans., Yale U. Press 2d prtg.1954) (1912), *with* Stephanie Kelton, *The Deficit Myth: Modern Monetary Theory and the Birth of the People's Economy* (New York: PublicAffairs 2020)

[42] See, *supra* note 32.

Genuine decentralization

As a corollary of there being no leadership team in Bitcoin, there is also a high degree of decentralization. Decentralization relies on a combination of factors and Bitcoin–through hard fought "fork wars"[43] and other conflicts within the ecosystem—has retained the highest level of decentralization of any blockchain. Even after 13 years of data production, the cost of running a node is relatively trivial.[44] This stands in direct contrast to Ethereum and other popular blockchains, which effectively close off the opportunity for most people because the extreme amounts of data to process make running a node impractical. Thus, only highly sophisticated individuals or entities are typically able to run nodes that enforce protocol rules.

And without widespread decentralization, protocols again run into a *Howey* test problem because it becomes increasingly clear that a small and identifiable group is working to improving the value of the underlying token. Thus, even if the token were not issued by some sort of leadership team, users are still relying primarily on "the efforts of others" to receive pecuniary gain.

Howey and Bitcoin's Four Factors

These attributes, among others, have led the current Chairman of the SEC, Gary Gensler, and his predecessor, Jay Clayton, to publicly declare that Bitcoin is not a security.[45] Indeed, it is difficult to see how a widely distributed open protocol like Bitcoin could satisfy the requirement under *Howey* that profit derive from a "common enterprise." That is to say, Bitcoin's demonstrable decentralization insulates it from a securities laws.

The fair lunch further insulates Bitcoin because unlike other cryptocurrency projects, the inception and early years of Bitcoin look less like the "investment opportunities" we hear pitched today than an invitation to participate in a science experiment. No riches were initially promised, nor could they have been. Indeed, the "free circulation" period cuts against any theory that Bitcoin could have been initially pitched as an investment. If anything, early bitcoin required computing power, energy, and time to acquire *despite* the absence of the possibility of monetary gain. Bitcoin's founding era stands in marked contrast to what the world of cryptocurrency has become.

Finally, the lack of an identifiable leadership team suggests a lack of common enterprise as well. And as a practical matter, the leaderless nature of Bitcoin creates a headache for even unusually fervent regulators that might seek to enforce subpoenas to undermine or rein in the protocol. There is no "CEO of Bitcoin" for overzealous politicians to haul before Congress to publicly chastise for electoral gain. There is not even a person or group that a court could plausibly enjoin

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[43] Bier, *supra* note 26.

[44] The author of this article runs a full Bitcoin node, which verifies the state of the Bitcoin blockchain and enforces protocol rules at all times. He can attest to the low-cost, low-energy nature of the process. Even possessing very little practical computer knowledge beyond the ability to use YouTube and Google, running a node is entirely accessible for most people. If the author can run a node, anyone can run a node.

[45] Kevin Helms, SEC Chair Gensler Affirms Bitcoin Is a Commodity — 'That's the Only One I'm Going to Say' (Jun. 27. 2022), https://news.bitcoin.com/sec-chair-gensler-bitcoin-is-a-commodity/ (last visited August 9, 2022)

in order to alter certain aspects of the protocol. The court would need the obedience or acquiescence of the globally distributed userbase.

Conclusion

Because many cryptocurrency projects remain vulnerable to regulatory scrutiny, the SEC may be gearing up for a deluge of actions against the ever-expanding cryptocurrency space. In some respects, the broadening enforcement actions now being brought suggests the deluge has already begun.

Of course, each token contains its own unique attributes and history that might insulate it in ways similar to Bitcoin. And because more are being created seemingly daily—and not all are definitively subject to the jurisdiction of the United States—caution should be exercised before writing off the entire space as a potential regulatory liability. That said, few projects have followed the admittedly painstaking lead that Bitcoin first set in 2009. And it remains good advice today that projects seeking shelter from the coming securities storm should work to emulate the underlying structure and launch of Bitcoin. If such a strategy conflicts with business goals, you might just be offering or investing in a security.

CRYPTO ETHICS

Nicole G. Iannarone & Dylan Mason*

INTRODUCTION

Just over thirteen years ago, the first few lines of code were put to the Bitcoin blockchain. Nine days later, the mysterious Bitcoin developer Satoshi Nakomoto sent ten Bitcoins to another developer.[1] That small transaction set off a cryptocurrency revolution. Public interest in cryptocurrencies has exploded. Nearly 16% of Americans had invested in, traded, or otherwise used some form cryptocurrency.[2] In 2021, venture capital funds invested around $30 billion in cryptocurrencies, an amount greater than the last ten years of investment in that area.[3] Cryptocurrency is even being legitimized by state actors -- El Salvador recently adopted Bitcoin as legal tender.[4]

Retail investor interest in cryptocurrency may derive from its rapid appreciation and purported ability to create crypto millionaires overnight. Cryptocurrency also has the ability to bankrupt overnight. In June 2022, cryptocurrency fell $2 trillion.[5] Though the recent decline is the largest so far, cryptocurrency is characterized by volatility. Because cryptocurrencies have no intrinsic value and are not backed by traditional valuation methods, their value is highly susceptible to change based on public sentiment.[6] As such, holders of cryptocurrency find that the value of their investment is fluctuating rapidly on as much as a daily basis.

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[1] Elizabeth Lopatto, *How Bitcoin Grew Up And Became Big Money*, The Verge (Jan. 3, 2019), https://www.theverge.com/2019/1/3/18166096/bitcoin-blockchain-code-currency-money-genesis-block-silk-road-mt-gox.

[2] Andrew Perrin, *16% Of Americans Say They Have Ever Invested In, Traded or Used Cryptocurrency*, Pew Research Center (Nov. 11, 2021), https://www.pewresearch.org/fact-tank/2021/11/11/16-of-americans-say-they-have-ever-invested-in-traded-or-used-cryptocurrency/.

[3] Crystal Kim, *Crypto Attracts More Money In 2021 Than All Previous Years Combined*, Bloomberg (Dec. 21, 2021), https://www.bloomberg.com/news/articles/2021-12-19/ftx-moonpay-axie-lead-crypto-firms-attracting-record-30-billion-in-2021.

[4] Joe Hernandez, *El Salvador Just Became The First Country to Accept Bitcoin As Legal Tender*, NPR (Sep. 7, 2021), https://www.npr.org/2021/09/07/1034838909/bitcoin-el-salvador-legal-tender-official-currency-cryptocurrency.

[5] Emily Nicolle and Olga Kharif, *A $2 Trillion Free-Fall Rattles Crypto to the Core*, Blomberg (June 26, 2022), https://www.bloomberg.com/news/articles/2022-06-26/crypto-winter-why-this-bitcoin-bear-market-is-different-from-the-past.

[6] Dymtro Spilka, *Why Are Bitcoin Prices So Volatile?*, Kiplinger (Aug. 12, 2021), https://www.kiplinger.com/investing/cryptocurrency/603280/why-are-bitcoin-prices-so-volatile.

The growth of cryptocurrency as a popular investment has more than just retail investor protection concerns. Lawyers are now more likely than ever to be asked to accept cryptocurrency as payment for their legal services. For lawyers looking to keep a finger on the pulse of developing technological trends that might affect the profession, cryptocurrency and its volatile nature presents a host of new and unique ethical challenges. Chief among them is whether or not attorneys can accept cryptocurrency as payment for fees in lieu of traditional compensation. Though few bar associations have weighed in on the ethics of accepting cryptocurrency for fee payment, it is all but certain that lawyers will be (and may have already been) confronted with clients wishing to pay in this manner while having little to no guidance from their state bar. In this Article, we outline the ethical and practical considerations for attorneys who are considering accepting cryptocurrency as payment for legal fees. Part I provides a brief primer on cryptocurrency, including cryptocurrency types, storage, and risks. In Part II, we describe the general ethical rules governing attorneys' fees. Finally, in Part III, we describe how the ethical rules relating to attorneys' fees may apply to the acceptance of cryptocurrencies in a law practice.

I. CRYPTOCURRENCY BASICS

In order to understand the ethical concerns lawyers face when deciding whether to accept cryptocurrency in lieu of traditional payment methods, a knowledge of some cryptocurrency (also known as "crypto") basics is essential. This Part begins by providing a high-level overview of cryptocurrency.[7] It then describes the predominant crypto coins before discussing their storage modalities and common crypto scams.

A. What is Cryptocurrency?

At the simplest level, cryptocurrencies are best understood as a medium of exchange, often used in ways similar to the U.S. dollar. Unlike U.S. dollars, however, there is no central authority that either manages or maintains the value of cryptocurrency.[8] According to FINRA, "cryptocurrency is a digital representation of a stored value secured through cryptography."[9] Cryptocurrency like Bitcoin is powered by a distributed ledger known as blockchain.[10] The blockchain is said to be distributed and decentralized because the management of it is not by one single entity but instead an extremely large number of computers across the internet.[11] The blockchain is a record of

[7] This short article is intended only to provide a high level, simplistic overview. We recommend reviewing the sources listed in the footnotes in this Part I for a more complete and technical explanation of blockchain and cryptocurrency.

[8] *INVESTOR ALERT: BITCOIN AND OTHER VIRTUAL CURRENCY-RELATED INVESTMENTS*, Securities and Exchange Commission (May 7, 2014), https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html.

[9] FINRA, *Cryptocurrencies*, https://www.finra.org/investors/learn-to-invest/types-investments/initial-coin-offerings-and-cryptocurrencies/cryptocurrencies.

[10] FINRA, *Virtual Currencies*, https://www.finra.org/investors/insights/virtual-currencies.

[11] Kate Ashford and John Schmidt, *What Is Cryptocurrency?*, Forbes (Jan. 25, 2022), https://www.forbes.com/advisor/investing/what-is-cryptocurrency/.

individual transactions that are grouped together into blocks that are subsequently linked with other blocks to form a chain.[12]

Chains are verified by some form of "incentivized network consensus" to assure holders that the chain of transactions is accurate.[13] In the context of Bitcoin, this process is known as "mining."[14] Mining can be accomplished through tasks that, when completed, create a new block on the chain.[15] To incentivize users to complete tasks to verify the transactions, they receive Bitcoin in return for their work.[16] Blockchains can be public (like Bitcoin), which allows anyone to access the information they contain, or private, in which membership in the blockchain is controlled.[17]

The value of the cryptocurrency derived from blockchains is dependent on user interest and is prone to significant fluctuations. Public opinion readily affects these changes. For example, Tesla CEO Elon Musk's tweets referencing Bitcoin have correlated with swings in its value.[18]

B. Predominant Crypto Coins

Cryptocurrencies have expanded greatly since the invention of Bitcoin. Bitcoin is one of the earliest, and most established, crypto coins.[19] It makes use of a proof of work system in order to verify each new transaction and ensure consensus across the blockchain.[20] Another popular cryptocurrency, Ethereum, makes use of a "proof of stake" method of consensus verification.[21] The Ethereum blockchain also has the ability to host what are known as "smart contracts," which are not contracts in the legal sense but instead self-executing computer algorithms that self-enforce their own constraints.[22] While the Bitcoin blockchain is an example of a simple smart contract, Ethereum allows developers to take smart contracts a step further by allowing developers to layer additional code into the blockchain and create more advanced autonomous

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[12] Chris Jaikaran, Cong. Rsch. Serv., R45116, Blockchain: Background and Policy Issues 1 (2018).

[13] Carla L. Reyes, *Conceptualizing Cryptolaw*, 96 Neb. L. Rev. 384, 393 (2017).

[14] *Id*.

[15] *Id*.

[16] *Id*.

[17] Congressional Research Service Report R 45116 at 4.

[18] Rani Molla, *When Elon Musk Tweets, Crypto Prices Move*, Vox (Jun. 14, 2021), https://www.vox.com/recode/2021/5/18/22441831/elon-musk-bitcoin-dogecoin-crypto-prices-tesla

[19] Megan DeMatteo, *There Are Thousands of Different Altcoins. Here's Why Crypto Investors Should Pass on Most of Them*, NextAdvisor (May 3, 2022), https://time.com/nextadvisor/investing/cryptocurrency/altcoins/.

[20] Reyes, *supra* note 11 at 393.

[21] *Id*.

[22] *Id* at 397.

smart contracts for such functions as the trading of securities.[23] Ethereum is also the blockchain on which non-fungible tokens, or NFTs, are typically created.[24] Another popular cryptocurrency is Dogecoin. Created in 2013 to make fun of Bitcoin and other cryptocurrencies, it has created a loyal community of holders.[25] Dogecoin peaked in popularity in early 2021 at the time of the Gamestop short squeeze, when supportive tweets from celebrities such as Elon Musk and Snoop Dogg drove its value up 800%.[26] Dogecoin is indicative of the tendency of some coins to derive their success from online communities engaged with for the enjoyment of the holders.

C. Crypto Storage

Like regular dollars, cryptocurrency is stored in a wallet. Unlike physical wallets in which we hold currency and credit cards, crypto wallets are electronic media that stores the digital codes or passwords a crypto owner must use to access their cryptocurrency.[27] Cryptocurrency wallets fall into two broad categories: hardware ("cold") and software ("hot").[28] Cold wallets are hardware devices that store the codes to access cryptocurrencies.[29] Because cold wallets are purchased by cryptocurrency owners and hosted on their personal device (as opposed to the Internet), they are more secure than hot wallets.[30] In contrast, hot wallets are (usually free) programs, apps, or websites that store cryptocurrency access codes. From a security standpoint, hot wallets are riskier and more susceptible to security breaches and hacking.[31]

D. Crypto Frauds

Securities arbitration attorneys are well aware that where there is public interest and perceived market appreciation, there is also likely to be fraud. Fraudsters hoping to capitalize on the popularity of cryptocurrencies have been known to lure in unsuspecting investors by claiming to create a new coin only to steal the investor's funds. One common scheme is a "rug pull," where investors are lured in by the announcement of a new coin only for the creator to disappear with

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[23] *Id* at 398.

[24] Robyn Conti, *What Is An NFT? Non-Fungible Tokens Explained*, Forbes (April 8, 2022), https://www.forbes.com/advisor/investing/cryptocurrency/nft-non-fungible-token/#:~:text=NFTs%20exist%20on%20a%20blockchain,blockchains%20support%20the%20as%20well.

[25] Usman W. Chohan, *A History of Dogecoin*, Critical Blockchain Research Initiative (2021).

[26] *Id* at 8.

[27] Carol Goforth, *The Lawyer's Cryptionary: A Resource for Talking to Clients about Crypto-transactions*, 41 CAMPBELL L. REV. 47, 113 (2019).

[28] *Id*.

[29] *Id*.

[30] *Id*.

[31] *Id* at 114.

the money.[32] Investors defrauded by a rug pull are often left without the ability to locate anyone from which to recover their investment.[33]

Lawyers considering accepting cryptocurrency must be aware of the myriad risks involved with cryptocurrency investments, including potential hacking risks, ensuring cryptocurrency is securely stored, and avoiding fraudulent cryptocurrencies. Cryptocurrencies – and the risks associated with them – are subject to rapid change. A lawyer should conduct research into the latest frauds, scams, and security concerns before using it in practice.

II. ETHICS AND ATTORNEYS' FEES

Before describing the particular ethical concerns that arise from the use of cryptocurrency in a law practice, a refresher on the ethical considerations relating to attorneys' fees is in order.

A. Attorneys' Fees Must Be Reasonable

Lawyers' ethical responsibilities concerning fees for their services is presented as a simple maxim: fees must be reasonable.[34] While the rule is presented simply, defining what "reasonable" means can be difficult because it is context-specific. Model Rule 1.5 states that lawyers have a duty not to charge, collect or otherwise arrange an unreasonable fee or payment for expenses.[35] Rule 1.5(a) also provides a non-exclusive list of factors to be considered in determining whether the fee is unreasonable.[36] These factors include:

> "(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."[37]

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[32] David Yaffe-Bellany, *Millions for Crypto Start-Ups, No Real Names Necessary*, The New York Times (March 2, 2022), https://www.nytimes.com/2022/03/02/technology/cryptocurrency-anonymity-alarm.html.

[33] *Id*.

[34] MODEL R. OF PROF'L CONDUCT R. 1.5.

[35] MODEL R. OF PROF'L CONDUCT R. 1.5(a) ("A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses.").

[36] *Id*.

[37] *Id*.

Comment [1] to Model Rule 1.5 makes clear that these factors are neither exclusive nor are they necessarily applicable to each case.[38] In addition to ensuring that fees are reasonable, they must also be communicated clearly to the lawyer's client.[39] Though lawyers are not required to have written fee agreements for non-contingent representations, the comments to Model Rule 1.5 explain why doing so is a best practice: "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."[40] When the lawyer's fee is contingent on the outcome, however, a written fee agreement signed by the client is required.[41] Contingency fee agreements require great detail, including how the fee is calculated, the percentage of the recovery the lawyer receives at various stages of the case, the costs and expenses that will be deducted from the overall recovery and whether they are deducted before or after calculating the lawyer's contingent fee.[42] The lawyer must fulfill the undertaking of ensuring the client is aware of the fees to be charged in the case "before or within a reasonable time after commencing the representation."[43]

B. Attorney Trust Accounts: Separating Client and Lawyer Property

In addition, in the event a lawyer receives some form of advance payment or retainer, the funds or property received must be safeguarded. ABA Model Rule 1.15 outlines the requirements related to safekeeping client property.[44] Model Rule 1.15(a) specifies that lawyers holding the property of a client or third party in connection with a representation must keep it in an account separate from the lawyer's own property. In addition, lawyers are required to maintain complete records relating to client property and maintain them for up to five years after representation is terminated.[45] Model Rule 1.15(c) requires that unearned retainer fees be deposited and maintained in an attorney trust account until the lawyer's fee is earned. After the fees are earned, they are to be withdrawn from the client's property and separately maintained in the lawyer's own accounts.[46] It is impermissible to commingle client and attorney funds.[47]

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[38] MODEL R. OF PROF'L CONDUCT R. 1.5, Comment [1].

[39] MODEL R. OF PROF'L CONDUCT R. 1.5(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…").

[40] MODEL R. OF PROF'L CONDUCT R. 1.5, Comment [2].

[41] MODEL R. OF PROF'L CONDUCT R. 1.5 (c).

[42] *Id*.

[43] MODEL R. OF PROF'L CONDUCT R. 1.5(b).

[44] MODEL RULES OF PROF'L CONDUCT r. 1.15.

[45] MODEL RULES OF PROF'L CONDUCT r. 1.15.

[46] *Id*.

[47] *Id*.

C. Special Rules Relating to Business Transactions with Clients

While lawyers are permitted to enter into business transactions with their clients, if they do so, the ABA Model Rules of Professional Conduct recognize that the power differential between clients and lawyers means that lawyers who wish to do so must satisfy certain ethical obligations. ABA Model Rule 1.8 makes clear that "[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 certain obligations are undertaken.[48] Thus, if an otherwise prohibited transaction is anticipated, the lawyer must ensure that the terms of the transaction are fair, reasonable, and disclosed to the client in writing.[49] In addition, the lawyer must inform the client that they should seek independent counsel in reviewing the transaction.[50] Finally, the transaction cannot go forward unless the client then provides their informed consent in writing.[51]

Each of these rules - reasonable of attorneys' fees, attorney trust account obligations, and permissible business transactions with clients – come into play when lawyers receive cryptocurrency in payment of their attorneys' fees. Responding to the question of whether attorneys can accept cryptocurrency in practice requires an analysis of all three questions: (1) are the attorneys' fees reasonable; (2) is the attorney safekeeping the client's property?; and (3) if this is a business transaction with a client, have the requirements been met? The next section describes how ethics authorities have approached all three questions when cryptocurrencies are involved.

III. ACCEPTING CRYPTOCURRENCIES IN PAYMENT OF LEGAL FEES

Though lawyers' obligations concerning charging reasonable fees and safeguarding property are not new, the rising popularity of cryptocurrency as fees complicates the application of Model Rules 1.5, 1.8(a) and 1.15. The volatility of cryptocurrencies and the relative speed in which their value can change means that what a lawyer is charging in cryptocurrency can have a very different monetary value even from one day to the next. For example, today, a lawyer may receive cryptocurrency valued at $1,000. Tomorrow, the same cryptocurrency may have increased in value to now be worth $10,000. This volatility raises significant questions about whether a lawyer's fees are reasonable or not, especially in the context of advance fees and retainers. Additionally, lawyers must also determine how they plan to keep cryptocurrency advances and retainers safe in accordance with the attorney trust account rules. The ABA Model Rules are intentionally technology neutral. They contain no clear guidance on how to safeguard a cryptocurrency a lawyer receives. So, for example, if a lawyer is able to navigate the reasonableness requirement and accept a cryptocurrency advance, the ABA Model Rules do not provide guidance into how such funds are maintained. Typical attorney trust accounts may not accept cryptocurrency, and lawyers will have to investigate which type of crypto wallet – if any – can satisfy ABA Model Rule 1.15's requirements.

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[48] MODEL RULES OF PROF'L CONDUCT R. 1.8(a).

[49] *Id*.

[50] *Id*.

[51] *Id*.

Only four bar associations have so far provided guidance on whether attorneys can accept cryptocurrency in a law practice. Thus, lawyers in Nebraska, New York, North Carolina, and the District of Columbia have some guidance that can assist them. Most ethics opinions relating to cryptocurrency begin with a discussion of Rule 1.5 and focus substantial attention on whether a lawyer's acceptance of cryptocurrency for attorneys' fees would be "reasonable." For example, the Nebraska ethics advisory opinion focuses on Rule 1.5 concerns. In Nebraska, an attorney may accept cryptocurrency as payment for legal fees so long as the cryptocurrency is converted to dollars immediately upon receipt using an objective payment processor and the client's account must be credited at the time of payment. [52]

Lawyers in Nebraska must also take care to ensure that if they do accept cryptocurrency in payment of legal fees and the acceptance of such fees is reasonable, they must implement "Know Your Customer" procedures if they receive cryptocurrency from third-party or anonymous payors. Finally, while cryptocurrency can be held in trust or escrow by Nebraska attorneys, it is not permitted in a client trust account, must be maintained separately from the attorney's property, must be maintained in an account with commercially reasonable safeguards, and the attorney must maintain records of the property for five years.[53] The opinion notes a few reasonable safeguards, such as using cold storage, encrypting the private key used to access the assets, or using storage accounts with multi-signature verification.[54]

North Carolina similarly focuses on Model Rule 1.5 issues, but also raises concerns related to Rule 1.8, suggesting that cryptocurrency may implicate a business transaction between client and lawyer.[55] Thus, lawyers in North Carolina are permitted to accept cryptocurrency as a flat fee in exchange for legal services.[56] If they do so, however, they must meet several requirements: (1) ensuring that the terms are fair and reasonable and disclosed in writing to the client with a mutually agreed upon valuation of the cryptocurrency; (2) the client must be advised in writing to seek independent legal counsel; and (3) the lawyer is not permitted to represent the client in the transaction concerning acceptance of cryptocurrency but must obtain the client's written informed consent to participate in the transaction.[57] North Carolina also addressed the issue of whether lawyers may accept cryptocurrency as an advance payment or hold it in trust for settlement, answering with a resounding NO.[58] According to the opinion drafters, cryptocurrency wallets (including cold wallets) are insufficiently secure to meet North Carolina's Rule 1.15 (safekeeping property) at the time the opinion was drafted, but the state is open to reconsidering the issue in

[52] Neb. Lawyer's Advisory Comm., Op. 17-03 (2017).

[53] *Id*.

[54] *Id*.

[55] N.C. State Bar, Formal Ethics Op. 2019-5 (2019).

[56] *Id*.

[57] *Id*.

[58] *Id*.

the event they feel the technology has become more secure.[59] The North Carolina opinion raised another issue, that it did not opine on: whether the source of funds is legal. The opinion notes

> This opinion does not reach the legal issues surrounding an individual's receipt of and transacting in virtual currency. Before transacting in virtual currency, lawyers should appraise themselves of the legal ramifications surrounding the use of virtual currency, including potential tax and criminal implications. As with other forms of payment, lawyers should take the appropriate steps to ensure any virtual currency received is not the product of or otherwise connected to illegal activity.

The DC Bar has also issued an opinion on whether attorneys may accept cryptocurrency in practice.[60] DC's Bar notes that whether fees paid in cryptocurrency are reasonable depends not only on the terms of the agreement and whether the payment is made in advance but also on how well the lawyer explains the particular financial risk embedded in the fee structure and the general volatility of cryptocurrencies.[61] The DC bar also notes in its opinion that a transaction involving cryptocurrency is closer to one involving property than fiat currency.[62] It delineates what transactions are covered by Rule 1.8(a) versus 1.5. Thus, a transaction where a client pays for a fee calculated in dollars for services already rendered is governed by Rule 1.5. On the other hand, a fee negotiated in advance or calculated in cryptocurrency is more akin to a transaction and is subject to Rule 1.8's requirements.[63] Whether or not the transaction is reasonable under Rule 1.8 is to be measured at the time the agreement is made. The DC opinion notes that what must be included in a written agreement to satisfy Rule 1.8(a) varies based on the transaction but should broadly include explanations of billing rates and their frequency, how the client is to be billed, the frequency of calculations in dollars of the value of the fees and whether market fluctuations affect them, the use of a cryptocurrency platform to determine value, and who is responsible if the currency loses value and that value cannot be satisfied by third party liens.[64] The DC bar opinion explicitly permits the storage of currencies so long as the lawyer takes steps to address the unique concerns storing crypto presents, such as avoiding fraudulent online wallets and anticipating security breaches in legitimate wallets, theft or malware stealing private keys kept in hot wallets, and the loss of keys kept in cold wallets.[65]

Finally, the New York City Bar Association, a voluntary bar association, has issued its own advice.[66] The New York City Bar Association frames the question as "Is the acceptance of digital

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[59] *Id*.

[60] D.C. Bar, Ethics Op. 378 (2020).

[61] D.C. Bar, Ethics Op. 378 (2020).

[62] D.C. Bar, Ethics Op. 378 (2020).

[63] *Id*.

[64] *Id*.

[65] D.C. Bar, Ethics Op. 378 (2020).

[66] NYCBA Comm. on Prof'l and Jud. Ethics, Op. 2019-5 (2019).

assets as payment a 'business transaction' under Model Rule 1.8(a)?"[67] The answer? According to the New York City Bar Association: It depends. A business transaction exists if the attorney offers legal services in exchange for a flat fee or hourly fee payable only in cryptocurrency.[68] On the other hand, if cryptocurrency is not mandated but only one form of optional currency accepted for payment of legal fees, there is not a business transaction under Rule 1.8(a) at issue.[69] The New York City Bar Association urges lawyers to treat cryptocurrency transactions that do constitute a business transaction under Rule 1.8(a) as fee arrangements acquiring an interest in property.[70] The opinion clarifies exactly what makes an arrangement involving cryptocurrency adverse to a client, explaining that if the attorney offers legal services in exchange for a flat or hourly fee payable only in digital assets, the attorney and client's interests differ and the requirements in Rule 1.8(a) are implicated. In contrast, an agreement where the use of crypto as payment is optional does not implicate Rule 1.8, as the attorney's interests are not adverse to the client's.[71]

CONCLUSION

As the usage of cryptocurrencies in the global economy continues to change, so too will the legal profession's approach to their usage in fee agreements. Until then, attorneys can mitigate any ethical pitfalls in their use by informing themselves about cryptocurrency and its risks. Moreover, the guidance provided in existing ethics opinions may provide persuasive authority to help attorneys outside those jurisdictions develop their own plan. However, lawyers should be sure to adhere to the foundational ethics rules that cryptocurrency implicate: Rule 1.5's requirement that all fees be reasonable; Rule 1.8(a)'s requirements concerning business transactions with clients; and Rule 1.15's requirements for safely maintaining client property. Though not all state bar associations have yet interpreted their ethical rules in light of the increasing popularity of cryptocurrency, these technology-neutral rules are sufficiently malleable to guide the lawyer seeking to accept cryptocurrency, and we can expect to see more ethics opinions from additional jurisdictions in the future. Finally, lawyers should consider seeking counsel from their licensing jurisdiction's ethics hotline if they have questions.

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[67] *Id*.

[68] *Id*.

[69] *Id*.

[70] NYCBA Comm. on Prof'l and Jud. Ethics, Op. 2019-5 (2019).

[71] *Id*.

THE OBLIGATIONS AND REGULATORY CHALLENGES OF ONLINE BROKER-DEALERS AND TRADING PLATFORMS

Christine Lazaro and Teresa J. Verges[1]

Investing has been evolving for decades. On "Mayday" in 1975, the SEC abolished fixed commissions, changing the face of the brokerage industry.[2] A few months later, Charles Schwab opened its first offices, and discount brokerages were born.[3] By the mid-1980s, there were over 600 discount brokers operating.[4] By 1990, discount brokerage firms captured just under than 10% of the market, although Charles Schwab captured 40% of the discount brokerage market.[5] Throughout the 1990s, new firms entered the market, including E*Trade and AmeriTrade.[6] Online trading became more prevalent; by 1999 25% of all trades occurred online.[7] The term "day trader" entered our vocabulary.[8] Commissions declined, until they reached zero.[9]

Investors now have more choices than ever when deciding how and with whom to invest. In addition to the large full service brokerage firms, there are independent broker-dealers, discount brokers, and online platforms and apps. Across the models, the level of service varies, as does the minimum amount needed to open an account and the ease with which an account can be opened.

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[2] *See* Jason Zweig, *Lessons of May Day 1975 Ring True Today: The Intelligent Investor*, WALL ST. J. (Apr. 30, 2015), https://www.wsj.com/articles/lessons-of-may-day-1975-ring-true-today-the-intelligent-investor-1430450405.

[3] *See id.*

[4] *See* Stephen Mihm, *The Death of Brokerage Fees Was 50 Years in the Making*, BLOOMBERGOPINION (Jan. 3, 2020), https://www.bloombergquint.com/view/how-nyse-went-from-quasi-cartel-to-zero-fee-stock-trading.

[5] *See* Richard D. Hylton, *All About: Discount Brokers; Now Fewer Firms Are Chasing Small Investors Discount Brokers*, N.Y. TIMES (June 17, 1990), https://www.nytimes.com/1990/06/17/business/all-about-discount-brokers-now-fewer-firms-are-chasing-small-investors-discount.html.

[6] *See* Bob Pisani, *Man Vs. Machine: How Stock Trading Got So Complex*, CNBC (Sept. 13, 2010), https://www.cnbc.com/2010/09/13/man-vs-machine-how-stock-trading-got-so-complex.html.

[7] *See* Arthur Levitt, Chair, Sec. Exch. Comm'n, Remarks to the National Press Club, Plain Talk About On-Line Investing (May 4, 1999), http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1990/1999_0429_LevittDraftT.pdf.

[8] *See* Pisani, *supra* note 6.

[9] *See* Mihm, *supra* note 4.

Both new and experienced investors responded to these new trading models and reduced barriers to entry. 2020 witnessed a surge in new retail brokerage accounts opened on online platforms.[10] One research analyst at JMP Securities estimates that more than 10 million new online brokerage accounts were opened in 2020.[11] According to a joint study conducted by the FINRA Investor Education Foundation and NORC at the University of Chicago, 66% of survey respondents who opened a new account in 2020 were new investors, who had not previously owned a taxable investment account.[12] The FINRA/NORC study found that the new investors were younger, had lower incomes, and were more racially diverse, compared to the other groups measured, specifically experienced investors that also opened online brokerage accounts in 2020, or "holdover" account owners who owned a brokerage account but did not open a new account in 2020.[13] The FINRA/NORC study attributed the surge in new retail investors to the reduction in barriers to entry for retail investing, including no-minimum and low-minimum accounts and low or zero trading commissions.[14]

In addition to lowering the barriers to the markets, the online platforms have changed how investors interface with firms and the markets. They offer a number of different design features, commonly described as "gamification." These may include games when an investor opens an account; animations, including confetti when a milestone is reached; social networking tools; prizes or rewards for activity streaks; points, badges, and leaderboards; lists of popular stocks; free stocks for referring additional customers; and push notifications.[15]

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[10] *See* FINRA INVESTOR EDUCATION FOUNDATION AND NORC REPORT, INVESTING 2020: NEW ACCOUNTS AND THE PEOPLE WHO OPENED THEM, at 1 (Feb. 2021) (hereinafter, "FINRA/NORC Study"), https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them_1_0.pdf.

[11] *See* Susan Tompor, *Why New Investors Bought Stock During the COVID-19 Pandemic*, DET. FREE PRESS (Feb. 5, 2021), https://www.freep.com/story/money/personal-finance/susan-tompor/2021/02/05/how-invest-stock-market/4360276001/.

[12] *See* FINRA/NORC Study, *supra* note 11 at 2.

[13] *See id.*

[14] *See id.* at 7-8. Another reason for the surge of new investors was the market volatility related to the COVID-19 pandemic, prompting new investors to take advantage of market dips. *See id.* at 1, 8. COVID-19 relief stimulus checks also contributed to the spike in online brokerage accounts opened by younger, new investors. *See* Jessica Menton, *Stimulus Check: Young Investors Use $1,400 COVID-19 Relief Payments to Join Stock Market Boom*, USA TODAY (Mar. 17, 2021), https://www.usatoday.com/story/money/2021/03/17/stimulus-check-young-investors-covid-relief-payments-stock-market/4693988001/.

[15] *See* Robert W. Cook, President and Chief Executive Officer, FINRA, Statement Before the Financial Services Committee U.S. House of Representatives (May 6, 2021), https://www.finra.org/media-center/speeches-testimony/statement-financial-services-committee-us-house-representatives; *see also* Annie Massa and Tracy Alloway, *Robinhood's Role in the 'Gamification' of Investing*, BLOOMBERG WEALTH (Dec. 19, 2020), https://www.bloomberg.com/news/articles/2020-12-19/robinhood-s-role-in-the-gamification-of-investing-quicktake; Robinhood Financial, LLC, Docket No. E-2020-0047 (Mass. Off. of the Sec'y of the Commonwealth Sec. Div. Dec. 16, 2020), https://www.sec.state.ma.us/sct/current/sctrobinhood/MSD-Robinhood-Financial-LLC-Complaint-E-2020-0047.pdf.

However, regulators are concerned that many new investors, prompted by gamification, have engaged in high-risk trading strategies without an appreciation of the risks. Noting the surge in online trading, including options trading, in its 2021 exam report FINRA identified emerging "digital communications risks" associated with digital platforms and mobile apps that have interactive and "game-like" features, which could mislead investors about the risks of certain trading strategies, such as options trading.[16] FINRA also recently announced that it will seek public comment on gamification practices utilized by these platforms, with a view towards potential new rulemaking.[17] SEC Chairman Gensler also expressed concern about the "gamification" of trading apps with features that "encourage investors to trade more," and indicated that these new models may require new rules.[18]

The concerns raised today about online trading echo concerns raised by then-SEC Chairman Arthur Levitt in 1999.[19] Chairman Levitt recognized that a firm's obligations do not change even though their platforms have changed:

> The laws regulating our markets are a product of the New Deal era. To me, their concepts are as immutable as the Constitution. They have weathered challenge after challenge, decade after decade, and are every bit as relevant and effective today as they were the day they were written. Companies offering their shares -- whether off a website or through a prospectus -- still have to disclose what they are selling and why. Brokers -- whether traditional or on-line -- still have the same obligations to their customers. And fraud -- whether perpetrated over the Internet, on the phone, or in-person -- is still fraud.[20]

Chairman Levitt raised concerns about the influx of new and inexperienced investors trading inconsistently with their goals and risk tolerances.[21] He recognized that as firms grow, their ability to provide effective customer service must keep pace.[22] He emphasized that firms have an obligation of best execution, regardless of how the trade has been placed.[23] He also raised concerns about the clarity of communications, and the accuracy of advertising.[24] These same concerns are echoed today by FINRA, the SEC and the state regulators.

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[16] *See* FINRA, 2021 REPORT ON FINRA'S EXAMINATION AND RISK MONITORING PROGRAM, at 22 (Feb. 2021) (hereinafter "2021 FINRA Report)", https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program.

[17] *See* Sarah E. Aberg, Shane J. Killeen, *Game On: FINRA Hints at Upcoming Gamification Sweep*, The Nat'l L. Rev. (June 1, 2021), https://www.natlawreview.com/article/game-finra-hints-upcoming-gamification-sweep.

[18] Gary Gensler, Chair, Sec. Exch. Comm'n, Statement Before the House Committee on Financial Services, at 2 (May 6, 2021), https://financialservices.house.gov/uploadedfiles/hhrg-117-ba00-wstate-genslerg-20210506.pdf.

[19] *See* Levitt, *supra* note 7.

[20] *Id.*

[21] *See id.*

[22] *See id.*

[23] *See id.*

Regulators may ultimately promulgate new rules to address unique features of these platforms or amend existing rules to address new technology and communication practices. However, as noted by Chairman Levitt, brokerage firms offering self-directed trading services through digital platforms are still subject to existing rules and standards applicable all broker-dealers. This article reviews these primary regulatory obligations.

I. Duties of Broker-Dealers Operating Online Platforms and Trading Apps to Retail Customers

Digital trading platforms and mobile apps provide investors with the ability to open a brokerage account (often within minutes) and trade securities from the comfort of their homes. The platforms provide investors with the ability to trade securities for their own accounts, without the guidance or investment recommendations of an individual broker or investment adviser representative. While online broker-dealer platforms may look different from traditional broker-dealers, however, these firms still have many of the same basic obligations to their customers.

As described below, all brokerage firms have ongoing obligations in connection with approving, opening, and maintaining customer accounts, conducting appropriate due diligence in connection with certain trading approvals, and complying with "know your customer" and anti-money laundering regulations. Firms are also prohibited from making false or misleading statements to investors and are subject to rules governing communications to retail investors, some of which may be deemed an "investment recommendation" and therefore, subject to the SEC's Regulation Best Interest or FINRA's suitability rule. All firms are also required to implement written policies and procedures to safeguard confidential customer information, funds and assets. The very technology used by digital trading platforms requires these firms to adopt strong cybersecurity protections for their customers.

A. Opening Customer Accounts, Due Diligence and Suitability Assessments

(i) Opening and Maintenance of Accounts and Customer Identification Program

Regardless of its business model, FINRA rules require all firms to obtain, maintain and regularly update specific customer information in connection with the opening and maintenance of a customer account.

FINRA Rule 2090 requires firms to "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer."[25] The "essential facts" necessary to comply with the know your customer obligation are those required to: "(a) effectively service the customer's account, (b) act in accordance with any special handling

[24] *See id.*

[25] FINRA, Rule 2090, Know Your Customer (2012). Rule 2090 is modeled after former NYSE Rule 405(1); Rule 2090 and Rule 2111 became effective on October 7, 2011. FINRA REGUL. NOTICE 11-02, SEC APPROVES CONSOLIDATED FINRA RULES GOVERNING KNOW-YOUR-CUSTOMER AND SUITABILITY OBLIGATIONS (Oct. 7, 2011), https://www.finra.org/rules-guidance/notices/11-02.

instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."[26]

The "know your customer" obligation arises at the beginning of the firm's relationship with the customer and extends throughout that relationship.[27] This makes sense, as customers' profiles, financial status, investment objectives, risk tolerance and other essential information can and will change over time. Moreover, the "know your customer" obligation does not depend on whether the broker or the firm has made a recommendation.

At least some (but certainly not all) of the essential facts necessary to comply with the "know your customer" rule are captured through the firm's compliance with FINRA Rule 4512, which sets forth the minimum information firms must obtain, maintain and update for every customer account.[28] For retail investor customer accounts, the firm must obtain the customer's name, residential address, tax identification or social security number, the customer's occupation and name of employer, determine whether the customer is of legal age to open a brokerage account, and if the customer is a corporation, partnership or other legal entity, obtain the names of any persons authorized to trade in the account.[29] The firm should also identify for each account the associated person(s), if any, responsible for the account and the scope of each associated person's responsibility,[30] and the name of a "trusted contact" (unless the customer refused to provide one).[31]

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[26] FINRA, Rule 2090.01, Essential Facts (2012).

[27] *See* FINRA, REGUL. NOTICE 11-02, *supra* note 25; *see also Obligations to Your Customers*, FINRA (explaining the first step in serving the customer is to "know your customer" and ensure that the facts obtained are accurate and updated), (available at https://www.finra.org/registration-exams-ce/manage-your-career/obligations-your-customers) (last accessed Mar. 19, 2022). Firms typically comply with the maintenance requirement by sending periodic letters or notices to customers (either annually or upon a change in the account) reflecting the information they have for the customer and shifting the burden on the customer to contact the firm if any information is correct.

[28] *See* FINRA, Rule 4512, Customer Accout Information (2019).

[29] *See* FINRA, Rule 4512(a) (2019). In 2001, the SEC amended its books and records regulations to add, among other things, a new customer account record rule requiring firms to obtain similar information, but expanded the required information to include investment objectives, annual income and net worth (excluding value of primary home). 17 C.F.R. § 240.17a-3(a)(17) (2021) (eff. May 2, 2003). The SEC adopted the new customer account rule in order to provide SRO and state regulators access to the types of records they would need to determine the firm's compliance with the suitability rule. SEC. EXCH. COMM'N, REL. NO. 34-44992, BOOKS AND RECORDS REQUIREMENTS FOR BROKER AND DEALERS UNDER THE SECURITIES EXCHANGE ACT OF 1934 (Nov. 2, 2001), https://www.sec.gov/rules/final/34-44992.htm. However, the SEC exempted brokers and dealers who are not required to comply with the suitability rule. 17 C.F.R. § 240.17a-3(a)(17)(i)(D) (2021) ("this section will not be applicable to an account for which, within the last 36 months, the member, broker or dealer has not been required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member").

[30] *See* FINRA, Rule 4512(a)(C) (2019).

[31] *See* FINRA, Rule 4512.06, Trusted Contact Person (2019). The firm must maintain and preserve this information for a period of at least six years after the date the information is obtained or updated. *See* FINRA, Rule 4512.01, Customer Account Retention Periods (2019).

Regardless of business model, a firm's supervisory system must include written procedures for the review and approval of customer accounts in compliance with the firm's regulatory obligations.[32] Rule 4512 requires that the firm maintain a record of the signature of the supervisory principal "denoting that the account has been accepted in accordance with the member's policies and procedures for acceptance of accounts."[33]

The account approval and maintenance processes are increasingly automated, especially in the context of self-directed broker trading platforms. Retail investors, particularly younger and new investors, more frequently choose to invest through self-directed discount trading platforms and apps.[34] Investors can complete an application online or through an app, directly providing their customer information to the trading platform, and obtain trading approval in minutes.[35]

The ease with which new customer accounts can be opened and approved through automated processes, however, underscores the importance of firms developing and implementing a written Customer Identification Program in compliance with the Bank Secrecy Act ("BSA").[36] The BSA requires firms to monitor for, detect and report suspicious activity conducted or attempted to the U.S. Treasury's Financial Crimes Enforcement Network ("FinCEN").[37] A failure to file suspicious activity reports with FinCEN constitutes a violation of FINRA Rules 3310 and 2010.[38]

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[32] Under FINRA Rule 3110, Supervision, a firm's supervisory system must include written procedures to supervise the types of business in which a firm engages and its associated persons that are reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA Rules. *See* FINRA, Rule 3110(b)(1), Supervision (2022). These rules include requirements for the opening and maintenance of every customer account.

[33] FINRA, Rule 4512(a)(1)(D) (2019).

[34] *See* FINRA/NORC Study, *supra* note 10, at 1.

[35] *See, e.g.* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Robinhood Financial, LLC, Docket No. 2020066971201 (June 30, 2021) at 17, https://www.finra.org/sites/default/files/2021-06/robinhood-financial-awc-063021.pdf (hereinafter "Robinhood 2021 AWC") (account approval "nearly instantaneously").

[36] 31 U.S.C. § 5311 *et seq.* (2021). The BSA's implementing regulations require that firms "establish, document, and maintain a written Customer Identification Program . . . appropriate for [the firm's] size and business" and that the program contain "procedures for verifying the identity of each customer to the extent reasonable and practicable." 31 C.F.R. § 1023.220(a)(1) and (a)(2) (2021).

[37] *See* 31 C.F.R. § 1023.320 (2021). Title 31 U.S.C. § 5318(g) authorizes the Treasury Department to issue suspicious activity reporting requirements for broker-dealers. The Treasury Department issued the implementing regulation, 31 C.F.R. § 103.19(a)(1) (2021), in July 2002, providing that with respect to any transaction after December 30, 2002, "[e]very broker or dealer in securities within the United States . . . shall file with [the Financial Crimes Enforcement Network (FinCEN)] . . . a report of any suspicious transaction relevant to a possible violation of law or regulation." FinCEN issued 31 C.F.R. § 1023.320 (2021) (the SAR Rule) (effective Jan. 3, 2011) amending BSA regulations, requiring a broker-dealer to make SARs and supporting documentation available to any SRO that examines the broker-dealer for compliance with the requirements of the SAR Rule upon the request of the SEC. *See* FINRA, REGUL. NOTICE 12-08, SEC REQUESTS BROKER-DEALERS MAKE SARS AND SAR INFORMATION AVAILABLE TO FINRA (Jan. 2012), https://www.finra.org/rules-guidance/notices/12-08.

[38] *See, e.g.,* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Precision Securities, LLC, Docket No. 2020067467601 (July 19, 2021) (firm operated a trading platform used primarily by day- and swing-traders; however, firm did not reasonably design AML program to monitor and

FINRA Rule 3310 requires firms "to develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the member's compliance with the requirements of the [BSA]."[39] At a minimum, the firm's anti-money laundering ("AML") program must: (a) implement policies, procedures and internal controls that can reasonably detect and cause reporting of suspicious transactions; (b) provide for annual testing of the procedures; (c) designate and identify to FINRA by name, title and contact information the personnel responsible for implementing and monitoring the day-to-day operations and controls of the program; and (d) include risk-based procedures for ongoing customer due diligence, including understanding the nature and purpose of customer relationships for the purpose of developing customer risk profiles.[40]

FINRA has reminded firms about their obligations to implement AML programs to monitor and report suspicious activity. In Regulatory Notice 17-40, FINRA informed firms about additional customer due diligence requirements imposed by FinCEN, specifically, that firms identify and verify the identity of the beneficial owners of all legal entity customers at the time a new account is opened, subject to certain exclusions and exemptions.[41] FINRA has also brought enforcement actions against online trading platforms for failure to establish a Customer Identification program

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report suspicious activity in light of the firm's business model, including suspicious trading from China-based accounts for trading in excess of $200 million; FINRA fined firm $350,000); Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. ITG, Inc., Docket No. 2017054643601 (Mar. 3, 2021) (firm failed to establish and implement AML policies and procedures reasonably designed to detect and cause the reporting of suspicious low-priced securities trading; firm failed to investigate numerous red flags in connection with trading of at least 30 low-priced securities, including a potential pump and dump scheme; firm censured and fined $450,000).

[39] FINRA Rule 3310, Anti-Money Laundering Compliance Program (2018).

[40] *See id.* NASD Notice to Members 02-21 was issued shortly after the NASD filed Rule 3310's predecessor rule, promulgated in response to the passage of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (PATRIOT Act), Pub. L. No. 107-56, 115 Stat. 272 (2001). Title III of the PATRIOT Act, referred to as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (Money Laundering Abatement Act), imposes obligations on broker/dealers under new anti-money laundering (AML) provisions and amendments to the existing Bank Secrecy Act (BSA) requirements. 31 U.S.C. §§ 5311 *et seq.* (2021).

[41] *See* FINRA, REGUL. NOTICE 17-40, FINRA PROVIDES GUIDANCE TO FIRMS REGARDING ANTI-MONEY LAUNDERING PROGRAM REQUIREMENTS UNDER FINRA RULE 3310 FOLLOWING ADOPTION OF FINCEN'S FINAL RULE TO ENHANCE CUSTOMER DUE DILIGENCE REQUIREMENTS FOR FINANCIAL INSTITUTIONS (Nov. 2017), https://www.finra.org/rules-guidance/notices/17-40. FINRA again reminded firms about their obligations to monitor and report suspicious activity, providing a series of red flags that would alert firms to issues involving: (i) customer due diligence and interactions with customers; (ii) deposits in securities; (iii) red flags in securities trading; (iv) red flags in money movement; (v) red flags in insurance products; and (vi) various other potential red flags associated with the account or account activity. *See* FINRA, REGUL. NOTICE 19-18, ANTI-MONEY LAUNDERING (AML) PROGRAM (May 2019), https://www.finra.org/rules-guidance/notices/19-18.

tailored to the firm's business model,[42] and failure to adapt its AML program to its growth sufficient to surveil suspicious money movements and investigate suspicious activity.[43]

Most recently, FINRA warned about the heightened risk for fraud during the COVID-19 Pandemic in Regulatory Notice 20-13, which stated that that firms reported an increase in newly-opened fraudulent accounts, with fraudsters targeting online account platforms, particularly "firms that recently started offering such services."[44] FINRA warned that fraudsters were using stolen or synthetic identities to establish fraudulent accounts to divert congressional stimulus funds, unemployment payments or engage in automated clearing house (ACH) fraud.[45] For firms that opened accounts through electronic means, FINRA stressed the importance of a strong Customer Identification Program (in the opening and ongoing monitoring of customer accounts), which utilized *both* documentary and non-documentary (i.e., independent verification of customer information) methods of verifying customer identity, limited automated approval of multiple accounts opened by the same customer, and used other verification procedures for bank accounts and transfers.[46]

FINRA's 2021 enforcement action against Robinhood Financial included charges against the firm for its failure to establish and implement a reasonably designed Customer Identification Program.[47] According to the FINRA AWC, the firm approved more than 5.5 million new customer accounts between June 2016 to November 2018, relying primarily on a customer identification process that was "largely automated" and suffered from "multiple flaws."[48] Among other things,

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[42] *See, e.g.,* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Score Priority Corp., Docket No. 2020067466901 (Apr. 14, 2021) (FINRA imposed $250,000 fine and censure against online, self-directed broker-dealer that failed to develop and implement an AML program reasonably expected to detect and report suspicious activity from transactions and money movements in domestic and foreign-based retail accounts; firm also failed to establish a Customer Identification Program tailored to the firm's business and a due diligence program reasonably designed to detect money-laundering activities).

[43] *See, e.g.,* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Interactive Brokers LLC, Docket No. 2015047770301 (Aug. 10, 2020) (assessing $15 million fine and censure against Interactive Brokers, finding that the firm failed to reasonably design its AML program to match its significant growth, and that its existing AML program was deficient because it failed to surveil thousands of suspicious money movements in the hundreds of millions of dollars, and the firm failed to investigate potentially suspicious activity).

[44] FINRA, REGUL. NOTICE 20-13, HEIGHTENED THREAT OF FRAUD AND SCAMS, FINRA REMINDS FIRMS TO BEWARE OF FRAUD DURING THE CORONAVIRUS (COVID-19) PANDEMIC (May 5, 2020), https://www.finra.org/rules-guidance/notices/20-13; *see also* FINRA, REGUL. NOTICE 19-18, *supra* note 41 (providing a comprehensive list of "money laundering red flags" that is not exhaustive or all-inclusive).

[45] FINRA, REGUL. NOTICE 20-13, *supra* note 44.

[46] *See id.* at 2-3. In addition to fraudulently opened accounts, Regulatory Notice 20-13 identified three additional scams which increased during the pandemic, including firm imposter scams (where fraudsters impersonate firms and associated persons in communicating with customers); IT Help Desk scams (fraudsters posing as persons associated with the firm to obtain new sign-on credentials from the firm's IT desk); and business email compromise schemes (fraudsters posing as manager or executive requesting payment for an invoice or other expense). *See id.*

[47] *See* Robinhood 2021 AWC, *supra* note 35, at 26.

[48] *See id*. at 26-27.

Robinhood did not have any employees whose primary job responsibilities related to the Customer Identification Program, as required by FINRA Rule 3310, Anti-Money Laundering Compliance Program, and had just one principal responsible for more than half of the new accounts.[49] The firm's automated system approved accounts even after its clearing firm flagged an account as needing "further review" due to the presence of a "fraud victim warning."[50]

Moreover, FINRA found that Robinhood ignored its own written procedures for the verification of these accounts. For example, although the clearing firm recommended thorough verification of flagged accounts, Robinhood *overrode* those alerts to approve the accounts anyway without any additional verification.[51] As a result of these failures, FINRA found that Robinhood had violated FINRA Rules 3310, Anti-Money Laundering Compliance Program and 2010, Standards of Commercial Honor and Principles of Trade.[52]

Brokerage firms' obligations to conduct customer due diligence, obtain and maintain updated customer information, and implement strong supervisory systems to monitor against fraudulent activity is also central to firms' obligations to protect customer information and assets, as discussed below.

(ii) Approving Customer Accounts for Options Trading and Margin

The 2021 Report on FINRA's Examination and Risk Monitoring Program stated that 2020 "witnessed a surge in new retail investors entering the market via online brokers, as well as an increase in certain types of trading, including options," noting the increase in "game-like" features of trading apps and other communications that may encourage investors to engage in higher risk trading.[53] Robert Cook, FINRA's CEO, echoed this concern in his May 6, 2021 statement before the U.S. House of Representatives Financial Services Committee, observing that game-like features on trading Apps "may encourage investor behaviors that impact sound investment decisions."[54] Cook announced that FINRA established a cross-departmental working group to assess how broker-dealers use their trading platforms and mobile apps to influence customer behavior, and determine whether additional rulemaking or guidance is necessary.[55]

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[49] *See id.* at 27.

[50] *Id.* The clearing firm flagged accounts as needing further review because, among other reasons, the customer's social security was not issued by the Social Security Administration, the customer's age could not be verified, the customer's address was a storage facility, P.O. Box or cash-checking facility, or the customer's address had been used ten times or more by individuals with different social security numbers. *Id.*

[51] *See id.* Robinhood approved 90,000 accounts that had been flagged for potential fraud, without requesting additional identification (such as a driver's license or passport), ignoring its own requirements to obtain other physical verification of customer identities. *See id.*

[52] *See id.* In the AWC, FINRA tied Robinhood's violations of its other conduct rules – including Rule 3310 – to Rule 2010 which requires firms maintain a high standards in the conduct of their business. FINRA explained that a violation of Rule 3310 also constitutes a violation of Rule 2010. *See id.*

[53] 2021 FINRA Report, *supra* note 16, at 22.

[54] Cook, *supra* note 15.

[55] *See id.*

To the extent trading platforms and mobile apps are directing or facilitating higher risk trading in the form of options trading, however, these firms are required to approve each customer for a specific level of options trading (and use of margin) based on the customer's profile and experience.

FINRA Rule 2360 requires firms to conduct due diligence in approving a customer's account for options trading, including obtaining the essential facts about the customer, the customer's financial situation and investment objectives, and the customer's *investment experience* and knowledge, including the number of years and type of trading.[56]

FINRA Rule 2360(b)(16)(A)-(D) require a brokerage firm to consider the various levels of options trading (e.g., buying covered calls, uncovered writing), the risks specific to the customer in light of the customer's profile and experience, and "determin[e] whether and *to what extent* to approve the account for options trading."[57] Subsection (16)(B)(ii)(d) further requires a firm to note in the customer's account records the "[n]ature and types of transactions for which" it is approved. A firm cannot accept an options order unless it has provided the customer with an options disclosure document[58] and the customer's account has been approved for options trading by a registered Options Principal or Limited Principal – General Securities Sales Supervisor.[59]

In 2021, FINRA reminded firms that the obligations to conduct due diligence in connection with options account approvals and margin equally applies to self-directed accounts.[60] FINRA's notice was prompted by the significant increase in the number of customers opening self-directed accounts and trading options.[61] The notice explained that Rule 2360(b)(16) requires a firm to specifically approve (or disapprove) each customer for options trading and the appropriate level of options trading for that customer based upon "detailed customer information, including, among others, the customer's knowledge, investment experience, age, financial situation and investment objectives."[62] This obligation applies regardless of whether the account is self-directed or the options are recommended.[63]

Since option transactions are often required to be traded in a margin account, FINRA's notice reminded firms of margin maintenance requirements under Rule 4210, explaining that firms must

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[56] FINRA, Rule 2360(b)(16)(B), Diligence in Opening Accounts (2020).

[57] *Id.*

[58] The specific disclosure document is entitled "Characteristics and Risks of Standardized Options," a 188-page pamphlet available for download on the Options Clearing Corporation website at: https://www.theocc.com/Company-Information/Documents-and-Archives/Options-Disclosure-Document.

[59] *See* FINRA, Rule 2360(b)(16)(A), Approval Required (2020).

[60] *See* FINRA, REGUL. NOTICE 21-15, FINRA REMINDS MEMBERS ABOUT OPTIONS ACCOUNT APPROVAL, SUPERVISION AND MARGIN REQUIREMENTS (Apr. 9, 2021), https://www.finra.org/rules-guidance/notices/21-15.

[61] *See id.* at 1.

[62] *Id.* at 2.

[63] *See id.* The notice also referenced requirements under FINRA Rule 2090, Know your Customer, FINRA Rule 4512, Customer Account Information, and FINRA Rule 3310, Anti-Money Laundering (AML) Program. *See id.* at 1-2.

also "have procedures to review the limits and types of credit extended to all customers, to review the need for higher margin requirements for individual securities and customers and to formulate their own margin requirements."[64]

Despite due diligence and supervisory approval requirements, customers frequently get "instant" approval for options trading in margin accounts when opening self-directed accounts online or through an app, like Robinhood. This is because online trading firms have largely automated the customer account opening process, which often includes an application to trade options. Firms are nevertheless required to implement supervisory reviews of any automated processes, however, to ensure that they comply with FINRA rules.

One of the charges against Robinhood in FINRA's enforcement action was its failure to establish or maintain a supervisory system to achieve compliance with FINRA Rule 2360(b)(16), because it used an automated system that did not sufficiently implement the due diligence requirements under the rule. The AWC stated that the firm had relied almost entirely on an automated system that used algorithms – known by Robinhood as "option account approval bots" – to review customer responses to eligibility questions and, based on those responses, approve or reject option applications "nearly instantaneously."[65] But the system failed to comply with Rule 2360(b)(16)'s due diligence and approval obligations in several respects:

- The bots considered only the information provided in the immediate customer application, without regard to any prior application or information provided by the customers;[66]

- The bots approved customers for level 3 trading (requiring three years of trading experience) even if the customers were under 21 years old, or had previously represented they had no options experience, or who had previously certified that they did not understand option spreads;[67]

- Robinhood's principals reviewed on a weekly basis less than 0.1% of the accounts to ensure that the bots performed as programmed; moreover, the reviews were limited only to ensuring that the bots functioned as programmed, and not whether the information provided was consistent for that customer or whether options trading was appropriate for that customer in the first place;[68] and

- Robinhood's system approved thousands of accounts where the customer had provided false information, or where the customer had revised risk tolerance information that would have made them ineligible to trade options under the firm's own criteria.[69]

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[64] *Id.* at 4.

[65] Robinhood 2021 AWC, *supra* note 35, at 17.

[66] *See id.*

[67] *See id.* at 17-18.

[68] *See id.* at 18.

[69] *See id.* at 18-19.

As a result of these failures, FINRA found that Robinhood failed to supervise its system for approving options trading and exercise due diligence in approving customers for options trading, in violation of FINRA Rules 3110, 2360 and 2010.[70]

B. Communications and Investment Recommendations

Brokerage firms have certain obligations when they communicate with the public. The 2200 series of the FINRA rules govern communications and disclosures. FINRA Rule 2210 broadly covers communications with the public. FINRA Rules 2220, 2264, and 2270 cover more specific types of communications relating to options trading, margin trading, and day-trading. As previously noted, these rules apply regardless of the way the firm does business – through brokers, online, or through a mobile app. Firms are obligated to ensure that all communications comply with FINRA rules.

(i) Communicating with the Public

FINRA categorizes communications as Retail, Correspondence, and Institutional.[71] A "retail communication" is "any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period."[72] "Correspondence" is defined as "any written (including electronic) communication that is distributed or made available to 25 or fewer retail investors within any 30 calendar-day period."[73] An "institutional communication" is defined as "any written (including electronic) communication that is distributed or made available only to institutional investors, but does not include a member's internal communications."[74]

How a communication is defined determines the firms' approval and review obligations in connection with the communication. All retail communications must be approved by a principal of the firm either before it is first used or before it is filed with FINRA.[75] Correspondence must be reviewed and supervised as determined by FINRA Rule 3110.[76] Institutional communications must be reviewed by a principal.[77]

FINRA has also instituted broad content standards for all communications. Communications must be "fair and balanced," and may not omit any "material fact or qualification if the omission, in light of the context of the material presented, would cause the communications to be misleading."[78]

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[70] *See id.* at 21.

[71] *See* FINRA, Rule 2210, Communications with the Public (2019).

[72] FINRA, Rule 2210(a)(5) (2019).

[73] FINRA, Rule 2210(a)(2) (2019).

[74] FINRA, Rule 2210(a)(3) (2019).

[75] *See* FINRA, Rule 2210(b)(1)(A) (2019).

[76] *See* FINRA, Rule 2210(b)(2) (2019).

[77] *See* FINRA, Rule 2210(b)(3) (2019).

[78] FINRA, Rule 2210(d)(1)(A) (2019).

Firms are not permitted to make "any false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication."[79] Further, communications must "provide balanced treatment of risks and potential benefits."[80] Additionally, firms must consider to whom they will be making the communication, and provide appropriate details and explanations.[81]

The rules do not make any differentiation for the method of delivery. Electronic communications are captured by each definition. Accordingly, communications that take place via social media web sites or through apps are subject to the requirements of the rule. FINRA understands that firms are utilizing different means of communication, including icons, illustrations, cartoons, animations, short videos, and pictograms.[82] FINRA recognizes that these new technologies can help investors understand the firm's products and services, while also delivering required disclosures.[83]

Regardless of how the firm communicates with the public, firms are still obligated to follow FINRA rules and ensure communications are fair and balanced and not misleading.[84] FINRA has provided some guidance as to what that means for non-promotional materials:

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

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[79] FINRA, Rule 2210(d)(1)(B) (2019).

[80] FINRA, Rule 2210(d)(1)(D) (2019).

[81] *See* FINRA, Rule 2210(d)(1)(E) (2019).

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

[83] *See id.*

[84] *See id.*

- **Post-sale communications:** Once a sale has occurred, members may provide communications to investors that discuss the product, such as changes to its portfolio or information about how the product has responded to changes in market conditions. These subsequent communications typically do not require the same extent of disclosure as communications leading up to a sale. Of course, a post-sale communication that recommends additional purchases or another product would be a promotional communication.[85]

Promotional materials that discuss the benefits of a particular product, type of product, or service may require extensive disclosures, including a balanced discussion of the risks or drawbacks.[86]

FINRA has also provided specific guidance to firms communicating commission discounts. For example, FINRA has stated that the communications must recognize that stocks are not the only type of securities available, and discounts may vary depending on the product traded.[87] Firms must also acknowledge that certain products, such as mutual funds, may have sales charges that cannot be discounted.[88] Further, firms must include a description of any factors that would impact the discount, such as initial deposit requirements, minimum transaction size, or registration fee.[89] Firms must also disclose any services charges that are applicable, such as charges applicable to limit orders, safekeeping of securities, odd lot transactions, or research.[90]

Communications that recommend a particular security or investment strategy are subject to other rules and limitations.

Both FINRA and the SEC set standards of conduct that are applicable when a recommendation of a security or investment strategy is made to an investor. However, neither FINRA nor the SEC define the term "recommendation." When it enacted Reg. Best Interest, the SEC stated that it would define the term consistently with how it had been defined previously, specifically referencing FINRA's Suitability Rule and FINRA Notice to Members 01-23.[91]

FINRA Notice to Members 01-23, Online Suitability, discusses the obligations of firms when communicating with customers online.[92] FINRA explained that:

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[85] *Id.*

[86] *See id.*

[87] *See Guidance: Recommendations Concerning Advertising and Promotion of Commission Discounts*, FINRA, https://www.finra.org/rules-guidance/guidance/recommendations-concerning-advertising-and-promotion-commission-discounts.

[88] *See id.*

[89] *See id.*

[90] *See id.*

[91] *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,335 (July 12, 2019) (hereinafter "Reg. Best Interest Adopting Release").

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

> [T]he "facts and circumstances" determination of whether a communication is a "recommendation" requires an analysis of the content, context, and presentation of the particular communication or set of communications. The determination of whether a "recommendation" has been made, moreover, is an objective rather than a subjective inquiry. An important factor in this regard is whether—given its content, context, and manner of presentation— a particular communication from a broker/dealer to a customer reasonably would be viewed as a "call to action," or suggestion that the customer engage in a securities transaction. Members should bear in mind that an analysis of the content, context, and manner of presentation of a communication requires examination of the underlying substantive information transmitted to the customer and consideration of any other facts and circumstances, such as any accompanying explanatory message from the broker/dealer. Another principle that members should keep in mind is that, in general, the more individually tailored the communication to a specific customer or a targeted group of customers about a security or group of securities, the greater likelihood that the communication may be viewed as a "recommendation.[93]

FINRA went on to provide examples of communications that would likely fall outside the definition, and communications that would generally fall within the definition of recommendation.[94] For example, the following types of communications are likely not recommendations:

- A website with an electronic library that contains research reports, news, quotes, and charts;
- A search tool that allows a customer to sort or filter information about securities, so long as the firm does not limit it to or prefer securities in which the firm makes a market or for which it has issued a "buy" recommendation; and
- An email or other electronic subscription service that alerts a customer to news affecting securities in the customer's portfolio or on the customer's "watch list."[95]

The following communications are more likely to be deemed recommendations:

- An email or pop-up to a targeted customer or targeted group of customers encouraging the purchase of a security;
- A list of stocks accompanied by a request that the customer purchase one or more stocks on the list;
- A portfolio analysis tool that provides a list of specific securities the customer could buy or sell to meet the investment goals the customer has inputted; and
- Sending or pushing specific investment suggestions following the firm's use of data mining technology to analyze a customer's financial or online activity.[96]

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[93] *Id.*

[94] *Id.*

[95] *See id.*

[96] *See id.*

FINRA acknowledged that the examples provided were not all inclusive, and were based on then prevalent technologies.[97] It suggested that firms analyze each communication to determine whether it reasonably could be considered a "call to action," such that it would influence a customer to trade a particular security or group of securities.[98] Such analysis should take place regardless of whether the customer requested the information, or if it was a computer software program that determined the information should be sent.[99] FINRA also reminded firms that they cannot discharge or avoid their obligations by using disclaimers.[100]

FINRA also recognized that firms may communicate on social media. The fact that the communication is widely disseminated or limited to a select one or more individuals is not determinative of whether the firm has made a recommendation.[101] Firms must still consider the facts and circumstances of the communication.[102]

If the communication is deemed to be a recommendation, then firms must comply with FINRA Rule 2111, Suitability or Reg. Best Interest. FINRA Rule 2111 applies to all recommendations made to customers prior to June 30, 2020. For recommendations made on or after June 30, 2020 either FINRA Rule 2111 or Reg. Best Interest applies. Reg. Best Interest applies to recommendations made to retail investors, defined as natural persons and their legal representatives, seeking advice for personal, family, or household purposes.[103] FINRA Rule 2111 applies to any recommendations not covered by Reg. Best Interest.[104]

If FINRA Rule 2111 applies, firms must comply with the three suitability components, reasonable-basis suitability, customer-specific suitability, and quantitative suitability. Reasonable-basis suitability requires that a firm "have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors."[105] This requires the firm to have an understanding of the recommendation's risks and rewards.[106]

The customer-specific obligation requires that a firm "have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile."[107] The customer's investment profile includes the customer's age, other investments,

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[97] *See id.*

[98] *See id.*

[99] *See id.*

[100] *See id.*

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

[102] *See id.*

[103] Reg. Best Interest Adopting Release, *supra* note 91 at 33,343.

[104] *See* FINRA Rule 2111.08 (2020).

[105] FINRA, Rule 2111.05(a) (2020).

[106] *Id.*

[107] FINRA, Rule 2111.05(b) (2020).

financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance.[108]

Quantitative suitability requires that the firm "have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile."[109]

If the recommendation is governed by Reg. Best Interest, the firm must comply with the Disclosure, Care, Conflict of Interest, and Compliance obligations.[110] The Care obligation, in many ways, mirrors FINRA Rule 2111. It also consists of reasonable-basis, customer-specific, and quantitative obligations. Pursuant to the reasonable-basis obligation, the firm must "[u]nderstand the potential risks, rewards, and costs associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers."[111]

Under the customer-specific obligation, the firm must "[h]ave a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer, or such natural person ahead of the interest of the retail customer."[112]

The quantitative obligation requires the firm to "[h]ave a reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile and does not place the financial or other interest of the broker, dealer, or such natural person making the series of recommendations ahead of the interest of the retail customer."[113]

As noted, neither FINRA nor the SEC have defined recommendation, and have not said whether they would deem gamification features to be recommendations. They have recognized that gamification or prompts that promote or encourage trading activity may be subject to Reg. Best Interest.[114]

Massachusetts filed an Administrative Complaint against Robinhood that sought to hold the firm responsible for violations of its newly enacted fiduciary regulation.[115] Like the Suitability Rule and Reg. Best Interest, the regulation imposes obligations on a firm when it makes recommendations.

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[108] FINRA, Rule 2111(a) (2020).

[109] FINRA, Rule 2111.05(c) (2020).

[110] 17 C.F.R. § 240.15l-1(a)(2) (2021).

[111] 17 C.F.R. § 240.15l-1(a)(2)(ii)(A) (2021).

[112] 17 C.F.R. § 240.15l-1(a)(2)(ii)(B) (2021).

[113] 17 C.F.R. §240.15l-1(a)(2)(ii)(C) (2021).

[114] *See* Cook, *supra* note 15; *see also* Gensler, *supra* note 18.

[115] Robinhood Financial, LLC, *supra* note 15.

Massachusetts relied in part on Robinhood's communications, including push notifications of lists of stocks, in arguing that Robinhood was making recommendations.[116]

(ii) Options Communications

In addition to the general rules concerning communications, FINRA has enacted more specific rules with respect to options communications. With the increased prevelance of options trading in self-directed online accounts, FINRA and the SEC have both voiced concerns that investors may not fully appreciate the risks involved.[117] When communicating about options, firms must meet additional standards.

There are two different standards to which communications regarding standardized options, prior to the delivery of disclosure documents, must conform.[118] If the options are not exempt by Securities Act Rule 238, and the communication is taking place prior to the prospectus delivery that "meets the requirements of Section 10(a) of the Securities Act", then the communication must "conform to Securities Act Rule 134 or 134a, as applicable."[119] However, if the communications are about options that are exempt from by Securities Act Rule 238, and are made before the delivery of disclosure documents are made, then there are five rules that must be adhered to.[120] First, the options being discussed can only be generally described.[121] Second, the communication must include contact information to enable the readers to obtain the disclosure documents.[122] Third, the communication may not contain "recommendations or past or projected performance figures, including annualized rates of return, or names of specific securities."[123] However, the communication may include any statement required by state or administrative law.[124] Finally, the

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

[117] *See* Cook, *supra* note 15.

[118]" *See* FINRA, Rule 2220(d), Options Communications (2014).

[119] FINRA, Rule 2220(d)(1)(B) (2014).

[120] *See* FINRA, Rule 2220(d)(1)(A) (2014).

[121] *See* FINRA, Rule 2220(d)(1)(A)(I) (2014) ("The text may also contain a brief description of options, including a statement that identifies registered clearing agencies for options and a brief description of the general attributes and method of operation of the exchanges on which such options are traded, including a discussion of how an option is priced.").

[122] *See* FINRA, Rule 2220(d)(1)(A)(ii) (2014).

[123] FINRA, Rule 2220(d)(1)(A)(iii) (2014).

[124] *See* FINRA, Rule 2220(d)(1)(A)(iv) (2014).

communication is allowed to contain advertising devices, such as borders, logos, and graphics, provided that such devices are not misleading.[125]

While FINRA Rule 2220(d)(1) deals with the substance of options communications, FINRA Rule 2220(d)(2) deals with communication standards that apply to firms. Firms are prohibited from including in their options communications any information that is false or misleading, or omits any materially relevant information.[126] Furthermore, firms may not make promises of results, nor make unwarranted claims or forecasts.[127] Firms are also prohibited from including opinions that lack any reasonable basis.[128] Additionally, if warnings or caveats are included in such communications, then they must be legible.[129] Such warnings may not be misleading or irrelevant.[130] These communications may not suggest that a secondary market for the options is available.[131] Finally, communications may not be made if they "would constitute a prospectus as that term is defined in the Securities Act, unless it meets the requirements of Section 10 of the Securities Act."[132]

Firms are further prohibited from using options communications that are deficient in certain ways. Communications must reflect the risks of options trading and the complexities of options as related to other investments.[133] The communication must contain a warning that options are not suitable for all investors.[134] Conversely, firms are prohibited from making a communication if it suggests that options are suitable to all.[135] Also, any communications must inform the reader that supporting documentation for all claims made is available upon request.[136] However, certain of these requirements do not apply to institutional communications.[137] Finally, all communications

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[125] *See* FINRA, Rule 2220(d)(1)(A)(v) (2014).

[126] *See* FINRA, Rule 2220(d)(2)(A)(i) (2014).

[127] *See* FINRA, Rule 2220(d)(2)(A)(ii) (2014).

[128] *See id.*

[129] *See* FINRA, Rule 2220(d)(2)(A)(iii) (2014).

[130] *See id.*

[131] *See* FINRA, Rule 2220(d)(2)(A)(v) (2014).

[132] FINRA, Rule 2220(d)(2)(A)(iv) (2014).

[133] *See* FINRA, Rule 2220(d)(2)(A)(vi) (2014).

[134] *See* FINRA, Rule 2220(d)(2)(A)(vii) (2014).

[135] *See id.*

[136] *See* FINRA, Rule 2220(d)(2)(A)(viii) (2014) (such documentation includes "comparison, recommendations, statistics, or other technical data").

[137] *See* FINRA, Rule 2220(d)(2)(B) (2014); *see also* FINRA, Rule 2220(a)(1)(B) (2014) (stating institutional communications are defined by FINRA, Rule 2210(a)).

must be equally balanced between the upside benefits with the attendant risks.[138] All such risk warnings must be as specific as the statement of opportunities.[139]

So long as certain conditions are met, projections may be included in options communications.[140] First, all such communications must include or follow the options disclosure document.[141] Furthermore, "no suggestion of certainty of future performance [may be] made."[142] Additionally, parameters must be given to accompany the projection figures,[143] along with "all relevant costs, including commissions, fees, and interest charges."[144] All projections must be plausible, intended to be used as a point of reference,[145] and all material assumptions for those projections must be identified.[146] The risks for the options transaction must be disclosed.[147] Finally, "in communications relating to annualized rates of return, that such returns are not based upon any less than a 60-day experience; any formulas used in making calculations are clearly displayed; and a statement is included to the effect that the annualized returns cited might be achieved only if the parameters described can be duplicated and that there is no certainty of doing so."[148]

Similarly, options communications may include statistics of past performance of recommendations, and transactions, provided that certain requirements are met.[149] First, the disclosure document must accompany or precede any such information.[150] Next, the information must be presented in "a balanced manner."[151] Additionally, the statistics need to be "confined to a specific 'universe' that can be fully isolated and circumscribed and that covers at least the most recent 12-month period."[152] All recommendations or transactions must include: the initial date, the initial price at the initial date, and the "date and price of each recommendation or transaction at

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[138] *See* FINRA, Rule 2220(d)(2)(C) (2014).

[139] *See id.* ("[B]road generalities must be avoided.").

[140] *See* FINRA, Rule 2220(d)(3) (2014).

[141] *See* FINRA, Rule 2220(d)(3)(A) (2014).

[142] FINRA, Rule 2220(d)(3)(B) (2014).

[143] *See* FINRA, Rule 2220(d)(3)(C) (2014).

[144] FINRA, Rule 2220(d)(3)(D) (2014).

[145] *See* FINRA, Rule 2220(d)(3)(E) (2014).

[146] *See* FINRA, Rule 2220(d)(3)(F) (2014).

[147] *See* FINRA, Rule 2220(d)(3)(G) (2014).

[148] FINRA, Rule 2220(d)(3)(H) (2014).

[149] *See* FINRA, Rule 2220(d)(4) (2014).

[150] *See* FINRA, Rule 2220(d)(4)(A) (2014).

[151] FINRA Rule, 2220(d)(4)(B) (2014).

[152] *Id.*

the end of the period or when liquidation was suggested or effected, whichever was earlier."[153] The performance must also include the relevant costs, inclusive of commissions, fees, and margin obligations.[154] If annualized rates of return are communicated, then all material assumptions used in those calculations must also be communicated.[155]

Furthermore, an overview of general market conditions during the covered periods must be made.[156] Any comparison made between the general state of the market and the performance record must be valid.[157] Also, there must be a specific warning that past performance does not guarantee future results.[158] Finally, the statistics or record must come with the initialed determination of a Registered Options Principal that they "fairly [re]present the status of the recommendations or transactions reported upon."[159]

Communications regarding an options program[160] must include "the cumulative history or unproven nature of the program and its underlying assumptions."[161] Finally, if a firm violates any other SEC or SIPC rule related to options communications, the firm will have also violated FINRA Rule 2220.[162]

(iii) Margin Disclosure Statement

Certain communications must be made if the firm makes a certain type of trading available, regardless of whether the investor has requested it. Before opening a margin account on behalf of a customer, a firm is obligated to provide the customer with a Margin Disclosure Statement.[163] If the firm offers margin accounts, the firm must also make the statement available on its website in a clear and conspicuous manner.[164]

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[153] FINRA, Rule 2220(d)(4)(C) (2014). This is further limited as follows: "provided that if the communications are limited to summarized or averaged records or statistics, in lieu of the complete record there may be included the number of items recommended or transacted, the number that advanced and the number that declined, together with an offer to provide the complete record upon request."

[154] *See* FINRA, Rule 2220(d)(4)(D) (2014).

[155] *See* FINRA, Rule 2220(d)(4)(E) (2014).

[156] *See* FINRA, Rule 2220(d)(4)(F) (2014).

[157] *See id*.

[158] *See* FINRA, Rule 2220(d)(4)(G) (2014).

[159] FINRA, Rule 2220(d)(4)(H) (2014).

[160] *See* FINRA, Rule 2220(d)(5) (2014) ("i.e., an investment plan employing the systematic use of one or more options strategies").

[161] *Id.*

[162] *See* FINRA, Rule 2220(d)(6) (2014).

[163] *See* FINRA, Rule 2264(a), Margin Disclosure Statement (2011).

The statement is intended to highlight many of the risks attendant with margin trading. FINRA sets forth the required content of the statement, which includes the following sections: "You can lose more funds than you deposit in the margin account;" "The firm can force the sale of securities or other assets in your account(s);" "The firm can sell your securities or other assets without contacting you;" "You are not entitled to choose which securities or other assets in your account(s) are liquidated or sold to meet a margin call;" "The firm can increase its 'house' maintenance margin requirements at any time and is not required to provide you advance written notice;" "You are not entitled to an extension of time on a margin call."[165] Each section contains a brief explanation. At least once a calendar year, the firm must also send to each customer with a margin account either the statement or a summary disclosure that includes each of the section headings.[166] Firms are permitted to customize the disclosure so long as it is substantially similar to the content required by the rule.[167]

(iv) Day-Trading Disclosure Statement

If a firm promotes a day-trading strategy, whether directly or indirectly, it may not open an account for any customer unless it has provided the customer with the day-trading disclosure statement and posted the statement on its website in a clear and conspicuous manner.[168] FINRA does offer to review communications and provide guidance to firms as to whether the communication will be deemed to be "promoting a day-trading strategy."[169]

As with the Margin Disclosure Statement, the content of the statement is set forth by FINRA, and includes the following headings: "Day trading can be extremely risky;" "Be cautious of claims of large profits from day trading;" "Day trading requires knowledge of securities markets;" "Day trading requires knowledge of a firm's operations;" "Day trading will generate substantial commissions, even if the per trade cost is low;" "Day trading on margin or short selling may result in losses beyond your initial investment;" and "Potential Registration Requirements."[170]

C. Cybersecurity: Protection of Customer Information, Funds and Securities

The technology that has transformed the brokerage industry and driven the growth of online platforms and brokerage apps has also created supervisory challenges for financial firms. The use of cloud-based servers, remote access to trading platforms and customer data, email and electronic wire transfers, and even algorithms (or "bots") to open and monitor customer accounts, among other things, provide opportunities for malicious actors to steal confidential information and customer assets and to disrupt a firm's business operations.

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[164] *See id.*

[165] *Id.*

[166] *See* FINRA, Rule 2264(b) (2011).

[167] *See* FINRA, Rule 2264(c) (2011).

[168] *See* FINRA, Rule 2270(a), Day-Trading Risk Disclosure Statement (2013).

[169] *See* FINRA, Rule 2270.01, Review by FINRA's Advertising Regulation Department (2013).

[170] FINRA Rule 2270(a) (2013).

In a 2021 annual report on examinations and risk monitoring program, FINRA observed that cybersecurity "remains one of the principal operational risks facing broker-dealers" and that it expects firms "to develop reasonably designed cybersecurity programs and controls that are consistent with their risk profile, business model and scale of operations."[171]

The SEC and FINRA have increasingly focused on cybersecurity risks, issuing risk alerts and guidance to the industry about its obligations to protect confidential customer information under Rule 30 of the SEC's Regulation S-P, establish written procedures to identify and respond to "identity theft red flags" as required under Rule 201 of the SEC's Regulation S-ID, and protect against cybersecurity attacks that could result in disruption of operations and services to customer, implicating FINRA Rule 4370.

(i) SEC Regulation S-P Rule 30: The Safeguard Rule

The SEC's Rule 30 under the SEC's Regulation S-P, adopted in 2000 and known as "the Safeguard Rule," requires every broker-dealer to adopt and maintain "written policies and procedures that address administrative, technical, and physical safeguard for the protection of customer records and information."[172] The policies and procedures must be reasonably designed to "(1) insure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer."[173]

After Regulation S-P Rule 30 was initially adopted, firms' security policies generally focused on administrative and physical risks to customers' personally identifiable information ("PII"), rather than risks related to changing technology.[174] FINRA Regulatory Notice 05-49 reminded firms that their policies and procedures to protect against unauthorized access to or use of customer records

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[171] 2021 FINRA Report, *supra* note 16.

[172] Privacy of Consumer Financial Information (Regulation S-P), 65 Fed. Reg. 40,334 (June 29, 2000) (codified at17 C.F.R. § 248.30(a)). The SEC promulgated Regulation S-P pursuant to Title V of the Gramm-Leach-Bliley Act ("GLBA"), passed in 1999, which directed federal agencies with oversight over financial institutions to establish standards for the protection of customer information. 15 U.S.C. § 6801(b) (2010). Title V governs imposed upon financial institutions "an affirmative and continuing obligation . . . to protect the security and confidentiality of [customer] nonpublic personal information." 15 U.S.C. § 6801(a) (2010). It further directed federal agencies with oversight over the financial industry to promulgate rules that "establish appropriate standards for the financial institutions subject to their jurisdiction relating to administrative, technical, and physical safeguards . . ." 15 U.S.C. § 6801(b) (2010). The SEC adopted amendments to the Safeguard Rule, effective January 2005, to require that the policies and procedures adopted be in writing. SEC. EXCH. COMM'N, REL. NOS. 34-50781, IA-2332, IC-26685, DISPOSAL OF CONSUMER REPORT INFORMATION (Dec. 2, 2004), https://www.sec.gov/rules/final/34-50781.htm.

[173] 15 U.S.C. § 6801(b) (2010).

[174] Jeffrey Taft, Matthew Bisanz, and Leslie Cruz, *The SEC's Regulation S-P in the Age of Cybersecurity*, THE INVESTMENT LAWYER, Vol. 9, No. 9 (Sept. 2019), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/09/il_0919_taftbisanzcruz.pdf (observing that when Regulation S-P was first adopted many safeguarding procedures "focused on administrative and physical safeguards, and to a lesser extent on technical safeguards").

or PII that could result in substantial harm or inconvenience to customers should "adequately reflect changes" in technology or alternative work arrangements.[175]

FINRA acknowledged that there can be no "one-size-fits-all" policy or procedure, but stressed that members should consider at a minimum whether: (1) the firm's existing policy adequately addresses the technology it currently uses; (2) the firm has taken appropriate technological precautions to protect customer information; (3) the firm is providing training to its employees about its available technology, its use and the steps necessary to protect customer information; and (4) the firm is conducting periodic audits to detect vulnerabilities and ensure the systems are, in practice, protecting customer records and information from unauthorized access.[176]

Despite their increasing reliance on technology, many financial firms have not adequately adapted their written policies and procedures to new technology or have otherwise failed to address new vulnerabilities in their systems. In 2015, the SEC's Office of Compliance Examinations and Inspections ("OCIE") issued a risk alert after a cybersecurity examinations sweep found that while most of the firms examined had adopted written security policies and procedures, 88% of broker-dealers and 74% of registered investment advisers had experienced cyber-attacks (directly or through one or more of their vendors) or had security gaps.[177]

The SEC's early enforcement cases under Regulation S-P Rule 30 focused on administrative and physical risks to PII, such as handling customer information when winding down business operations.[178] More recently, the SEC has charged brokerage firms and investment advisers with violations of Regulation S-P Rule 30 for failures to adopt, implement or enforce written policies and procedures applicable to the firm's use of technology, including, the use of email addresses not affiliated with the firm's domain name to receive over 4,000 faxes containing customer PII (in violation of written policies),[179] storing customer PII on a third-party web server without adopting written policies and procedures regarding the security and confidentiality of that information and the protection of that information from threats or unauthorized access,[180] and failing to ensure the

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[175] FINRA, NOTICE TO MEMBERS 05-49, SAFEGUARDING CONFIDENTIAL CUSTOMER INFORMATION at 1 (July 2005), https://www.finra.org/rules-guidance/notices/05-49. Regarding the use of wireless networks, FINRA stressed the importance of using appropriate safeguards, such as encryption, to prevent unauthorized parties from accessing customer information, and the use of firewalls to mitigate risks of outside intrusion by hackers.

[176] *Id.* at 4.

[177] *See* SEC. EXCH. COMM'N OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, NATIONAL EXAM PROGRAM RISK ALERT, CYBERSECURITY EXAMINATION SWEEP SUMMARY, at 2-3 (Feb. 3, 2015), https://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

[178] *See, e.g.,* David C. Levine, SEC. EXCH. COMM'N, REL. NO. 34-64222, 100 SEC Docket 3049, 2011 WL 1325568, *5 (Apr. 7, 2011) (finding brokerage firm violated, and its senior officer aided and abetted the firm's violations, of Rule 30(a) of Regulation S-P because firm failed to adopt policies and procedures to protect customer information while firm was winding down its business).

[179] *See* Craig Scott Capital, LLC, SEC. EXCH. COMM'N, REL. NO. 34-77595 (Apr. 12, 2016) (ordering cease-and-desist and fining firm $100,000 penalty, and $10,000 penalties against individual associated persons who used personal emails in violation of written policies).

[180] *See* R.T. Jones Capital Equities Management, Inc., SEC. EXCH. COMM'N, REL. NO. IA-4204 (Sept. 22, 2015) (the firm's third-party web server was hacked and the PII of more than 100,000 customers was rendered vulnerable to theft; firm fined $75,000).

reasonable design and operation of two web-based applications on the firm's Intranet that organized customer data and PII, to limit access to the PII, or to conduct any audits or testing of its applications to guard against unauthorized access.[181]

FINRA has brought enforcement actions against broker-dealers for violations of Regulation S-P Rule 30 in connection with similar security breaches due to firms' failure to adopt, implement and enforce written security policies to its current technology. A recurring problem is firms' use of third-party cloud services without adequately assessing and testing the third-party provider's security systems. FINRA charged Lincoln Financial Securities Corp. with violations of Regulation S-P Rule 30 because, commencing in 2011, one of the firm's branch offices started using a third-party cloud service provider to store records, including customer account applications that contained PII, without ensuring that the provider installed antivirus and encryption software.[182] Although hackers with foreign IP addresses had hacked into the server and gained access to PII for 4500 customers, the firm failed to implement a policy for months after the cyberattack, and failed to ensure its registered representatives and third-party vendor adequately applied the policy.[183] As a result of these supervisory failures, FINRA found that Lincoln Financial violated Regulation S-P Rule 30 and further violated FINRA's supervision rule and Rule 2010, censuring the firm and imposing a penalty of $650,000.[184]

(ii) SEC Regulation S-ID: The Identity Theft Red Flags Rule

The SEC's Rule 201 of Regulation S-ID, adopted in 2013 and known as the "Identity Theft Red Flags Rule,"[185] requires broker-dealers and investment advisers registered (or required to be registered) with the SEC to establish and implement a written Identity Theft Prevention Program that is designed to detect, prevent and mitigate identity theft[186] in connection with the opening of

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[181] *See* Morgan Stanley Smith Barney, SEC. EXCH. COMM'N, REL. NOS. 34-78021, IA-4415 (June 8, 2016) (for nearly three years one of the firm's associated persons exploited flaws in the applications to misappropriate data regarding 730,000 customer accounts; Morgan Stanley was ordered to cease-and-desist, censured, and fined $1,000,000).

[182] *See* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Lincoln Financial Securities Corp., Docket No. 2013035036601 (Nov. 14, 2016).

[183] *See id.*

[184] *See id.* at 2-3; 5. *See also* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Oak Tree Securities, Inc., Docket No. 2015043455201 (Sept. 28, 2017) (finding that for nearly two years Oak Tree used third party vendors to create and host its public website, but did not create any policies or procedures to ensure that it maintained the confidentiality of customer PII, or ensure that its vendors had procedures to protect PII; on at least seven occasions an internet search engine was able to access PII for over 700 customers).

[185] SEC. EXCH. COMM'N, REL. NOS. 34-69,359, IA-3582, IC-30,456, IDENTITY THEFT RED FLAGS RULES (Apr. 10, 2013; effective May 20, 2013) (codified at 17 C.F.R. § 248.201), https://www.sec.gov/rules/final/2013/34-69359.pdf. The SEC promulgated the rule (jointly issued with the CFTC) to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which amended section 615(e) of the Fair Credit Reporting Act, 15 U.S.C. § 1681, to add the SEC and CFTC to the list of entities required to promulgate rules to require financial institutions and creditors to implement identity theft protection programs. *See id.*

[186] The rule defines "identity theft" as a fraud committed or attempted using the identifying information of another person without authority. 17 C.F.R. § 248.201(b)(9) (2021).

a covered account or any existing covered account.[187] The SEC has explained that an Identity Theft Prevention Program "must include reasonable policies and procedures to: identify relevant red flags for the covered accounts and incorporate them into the Identity Theft Prevention Program; detect the red flags hat have been incorporated into the Identity Theft Prevention Program; respond appropriately to any red flags that are detected pursuant to the Identity Theft Prevention Program; and ensure that the Identity Theft Prevention Program is updated periodically to reflect changes in risks to customers from identity theft."[188]

In 2018, the SEC brought its first enforcement case for violations of the Identity Theft Red Flags Rule against Voya Financial Advisors, Inc. ("VFA"), finding that VFA had failed to update its Identity Theft Prevention Program despite significant changes in external cybersecurity risks, and failed to respond to cybersecurity incidents.[189] VFA, a dually registered firm with a national network of independent contractor registered representatives, provided its contractors with access to its brokerage and advisory customer information through a proprietary web portal, VPro.[190] The portal was managed and serviced by VFA's parent company, Voya, which handled VFA's cybersecurity functions, serviced support call centers, and responded to VFA's contractor representatives for assistance on VPro.[191]

The SEC found that during three days in April 2016, one or more persons impersonating VFA contractor representatives called the IT support team to reset their passwords, providing PII for the representatives; thereafter the callers were able to access to VPro and, thereby, gained access to the PII for approximately 5,600 customers.[192] The SEC found that VFA violated the Identity Theft Red Flags Rule by not updating its Identity Theft Prevention Program since 2009, by failing to conduct adequate identity theft training, and by failing to ensure that the Identity Theft Prevention Program included reasonable procedures designed to respond to and prevent red flags.[193]

In December 2020, FINRA charged a firm for Regulation S-ID Rule 201 violations in connection with security breaches. FINRA censured and fined Supreme Alliance $65,000 for failing to take action when the emails of its CEO (who was also the firm's chief compliance officer) was

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[187] The rule defines a "covered account" to include an account that a broker-dealer or investment adviser offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions, such as a brokerage account with a broker-dealer. 17 C.F.R. § 248.201(b)(3) (2021).

[188] Voya Financial Advisors, Inc., SEC. EXCH. COMM'N, REL. NOS. 34-84288, IA-5048, at 3-4 (Sept. 26, 2018).

[189] *See id.*

[190] *See id.* at 2.

[191] *See id.* at 4-5.

[192] *See id.* at 7-8.

[193] *See id.* at 7. During the relevant period, VFA had detected red flags prior to and after the April 2016 intrusion but did not reasonably respond to the red flags by changing security codes, or implementing other procedures to deny unauthorized persons access to VFA customer accounts. *See id.* The SEC also charged VFA with violations of the Safeguard Rule, Regulation S-P, Rule 30, because its policies and procedures were not reasonably designed to prevent and respond to cybersecurity risks. *See id.* at 3, 10.

hacked.[194] The firm's CEO started receiving hundreds of notifications in his firm email account that his emails could not be delivered to certain external addresses, but he ignored the messages for four months.[195] When the CEO finally forwarded one of the notifications to the firm's outside email vendor, the vendor notified him that his email was likely compromised.[196] Despite learning this, the firm failed to implement any of the procedures of its written policies, or mitigate the risk of identity theft.[197] The AWC explained that at least 200 of the 17,000 emails blind copied to an external source contained customer PII.[198] FINRA found that Supreme Alliance did not have a program to address the identification and detection of red flags, or provide its registered representatives with any guidance in the event an identity theft had occurred; instead, the firm had written "generic policies and procedures not tailored to the firm's actual business model."[199] As a result, the firm violated Rule 201 of Regulation S-ID.[200]

(iii) Protecting Customer Funds

FINRA has long stressed the importance of implementing written policies and procedures governing the withdrawal and transmittal of customer funds and assets. In 2009, FINRA reminded firms to have written policies and procedures reasonably designed to review and monitor all instructions to transmit or withdraw assets from customer accounts.[201]

Concerns over the rising number of incidents of customer funds stolen as a result of compromised emails and fraudulent email instructions mailed to firms prompted FINRA to issue Regulatory Notice 12-05.[202] FINRA explained that a firm's supervisory control system must include policies and procedures reasonably designed to review and monitor the transmittal of funds or securities from customer accounts to third-party accounts (resulting in a change of beneficial ownership), to outside entities, to locations other than the customer's primary residence, and between customer accounts and registered representatives.[203] The procedures must consider the specific risks

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[194] *See* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Supreme Alliance LLC, Docket No. 2019062898302 (Dec. 18, 2020).

[195] *See id.* at 3.

[196] *See id.*

[197] *See id.*

[198] *See id.*

[199] *Id.* at 2.

[200] *See id.* at 3. By virtue of its violation of Regulation S-ID, the firm also violated FINRA Rule 2010. *Id.*

[201] *See* FINRA, REGUL. NOTICE 09-64, CUSTOMER ASSETS, VERIFICATION OF INSTRUCTIONS TO TRANSMIT OR WITHDRAW ASSETS FROM CUSTOMER ACCOUNTS (Nov. 2009), https://www.finra.org/sites/default/files/NoticeDocument/p120372.pdf. The notice also highlighted questions for firms to consider in evaluating its policies and procedures for the transmittal of funds or securities.

[202] *See* FINRA, REGUL. NOTICE 12-05, CUSTOMER ACCOUNT PROTECTION, VERIFICATION OF EMAILED INSTRUCTIONS TO TRANSMIT OR WITHDRAW ASSETS FROM CUSTOMER ACCOUNTS (Jan. 2012), https://www.finra.org/rules-guidance/notices/12-05.

[203] *See id.* at 2.

associated with each method the firm allows for transmittal.[204] When firms accept email or other electronic wire or transfer instructions, their policies and procedures should include a method for verifying that the email or instructions were in fact sent by the customer, and they should train their employees to follow these procedures.[205]

In December 2020, FINRA charged Lincoln Investment with supervisory failures in connection with its transmittal of customer funds to malicious actors, arising from the failure of the firm to implement policies and procedures to identify and respond to "red flags" or suspicious activity.[206] First, the firm received multiple phone calls from a woman impersonating a customer and requesting transfers of funds to a bank account that was not previously associated with the customer.[207] The firm transferred funds from the customer's account despite numerous red flags, including the imposter's failure to answer security questions correctly.[208] Additionally, the firm failed to follow its own written policy concerning third-party transfer requests, transferring $30,000 to a third-party after an associated person received an email from a customer's email account which had been compromised.[209] FINRA charged Lincoln with violations of Rule 3110(a) for its failure to establish, maintain and enforce policies and procedures to safeguard customer assets, which "includes the responsibility to identify and respond to red flags," censured the firm and imposed a $35,000 penalty.[210]

(iv) Increasing Cybersecurity Concerns in the Age of COVID-19

The COVID-19 pandemic profoundly affected many aspects of society and our daily lives, leading to millions of Americans working (and studying) from home, relying on technology to remotely access workplaces, classrooms, and other sites. The increased reliance on technology, combined with billions of stimulus checks sent to Americans, created new opportunities for financial fraud, prompting regulators to issue alerts about COVID-19 pandemic scams targeting

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[204] *See id.*

[205] *See id.* at 2-3. Moreover, the obligation to have supervisory procedures for the reviewing and monitoring of customer assets applies both to clearing and introducing firms, and while Rule 4311(c) permits firms to allocate responsibility for the performance of certain functions between the clearing and introducing firms when accounts are carried on a fully disclosed basis, the rule "expressly requires that the carrying firm be allocated the responsibility for the safeguarding of customer funds and securities." *Id.* at 3. For example, the introducing firm may have the responsibility to verify the customer's identity and that the instructions came from the customer and, therefore, have policies and procedures to ensure it carries out this function, but the clearing firm must still have adequate policies and procedures to review and monitor all disbursements it makes from the customer's account. *See id.*

[206] *See* Letter of Acceptance, Waiver, and Consent, FINRA Dep't of Enforcement v. Lincoln Financial, Docket No. 2018056408401 (Dec. 10, 2020).

[207] *See id.* at 2-3.

[208] *See id.*

[209] *See id.* at 4.

[210] *Id.* at 2, 4. The AWC referenced FINRA Regulatory Notice 09-64 (Nov. 2009), which reminded members of their supervisory obligations to safeguard customer assets, which includes having policies and procedures governing the withdrawal or transmittal of funds or assets from customer accounts. *See id*. at 2.

consumers and investors.[211] According to one study, "[c]ybersecurity was the top near-term concern for independent broker-dealers" working from home or remote offices.[212]

FINRA has also issued several notices alerting members to the increased risk of fraudulent activity and the challenges for firms in safekeeping customer information and assets. On the heels of nationwide stay at home orders, FINRA reminded firms about their obligations under FINRA Rule 4370 and to consider pandemic-related business continuity plans,[213] and alerted them about addressing the increased vulnerability to cyberattacks and taking additional steps to protect customer information from being compromised on networks and mobile devices.[214]

In Regulatory Notice 20-08, which focused on providing firms with pandemic-related business continuity planning guidance, FINRA specifically addressed cybersecurity and advised firms to consider the increased risk of cyber events due to use of remote offices or telework.[215] FINRA stressed the importance that firms "remain vigilant in their surveillance against cyber threats and take steps to reduce the risk of cyber events."[216]

FINRA Regulatory Notice 20-13 outlined four common scams to which firms and their customers may be exposed during the COVID-19 pandemic.[217] First, FINRA observed the increase in new customer accounts and warned firms of an increase in fraudulent account openings and money transfers using synthetic or stolen customer identities, pointing firms to the importance of

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[211] *See Look Out for Coronavirus-Related Investment Scams*, SEC. EXCH. COMM'N (Feb. 4, 2020), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/look-out; *Fraud and Coronavirus (COVID-19)*, FINRA (Mar. 26, 2020), https://www.finra.org/investors/insights/fraud-and-coronavirus-covid-19.

[212] Bruce Kelly, *Broker-dealers Brace for Cyberthreats*, INVESTMENTNEWS (Jan. 18, 2021), https://www.investmentnews.com/broke-dealers-brace-for-cyberthreats-201403.

[213] *See* FINRA, REGUL. NOTICE 20-08, PANDEMIC-RELATED BUSINESS CONTINUITY PLANNING, GUIDANCE AND REGULATORY RELIEF (Mar. 9, 2020), https://www.finra.org/rules-guidance/notices/20-08. FINRA's 2021 Report explained that any cybersecurity breach that interrupts member operations or results in denials of service to customers also implicates Rule 4370 (Business Continuity Plans and Emergency Contact Information). *See* 2021 FINRA Report, *supra* note 16 at 8. Rule 4370 requires member firms to create and maintain a written business continuity plan identifying procedures relating to an emergency or significant business disruption, and update the plan in the event of any material change to the member's operations, structure, business or location. Rule 4370(a), (b). Although member firms have flexibility to design their business continuity plan, the plan must address the following elements relevant to cybersecurity risks: (1) data back-up and recovery (hard copy and electronic); (2) all mission critical systems; (3) financial and operational assessments; (4) alternative communications between customers and the member; (5) alternative communications between the member and its employees; (6) alternate physical location of employees; and (7) how the member will assure "customers' prompt access to their funds and securities in the event the member determines it is unable to continue its business." Rule 4370(c).

[214] *See Cybersecurity Alert: Measures to Consider as Firms Respond to the Coronavirus Pandemic (COVID-19)*, FINRA (Mar. 26, 2020), https://www.finra.org/rules-guidance/notices/information-notice-032620.

[215] *See* FINRA, REGUL. NOTICE 20-08, *supra* note 213.

[216] *Id.*

[217] *See* FINRA, REGUL. NOTICE 20-13, *supra* note 44.

Customer Identification Programs, monitoring for fraud during the account opening process, and verifying transfers in selected circumstances – essentially the very same best practices FINRA has identified for a robust AML program.[218] Second, FINRA noted the increase of firm imposter scams, where fraudsters impersonate firms or associated persons in either communicating with customers or creating a fake online presence or website, and provided guidance on how firms could mitigate those risks.[219] Third, the notice explained that the use of remote working arrangements increased opportunities for IT Help Desk scams, where fraudster pose as associated persons, and contact the firm's IT Help Desk staff for a password reset, thereby giving the fraudster access to the firm's network, confidential information and customer assets.[220] The fourth common scam the notice identified was email compromise schemes, where fraudsters taking advantage of remote working arrangements send an email posing as firm leadership or manager to request funds or a transfer.[221]

In 2021, FINRA issued Regulatory Notice 21-18, stating that it had received an increasing number of reports regarding online customer account takeovers, involving bad actors using compromised customer information (i.e., username and password), to gain unauthorized access to customers' online brokerage accounts.[222] In order to assist firms in identifying, preventing and responding to such attacks, FINRA hosted a roundtable discussion with representatives of 20 member firms of various sizes and business models to discuss approaches to mitigating account takeover risks.[223] The notice identified the relevant regulatory obligations to protect customer information and assets, listed common challenges to protecting customer accounts, and provided a list of best practices and approaches to authenticating customer identities, monitoring accounts, implementing automated threat detection, and procedures to respond to potential or reported account takeovers.[224]

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[218] *See id.* at 2-4; *see also* FINRA, REGUL. NOTICE 19-18, *supra* note 41.

[219] *See* FINRA, REGUL. NOTICE 20-13, *supra* note 44 at 5. FINRA specifically referred to its earlier Information Notice, *Imposter Websites Impacting Member Firms* (Apr. 29, 2019), which warned member firms about "imposter websites," where a malicious actor uses the names and/or photos of registered representatives to establish websites that look like the representatives' personal sites, and then directs the customers to enter personal information. *Id.* Several months after issuing Regulatory Notice 20-13, FINRA issued another notice warning firms and associated persons about imposter websites. *See* FINRA, REGUL. NOTICE 20-30, FRAUDSTERS USING REGISTERED REPRESENTATIVES NAMES TO ESTABLISH IMPOSTER WEBSITES (Aug. 20, 2020), https://www.finra.org/rules-guidance/notices/20-30. FINRA explained that firms could take steps to identify these pages by periodically searching the web for the names of its registered representatives or create alerts that automatically search for defined terms. *See id.* at 2.

[220] *See* FINRA, REGUL. NOTICE 20-13, *supra* note 44 at 6. Another variant of the scheme is a fraudster posing as an IT Help Desk staffer who contacts the associated person to harvest his or her credentials or introduce malware. *See id.*

[221] *See id.* at 7.

[222] *See* FINRA, REGUL. NOTICE 21-18, CYBERSECURITY (May 12, 2021), https://www.finra.org/rules-guidance/notices/21-18.

[223] *See id.* at 1.

[224] *See id.* at 4-7.

II. Conclusion

Technology has evolved the way investors interact with brokerage firms. These changes raise challenges for firms determining how to comply with the existing regulations in light of their new business models. However, the challenges firms face today mirror those in the early stages of online trading. While some things have changed, some have not.

Online platforms and mobile trading apps have increased the ability of investors to access the markets. Although the changes to technology have led more investors to be self-directed, they are still entitled to the protections of FINRA and SEC rules. Firms must still comply with the rules governing opening and approving accounts. Firms must confirm customer identies, even though they are only dealing with the investor virtually. Firms must comply with the communications rules, ensuring all communications are fair and balanced. And finally, firms must safeguard customer information, funds, and securities.

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Written Testimony before the
U.S. Senate Committee on Banking, Housing, and Urban Affairs

Regarding

Protecting Investors and Savers: Understanding Scams and Risks in Crypto and Securities Markets

July 28, 2022

Submitted by

Melanie Senter Lubin
Commissioner, Maryland Securities Division
2021-2022 NASAA President

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 the securities regulators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, the 13 provincial and territorial securities regulators in Canada, and the securities regulator in México. In the United States, NASAA is the voice of state securities agencies that protect investors, promote responsible capital formation, and support inclusion and innovation in the capital markets. U.S. NASAA members license firms and their agents, investigate alleged violations of securities laws, file enforcement actions when appropriate, and educate the public about investment fraud. NASAA members also participate in multi-state enforcement actions and information sharing. For more information, visit: www.nasaa.org.

I. Introduction

I am Melanie Senter Lubin. I want to start by thanking the entire Committee and its dedicated staff for organizing this hearing. I am honored to share the perspective of the North American Securities Administrators Association, or NASAA for short, regarding the primary threats to investors in today's securities markets and ways to mitigate these threats.

I am a 36-year veteran of the Division of Securities within Maryland's Office of the Attorney General. In 1998, I became the Maryland Securities Commissioner. The primary goal of the Maryland Securities Division is to protect Maryland investors from investment fraud and misrepresentation. My team uses all the tools that securities regulators have—investor education, registration, examination, and enforcement—to protect investors, promote responsible capital formation, and support inclusion and innovation in the capital markets.[1]

I also am a 36-year veteran of NASAA. During my career, I have been involved in essentially every aspect of our collective mission. At present, I am a member of NASAA's Board of Directors and its 2021-2022 President. I also am a member of four committees—the Federal Legislation Committee, the Investment Adviser Representative Continuing Education Committee, the Regulation Best Interest Implementation Committee, and the Steering Committee for the Central Registration Depository and the Investment Adviser Registration Depository systems. Since 2015, I have served as NASAA's non-voting representative to the Financial Stability Oversight Council ("FSOC"). Earlier this year, the Public Company Accounting Oversight Board ("PCAOB") appointed me to its new Standards and Emerging Issues Advisory Group.[2]

The breadth and depth of NASAA's work is tremendous. Approximately 300 volunteers from member agencies serve on 54 NASAA committees and project groups. At home and as part of these committees, our members protect investors from financial fraud and abuse, educate investors working to build secure financial futures, support responsible capital formation by businesses, and help ensure the integrity and efficiency of the capital markets that power our economies. To support these efforts, we work through NASAA to train regulator-members to perform their duties and coordinate on everything from investor education to reviews of securities offerings to rulemaking to enforcement. In addition, we facilitate engagement on policy proposals with many stakeholders. In all that we do, we strive to ensure that present and future generations of state, provincial, and territorial regulators can continue NASAA's century-old investor protection mission.

II. Summary of NASAA's Written Testimony

The purpose of this hearing is to examine scams and other risks facing investors. In my testimony, I will highlight NASAA member activity involving both registered and unregistered persons and firms, and cover the following four key points:

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[1] Maryland Securities Division, What We Do.

[2] NASAA, Maryland Securities Commissioner Melanie Senter Lubin Takes Helm as 104th President of North American Securities Administrators Association (Sept. 21, 2021); PCAOB, Standards and Emerging Issues Advisory Group Members; NASAA, Maryland Securities Commissioner Lubin to Represent NASAA on Financial Stability Oversight Council (Oct. 22, 2015).

1. At this time and based on available information, we believe that the top threats to retail investors are (1) fraudulent investments tied to digital assets; (2) fraudulent offerings related to promissory notes; (3) scams offered through social media; (4) scams otherwise offered online; and (5) financial schemes connected to self-directed individual retirement accounts ("SDIRAs").[3]

2. To ensure our markets are around for generations to come, we need to do an even better job at promoting lasting trust in, and informed use of, our regulated capital markets. Sadly, a concerning amount of distrust in our regulated markets persists nearly 15 years after the 2008-2009 Financial Crisis. Moreover, evidence suggests distrust is higher among communities of color than among white Americans and that black Americans are less likely to view cryptocurrency as risky than their white counterparts.[4]

3. Promoting lasting trust starts with making improvements in how we prevent and detect investor harm and ensuring that those charged with enforcing the law have the tools needed to do the job.

4. Promoting lasting trust also means that we must oppose legislation that would weaken investor protection and thereby fuel additional distrust in securities regulators and securities regulation. This is true regardless of whether the legislation pertains to traditional or emerging areas of our markets.

III. The Top Threats to Retail Investors

At NASAA, we use tools such as member surveys to gather data to inform our priorities and activities. Most years, we conduct a survey of our members to help us better understand present and emerging threats to investors. We encourage them to respond based on investor complaints, ongoing investigations, and current enforcement trends in their jurisdictions. The survey is voluntary, and a large majority of NASAA members participate.

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[3] So-called SDIRAs are individual retirement accounts ("IRAs") held by a custodian that allow investment in a broader set of assets than is permitted by other types of IRAs. The broader set of options may include real estate, promissory notes, tax lien certificates, private placement securities, precious metals, and digital assets such as cryptocurrencies, coins, and tokens. Generally, the SDIRA custodians do not (1) research, investigate, or recommend investments to accountholders; (2) verify the accuracy of information on the investor's statements; (3) ensure a full and accurate disclosure of all details regarding the investment; or (4) hold the investment funds or assets. Moreover, in most cases, the so-called "alternative" or "unconventional" investments permitted in SDIRAs are subject to fewer disclosure requirements than conventional IRA investments such as stocks and bonds. To learn more about the regulatory framework applicable to SDIRAs, see the December 2021 Recommendation Regarding Individual Retirement Accounts by the Investor Advisory Committee of the U.S. Securities and Exchange Commission ("SEC").

[4] *See* Taylor Nicole Rogers, Crypto Collapse Reverberates Widely Among Black American Investors, Financial Times (July 5, 2022); Morning Consult, Tracking Trust in U.S. Institutions (July 2022); Ariel-Schwab Black Investor Survey, Report of Findings (Apr. 2022); Lorie Konish, Why U.S. Minority Communities May Turn to Cryptocurrencies to Pay Their Bills, CNBC (Feb. 8, 2022); Bankrate, Survey: More Than Half of Investors Think the Stock Market Is Rigged Against Individuals (Mar. 2021); P. Sapienza and L. Zingales, Financial Trust Index (Feb. 5, 2020).

At NASAA, we believe that education and information are an investor's best defense. In turn, every year, we publish the results of our survey and work with the media to spread awareness of them. We also encourage members of Congress to review the results and share the information with their constituents.[5]

For each of the last three years (2019, 2020, 2021), the respondents to our survey identified 'investments tied to digital assets' as a top threat to investors. As background, the nature of the threat has evolved over the last five years or so. In early 2018, investors and con artists alike returned to cryptocurrency-related investment products looking for quick profits following news surrounding surging prices and a new product backed by Facebook.[6] Then, in early 2020, criminals and other bad actors started to take advantage of the COVID-19 pandemic as they do every other natural or man-made disaster. Moreover, a persistent concern the last five years has been the promotion of the digital assets space. Marketing that promises 'high returns' or 'high interest rates' to investors is a red flag of possible false, misleading, or other illegal activity.[7]

Throughout these and other developments in the markets, NASAA continued its ongoing work to educate and engage with the general public and a wide range of stakeholders. In addition, in early 2018, we organized a task force, called Operation Cryptosweep, to begin a coordinated series of investigations into initial coin offerings and other cryptocurrency-related investment products.[8] In early 2020, we continued the work of Operation Cryptosweep but rebranded and supplemented it. Our new COVID-19 Enforcement Task Force worked to disrupt many COVID-19-related threats to investors, including marketing directed toward older investors that promised lucrative guaranteed returns.[9]

For several reasons, I expect 'investments tied to digital assets' will be a top threat again when we publish the survey results for 2022. To begin with, in 2022, more digital asset companies enlisted celebrities and sports stars to market their platforms or products. For example, during Super Bowl LVI, an estimated 208 million-plus viewers watched comedy icon Larry David in an FTX commercial and NBA legend LeBron James in a Crypto.com commercial. In addition, they watched a Coinbase ad with a QR code bouncing from corner to corner of the TV screen. When scanned, the code brought viewers to Coinbase's promotional

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[5] *See, e.g.,* John F. Wasik, Why Crypto Cons Top The List of Investment Scams, Forbes (Apr. 11, 2022); Greg Iacurci, Regulators Want to Make It Easier for Americans to Buy Risky Investments (Dec. 20, 2019).
[6] *See* Chaim Gartenberg, Facebook Reportedly Plans to Launch Its Own Cryptocurrency,The Verge (May 11, 2018).
[7] *See, e.g.*, Hannah Lang, Carolina Mandl, and Elizabeth Howcroft, How Crypto Lender Celsius Stumbled on Risky Bank-like Investments, Reuters (June 15, 2022).
[8] *See* Daniel Kuhn, Maryland Targets Trading Platform Fraud as It Joins 'Cryptosweep' Effort, CoinDesk (Aug. 15, 2019); NASAA Updates Coordinated Crypto Crackdown (Aug. 7, 2019); NASAA Updates Coordinated Crypto Crackdown (Aug. 28, 2018); Joseph P. Borg, Alabama Securities Commission Director and former NASAA President, Ensuring Effectiveness, Fairness, and Transparency in Securities Law Enforcement (June 13, 2018); NASAA, State and Provincial Securities Regulators Conduct Coordinated International Crypto Crackdown (May 21, 2018).
[9] *See* Amanda Senn, Alabama Securities Commission Chief Deputy Director and NASAA Cybersecurity Committee Chair, Cybercriminals and Fraudsters: How Bad Actors Are Exploiting the Financial System During the COVID-19 Pandemic (June 16, 2020) ("Senn Testimony"); NASAA Updates COVID-19 Enforcement Task Force Actions (June 16, 2020); Christopher W. Gerold, then-Chief of New Jersey Bureau of Securities and 2019-2020 NASAA President, Examining the Impacts of the COVID-19 Pandemic on U.S. Capital Markets (May 26, 2020); NASAA Forms COVID-19 Enforcement Task Force (Apr. 28, 2020).

website, offering a limited-time promotion of $15 worth of free Bitcoin to new sign-ups, along with a $3 million giveaway that customers could enter. These ads all appeared to work. In the case of Coinbase, it saw installs of its app jump 309% week-over-week after the ad aired on Sunday, February 13, 2022, and then climb by another 286% on February 14.[10]

In the months that followed, we have seen a dramatic decline in the value of cryptocurrencies and other digital assets. By way of illustration, between February 13 and July 24, 2022, the total market capitalization of cryptocurrency fell from approximately $1.9 trillion to approximately $1 trillion. Excluding Bitcoin, the decline during that same period was from approximately $1.1 trillion to approximately $600 billion.[11]

In addition, we have seen several bankruptcies and collapses relating to digital assets. Though the facts are still emerging, it appears the eventual implosion of Terra and the loss of over $50 billion in the values of Terra LUNA and TerraUSD over a three-day period had cascading, interconnected consequences for many market participants.[12] By way of example, in June 2022, a court in the British Virgin Islands ordered Three Arrows Capital ("3AC"), a Singapore-based hedge fund that once managed as much as $10 billion in assets, into liquidation.[13] Days later, 3AC filed for bankruptcy under Chapter 15 of the U.S. bankruptcy code, which allows a foreign debtor to deal with their U.S. assets. On July 5, Voyager Digital Holdings, Inc. ("Voyager"), a cryptocurrency brokerage that allowed customers to buy, sell, trade, and store cryptocurrency on a single platform, filed for Chapter 11 bankruptcy protection. At the time of bankruptcy, Voyager had over 3.5 million active users of its mobile application and over $5.9 billion of cryptocurrency assets held.[14] A few days later, another trading platform, Celsius Network ("Celsius") declared bankruptcy. Celsius had approximately 1.7 million registered users and

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[10] *See* Francesca Fontana, The Crypto Firms That Bought Those Super Bowl Ads Aren't So Super Anymore (June 18, 2022); NFL, Super Bowl LVI Total Viewing Audience Estimated at Over 208 Million (Mar. 1, 2022); Sarah Perez, Super Bowl Ads Boosted Crypto App Downloads by 279%, Led by Coinbase, TechCrunch (Feb. 17, 2022); Chaim Gartenberg, Coinbase's Bouncing QR Code Super Bowl Ad Was So Popular It Crashed the App (Feb. 13, 2022); The Moment of Truth | Crypto.com (Feb. 13, 2022); Don't Miss Out on Crypto: Larry David FTX Commercial (Feb. 13, 2022).

[11] *See* CoinMarketCap charts, available at https://coinmarketcap.com/charts/.

[12] *See* Declaration of Alex Mashinsky, Chief Executive Officer of Celsius Network, LLC, In Support of Chapter 11 Petitions and First Day Motions, Case No. 22-10964 (July 14, 2022) ("By July 2022, Celsius had approximately 1.7 million registered users and approximately 300,000 active users with account balances of more than $100, and approximately $6.0 billion in assets and was preparing to go forward with an initial public offering of Debtor Celsius Mining LLC").

[13] *See* Grady McGregor, Founders Who 'Cannot Be Trusted' and a $50 Million Yacht: New Three Arrows Capital Bankruptcy Filing Sheds Light on the Crypto Hedge Fund's Epic Demise, Fortune (July 19, 2022); Yiwen Lu, Judge Freezes Assets of Crypto Hedge Fund Three Arrows Capital (July 13, 2022).

[14] *See* In re Voyager Digital Holdings, Inc., No. 22-10943 (MEW) (Bankr. S.D.N.Y. July 5, 2022); Declaration of Stephen Ehrlich, Chief Executive Officer of the Debtors (July 26, 2022). In March 2022, the Alabama Securities Commission gave Voyager 28 days to show cause why it should not be directed to cease and desist from selling unregistered securities in Alabama. State securities regulators in Indiana, Kentucky, New Jersey, Oklahoma, Texas, Vermont, and Washington took the same or similar action against Voyager. *See, e.g.*, Danny Nelson, State Regulators Crack Down on Voyager Digital's Crypto Interest Offering (Mar. 29, 2022); Danny Nelson and David Morris, Behind Voyager's Fall: Crypto Broker Acted Like a Bank, Went Bankrupt, CoinDesk (July 13, 2022).

approximately 300,000 active users with account balances of more than $100, and approximately $6 billion in assets.[15]

Last, on top of the issues occurring with platforms such as BlockFi,[16] Celsius, and Voyager, we are seeing unregistered sales of securities in or relating to the "metaverse," which we presently view as an umbrella marketing term for efforts to deliver more virtual reality and augmented reality experiences through computers, games, phones, and other systems. By way of example, in April 2022, the Alabama Securities Commission and the Texas State Securities Board entered cease-and-desist orders against Sand Vegas Casino Club and its cofounders, Martin Schwarzberger and Finn Ruben Warnke. The orders accused the respondents of illegally offering securities in the form of non-fungible tokens ("NFTs") to fund the development of a virtual casino in the metaverse.[17] In May 2022, the Alabama Securities Commission, Kentucky Department of Financial Institutions, New Jersey Bureau of Securities, Texas State Securities Board, and Wisconsin Department of Financial Institutions simultaneously filed cease-and-desist orders against Flamingo Casino Club. The enforcement actions accused Flamingo Casino Club of scamming people through fraudulently selling NFTs that purport to convey ownership of a metaverse casino with alleged ties to Russia and give investors a right to share in the profits of the casino when other users play virtual games such as craps, blackjack, or roulette.[18]

During the last three years (2019, 2020, 2021), our survey respondents have identified four additional types of threats at least two out of the last three years. Specifically, survey respondents identified (1) fraudulent offerings related to promissory notes; (2) financial schemes connected to SDIRAs; (3) scams offered through social media; and (4) scams otherwise offered online.[19]

With respect to other online or digital threats, the potential harm to investors cannot be understated. In the last decade, an overwhelming majority of Americans have become Internet

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[15] *See* Declaration of Alex Mashinsky, Chief Executive Officer of Celsius Network, LLC, In Support of Chapter 11 Petitions and First Day Motions, Case No. 22-10964 (July 14, 2022). In June 2022, several state securities regulators, including the Alabama Securities Commission and the Texas State Securities Board, made public their investigations into Celsius' decision to halt customer withdrawals. The investigations were designed to build on earlier work by state regulators to urge Celsius to comply with state and federal law. *See* Francis Yue, 'I Just Wake Up and Cry': Voyager and Celsius Bankruptcies Have Destroyed Some Crypto Investors' Confidence in Centralized Platforms, MarketWatch (July 15, 2022); Maria Ponnezhath and Tom Wilson, Major Crypto Lender Celsius Files for Bankruptcy, Reuters (July 14, 2022); Cheyenne Ligon, Texas, Other States Open Investigation Into Celsius Network Following Account Freeze (June 16, 2022); New Jersey Bureau of Securities Orders Cryptocurrency Firm Celsius to Halt the Offer and Sale of Unregistered Interest-Bearing Investments (Sept. 17, 2021).

[16] *See* Jay Zhuang, Zac Prince Confronts Claims Comparing BlockFi to Celsius and Voyager, CryptoPotato (July 13, 2022). Prior to 2022, state securities regulators initiated a comprehensive review and investigation of BlockFi focused on the sale of unregistered securities to retail investors through BlockFi interest accounts. This work, which the SEC later assisted with, ultimately led to a settlement with BlockFi. *See* NASAA and SEC Announce $100 Million Settlement with BlockFi Lending, LLC (Feb. 14, 2022).

[17] *See, e.g.*, Sand Vegas Casino Club Located in the Metaverse Is Soliciting Investors to Invest Real Money in Un-Registered Investments (Apr. 13, 2022). Sand Vegas Casino Club has no affiliation with the Las Vegas Sands Corporation.

[18] *See, e.g.*, Five States File Enforcement Actions to Stop Russian Scammers Perpetrating Metaverse Investment Fraud (May 11, 2022). Flamingo Casino Club has no relationship or affiliation with Flamingo Las Vegas.

[19] *See* NASAA Reveals Top Investor Threats for 2022 (Jan. 10, 2022); NASAA Announces Top Investor Threats for 2021 (Mar. 3, 2021); NASAA Announces Top Investor Threats for 2020 (Dec. 23, 2019).

users who own a smartphone.[20] Meanwhile, criminals and other fraudsters still tend to go wherever potential victims are likely to be.

As state securities regulators in a constantly evolving landscape, we have adapted time-tested investigatory techniques to online communications. By way of illustration, in June 2021, the Texas State Securities Board issued a cease-and-desist order against an unregistered person who was impersonating ARK Invest and the ARK Innovation ETF in the financial services sections of Craigslist, a U.S. classified advertisements website. The order accused the individual of leveraging public interest in ARK Invest and the ARK Innovation ETF to bait-and-switch investors with fraudulent securities issued by an unrelated unincorporated entity. The individual used fake advertisements with false and misleading information to promote a cryptocurrency product supposedly generating profits of 40% per month. The advertisements encouraged readers to act quickly, a move designed to play on COVID-19, stimulus payments, a potential economic meltdown, and FOMO (an acronym for Fear of Missing Out).[21]

With respect to the financial schemes occurring through SDIRAs, for years, state securities regulators have received reports or complaints of fraudulent investment schemes that use a SDIRA as a key feature. Experience indicates that fraudsters prey on and amplify any misperceptions that SDIRA owners have regarding the duties and responsibilities of SDIRA custodians or investment promoters.

To protect prospective and existing SDIRA owners, we have published multiple educational resources to warn investors of the potential risks associated with investing in risky products through SDIRAs. In addition, we have brought enforcement actions where appropriate.[22] For example, in March 2021, the state of Missouri ordered Retire Happy LLC and two individuals to pay $6.21 million in civil penalties, in excess of $700,000 in restitution with interest, and more than $52,000 in investigation costs. In the first part of the scheme, the defendants influenced and assisted investors to facilitate rollovers of their retirement accounts from well-known financial institutions where investors' funds were invested in traditional investments such as stocks, bonds, and mutual funds, to a relatively unknown and unconventional custodian that would allow investments in a wider array of products not generally permitted by well-established financial institutions. Once the rollovers were completed and the investors' retirement account investments had been liquidated to cash, investors were solicited to reinvest their savings into highly illiquid and highly risky alternative investments. These were principally unsecured and unregistered promissory notes in fledgling companies. In the end, Missouri investors lost more than $700,000 of their retirement savings in these alternative investments while defendants

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[20] *See* Andrew Perrin, Mobile Technology and Home Broadband 2021, Pew Research Center (June 3, 2021); Pew Research Center, Internet/Broadband Fact Sheet (Apr. 7, 2021); Jason Wallace, U.S. State Securities Regulators Label Social Media as "New Cold Call," Ripe for Fraud, Reuters (Oct. 22, 2020).

[21] Texas State Securities Board, Securities Commissioner Stops Fraudster from Impersonating ARK Invest and an ETF Managed by Cathie Wood (June 17, 2021). Read the order.

[22] *See, e.g.*, CFTC Press Release, CFTC and 30 States Charge Los Angeles Precious Metals Dealers in Ongoing $185 Million Fraud Targeting the Elderly, Rel. No. 8254-20 (Sept. 25, 2020) (30 states and the CFTC obtained an asset freeze and a receivership in a $185 million precious metals scam targeting senior citizens nationwide that made use of SDIRAs to execute the scheme); NASAA, Informed Investor Advisory: Third-Party Custodians of Self-Directed IRAs and Other Qualified Programs (Dec. 2014); NASAA and the SEC, Self-Directed IRAs and the Risk of Fraud (Sept. 28, 2011).

pocketed tens of thousands of dollars of investor money through undisclosed commissions and fees.[23]

Last, while not a 'top threat' in our surveys, a major, persistent theme from our threats surveys over the years is the extent of the harm that occurs in private offerings. While a private offering is a popular way for companies to raise capital in the United States, state securities regulators dedicate significant resources to respond to fraud and other violations involving offerings under Regulation D of the Securities Act of 1933. In 2020, we opened at least 196 investigations and 67 enforcement actions involving offerings reliant upon the law. This includes at least 69 investigations and 24 enforcement actions relating to Regulation D, Rule 506(c), which generally permits issuers to publicly advertise unregistered securities so long as they limit sales to accredited investors.[24]

In or about September 2022, NASAA anticipates releasing its figures from its most recent enforcement survey. In the meantime, to view additional data regarding NASAA's top threats surveys and an illustrative list of state enforcement actions involving private offerings, see Tables A and B of the Appendix.

IV. Promoting Trust in Our Regulated Capital Markets

Nearly 15 years after the 2008-2009 Financial Crisis, a concerning amount of distrust in our regulated capital markets persists. In a survey conducted in July 2022 by *Morning Consult*, the percentages of Gen Z, Millennial, Gen X, and Baby Boomer respondents who expressed trust in Wall Street were 33%, 32%, 34%, and 36%, respectively. In a survey conducted in March 2021 by *Bankrate*, among those invested in the stock market (including those invested through retirement plans), 56% agreed the market is rigged against individual investors (20% strongly agreed and 35% somewhat agreed). Moreover, distrust of our regulated markets appears to be higher among communities of color than among white Americans.[25]

As state securities regulators, we are not well-positioned to study all the various reasons why there continues to be a persistent lack of trust in our regulated markets. However, based on our experience working with victims and conversations with other key stakeholders such as peer regulators, we can state confidently that the proliferation and persistence of scams and offers that are 'too good to be true' are key contributing factors to the erosion of trust.

To combat the distrust, we work tirelessly to educate entrepreneurs and investors, register professionals and their products, write rules, conduct examinations, and, if needed, hold firms

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[23] *See, e.g.*, Ashcroft's Securities Division Orders Las Vegas Company to Pay $6.9 Million (Mar. 16, 2021). State securities regulators in other jurisdictions, including Massachusetts, Michigan, and Nevada, also sued Retire Happy, LLC. *See* Travis Anderson, Sec. of State Galvin's Office Sanctions Retire Happy Company for Allegedly Defrauding Senior Citizens and Retirees, Boston Globe (Dec. 22, 2020).

[24] *See* NASAA 2021 Enforcement Report at p. 9.

[25] *See* Taylor Nicole Rogers, Crypto Collapse Reverberates Widely Among Black American Investors, Financial Times (July 5, 2022); Morning Consult, Tracking Trust in U.S. Institutions (July 2022); Ariel-Schwab Black Investor Survey, Report of Findings (Apr. 2022); Lorie Konish, Why U.S. Minority Communities May Turn to Cryptocurrencies to Pay Their Bills, CNBC (Feb. 8, 2022); Bankrate, Survey: More Than Half of Investors Think the Stock Market Is Rigged Against the Individual (Mar. 24, 2021); P. Sapienza and L. Zingales, Financial Trust Index (Feb. 5, 2020).

and professionals accountable for harming investors. Whenever possible, we work collaboratively with academics, consumer groups, peer regulators, trade associations, and other external partners to inform and advance our efforts.[26] Often, we collaborate with organizations and individuals with a physical or otherwise active presence in our states.

When working with investors who may be new to the capital markets, we are careful to use our entire regulatory toolkit. By way of example, during the last decade, we have invested considerable resources into educating investors of all ages and backgrounds about investing basics, including the basics related to digital assets.[27] We also have convened policymakers and industry participants several times, both in open-door and closed-door settings, to discuss trends and regulatory issues relating to the emergence of digital assets.[28] Last, though we always prefer to use our resources on education and regulatory services, we have had to invest resources into enforcing the law. Indeed, as explained earlier in my testimony, NASAA members have led efforts in the United States to investigate and, if appropriate, pursue action against hundreds of companies and individuals for fraud or similar misconduct relating to digital assets.[29]

V. Passing Legislation and Conducting Congressional Oversight that Inspires Trust in Regulated Capital Markets

NASAA urges Congress to act on a swift, bipartisan basis to pass a package of bills and conduct oversight that will help to foster lasting trust in, and informed use of, the regulated capital markets. In doing so, Congress should prioritize proposals that would empower all of us to better prevent harm to investors before it occurs, better detect harm to investors before it spreads, and better address violations of the law. The following is a representative list of proposals and oversight actions to advance:

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[26] Among other collaborative efforts, we have released numerous educational resources for older investors, as well as training materials for financial firms that serve them. *See, e.g.*, NASAA, SEC to Jointly Host First Older Investor Roundtable Focused on Emerging Issues and Protection Challenges (Apr. 25, 2022); NASAA Releases Annual Enforcement Report (Sept. 29, 2021); FINRA, NASAA and SEC OIEA Urge Investors to Establish a Trusted Contact to Increase Investor Protection (Sept. 28, 2021); NASAA, SEC and FINRA Offer Free Resource to Securities Firms to Assist in Detection, Prevention, and Reporting of Financial Exploitation of Seniors (June 15, 2021); NASAA, SEC & FINRA Issue Senior Safe Act Fact Sheet to Help Promote Greater Reporting of Suspected Senior Financial Exploitation (May 23, 2019); SEC and NASAA, Making Sense of Financial Professional Titles (Sept. 2013); AARP and NASAA Launch "Free Lunch Seminar Monitor" Program (Oct. 14, 2008); *See generally* SEC Chair Gensler Testifies Before U.S. House Financial Services Subcommittee (May 19, 2022) ("Without examination against and enforcement of our rules and laws, we can't instill the trust necessary for our markets to thrive. Stamping out fraud, manipulation, and abuse lowers risk in the system. It protects investors and reduces the cost of capital. The whole economy benefits from that.").

[27] *See, e.g.,* NASAA, Informed Investor Advisory: Decentralized Finance (DeFi) Defined (Dec. 6, 2021); Informed Investor Advisory: Protecting Your Online Accounts (Sept. 16, 2021); Informed Investor Advisory: Social Media, Online Trading and Investing (Apr. 1, 2021); Informed Investor Advisory: Initial Coin Offerings (Apr. 16, 2018); Informed Investor Advisory: Cryptocurrencies (Apr. 13, 2018); Informed Investor Advisory: The Next Big Thing (Nov. 9, 2015); Informed Investor Advisory: Virtual Currency (Apr. 29, 2014).

[28] *See, e.g.*, NASAA Announces Speakers and Agenda for 2021 Fintech and Cybersecurity Symposium (Dec. 7, 2021); NASAA Announces Agenda for Fintech and Cybersecurity Symposium (Oct. 14, 2020); NASAA Announces Agenda for Fintech and Cybersecurity Symposium (Oct. 4, 2019); NASAA Announces Agenda and Speakers for 2018 Fintech Forum (May 10, 2018); Speakers Announced for NASAA Public Policy Roundtable (Apr. 9, 2018); NASAA Public Policy Conference to Explore Challenges to Forecasting Markets and Investor Participation (Mar. 20, 2014).

[29] *See, e.g.*, Senn Testimony.

Preventing Investor Harm

- **The Empowering States to Protect Seniors from Bad Actors Act** (H.R. 5914 | S. 3529): This bicameral, bipartisan legislation, which the House of Representatives ("House") passed on May 11, 2022, would establish a grant program that would enhance existing efforts by state securities and insurance regulators to protect senior investors and policyholders from financial fraud. Importantly, with respect to the grant program, the bill would: (A) make the SEC the program administrator; (B) give the SEC the authority and tools necessary to operate a data-driven grant program; (C) empower the SEC to make grants to state regulators from across the United States; (D) authorize an appropriation of $10,000,000 to the SEC for each of the fiscal years 2023 through 2028 to make such grants; (E) require the SEC to cap each grant at $500,000; and (F) effectively create more opportunities for federal and state securities regulators to communicate and coordinate in their efforts to protect senior investors.[30] On July 14, 2022, the House passed H.R. 7900, the National Defense Authorization Act, as amended. The legislation included H.R. 5914 as an amendment.[31]

- **The Insider Trading Prohibition Act** (H.R. 2655 | S. 3990): S. 3990 would make it easier for market participants, courts, and other stakeholders to identify, follow, and enforce the law by creating a codified definition of illegal insider trading. In short, the bill would make it unlawful for a person to trade while aware of material, non-public information if that person knows, or has reason to know, that the information was obtained wrongfully. In addition, the bill would prohibit a person with material, non-public information from wrongfully passing along that information to others, or tipping them, if the person is aware that the communication would result in trading and the recipient in fact trades based on that communication. In May 2021, the House passed H.R. 2655 by a vote of 350 to 75.[32]

- **The 8–K Trading Gap Act of 2021** (H.R. 4467 | S. 2360): This bicameral legislation, which received bipartisan support last Congress, would close a loophole by requiring the SEC to prohibit corporate insiders from making trades during the four-day period they have between the occurrence of a significant event – such as bankruptcy or an acquisition – and the public company's legally-mandated disclosure. The SEC requires public companies to file an 8-K to announce significant events relevant to shareholders. Companies have four business days to file an 8-K for most specified items.[33]

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[30] *See* NASAA, Letter to Senate Banking Committee Leadership Regarding S. 3529, the Empowering States to Protect Seniors from Bad Actors Act (Jan. 25, 2022); NASAA, Letter to House Financial Services Committee Leadership Regarding H.R. 5914, the Empowering States to Protect Seniors from Bad Actors Act (Nov. 15, 2021).
[31] *See* H.R. 7900 - National Defense Authorization Act for Fiscal Year 2023.
[32] *See generally* NASAA, Letter to Senate Banking Committee Leadership Regarding Trust in Our Capital Markets (Apr. 5, 2022); NASAA, Letter to Rep. Himes Regarding H.R. 2655 (May 17, 2021); Written testimony of Melanie Senter Lubin, Putting Investors First: Reviewing Proposals to Hold Executives Accountable (Apr. 3, 2019).
[33] The House passed The 8-K Trading Gap Act of 2019 by a vote of 384 to 7. *See* Van Hollen, Maloney Introduce Bicameral Legislation to Help Eliminate Corporate Insiders' Unfair Advantage in Stock Sales (July 15, 2021).

- **Request a Study by the Government Accountability Office ("GAO") Regarding Opportunities to Strengthen the Regulatory Framework Applicable to SDIRAs.** Presently, the government divides the responsibility for overseeing SDIRAs among several federal, state, and independent entities. The U.S. Department of Labor, the SEC, the Financial Industry Regulatory Authority, Inc., the state securities regulators, the Office of the Comptroller of the Currency, state banking regulators, and the Internal Revenue Service ("IRS")[34] all provide some oversight of some aspect of SDIRA-related investing. The specific mix of regulators varies depending on the type of financial institution that provides the account, the state in which the financial institution conducts the business, and the type of plan offered.[35] When GAO examines the framework, it should examine closely the practical and other consequences of federal and state securities regulators having no authority over SDIRA custodians. In the experience of state securities regulators, fraudsters portray SDIRA custodians to prospective investors as fiduciaries but then the custodians do not undertake the work of a fiduciary. Additionally, or alternatively, fraudsters lull victims into fraudulent schemes by using the general public's familiarity with IRAs against them.

Detecting Investor Harm

- **The Financial Exploitation Prevention Act of 2021** (H.R. 2265): This bipartisan legislation, which the House passed in October 2021, would require registered open-end investment companies and the transfer agents who service them to contact customers who hold non-institutional accounts directly with the company to request information for a trusted contact who can be notified if the company or transfer agent identifies possible financial exploitation. It also would allow the company or transfer agent in limited circumstances to postpone the date of payment upon redemption of any redeemable security. Among other requirements, the company or transfer agent must reasonably believe the redemption was requested through the financial exploitation of a security holder. Also, the security holder must be (i) an individual age 65 or older or (ii) an adult who the company or agent reasonably believes cannot protect their own interests due to the adult's mental or physical impairment (collectively, Specified Adults). Third, H.R. 2265 would require the SEC, in consultation with NASAA and other policymakers, to submit a report to Congress that includes recommendations regarding the regulatory and legislative changes necessary to address the financial exploitation of security holders who are Specified Adults. NASAA has proposed some improvements to the text that still need to be addressed.[36]

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[34] The IRS maintains an electronic list of entities approved, under Treasury Regulation Section 1.408-2(e), to serve as nonbank trustees or custodians. See IRS, Approved Nonbank Trustees and Custodians; Treasury Inspector General for Tax Administration, Oversight of Nonbank Trustees Has Improved, but Resources Expended on the Program Should be Reevaluated, 2012-10-055 (May 11, 2012); GAO, Individual Retirement Accounts: IRS Could Better Inform Taxpayers about and Detect Noncompliance Related to Unconventional Assets, GAO-20-210 (Jan. 2020) at 7.

[35] *See* GAO, Retirement Security: Improved Guidance Could Help Account Owners Understand the Risks of Investing in Unconventional Assets, GAO-17-102 (Dec. 2016) at 11-13.

[36] We urge lawmakers to clarify the relationship between this legislation and state law so that nothing in this legislation can be construed to preempt or limit any provisions of state law unless the legislation provides a greater level of protection to investors. Lawmakers may wish to use the 'no preemption provision' in the 2018 Senior Safe

- **SEC Whistleblower Reform Act of 2022** (S. 3977): This bipartisan legislation would protect whistleblowers from retaliation if they reported violations to a direct superior. Currently, they are only protected if they report directly to the SEC or certain select officials.[37] In addition, the bill would ensure that claims and awards are processed in a timely manner. Although the SEC has been improving, they previously had a backlog of claims and awards that was several years long.[38] Last, the bill would clarify that whistleblowers cannot waive their rights through a pre-dispute arbitration agreement.

Legislation to Foster Accountability

- **The FAIR Act of 2022** (H.R. 963 | S. 505): The House approved this bicameral, bipartisan legislation by a vote of 222 to 209. The bill was referred to the Senate Committee on the Judiciary. Among other things, this legislation would prohibit broker-dealers and registered investment advisers from including pre-dispute arbitration clauses in customer contracts as well as invalidate any standing mandatory pre-dispute arbitration clauses in current employment and customer agreements.[39]

- **Stronger Enforcement of Civil Penalties Act of 2021** (S. 2147): This bipartisan legislation would make several changes that are all designed to deter misconduct by bad actors. Specifically, the bill would broaden the SEC's options to tailor penalties to the particular circumstances of a given violation. In addition to raising the per violation caps for severe, or "third tier," violations to $1 million per offense for individuals and $10 million per offense for entities, the legislation would give the SEC more options to collect greater penalties based on the ill-gotten gains of the violator or on the financial harm to investors. Moreover, the bill would authorize the SEC to triple the penalty cap applicable to recidivists who have been held

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Act as a model for drafting a preemption provision. *See* 12 U.S.C. § 3423(c) ("Relationship to State law. Nothing in this section shall be construed to preempt or limit any provision of State law, except only to the extent that subsection (a) provides a greater level of protection against liability to an individual described in subsection (a)(2)(A) or to a covered financial institution described in subsection (a)(2)(B) than is provided under State law."). We also urge lawmakers to incorporate a requirement that, if a company or transfer agent reasonably believes that financial exploitation of a Specified Adult may have occurred, may have been attempted, or is being attempted, it must promptly notify the SEC, the relevant state securities regulator, and the relevant adult protective services agency. Lawmakers may wish to use language from the NASAA model act to draft an equivalent notification requirement for this legislation. *See* NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation, Section 7 and its associated legislative commentary.

[37] *See* Digital Realty Trust, Inc. v. Somers, Case No. 16-1276 (S. Ct. Feb. 21, 2018); SEC, Frequently Asked Questions: Whistleblower Rule Amendments.

[38] In 2015, *The Wall Street Journal* reported that data it had obtained showed that of the 297 individuals who had applied for whistleblower awards, 247 – or roughly 83 percent – had not yet received a decision from the SEC as to whether they will receive an award. Some claimants had been waiting for a decision from the Commission for over two years. *See* Rachel Louise Ensign and Jean Eaglesham, SEC Backlog Delays Whistleblower Awards, Wall St. Journal (May 4, 2015). Fortunately, the SEC appears to be addressing the backlog. *See* Erika Kelton, Watch Out, Wall Street – Record Number of Whistleblowers Flock to the SEC, Forbes (Nov. 30, 2021).

[39] *See generally* NASAA, Letter to Senate Banking Committee Leadership Regarding Mandatory Arbitration Agreements in Our Capital Markets (Mar. 12, 2022) (explaining that NASAA believes Congress should act now on a swift, bipartisan basis to empower investors and give them a choice when it comes to resolving disputes with securities firms and professionals).

either criminally or civilly liable for securities fraud within the previous five years. Last, the bill would allow the SEC to seek civil penalties against those who violate existing federal court or SEC orders, an approach that would be more efficient, effective, and flexible than the current civil contempt remedy.

VI. Opposing Legislation that Weakens Regulatory Authority and Undermines Trust in Our Regulated Capital Markets

As set out previously, NASAA believes that Congress should act on a swift, bipartisan basis to pass a package of bills and conduct oversight that will help foster trust and spur participation in the regulated capital markets. Conversely, Congress should work on a bipartisan basis to oppose legislation that would undermine these important goals.

Pending Legislation Relating to Digital Assets

Efforts are underway on potential legislative proposals aimed at regulating digital assets. As a general matter, NASAA is concerned that pending federal legislation would only serve to foster additional distrust in our regulated capital markets. Of particular concern are the proposals that would generate cascading costly consequences for everyone and preempt or restrict the authority of state securities regulators.[40]

Importantly, NASAA firmly believes that we would all be taking a gigantic step in the wrong direction if legislation were to create new terms for the federal securities laws that are redundant of existing ones. The core terms in the federal securities laws—security, investment contract, broker, dealer, investment adviser, and so forth—have been used time and again for decades to bring new practices, products, professionals, and technologies into and under the securities regulatory framework. Creating terms and frameworks unique to digital assets but redundant of the core structure would have costly consequences for everyone, including investors, regulated entities, regulators, and taxpayers.

In addition, NASAA firmly opposes the establishment of a self-regulatory organization ("SRO") or other regulatory body specific to digital assets. SROs, which are inherently conflicted, divert resources away from the public regulatory agencies and exacerbate the communication and coordination challenges that regulators and regulated entities and professionals face. Further, given cascading bankruptcies, continual losses through hacking and theft likely resulting from insufficient cybersecurity practices, and the constant threat of Ponzi schemes being conducted through digital asset businesses, it is clear that this industry has demonstrated it cannot regulate itself.[41]

Finally, to strengthen regulation in the digital asset space and restore the trust of the investors who have been harmed in this space already, the government must be even more effective in its efforts to educate, refresh and write rules, enforce the law, and, if needed, pass legislation.

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[40] *See, e.g.*, S. 4356, Lummis-Gillibrand Responsible Financial Innovation Act; H.R. 1628, Token Taxonomy Act of 2021.

[41] *See, e.g.*, NASAA Letter to Senate Banking Committee Leadership with NASAA's Core Principles (Jan. 28, 2022).

These efforts should prioritize investor and consumer protection.

With respect to legislation, NASAA is not advocating for rushed legislation meant to foster the responsible development of digital assets. Put simply, we do not believe the best path forward is rushed legislation that fails to consider and reinforce the well-established securities regulatory framework and the important roles of state and federal securities regulation in our economy. Rather, NASAA believes that, before passing laws relating to digital assets that may be in place for years or even decades to come, Congress should allow the full policymaking process to occur and, when engaging in this process, seek to better understand and preserve the important role of the states.

On NASAA's part, we are engaging in processes associated with the March 2022 Executive Order on Ensuring Responsible Development of Digital Assets ("Executive Order") through our participation in FSOC, as well as direct engagement with senior staff at the SEC and the Department of the Treasury.[42] In addition, we have had preliminary talks with senior SEC staff regarding the rulebook project that SEC Chair Gensler and his staff are spearheading. In those talks, we have urged the SEC to work expeditiously and continue to engage with NASAA as more details about the project come together.[43] Generally, we agree that, in order to bring transparency and investor protection into these markets, we need to work toward registration of all trading platforms and systems subject to securities laws and further agree that it is highly unlikely that unregistered platforms with dozens of products being traded on them do not have at least one security being traded on them.[44]

In addition, while letting the full policymaking process occur, we are continuing to do the following:

- First, we are looking for and acting on opportunities to expand awareness of investing in our regulated capital markets among people of all ages and backgrounds while encouraging informed, goal-oriented, investment decision-making.
- Second, we are using clear, consistent messages to entrepreneurs and investors that issuers of digital assets and intermediaries and individuals handling digital assets must register promptly with the appropriate securities regulator or seek appropriate relief from them. As Congress knows well, these registration laws have helped establish the most trusted capital markets in the world. Moreover, our securities laws are at their most effective when new participants in the capital markets are using them. Last, it costs significantly more for everyone, including companies, investors, regulators, and taxpayers, to bring a mature, unregistered entity or professional than a new one into compliance with securities laws.
- Third, we are underscoring to market participants that they will be treated fairly. Today, most digital assets that are securities are structured the same way. Entrepreneurs seek to raise money from the public by selling an asset to an investor who is expecting a profit from the efforts of the entrepreneur. To allow digital asset-issuers more time to disclose

[42] White House, Executive Order on Ensuring Responsible Development of Digital Assets (Mar. 9, 2022).
[43] *See, e.g.*, Stefanie Palma and Patrick Jenkins, SEC Chair Urges 'One Rule Book' for Crypto to Avoid Gaps in Oversight, Financial Times (June 24, 2022).
[44] *See, e.g.*, SEC Chair Gensler, Remarks Before the Aspen Security Forum (Aug. 3, 2021).

material facts to investors and to otherwise provide them special treatment under state and federal securities laws would undermine the public securities markets, disaggregate regulation of essentially identical securities offerings, and give certain businesses an unfair competitive advantage. Such an approach would be contrary to our fundamental, longstanding promises to entrepreneurs and investors, including our promise to maintain ***fair*** markets.

We urge Congress to join NASAA in sending the above clear, consistent messages, particularly to the next generation of entrepreneurs and investors.

Pending Legislation Relating to Traditional Capital Formation

Similarly, efforts are underway to pass legislation that would restrict the role of regulation, particularly state regulation, in capital formation. Notably, these proposals would expand the private capital markets at the expense of the public markets in the United States.[45] As I will explain, any further erosion of the public capital markets and the authority of state securities regulators is simply dangerous for businesses, investors, and capitalism more generally, and thus is a recipe for producing additional distrust in our regulated capital markets.

As a general matter, we oppose policies designed to expand the opaque, less regulated private markets. Put simply, expanding the private markets by relaxing or repealing capital formation requirements would exacerbate an already critical problem for our nation and our capital markets—nobody, including businesses, investors, legislators, and regulators, has a clear line of sight into these private (and dark) markets. In these dark markets, all but the most sophisticated, well-funded investors typically lack adequate information about the business and operations of the private companies in which they are investing. Public and private companies alike typically struggle to account for private companies when they conduct risk assessments and as applicable provide disclosures. Last, regulators and legislators, who are charged in different ways with overseeing these markets, lack the information necessary to know if the next financial crisis is coming.[46] This combination of blindfolds undermines our shared goal of having free markets that, through and because of regulation, are fair, orderly, and efficient.

With respect to the active efforts to expand the private markets, we are especially concerned with the Small Entrepreneurs' Empowerment and Development (SEED) Act, the Improving Crowdfunding Opportunities Act, and the Facilitating Main Street Offering Act.[47]

- The SEED Act would exempt so-called "micro-cap offerings" – or offerings valued at $500,000 or less in a single year – from core regulatory protections of the Securities Act of 1933, including registration and disclosure protections, and preempt the authority of states to require registration with or notice to the states of these offerings.

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[45] *See, e.g.*, Banking Republicans Roll Out Capital Formation Legislation to Mark 10th Anniversary of JOBS Act (Apr. 4, 2022).
[46] *See* SEC Commissioner Allison Herren Lee, Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy (Oct. 12, 2021).
[47] S. 3939, Small Entrepreneurs' Empowerment and Development (SEED) Act of 2022; S. 3967, The Improving Crowdfunding Opportunities Act; and S. 3966, Facilitating Main Street Offerings Act.

- The Improving Crowdfunding Opportunities Act would prohibit state governments from requiring securities issuers to report information to the state regarding trades of their securities made through funding portals.
- The Facilitating Main Street Offering Act would undermine responsible capital formation and investor protection by preempting state securities regulation of secondary trading of Regulation A securities issued in Tier 2 offerings.

NASAA's opposition is two-fold. First, we fundamentally disagree with the principle that the way to pursue more capital raising is to take away the choice of state governments to decide if and how their securities regulators will review securities offering materials for compliance with basic fairness standards and/or the choice of receiving notification of an offering or sale that has occurred within their state. This is especially so when these offerings will be offered and sold by businesses in our communities to investors in our communities. State securities regulators regularly witness firsthand the value that comes from having small businesses engage directly with local regulators regarding small-dollar offerings. This engagement helps entrepreneurs better understand their options for raising capital. It also deters fraud and other misconduct that can harm business owners and investors alike. Last, it facilitates investor access to information necessary to make informed investment decisions, thus enhancing the fairness and efficiency of our capital markets. Again, any further erosion of the authority of state securities regulators is clearly dangerous to businesses and investors and counter-productive to the goal of promoting responsible capital formation.[48]

Second, the explosive growth of America's marketplace for private securities offerings the last several decades has created significant policy challenges for Congress, as well as for state and federal securities regulators. One facet of the challenge is the widespread and growing disparity in access to investment opportunities. This challenge would not exist, or at least not exist to the

[48] In 1996, the National Securities Markets Improvement Act ("NSMIA") added Section 28 to the Securities Act of 1933, providing the SEC with significant flexibility to tailor the exempt offering framework by giving the Commission authority to exempt persons, securities, and transactions, or classes thereof, from registration. NSMIA also preempted state registration requirements with respect to offerings conducted under SEC Regulation D Rule 506, which had the effect of dis-incentivizing companies from pursuing exchange listings to avail themselves of exemptions available under state law for exchange-listed securities. In 2012, the Jumpstart Our Business Startups Act ("JOBS Act") enacted provisions that increased the attractiveness of exempt offerings relative to initial public offerings and played a significant role in companies choosing to stay private. In particular, the JOBS Act raised the number of holders of record that a company can have, from 500 to 2,000, before the company is required go public; removed a long standing prohibition against the use of general solicitation for private offerings under Regulation D, Rule 506 and Rule 144A; raised offering limits from $5 million to $50 million under Regulation A; preempted state registration of Regulation A+ offerings, if the securities are offered or sold to a qualified purchaser; created a new exemption for crowdfunding; and relieved emerging growth companies from certain regulatory and disclosure requirements during an initial public offering. In 2015, the FAST Act created a new Section 4(a)(7) under the Securities Act of 1933, which preempted state law to establish a nonexclusive safe harbor for private resales under the so-called "Section 4(a)(1½)" exemption to facilitate secondary trading. Collectively, these changes made it easier for companies to raise money outside the registration framework and further reduced incentives for companies to go public. *See* Michael Pieciak, former Vermont Commissioner of Financial Regulation and 2018-2019 NASAA President, Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment (Sept. 11, 2019) ("Pieciak Testimony").

extent it does, if we had not spent decades investing in regulation and legislation that tilts the markets heavily in favor of private securities and funds.[49]

Rather than proposals like the ones I described, NASAA would urge Congress to develop legislation that would foster responsible capital formation and preserve the important role that state securities regulators play in it. For example, NASAA urges members of Congress to support **The Promoting Opportunities for Non-Traditional Capital Formation Act** (H.R. 7977). In short, this bill would require the SEC's Advocate for Small Business Capital Formation (the "Advocate") to provide educational resources and host events to promote capital raising options for traditionally underrepresented small businesses and businesses located in rural areas. In addition, it would require the Advocate to meet at least annually with representatives of state securities regulators to discuss opportunities for collaboration and coordination with respect to these efforts.[50] While NASAA appreciates the efforts of the prior Advocate to engage state regulators, NASAA believes an annual meeting requirement would ensure such engagement occurs on a more regular basis. Moreover, it potentially would prompt ongoing discussions and collaboration between the Advocate and state securities regulators. As then-SEC Commissioner Michael Piwowar said in 2017, "For a capital formation agenda to succeed, it is essential that state and federal regulators work together to support the businesses that seek to engage in these offerings while also protecting investors."[51]

VII. Conclusion

Thank you again for the opportunity to testify. I hope I have provided a helpful roadmap for how we collectively can work together on a swift, bipartisan basis to promote lasting trust in, and informed use of, our regulated capital markets. I look forward to your questions.

[49] *See, e.g.*, SEC Commissioner Allison Herren Lee, Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy (Oct. 12, 2021); Pieciak Testimony.
[50] *See* NASAA Letter to House Financial Services Committee Leadership Regarding H.R. 7977 (June 10, 2022).
[51] SEC Commissioner Michael Piwowar, Opening Remarks at 2017 SEC/NASAA Annual Section 19(d) Conference (May 9, 2017).

VIII. Appendix, Tables A and B

Table A – Results of NASAA Member Surveys Regarding Top Investor Threats[52]			
Threat Categories	**Top Threat**		
	2021	**2020**	**2019**
1. Financial schemes connected to self-directed individual retirement accounts	X	X	
2. Foreign exchange-related schemes		X	
3. Fraudulent offerings related to promissory notes	X		X
4. Fraudulent investments tied to digital assets	X	X	X
5. Ponzi schemes			X
6. Scams offered through social media	X	X	X
7. Scams otherwise offered online	X	X	X
8. Scams relating to precious metals		X	
9. Scams relating to real estate investments			X

[52] Most years, we conduct a survey of our members to help us better understand present and emerging threats to investors. We encourage them to respond based on investor complaints, ongoing investigations, and current enforcement trends in their jurisdictions. The survey is voluntary, and a large majority of NASAA members participate. The list of participants varies slightly each year. *See also* NASAA Reveals Top Investor Threats for 2022 (Jan. 10, 2022); NASAA Announces Top Investor Threats for 2021 (Mar. 3, 2021); NASAA Announces Top Investor Threats for 2020 (Dec. 23, 2019).

Table B: Illustrative Examples of 2021 State Administrative Matters Relating to Private Offerings

Note: As reported in the online Lexis Advance database. States may have actions that are not included in this database.
Source: Research paper presented at the 2022 ALI Regulation D Conference by NASAA member and Ohio Securities Commissioner Andrea Seidt.

No.	Respondent in State Action	State	Types of Violations			Frequent Modes of Solicitation			
			Registration	Licensing	Fraud(like)	Website	Social Media	Direct Solicitation	Phone
1	Alioski	AL	Y	Y	Y	X	X		
2	Reflect Bitcoin	AL	Y	N	N	X			
3	BlockFi	AL	Y	Y	N	X			
4	Carson	AL	Y	Y	N			X	
5	Celsius Network LLC	AL	Y	Y	N	X			
6	Acoin Trading	AL	Y	Y	Y	X			
7	Arbirate LLC	AR	Y	Y	Y	X			
8	Mycapitaltradefx.com	AR	Y	Y	Y	X			
9	French	AZ	Y	Y	Y				X
10	Verdugo Enterprise LLC	AZ	Y	Y	Y				
11	Okoye	AZ	Y	Y	Y	X			X
12	Family Tree Estate Planning LLC	AZ	Y	Y	Y				
13	Jardine	AZ	Y	Y	N	X			
14	Global Capital and Equity LLC	AZ	Y	Y	Y	X	X		
15	Automata FX Ltd	AZ	Y	Y	Y	X			
16	Grand Oak Enters LLC	AZ	Y	Y	Y			X	
17	Marketing Dynamics Inc	AZ	Y	Y	Y			X	

Table B: Illustrative Examples of 2021 State Administrative Matters Relating to Private Offerings

Note: As reported in the online Lexis Advance database. States may have actions that are not included in this database.
Source: Research paper presented at the 2022 ALI Regulation D Conference by NASAA member and Ohio Securities Commissioner Andrea Seidt.

No.	Respondent in State Action	State	Types of Violations			Frequent Modes of Solicitation			
			Registration	Licensing	Fraud(like)	Website	Social Media	Direct Solicitation	Phone
18	Hawkins	AZ	Y	Y	Y			X	
19	My Trader Coin	AZ	Y	Y	Y	X			
20	Meta 1 Coin Trust	AZ	Y	Y	Y	X	X		
21	D2D Fin LLC	AZ	Y	Y	Y	X		X	
22	Day	AZ	Y	Y	Y			X	
23	Wenima Dev LLC	AZ	Y	Y	Y	X			
24	Comet Confections PBC	CA	Y	N	N			X	
25	TradersFXinc.com	CA	Y	Y	Y	X			
26	Rivas	CA	Y	N	N			X	
27	Zhang	CO	Y	Y	N				
28	Renison	CT	Y	Y	Y				
29	Endeavor Global Partners Corp	CT	Y	Y	Y				
30	Maida	FL	Y	N	Y				
31	Hoagland	ID	Y	Y	Y			X	
32	Blalock	IL	Y	Y	Y				
33	Charles Winn LLC	IL	Y	Y	Y				X
34	Market Master LLC	IL	Y	Y	Y	X	X		

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			Registration	Licensing	Fraud(like)	Website	Social Media	Direct Solicitation	Phone
35	McGuar	IL	Y	Y	Y			X	
36	Region Home Buyers LLC	IN	Y	N	Y	X			
37	Wright	KY	Y	Y	Y	X			
38	BlockFi	KY	Y	Y	N	X			
39	Celsius Network LLC	KY	Y	Y	N	X			
40	Fuqua	KY	Y	Y	Y				
41	Zipbox Inc	MA	Y	Y	Y				
42	Davis	MD	Y	Y	Y	X			
43	Beasley	MD	Y	Y	Y	X	X	X	
44	Fusting	MD	Y	Y	Y			X	
45	Carlini	MD	Y	Y	Y			X	
46	Divel	MD	Y	Y	Y			X	
47	Plug N Go Electrix LLC	MD	Y	Y	N		X		
48	Ekane	MD	Y	Y	Y	X			
49	Retire Happy LLC	MO	Y	Y	Y			X	
50	Kucera	MO	Y	Y	Y			X	
51	Monarch Capital Inv Fund LLC	MO	Y	Y	Y			X	

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			Registration	Licensing	Fraud(like)	Website	Social Media	Direct Solicitation	Phone
52	Marg	MO	Y	Y	Y			X	
53	Green Clinic LLC	MO	Y	N	N				
54	Peabody	MO	Y	Y	Y			X	
55	Brendaleetrades.com	MO	N	Y	Y	X	X		
56	WCO Holdings LLC	MO	Y	Y	N			X	
57	Cryotherm USA Inc	MO	Y	Y	N			X	
58	Myers	MO	Y	Y	Y			X	
59	VonKahle	NH	Y	Y	Y	X			
60	Chamberlain	NJ	Y	Y	Y			X	
61	Frimer	NJ	Y	Y	Y			X	
62	BlockFi Inc	NJ	Y	Y	N	X			
63	Celsius Network LLC	NJ	Y	Y	N	X			
64	RealBitcoreMining	NJ	Y	Y	Y	X			
65	Bulk Inv	NJ	Y	Y	Y	X			
66	Forte Trade Ltd	NJ	Y	Y	Y	X			
67	Dilna Inv Ltd	NJ	Y	Y	Y	X			
68	FileFxOption	NJ	Y	Y	Y	X			

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			Registration	Licensing	Fraud(like)	Website	Social Media	Direct Solicitation	Phone
69	Valentine	NJ	Y	Y	Y				X
70	Howley	NJ	Y	Y	Y			X	
71	Diversified Capital Inc	NM	Y	Y	N				
72	New Age Wall Street LLC	NM	Y	Y	N	X			
73	Rodriguez	OH	N	Y	N				X
74	TMTE Inc	OH	Y	Y	N				X
75	Alverson	OH	Y	N	Y				
76	Wright	OH	Y	Y	Y	X			
77	Cryptobravos	OH	Y	N	Y	X			X
78	Full Logic Solutions LLC	OH	Y	N	N		X		
79	Carson	OK	Y	Y	Y				
80	Binary Active Stock Trade Ltd	OK	Y	Y	Y	X			
81	Geiger	OR	Y	Y	Y			X	
82	Fx Trader Stock	SC	Y	Y	Y	X	X		
83	Abend	SC	Y	Y	N			X	
84	Southern Union Revolving Fund Inc	TN	Y	N	N			X	
85	Digitaly Invest	TX	Y	Y	Y	X		X	

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			Registration	Licensing	Fraud(like)	Website	Social Media	Direct Solicitation	Phone
86	Delta Crypt Ltd	TX	Y	Y	Y	X			
87	Dailyforex247	TX	Y	Y	Y	X			
88	Bitles Ltd	TX	Y	Y	Y	X			
89	Hyperion Trust LLC	TX	Y	Y	Y	X			
90	Esco Capital	TX	Y	Y	Y	X			
91	Affort Projects SA	TX	Y	Y	Y	X			
92	Key Wealth Management Worldwide	TX	Y	Y	Y	X		X	
93	Prestige Asset Management LLC	TX	Y	Y	Y	X			
94	Wichkoski	TX	Y	Y	Y	X			
95	Riek Capital	TX	Y	Y	Y				
96	Hopkins	TX	Y	Y	N			X	
97	Trussel	TX	Y	N	Y			X	
98	Treasure Growth LLC	TX	Y	Y	Y	X	X		
99	Yuschik	VA	Y	Y	N				
100	Kim	VA	Y	Y	N				
101	Bouchereau	VA	Y	Y	Y			X	
102	Wealthbridge Inc	VA	Y	N	Y			X	

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No.	Respondent in State Action	State	Types of Violations			Frequent Modes of Solicitation			
			Registration	Licensing	Fraud(like)	Website	Social Media	Direct Solicitation	Phone
103	US Data Mining Group Inc	VA	Y	N	N				
104	BlockFi Inc	VT	Y	Y	N	X			
105	Wesleyan Inv Fdn Inc	WA	Y	N	N			X	
106	Charles Winn LLC	WA	Y	Y	Y				X
107	Trademining Inc	WA	Y	Y	Y	X	X		
108	Powell	WA	Y	Y	Y			X	
109	Guardian Data Sys LLC	WA	Y	Y	Y			X	
110	Symboli Blockchain LLC	WA	Y	N	Y				
111	NMJ Group	WA	Y	N	Y			X	
112	Coinchainbtc.com	WA	Y	N	Y	X	X		
113	Worldofcryptomining.com	WA	Y	N	Y	X			
114	24Xploittrade	WA	Y	N	Y	X	X		
115	FX-Bittrade	WI	Y	Y	Y	X	X		
116	Adkins	WI	Y	Y	Y	X			
117	BoomFX	WI	Y	Y	Y	X	X		
118	Charles Winn LLC	WI	Y	Y	Y				X
119	Smiley	WI	Y	Y	Y			X	

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			Registration	Licensing	Fraud(like)	Website	Social Media	Direct Solicitation	Phone
120	Behuz Inv	WI	Y	Y	Y	X	X		
121	Frigates	WI	Y	Y	Y		X		

FINRA Investor Education FOUNDATION | NORC at the University of Chicago

Consumer Insights: Money & Investing

March 2022

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Investors say they can change the world, if they only knew how: Six things to know about ESG and retail investors

Introduction

As conversations about climate change and discrimination based on race, gender, ethnicity and sexual orientation have intensified over the past decade, so too have efforts to create ways to invest that are consistent with investors' environmental and social values. One framework—Environment, Social and Governance (ESG)—incorporates financial considerations such as investment returns, fees, risk and tax matters alongside environmental impact and matters related to workers' wellbeing, the diversity of corporate leadership and corporate social responsibility more generally.[1]

The media often discuss ESG investing, but much of the research to date on the topic has focused on institutional investors rather than retail investors. ESG strategies appear widespread among institutional investors, with some studies suggesting that three-quarters of professional investors are implementing such strategies.[2] However, little is known about retail investors' understanding of and approach to ESG investing.

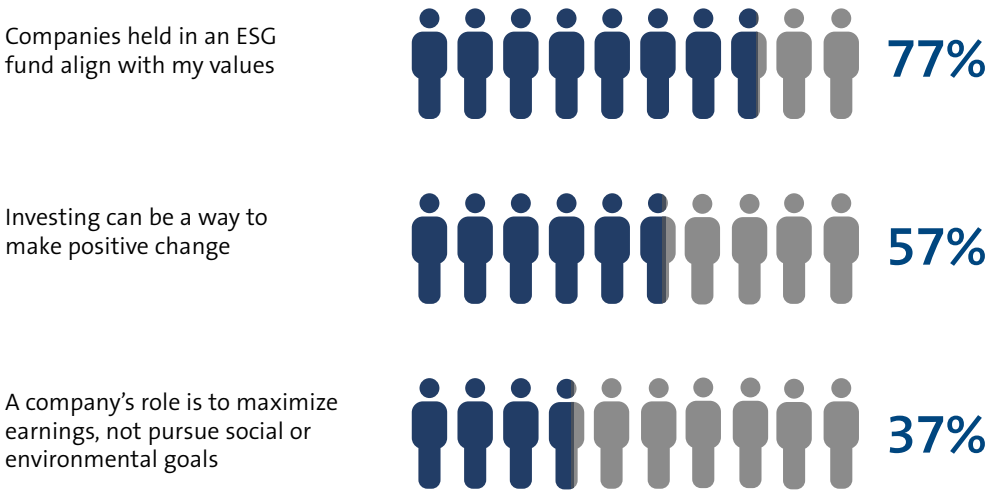
To better understand retail investors' perceptions and preferences related to ESG investing, NORC and the FINRA Investor Education Foundation conducted a study with 1,228 retail investors holding taxable accounts[3] who were randomly selected from the AmeriSpeak Panel (see Appendix Table 2 for sample characteristics). The study included questions about respondents' awareness and use of ESG investments[4] and their perceptions of socially responsible and environmentally sustainable investing. The study also assessed the relative importance retail investors assign to financial performance, environmental considerations, and social and governance issues when selecting investments.

#1. Most retail investors believe investing is a way to make positive change in the world.

Retail investors seem generally open to purchasing socially responsible or environmentally sustainable investments. More than half (57 percent) of respondents strongly or somewhat agree that investing can be a way to

make positive change in the world, and over three-quarters (77 percent) of respondents indicate that, if they had the opportunity to invest in a "socially responsible" mutual fund, they would assume that companies held by that fund would align at least somewhat with their personal values. Only about a third (37 percent) agree or strongly agree that a company's role should be to maximize earnings and not pursue social or environmental goals.

Figure 1. Beliefs about investing as a mechanism for change



Among women, only 6 percent disagree that investing can be a way to make a positive change in the world, compared to 11 percent of men. And only 11 percent of women assume the companies held in an ESG fund will be at odds with their personal values, compared to 18 percent of men. The most striking difference, however, is in the way men and women see the primary goal of a company: 28 percent of women agree that profit is the primary role, compared to 44 percent of men.

#2. Most retail investors report being unfamiliar with ESG investing, but familiarity is highest among groups traditionally underrepresented in investing.

Although media coverage of ESG investing has substantially increased in recent years, only 28 percent of investors report being at all familiar with ESG investing.[5] Only 24 percent of study participants can correctly define ESG investing, and only 21 percent know what the letters in ESG stand for; a quarter of the sample incorrectly believe ESG stands for "Earnings, Stock, Growth."

Self-reported familiarity is highest among investors under age 30 (37 percent), investors with annual incomes under $30,000 (40 percent), and African American investors (44 percent)—all groups historically underrepresented in investing. Women have substantially lower levels of familiarity with ESG; only 23 percent indicate they are at all familiar, compared to 33 percent of men.

Figure 2. Familiarity and knowledge of ESG investing among retail investors with taxable accounts

#3. Fewer than one in ten retail investors say they own ESG-focused investments in their taxable investment accounts.

Only 9 percent of respondents indicate they hold ESG investments, and over a third of all investors with taxable accounts do not know if their portfolio includes ESG investments (36 percent). Investors under age 30 (17 percent, compared to 8 percent among all others), those with annual incomes under $30,000 (15 percent, compared to 8 percent among all others), and non-white investors (12 percent compared to 8 percent) report holding ESG investments most frequently. White investors (8 percent) hold ESG investments less frequently than investors of all other race/ethnicities (12 percent). While some of these differences may be related to varying rates of familiarity among these groups, these patterns remain when we look at differences among only those familiar with ESG investing.

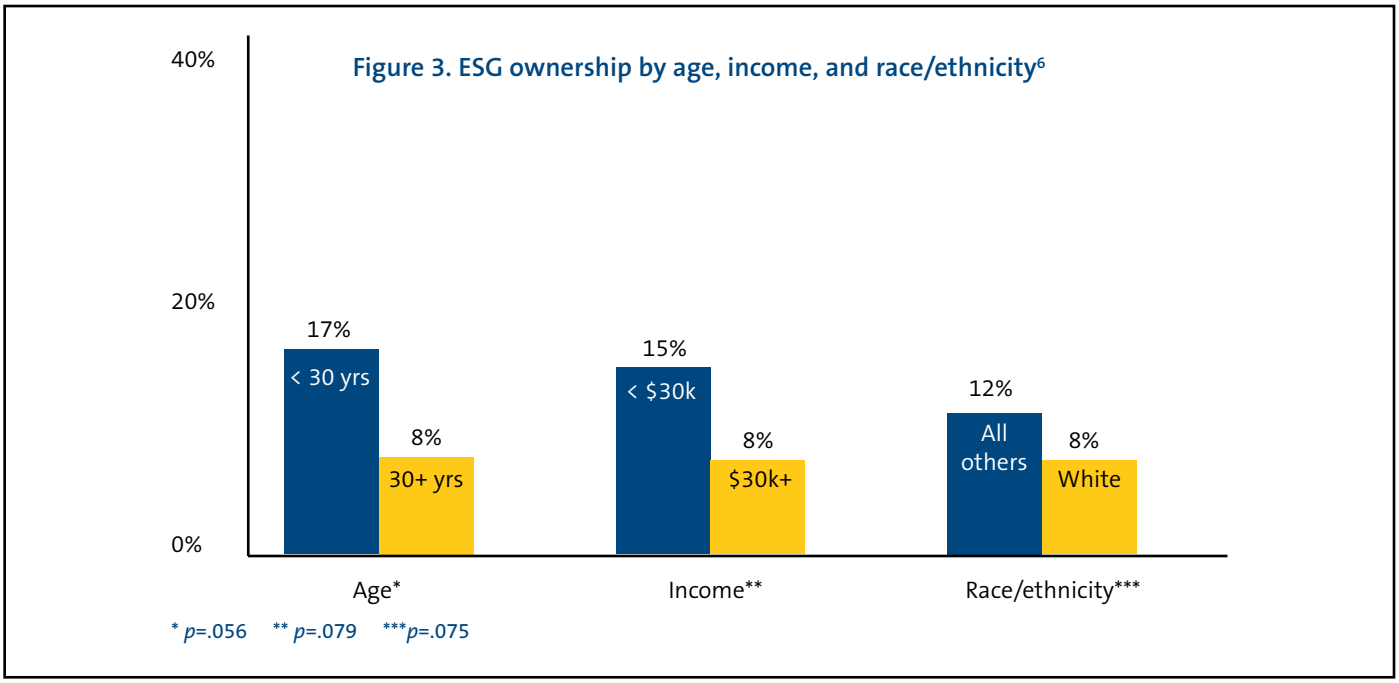


Figure 3. ESG ownership by age, income, and race/ethnicity[6]

There does appear to be an association, although nuanced, between ESG ownership and gender. Although there are no gender-based differences in the proportion of men and women with ESG holdings, significantly more women report they don't know if they own ESG investments (42 percent) than men (32 percent).

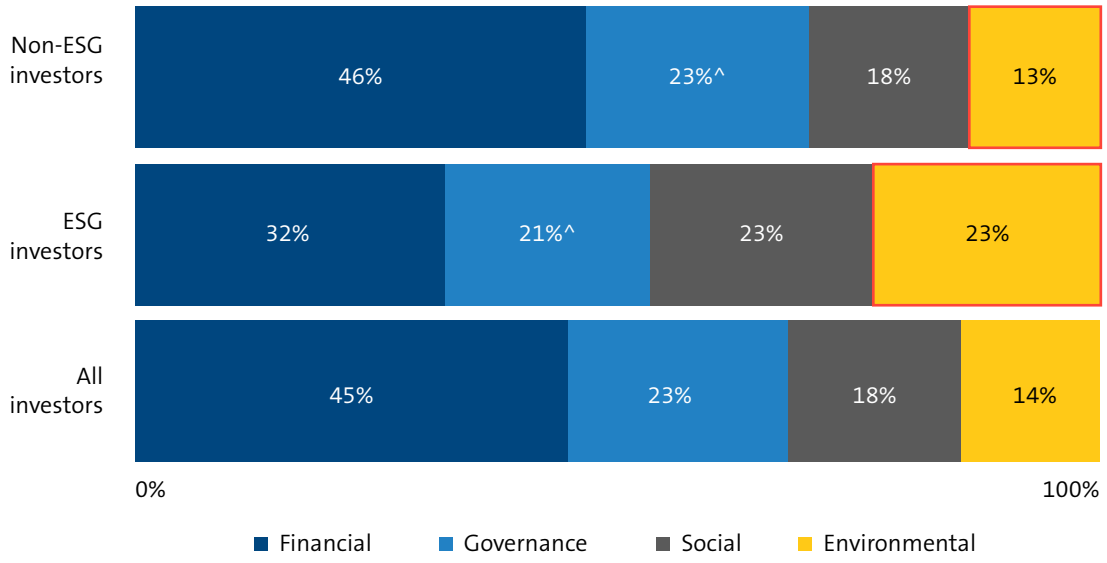
#4. Environmental issues motivate many ESG investors.

To understand the drivers of ESG demand among all retail investors in our sample, we asked a series of questions to estimate the relative importance investors assign to different aspects of investing.[7] For all retail investors in our sample (whether they hold ESG investments or not), financial factors (i.e., investment returns, fees, risk and tax matters) are most important when making investment decisions. These financial factors impact investment decisions about twice as much as the governance or social aspects of a potential investment. In aggregate, retail investors indicate environmental aspects are the least important considerations relative to social, governance and financial considerations when making investment decisions.

When we compare ESG investors to non-ESG investors, we see that both groups place the highest importance on financial considerations. However, we do see considerable differences in the relative importance the two groups assign to E, S and G considerations, particularly regarding social and environmental factors. While the importance of social aspects of the investment is six percentage points higher for ESG investors than for non-ESG investors (23 percent and 17 percent, respectively), the relative importance of environmental factors is nearly double—23 percent for investors with ESG holdings compared to 13 percent for non-ESG investors. We also find that ESG investors are almost evenly split on the importance they assign to environmental, social and governance issues: Among ESG investors, the relative importance is 21 percent for governance, 23 percent for social and 23 percent for environmental considerations. By contrast, non-ESG investors assign greater importance to governance items relative to social items, and least importance to environmental items.

This focus on environmental issues is consistent with the direct question we asked as to why the investor holds ESG investments. Over half of ESG-holding investors indicate they want to support corporations that are environmentally sustainable (51 percent). Other reported reasons for owning ESG include the belief that ESG investments will perform well financially (48 percent) and the desire to support socially responsible corporations (42 percent).

Figure 4a. Relative importance retail investors assign to financial, environmental, social and governance items when selecting investments

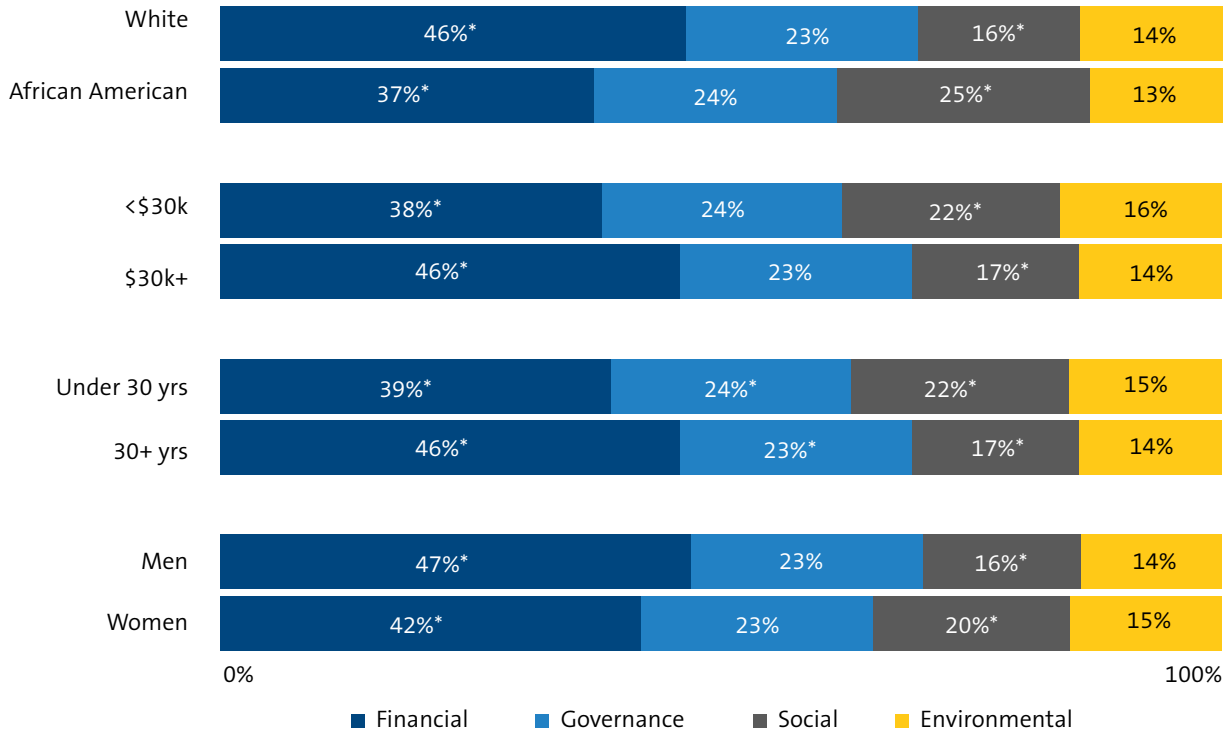


Note: The "All investors" category contains responses from those who do not know whether they hold ESG investments.

^ Not significantly different at $p<.05$.

Looking at the relative importance scores of different subgroups, there are notable patterns. First, we see decreased importance assigned to the financial factors among women, African American investors (compared to white investors), investors under age 30 and investors with annual incomes under $30,000. Second, we see increases in the importance of social factors among these same groups. And third, we do not see significant differences in the importance assigned to environmental factors based on demographics.

Figure 4b. Importance retail investors assign to financial, environmental, social and governance items when selecting investments, by demographics

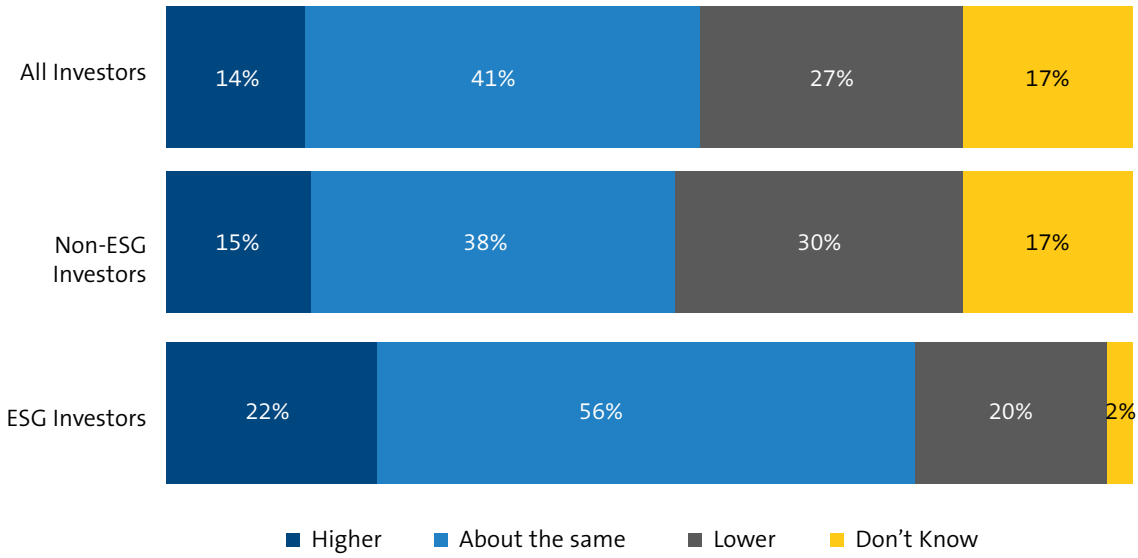


* Significantly different at $p<.05$.

#5. Most retail investors believe ESG investments will perform as well as or better than the market as a whole.

One hypothesis is that retail investors do not hold ESG-focused investments due to concerns about financial performance. This does not appear to be a major barrier to ESG investing; only about a quarter (27 percent) of investors believe that companies prioritizing their impact on the environment and society will generate lower returns, on average, compared to the rest of the market. A plurality of investors (41 percent) believe returns for these kinds of companies will not differ from the rest of the market, while 14 percent expect that ESG investments will do better than the market, in general. Above-average performance expectations for investment returns are most prevalent among investors under age 30 (22 percent) and among investors with incomes under $30,000 annually (26 percent).

Figure 5. When it comes to companies that prioritize their impact on the environment and society, would you expect returns higher, lower or about the same as the market in general?



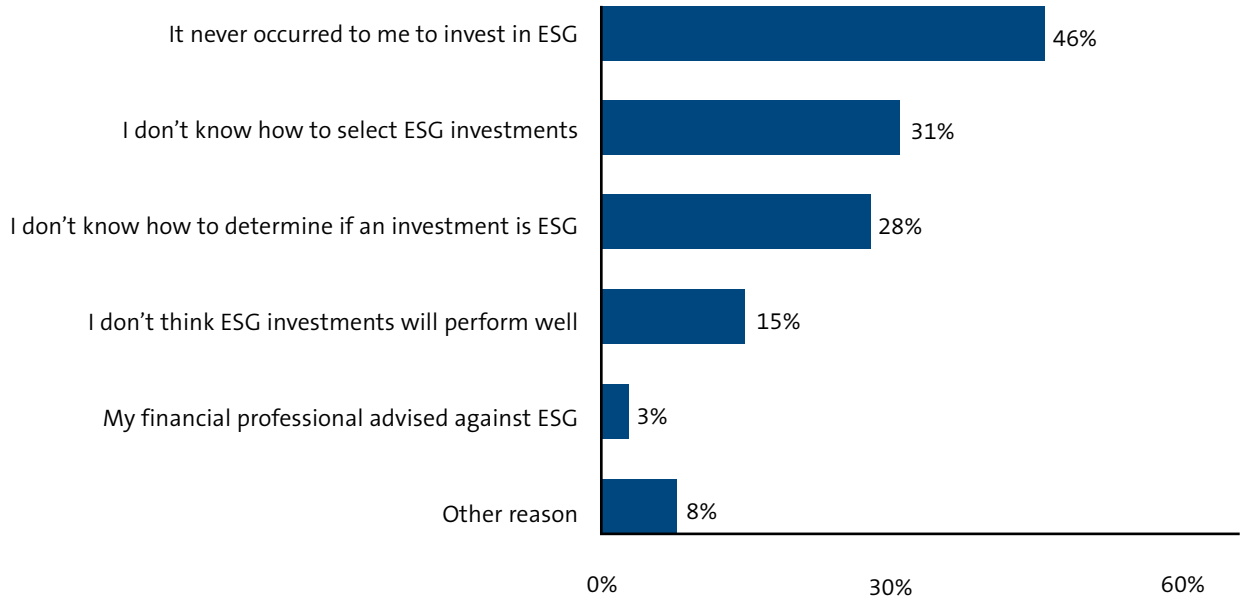
Note: The "All investors" category contains responses from those who do not know whether they hold ESG investments.

#6. Most non-ESG investors don't hold ESG investments because they haven't thought about it or don't know how.

Although there appear to be an increasing focus on ESG investing and a growing number of ESG investment products, retail investors frequently report that they simply don't consider environmental, social or governance issues before making an investment. When making investment decisions, 63 percent indicate they never or rarely consider the diversity of a company's leadership, 54 percent never or rarely consider environmental impacts, and 44 percent never or rarely consider companies' actions or statements related to social issues.

When investors are asked why they do not hold ESG investments, the most common response is related to a lack of familiarity and/or knowledge: Almost half of respondents (46 percent) indicate that it never occurred to them to select ESG type of investments, almost one-third (31 percent) indicate they don't know how to select investments of this type, and 28 percent say they don't know how to determine if an investment is ESG. Only 15 percent cite performance concerns as a reason for not holding ESG investments.

Figure 6. Why don't you hold ESG investments?



Conclusion

As with other recent trends affecting retail investing, emerging attitudes about ESG investing appear to be driven in significant part by younger generations and by non-white investors. As the investing population grows to include more diverse and younger Americans, our understanding of how investors view ESG investing is surely to change, as well. As such, this brief provides an early look at how retail investors view ESG investing, a look that will evolve as more retail investors learn about this area and if and when ESG investing becomes more common among retail investors.

Findings here indicate that familiarity with ESG is low among retail investors. This lack of awareness appears to be the primary barrier to ESG investing, as many investors believe investing can be a way to create change and that ESG investing can yield results similar to non-ESG investments. While all investors care about the financial performance of their investments, ESG investors are frequently motivated by environmental considerations. Those that report holding ESG investments generally believe such investments will perform as well as or better than the rest of the market.

Further, it's worth reflecting on what we didn't find in the data. The investing knowledge levels of ESG investors do not significantly differ from the knowledge levels of other retail investors. And study participants do not appear to follow different ESG considerations when investing than when engaging in other financial transactions, such as shopping.

Appendices

Maximum Difference Scaling

To elicit the relative preferences related to environmental (E), social (S) and governance (G) items compared to financial (F) considerations, study participants completed a maximum difference scaling exercise. We developed four items in each of the four categories (E, S, G + F).

Table 1. Maxdiff items and importance estimates

Item	Importance estimate
Financial	
The investment has the potential to earn high returns (Returns)	14.36
I am comfortable with the financial risk associated with holding the investment (Risk)	11.91
The fees and expenses associated with buying, holding, and selling the investment are low (Fees)	10.85
The investment has tax advantages (Tax advantages)	7.66
Governance	
The company has high standards for ethical conduct (Ethics)	8.71
The company respects shareholder rights (Respects shareholders)	6.84
The company's corporate directors exercise careful oversight of CEO and other executive pay (CEO pay)	4.57
The company's leadership is racially and ethnically diverse and is balanced in terms of gender (Diverse leadership)	2.69
Social	
The company does not discriminate on the basis of age, race, ethnicity, gender, disability, religion, or sexual orientation (No discrimination)	5.89
The company's workers receive a living wage and adequate benefits (Wages + benefits)	5.81
The company's hiring, promotion, training, and pay practices foster a diverse workforce (Diverse workforce)	3.23
The company supports community well-being through philanthropy, voluntarism, and civic engagement (Community support)	3.19
Environmental	
The company has a positive environmental track record (Positive record)	3.73
The company uses environmentally sustainable business practices (Sustainable practices)	3.59
The company supports policies that protect the environment (Environmental policies)	3.51
The company is forthcoming and transparent about its environmental practices (Transparent)	3.47

Figure 7. Relative importance of items, by category

The design for this study included ten sets of four items per set. For each set presented, we asked respondents to indicate the most and least important items they consider when making decisions about investments.

Example set:

Which of the following items are most and least important in making decisions about how to invest?

MOST important		LEAST important
O	The fees and expenses associated with buying, holding, and selling the investment are low	O
O	The company has a positive environmental track record	O
O	The company's workers receive a living wage and adequate benefits	O
O	The company supports community well-being through philanthropy, voluntarism, and civic engagement	O

We analyzed data using a Hierarchical Bayes multinomial logit model that estimates the predicted likelihood of a given item being selected as most important compared to a reference item for each observation in the sample. We then rescale these utilities (or 'importance' scores) so that the sum of all items is equal to 100. To get scores for each of the four categories (E, S, G and F), we summed the scores of each item in the category.

Methodology

About the data

This study uses data collected between October 27 and November 19, 2021, using the AmeriSpeak® Panel. Funded and operated by NORC at the University of Chicago, AmeriSpeak is a probability-based panel designed to be representative of the U.S. household population. Randomly selected U.S. households are sampled using area probability and address-based sampling, with a known, non-zero probability of selection from the NORC National Sample Frame. These sampled households are then contacted by U.S. mail, telephone and field interviewers (face to face). The panel provides sample coverage of approximately 97 percent of the U.S. household population. Those excluded from the sample include people with P.O. Box only addresses, some addresses not listed in the USPS Delivery Sequence File and some newly constructed dwellings. While most AmeriSpeak households participate in surveys by web, non-internet households can participate in AmeriSpeak surveys by telephone. Households without conventional internet access but having web access via smartphones are allowed to participate in AmeriSpeak surveys by web. AmeriSpeak panelists participate in NORC studies or studies conducted by NORC on behalf of governmental agencies, academic researchers, and media and commercial organizations. 1,228 U.S. adults ages 18 and older were included in the study analyses. The study was fielded in English only, and was administered online. Respondents were considered eligible for the study if they were either the primary decision-maker or shared in the decision-making related to finances in the household and held at least one non-retirement investment account. The screener completion rate was 30.3 percent, and the survey completion rate was 97.5%. The final AAPOR response rate (RR3) for the study was 3.8 percent, and the margin of error was 3.61 percentage points. AmeriSpeak participants self-identified their age, sex, education and race/Hispanic ethnicity.

Table 2. Study Sample Characteristics

Sample Size	1,228
Mean Age	49 yrs.
Percent	
Female	44%
Household Income $60,000 or Above	62%
Married	56%
College Degree	74%
High Investing Knowledge (3 of 5 correct questions)	78%
Opened a Taxable Investment Account < 5 Years Ago	40%

Weighting

Statistical weights for the study-eligible respondents are calculated using panel-base sampling weights to start. The base sampling weights are further adjusted to account for unknown eligibility and nonresponse among eligible housing units. The household-level nonresponse adjusted weights are then post-stratified to external counts for number of households obtained from the Current Population Survey. Then, these household-level post-stratified weights are assigned to each eligible adult in every recruited household. Furthermore, a person-level nonresponse adjustment accounts for nonresponding adults within a recruited household. Finally, panel weights are raked to external population totals associated with age, sex, education, race/Hispanic ethnicity, housing tenure, telephone status and Census Division. The external population totals are obtained from the Current Population Survey. Study-specific base sampling weights are derived using a combination of the final panel weight and the probability of selection associated with the sampled panel member. The screener nonresponse adjusted weights for the study are adjusted via a raking ratio method to general population age 18 and older population totals associated with the following socio-demographic characteristics: age, sex, education, race/Hispanic ethnicity and Census Division.

Imputation

A small subset of respondents did not report gender, race or ethnicity. As these variables are used in weighting, missing values were imputed using a proportional imputation approach. Missing values were assigned a random number between 1 and 0. If that random number is below the population benchmark for male (the same process was used for race and ethnicity), the observation was assigned male; otherwise, the observation was assigned female.

About FINRA and the FINRA Foundation

The Financial Industry Regulatory Authority (FINRA) is a not-for-profit organization dedicated to investor protection and market integrity. It regulates one critical part of the securities industry—brokerage firms doing business with the public in the United States. FINRA, overseen by the Securities and Exchange Commission, writes rules, examines for and enforces compliance with FINRA rules and federal securities laws, registers broker-dealer personnel and offers them education and training, and informs the investing public. In addition, FINRA provides surveillance and other regulatory services for equities and options markets, as well as trade reporting and other industry utilities. FINRA also administers a dispute resolution forum for investors and brokerage firms and their registered employees. For more information, visit www.FINRA.org.

The FINRA Investor Education Foundation supports innovative research and educational projects that give underserved Americans the knowledge, skills and tools to make sound financial decisions throughout life. For more information about FINRA Foundation initiatives, visit www.FINRAFoundation.org.

About NORC

NORC at the University of Chicago is an independent research institution that delivers reliable data and rigorous analysis to guide critical programmatic, business and policy decisions. Since 1941, NORC has conducted groundbreaking studies, created and applied innovative methods and tools, and advanced principles of scientific integrity and collaboration. Today, government, corporate and nonprofit clients around the world partner with NORC to transform increasingly complex information into useful knowledge.

Endnotes

1. www.cfainstitute.org/en/research/esg-investing
2. www.businesswire.com/news/home/20210422005347/en/ESG-Investing-Reaches-Critical-Mass-Ongoing-Momentum-Depends-on-What%E2%80%99s-Driving-the-Demand-Finds-Natixis-Investment-Managers-Survey
3. Most of these taxable investment account holders (79 percent) also hold retirement accounts.
4. As the term "ESG" may be unfamiliar to investors, the survey used "socially responsible or environmentally sustainable" to describe ESG-like investments.
5. www.cognitomedia.com/sites/default/files/inline-files/Cognito-report-on-ESG-media-relations-March-2021.pdf
6. Because a small proportion of the sample report familiarity with ESG, only white/all other race and ethnicity comparisons are reported. Due to smaller sample sizes, differences with p-values below .10 are reported.
7. *See* the Maximum Difference Scaling section in the Appendices for details on methodology.

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FINRA Investor Education FOUNDATION | NORC at the University of Chicago

Consumer Insights: Money & Investing

February 2021

Consumer Insights on Money and Investing: A Collaboration between the FINRA Foundation and NORC at the University of Chicago.

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Investing 2020: New Accounts and the People Who Opened Them

In a year when pandemic gripped the world, beginning and experienced retail investors flocked to the stock market.

Summary

During 2020, the COVID-19 pandemic and associated market and income volatility dramatically altered the financial well-being of many U.S. households. Nevertheless, the same period witnessed a surge in retail investors who entered the markets using taxable, non-retirement investment accounts via online brokers. To learn more about these new account openers, their motivations, the types of accounts they opened, and their investment knowledge and practices, the FINRA Investor Education Foundation and NORC at the University of Chicago surveyed 1,291 households from NORC's probability-based AmeriSpeak® Panel. The survey was fielded between October 26 and November 13, 2020.[1]

Respondents were grouped into one of three categories:

- **New Investors** who opened one or more non-retirement investment account(s) during 2020, and did not own a taxable investment account at any time before 2020[2] (38 percent);
- **Experienced Entrants** who opened a taxable investment account during 2020, and also owned an existing taxable investment account opened before 2020 (19 percent); and
- **Holdover Account Owners** who maintained a taxable investment account that was opened before 2020 but did not open a new account during 2020 (43 percent).

1. Sample characteristics can be found in the Appendices.
2. Although investors in this group were new to investing through a taxable account in 2020, they may have started investing through a tax-advantaged account, such as a 401(k) account or IRA, prior to 2020.

Results of this study indicate that New Investors were younger, had lower incomes, and were more racially diverse than Experienced Entrants and Holdover Account Owners. New Investors held smaller balances in their taxable accounts when compared with investors in the other two categories. With regard to trading frequency, the majority of all respondents in our sample reported making a few trades per month.[3] For both New Investors and Experienced Entrants, investing for retirement was the most frequently cited reason for opening the account, despite the study's focus on taxable investing.

New Investors during 2020 tended to be younger, earned lower incomes, and were more racially/ethnically diverse than Experienced Entrants and Holdover Account Owners.

New Investors and Experienced Entrants funded their new investment account primarily through a combination of savings and money from their paycheck. A large number of all investors in our sample reported not knowing whether their investment account charged commissions on trades or whether their account allowed purchasing on margin. While all investors reported relying on a variety of information sources when making financial decisions, Holdover Account Owners more frequently relied upon financial professionals, while Experienced Entrants more frequently conducted their own personal research, and New Investors more frequently relied on the advice of friends and family. Investment knowledge was lowest among New Investors (both self-assessed and objectively measured).

Timeframes for holding investments varied significantly among the three investor groups in our sample, with investors exhibiting a bimodal time preference for either short (one to three years) or long (10 years or more) timeframes.

Background

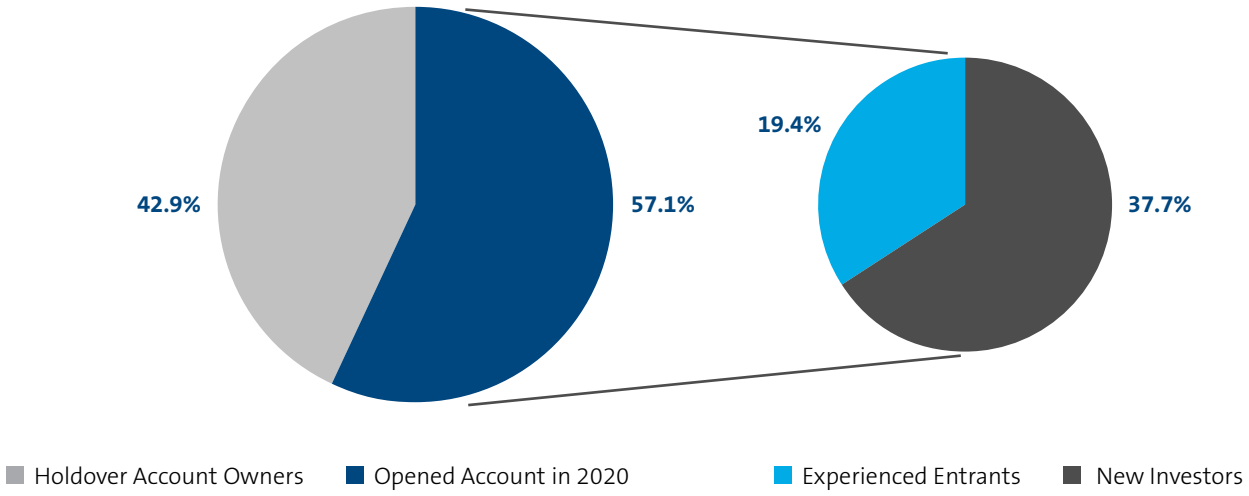
Historically, investing in the stock market has been dominated by individuals with access to a retirement account through their employer, or with both the funds and knowledge to open non-employer-sponsored accounts. More recently, new investment platforms began addressing some of the traditional barriers to investing, such as not knowing how to open an account, limited access to a financial professional, the perception that large sums of money are required to enter the market, and sensitivity to the costs of investing. These platforms, coupled with the market volatility seen in early 2020, appear to be driving a record number of Americans to open new taxable investment accounts. This study seeks to better understand the types of investors entering the market, their motives and decision-making related to investing, and, importantly, how they might differ from more experienced investors.

Are "New Investors" different demographically?

Fifty-seven percent of the respondents to this study opened a new taxable investment account in 2020. Among investors who opened a new account in 2020 in our sample, 66 percent were New Investors who had not previously owned a taxable investment account, making this their first experience with this type of account. Despite already holding a taxable investment account opened prior to 2020, 19 percent of the sample (whom we describe as Experienced Entrants) opened a new account in 2020.

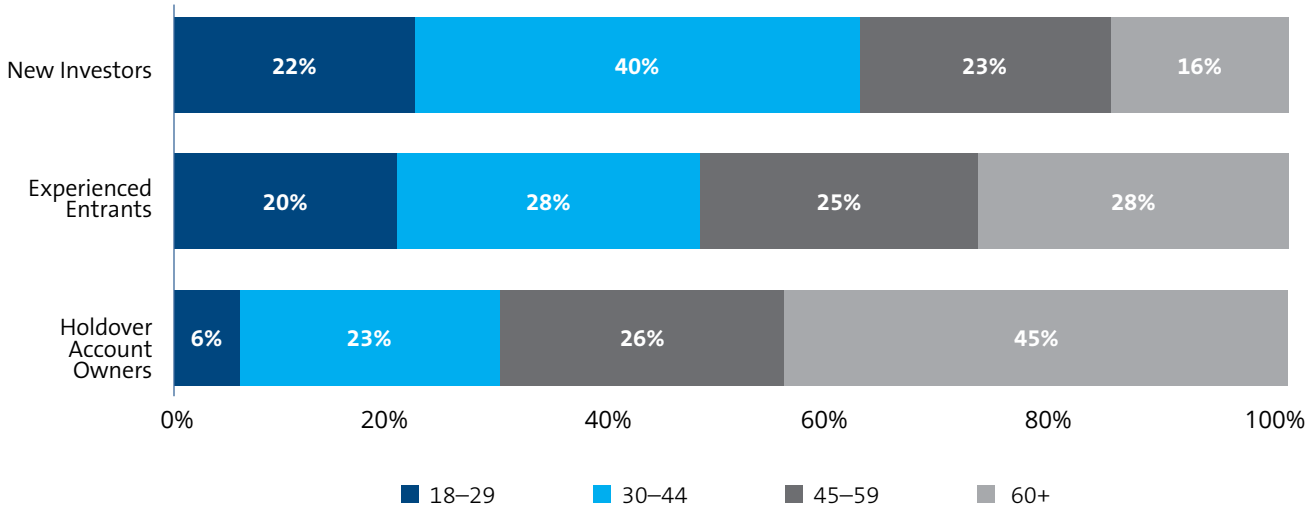
3. Data from the 2018 FINRA Foundation National Financial Capability Study suggest that this level of trading frequency may be higher than the trading frequency of investors with taxable accounts as measured in 2018. See *Investors in the United States: A Report of the National Financial Capability Study* for more information.

Figure 1. Sample Population by Investor Type



Consistent with the narrative that new investors tend to be younger than their experienced investor counterparts, almost two-thirds (66 percent) of New Investors were under 45. Investors aged 30–44 comprised the plurality of New Investors and Experienced Entrants (40 percent and 28 percent, respectively), while the plurality of Holdover Account Owners were aged 60 and over (45 percent). In fact, there were almost three times the number of investors aged 60+ among Holdover Account Owners (45 percent) compared with New Investors (16 percent).

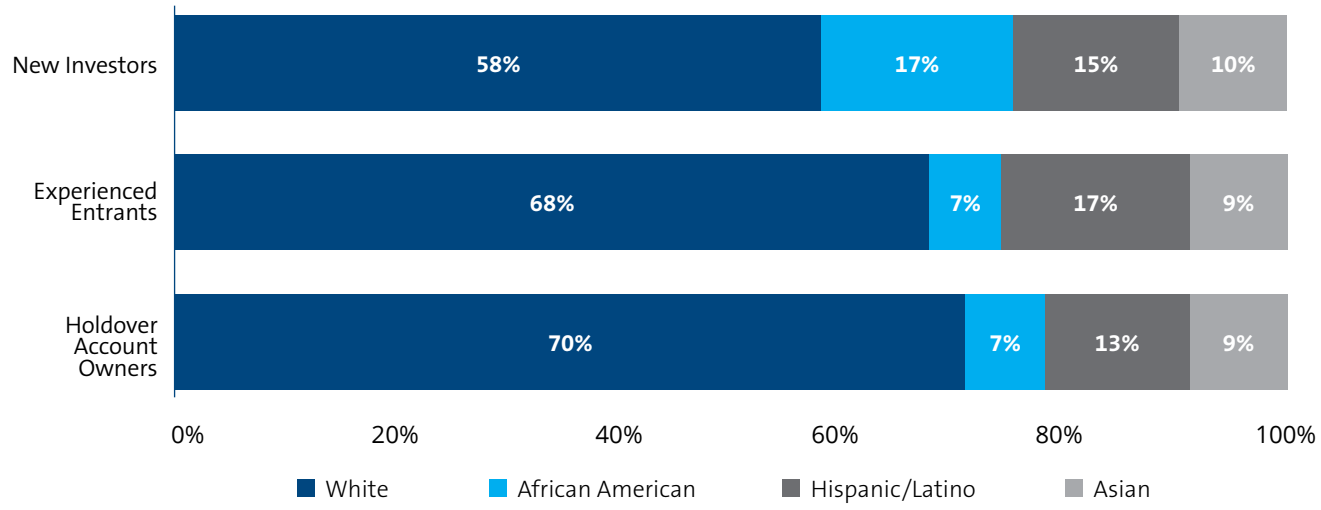
Figure 2. Investor Type by Age



New Investors earned less income compared to both Experienced Entrants and Holdover Account Owners, consistent with the narrative that New Investors are younger and may have less money to invest due to lower incomes. The plurality of all investor groups (37 percent) earned an income of $100,000 or more. However, 45 percent of Experienced Entrants and 41 percent of Holdover Account Owners earned $100,000 or more, while only 28 percent of New Investors earned that amount. Additionally, 24 percent of New Investors earned less than $35,000, while 7 percent of Experienced Entrants and 16 percent of Holdover Account Owners had similar earnings. In general, Experienced Entrants had higher incomes than both New Investors and Holdover Account Owners.

While the majority of investors in all three investment groups were white, New Investors were more diverse. Indeed, the largest proportion of African American (17 percent) investors were New Investors, and there were more Hispanic/Latino investors in both the New Investors (15 percent) and Experienced Entrants (17 percent) groups. Consistent with previous literature examining stock market participation and race/ethnicity, white respondents comprised the large majority (70 percent) of Holdover Account Owners, compared to African American respondents (7 percent) and Hispanic/Latino respondents (13 percent) (Fontes & Kelly, 2013; Gutter & Fontes, 2006; Fisch, Hasler, Lusardi, & Mottola, 2019).

Figure 3: Investor Type by Race/Ethnicity*

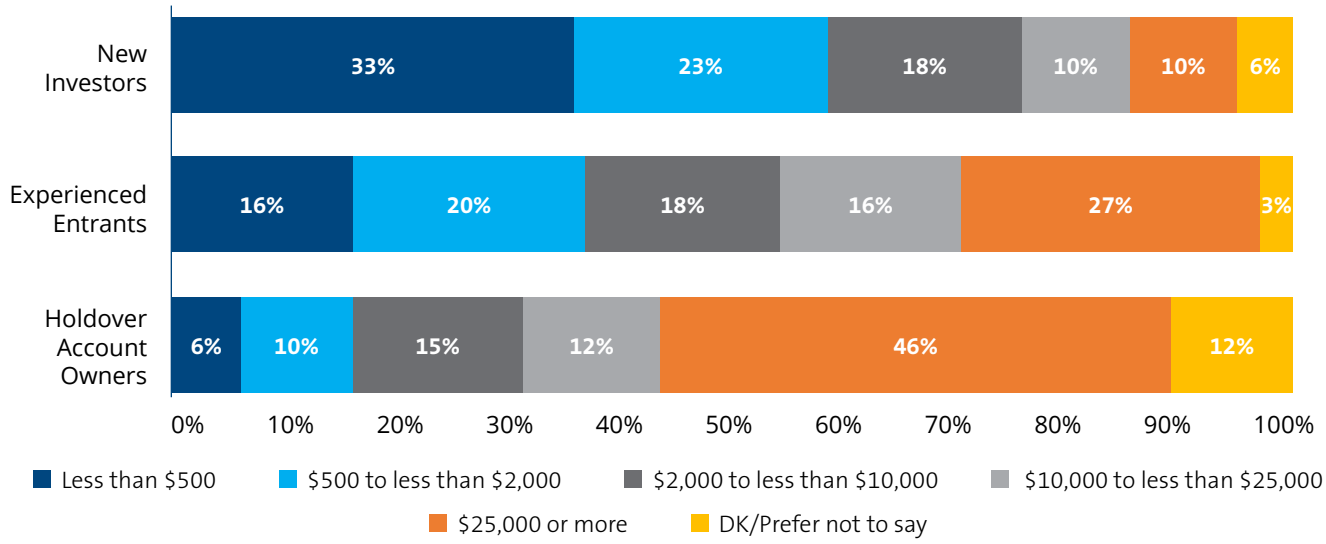


**Respondents indicating "other" or "two or more races" were omitted from this analysis due to small sample sizes.*

Investment account balances

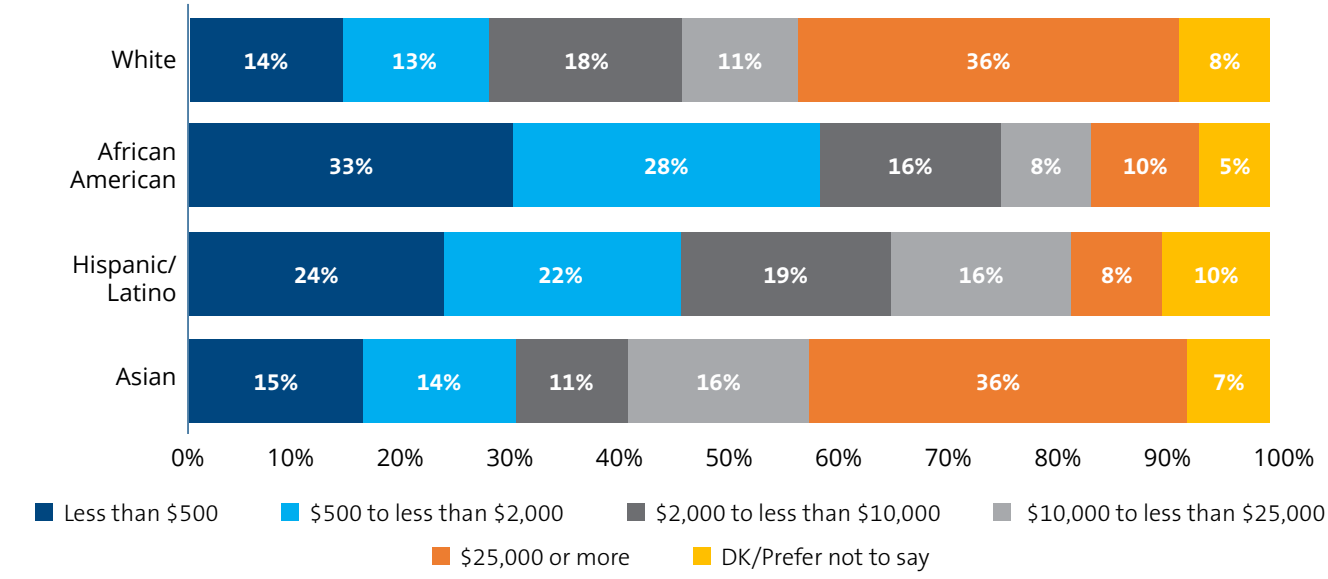
New Investors held much lower balances, in general, when compared to the other investor groups. More than twice as many New Investors held account balances less than $500 (33 percent) when compared to Experienced Entrants (16 percent), and more than five times as many when compared to Holdover Account Owners (6 percent). Holdover Account Owners most frequently held high-value accounts (over $25,000) (46 percent), but a large proportion of Experienced Entrants also had similar balances (27 percent).

Figure 4: Account Balance by Investor Type



As with investor type, there were significant differences in account balances based on race and ethnicity. African American and Hispanic/Latino investors had lower balances in general compared to white or Asian investors. Specifically, African American investors reported balances under $500 more than twice as frequently as white and Asian investors, and Hispanic/Latino investors reported balances under $500 approximately 70 percent more frequently than white investors. Conversely, while over one-third of white and Asian investors reported balances over $25,000, only 10 and 8 percent (respectively) of African American and Hispanic/Latino investors reported similar balances.

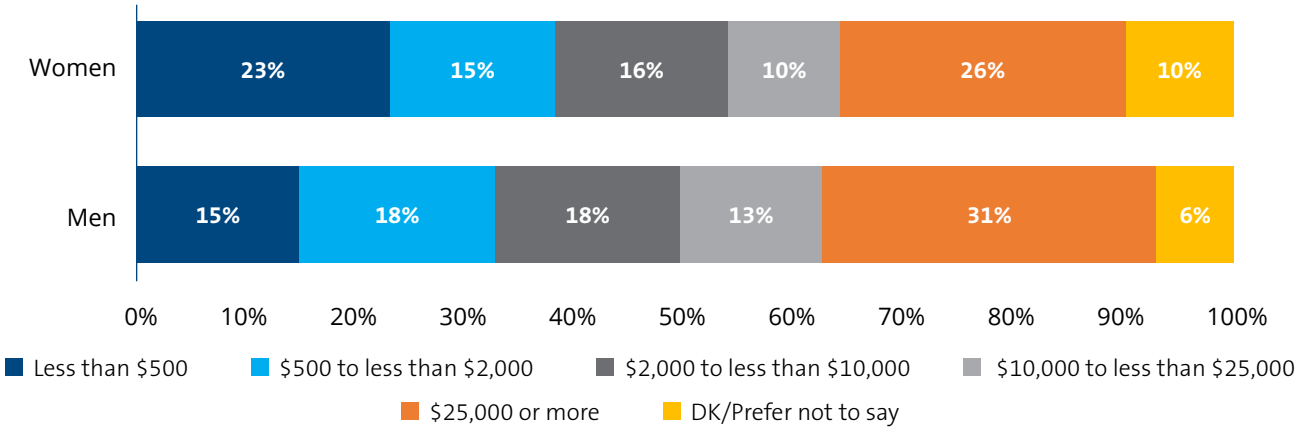
Figure 5: Account Balance by Race/Ethnicity*



**Respondents indicating "other" or "two or more races" were omitted from this analysis due to small sample sizes.*

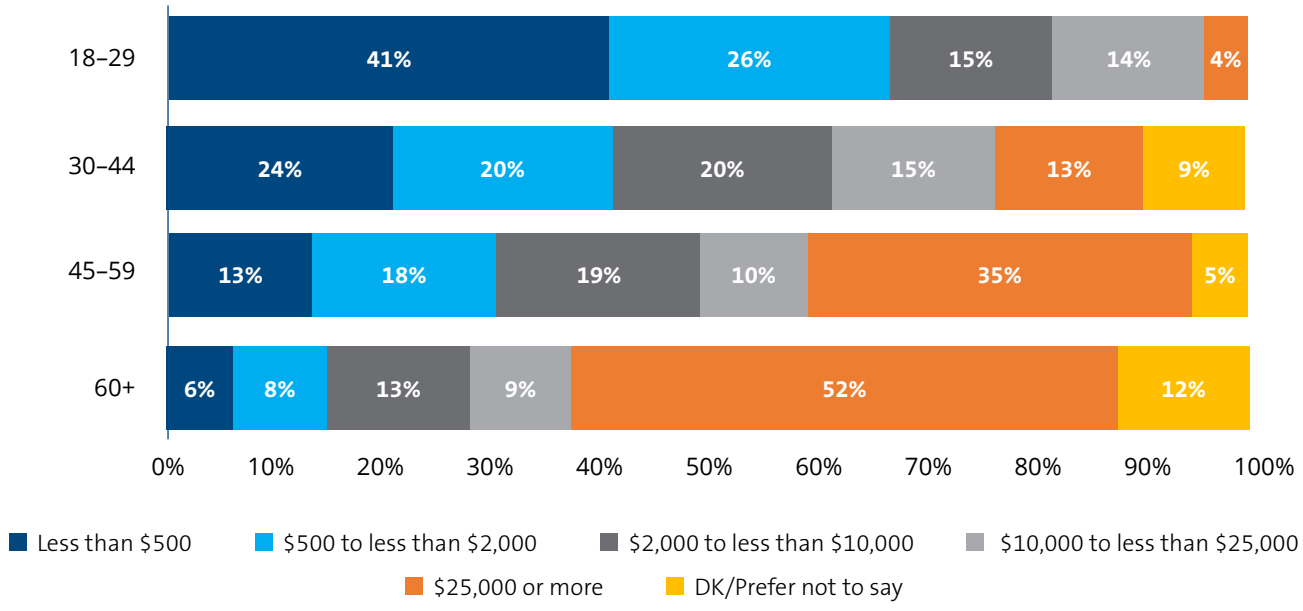
Account balance differences based on gender are less striking, but still significant. Women investors more frequently reported balances under $500, and male investors more frequently reported balances of $25,000 and over.

Figure 6: Account Balance by Gender



In general, younger investors held accounts with smaller balances, while older investors had accounts with larger balances. Indeed, while 52 percent of investors aged 60 and over held accounts with $25,000 or more, less than one-tenth of that number (4 percent) of investors aged 18–29 held similar balances. Conversely, only 6 percent of investors aged 60 and over held less than $500 in their account, while nearly seven times that proportion of 18–29 year-olds held under $500 in their account.

Figure 7: Account Balance by Age



What prompts investors to open a new account?

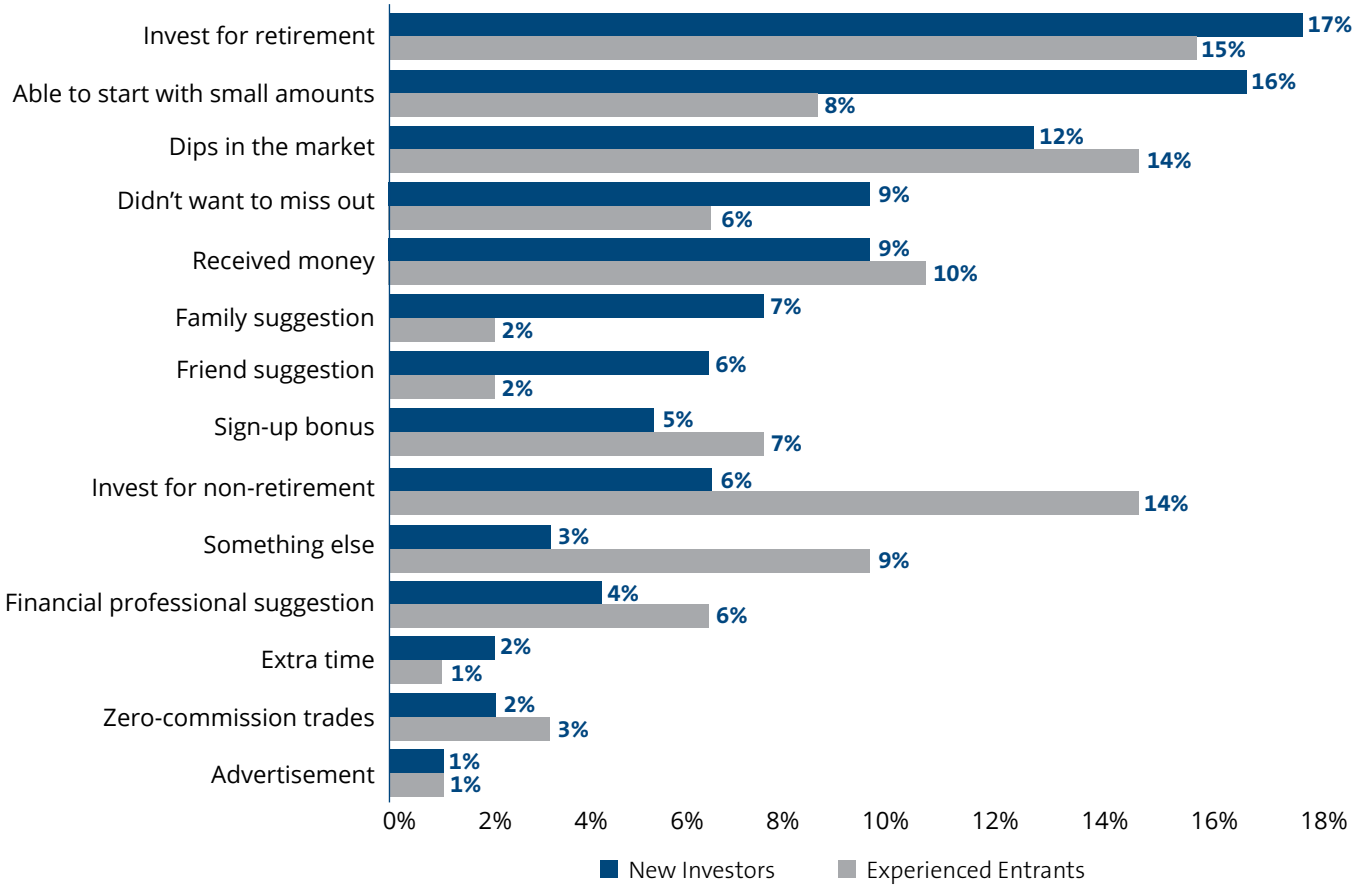
In general, results suggest that investors, and Experienced Entrants especially, enjoy investing. The majority of all investors either somewhat agreed, agreed, or strongly agreed with the statement, "I enjoy investing." New Investors (61 percent) and Experienced Entrants (72 percent) more frequently somewhat agreed, agreed, or strongly agreed with this statement than Holdover Account Owners (54 percent). Additionally, more Holdover Account Owners (17 percent) either somewhat disagreed, disagreed, or strongly disagreed with the statement than both New Investors (9 percent) and Experienced Entrants (10 percent).

With no-minimum and low-minimum investment accounts now widely available (for non-margin investors), the barrier to entry for retail investing has fallen, allowing greater access than ever before.

The three most frequently reported reasons that prompted New Investors to open an account were the ability to invest with a small amount of money (35 percent), wanting to invest for retirement (27 percent), and dips in the market that made stocks cheaper to buy (26 percent). Experienced Entrants were similar, but differed slightly, with investing for a goal other than retirement (25 percent), wanting to invest for retirement (22 percent), and the ability to invest with a small amount of money (21 percent) making up their top three reasons for opening a new investment account during 2020.

However, when asked for the *primary* reason that prompted them to open a new investment account during 2020, a plurality of New Investors (17 percent) cited wanting to invest for retirement, followed closely by the ability to invest with a small amount of money (16 percent). A plurality of Experienced Entrants (15 percent) also cited wanting to invest for retirement.

Figure 8: Primary Reason That Prompted Opening New Account During 2020



The three most frequently reported reasons that prompted New Investors to open an account were the ability to invest with a small amount of money, wanting to invest for retirement, and dips in the market that made stocks cheaper to buy.

Striking differences emerged among race/ethnicity groups when we examined what prompted investors to open a new account during 2020. Saving for retirement prompted more than one-quarter (26 and 28 percent, respectively) of white and Hispanic/Latino investors and more than one-third (34 percent) of Asian investors to open an account. However, saving for retirement did not rank among the top five prompts for African American investors. A suggestion from a friend (26 percent) or family member (20 percent) prompted African American investors to open an account, but did not feature prominently among reasons listed by white, Hispanic/Latino, or Asian investors. "The ability to invest with a small amount of money" was the only prompt featured in the top five across all racial/ethnicity groups.

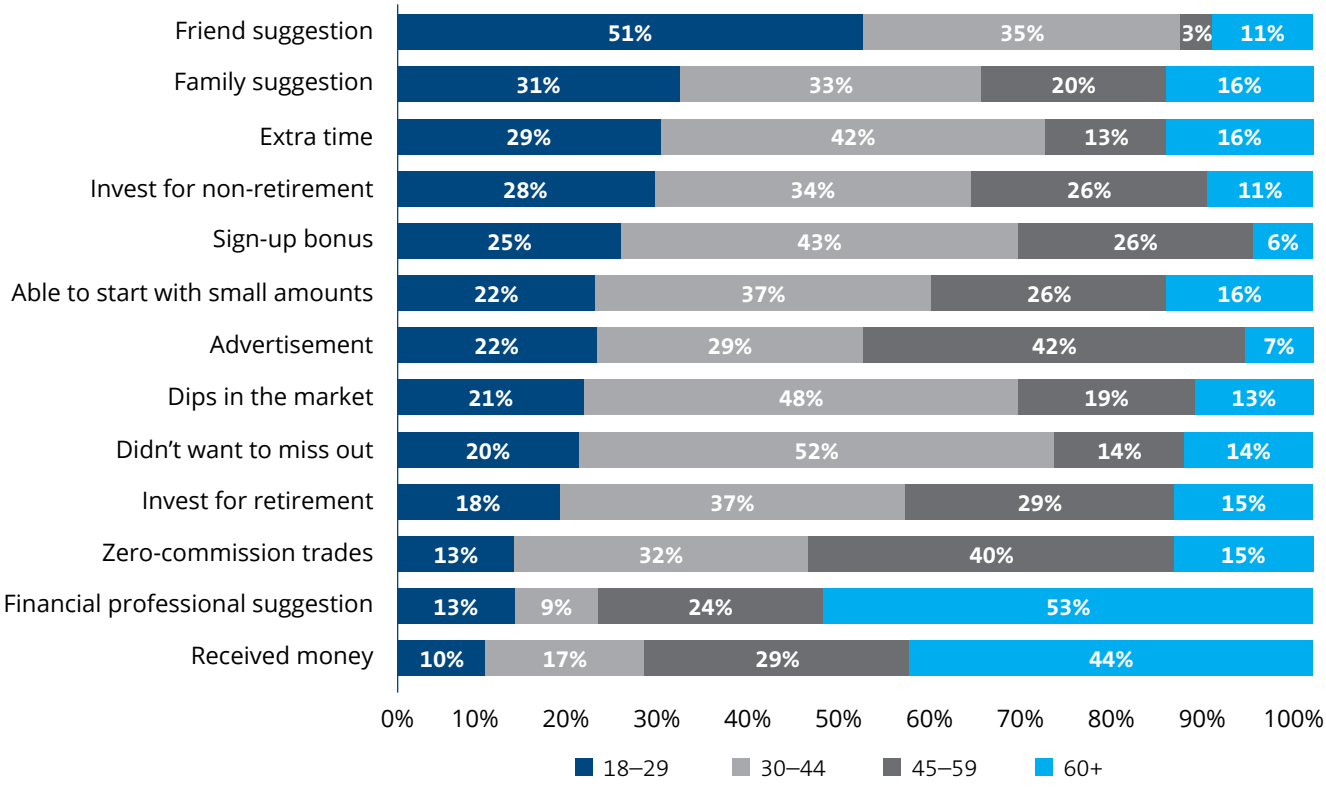
Figure 9. Most Cited Reasons for Opening a New Account During 2020, by Race/Ethnicity*

White Investors	African American Investors	Hispanic/Latino Investors	Asian Investors
Retirement (26%)	Invest with a small amount (35%)	Invest with a small amount (43%)	Retirement (34%)
Invest with a small amount (25%)	Didn't want to miss opportunity (27%)	Retirement (28%)	Market dips make investing cheaper (28%)
Market dips make investing cheaper (25%)	Friend suggestion (26%)	Goal other than retirement (20%)	Offered a sign-on bonus (24%)
Didn't want to miss opportunity (22%)	Extra time on my hands (21%)	Market dips make investing cheaper (18%)	Didn't want to miss opportunity (23%)
Goal other than retirement (19%)	Family member suggestion (20%)	Didn't want to miss opportunity (17%)	Invest with a small amount (21%)

**Respondents indicating "other" or "two or more races" were omitted from this analysis due to small sample sizes.*

Similar differences emerged when examining age and prompts to open investment accounts. The majority (51 percent) of investors who were prompted to open an account based on a friend's recommendation were 18-29, while only 13 percent of investors who were prompted to do so based on the suggestion of a financial professional were in this age group. Fifty-three percent of investors who were prompted to open an account based on the suggestion of a financial professional were over 60.

Figure 10: Age Breakdown by Reasons for Opening a New Investment Account During 2020



Goals[4]

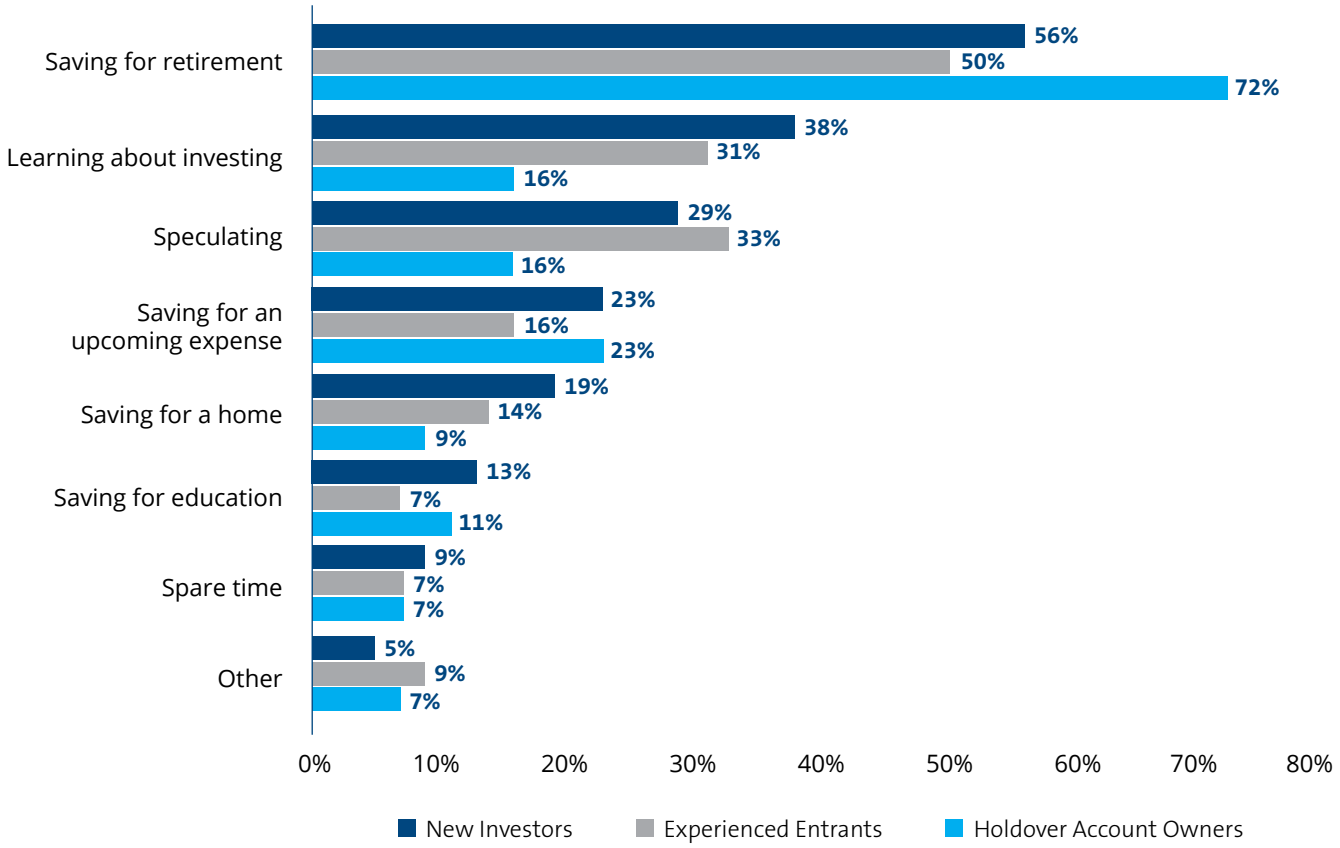
In addition to asking respondents to report what prompted them to open a new account in 2020, our survey asked investors to identify up to three goals they had for their investment account. Although several investment vehicles currently exist for retirement savings, including accounts that offer tax advantages (such as 401(k) accounts and IRAs), saving for retirement was the most frequently reported goal for *taxable* investment accounts among all respondents. The majority (72 percent) of Holdover Account Owners indicated "saving for retirement" was a goal of their taxable investment account, as did New Investors (56 percent) and Experienced Entrants (50 percent). "Learning about investing" was the second most frequently reported goal of New Investors (38 percent). "Saving for an upcoming expense (for example, a wedding, vacation, or car purchase)" was the second most frequently reported goal of Holdover Account Owners (23 percent).

Anecdotes about inexperienced market speculators driving up asset prices were the subject of frequent news articles throughout 2020 ("Amateur investors are making risky bets that could wipe them out"; "Young investors pile into stocks, seeing 'generational-buying moment' instead of risk"). Our survey revealed that "speculating or making fast profits to build wealth" was the second most frequently reported goal of Experienced Entrants (33 percent), and the third most frequently reported goal among New Investors (29 percent) and Holdover Account Owners (16 percent).

4. For New Investors and Experienced Entrants, the goals pertained to the investment account they opened during 2020. For Holdover Account Owners, the goals pertained to an investment account opened prior to 2020 that served as their primary taxable account for investing purposes.

Among all investors, specific savings goals, such as saving for retirement, meeting an upcoming expense, buying a home, or covering educational costs, were reported more frequently than nonspecific goals, such as filling up spare time and not having any specific goal.

Figure 11: Account Goals by Investor Type



Financial risk-taking

In general, Experienced Entrants appeared to be willing to take more financial risk. All three investment groups most frequently reported they were willing to take average financial risks expecting to earn average returns. However, while two out of five (40 percent) of New Investors and Holdover Account Owners (42 percent) reported a willingness to take substantial or above-average financial risks (expecting to earn substantial or above-average returns), more than half (51 percent) of Experienced Entrants reported willingness to take risk at these levels. Similarly, New Investors most frequently reported that they were unwilling to take any financial risk (9 percent), compared to the other investor groups (4 percent of Experienced Entrants and 7 percent of Holdover Account Owners).

Funding sources

Respondents were offered a number of funding sources and asked to identify sources used to open their new accounts (selecting all that applied). Fifty-four percent of New Investors reported using money from their paycheck to fund their new investment account, with 48 percent using savings. Conversely, 62 percent of Experienced Entrants reported using savings, with 44 percent using money from their paycheck. Only 5 percent of New Investors and 3 percent of Experienced Entrants funded their new accounts with borrowed money.

Trading behaviors

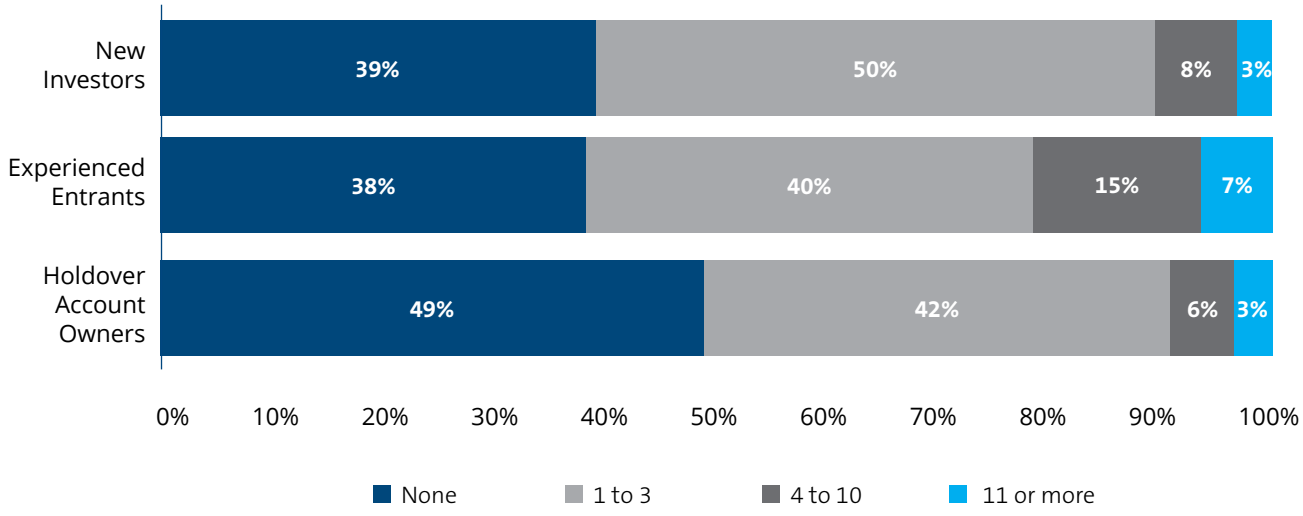
Those with accounts opened in 2020 (New Investors and Experienced Entrants) appear to trade more frequently than Holdover Account Owners. Sixty-one percent of New Investors, 62 percent of Experienced Entrants, and only 51 percent of Holdover Account Owners reported completing at least one trade per month in their investment accounts. Looking at all investors in our sample (all three categories combined), 43 percent reported "none" when asked how many trades they complete per month.

Those with accounts opened in 2020 (New Investors and Experienced Entrants) appear to trade more frequently than Holdover Account Owners.

The majority of investors who made no trades per month reported they expected their investment account to perform about the same as the stock market as a whole over the next 12 months. However, the plurality (44 percent) of investors who made 11 or more trades per month reported that they expected their new investment account to perform substantially better than the stock market as a whole over the next 12 months.

The majority of investors who accessed their accounts primarily through a mobile app (56 percent) reported making between one and three trades per month, while the plurality (45 percent) of investors who accessed their accounts primarily through a website reported making no trades per month. Among investors making 11 or more trades per month, 70 percent accessed their accounts primarily through a website and 27 percent accessed their accounts primarily through a mobile app.

Figure 12: Trading Activity by Investor Type



Product profiles

Investments

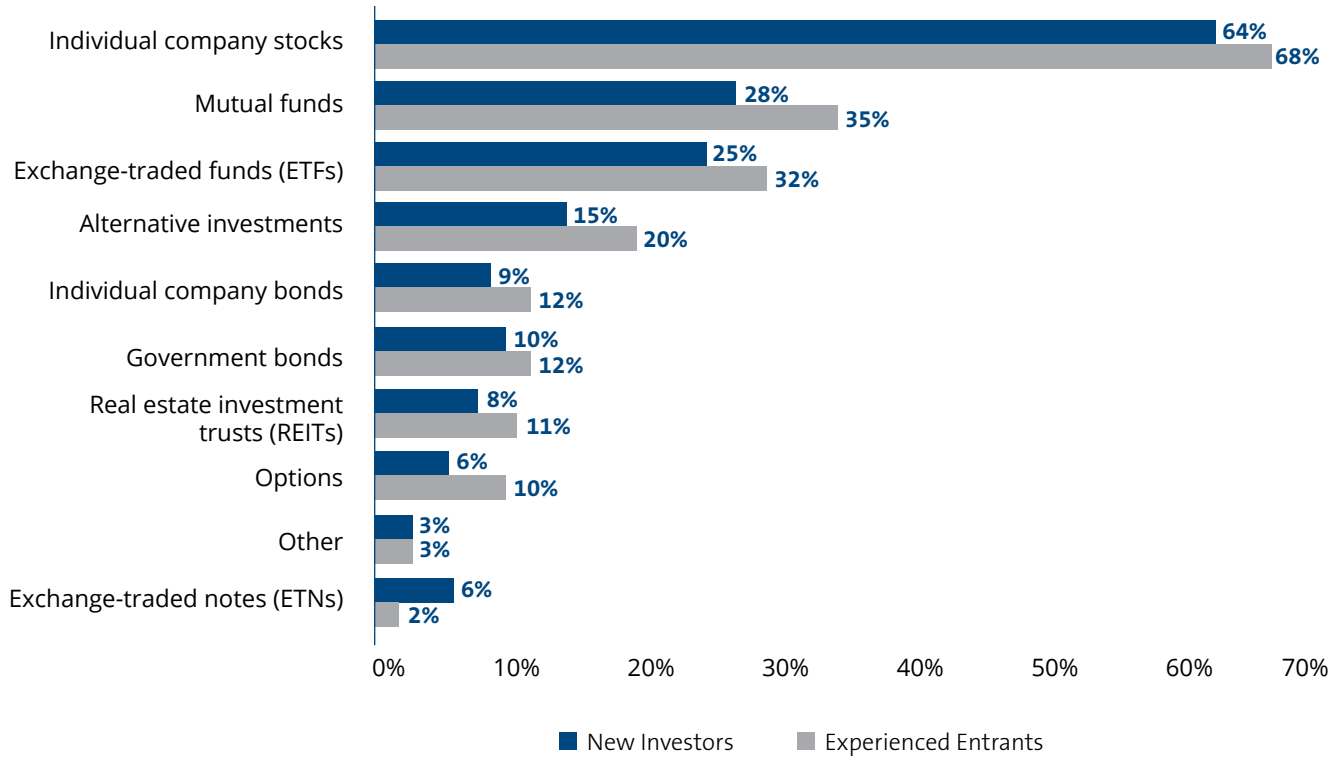
The most frequently traded investment type for both New Investors and Experienced Entrants using their new accounts was by far individual company stocks, followed by mutual funds, exchange-traded funds (ETFs), and alternative investments (for example, cryptocurrency, gold, hedge funds). New Investors traded "other" types of investments and options the least (among a range of investment types). Experienced Entrants traded other types of investments and exchange-traded notes (ETNs) the least.

Commission-free trades

The majority of New Investors (51 percent) and Experienced Entrants (58 percent) reported that their primary investment account offered commission-free trades. Among Holdover Account Owners, this figure was 45 percent. Interestingly, a large number of all investors reported not knowing whether their investment account charged commissions on their trades (38 percent of New Investors, 23 percent of Experienced Entrants, and 34 percent of Holdover Account Owners). The majority (60 percent) of investors accessing their accounts primarily through a mobile app and just under half (48 percent) of investors accessing their accounts primarily through a website reported owning an investment account that offered commission-free trades.

A large number of all investors reported not knowing whether their investment account charged commissions on their trades.

Figure 13: Investments Traded in New Account



Fractional shares

Fractional shares allow investors to hold an equity position in a company at less than the cost of a full share and may be appealing to some investors if the share price of a company is very high.

One-third (33 and 34 percent, respectively) of both New Investors and Experienced Entrants reported ever purchasing fractional shares with their investment account, while only 16 percent of Holdover Account Owners reported ever doing so. Similar to the finding about commission-free trades, a substantial number of all investors reported not knowing whether they had ever purchased fractional shares (19 percent of New Investors and Experienced Entrants, and 26 percent of Holdover Account Owners). Among investors who reported purchasing fractional shares, 55 percent accessed their accounts primarily through a mobile app, and 41 percent accessed their accounts primarily through a website. Additionally, among those investors who had purchased fractional shares, 62 percent owned an account that offered commission-free trades.

Margin trading

Margin allows investors to borrow money from a brokerage firm to buy stock. Buying on margin exposes investors to the potential for greater losses as well as greater gains. While only 29 percent of investors indicated they had an account that allowed them to make purchases on margin, almost half (48 percent) of investors did not know if their investment account allowed purchasing on margin. The majority (55 percent) of New Investors and a plurality of Experienced Entrants (40 percent) and Holdover Account Owners (46 percent) did not know whether their investment account allowed them to make purchases on margin. Of those who reported having a margin account, only about one-quarter (23 percent) reported actually using margin to purchase investments; this equates to 6 percent of respondents.

Options

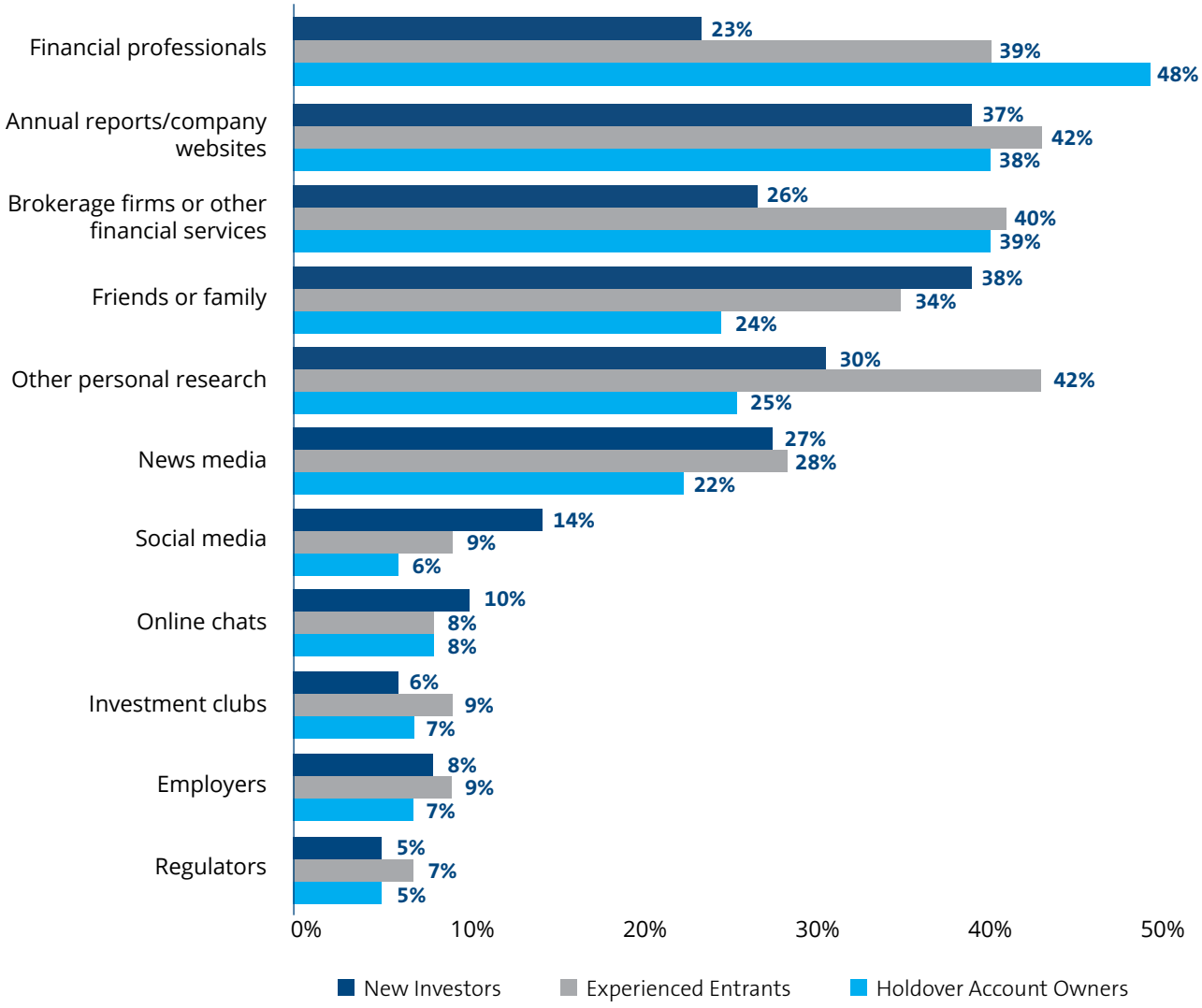
Options are tradable contracts that give a purchaser the right to buy or sell stock (or another security) at a specified price within a specified period of time. Experienced Entrants reported ever trading options (in any account) or currently trading options with their new investment account at nearly double the rate of New Investors (29 percent vs. 16 percent, respectively). Among investors who indicated they ever traded options or currently trade options with their new investment account, the majority (58 percent) reported they were willing to take either substantial financial risks expecting to earn substantial returns (9 percent) or above average financial risks expecting to earn above average returns (49 percent). Options traders also appeared to be confident in their investment performance, with nearly half (49 percent) reporting they expected their investment account to perform substantially better or better than the stock market as a whole over the next 12 months. The plurality of options traders (45 percent) indicated they made between one and three trades per month, and 25 percent reported they made no trades per month.

Decision-making and expectations

Information sources

The three investor groups displayed a marked difference when it came to the information they relied on for making investment decisions. While close to half (48 percent) of Holdover Account Owners in our sample reported relying on financial professionals when making investment decisions, only 23 percent of New Investors did so, with Experienced Entrants falling between these two groups (39 percent). New Investors tended to seek information from friends, colleagues, or family members (38 percent), as well as from the company they planned to invest in (for example, annual reports, company websites) (37 percent). Experienced Entrants reported preferring “other personal research” (42 percent) and information from the company they planned to invest in (42 percent). After financial professionals, Holdover Account Owners were nearly evenly split between relying on information from the company they planned to invest in (39 percent) and information from brokerage firms, mutual fund companies, or other financial services companies (38 percent). Regulators were the least frequently used information source among all three investor groups.

Figure 14: Information Sources Used When Making Investment Decisions



Investment decision-making

Differences emerged among our investor categories when examining how each group made investment decisions. While 14 percent of Holdover Account Owners reported always letting financial professionals choose investments for them, only 7 percent of Experienced Entrants and 8 percent of New Investors reported doing so. Conversely, 54 percent of New Investors and 51 percent of Experienced Entrants reported never letting financial professionals choose their investments for them, compared to 32 percent of Holdover Account Owners.

While almost half of all investors (48 percent) reported always or often conducting their own research and then making their investment decisions, web-based tools and mobile apps were the least frequently used method for choosing investments. Sixty-two percent of Holdover Account Owners, 60 percent of Experienced Entrants, and 50 percent of New Investors reported they never used web-based tools or mobile apps to choose their investments.

Holding period

Timeframes for holding investments varied significantly among the three investor groups in our sample. While the plurality (32 percent) of Holdover Account Owners planned to hold their investments for 10 years or more, only 23 percent of New Investors and 21 percent of Experienced Entrants planned to hold their investments for as long. The largest share of both New Investors (29 percent) and Experienced Entrants (27 percent) reported they planned to hold their investments for one to three years.

Investors appeared to exhibit a bimodal time preference, with all investor groups indicating their first and second planned holding periods were either short (one to three years) or long (10 years or more). Extremely short timeframes (less than a year) or midrange timeframes (four to nine years) were the least frequently planned holding periods. Notably, a substantial number of investors didn't know how long they planned to hold their investments (25 percent of New Investors, 16 percent of Experienced Entrants, and 19 percent of Holdover Account Owners).

Tax consequences as a factor of holding period

A majority of both Experienced Entrants (54 percent) and Holdover Account Owners (54 percent) reported that tax consequences factored into their decision about how long to hold investments before selling them. This attentiveness to tax consequences, combined with the fact that a majority of both groups identified saving for retirement as a goal for their taxable account, prompts the question of why these investors use taxable accounts rather than, or in addition to, tax-advantaged vehicles (such as 401(k) accounts and IRAs) to pursue their retirement goals. The answer is beyond the scope of the current study but may entail some combination of reaching contribution limits for retirement investing vehicles, not having access to such vehicles, wanting ready access to retirement savings without early withdrawal penalties, the relative ease of opening a taxable account, lack of knowledge about the tax implications of investing, and other factors.

Among New Investors, a plurality (41 percent) reported that tax consequences were *not* a factor when deciding how long to hold investments before selling them. Almost one in five New Investors (19 percent) did not know whether tax consequences factored into their decisions about how long to hold investments.

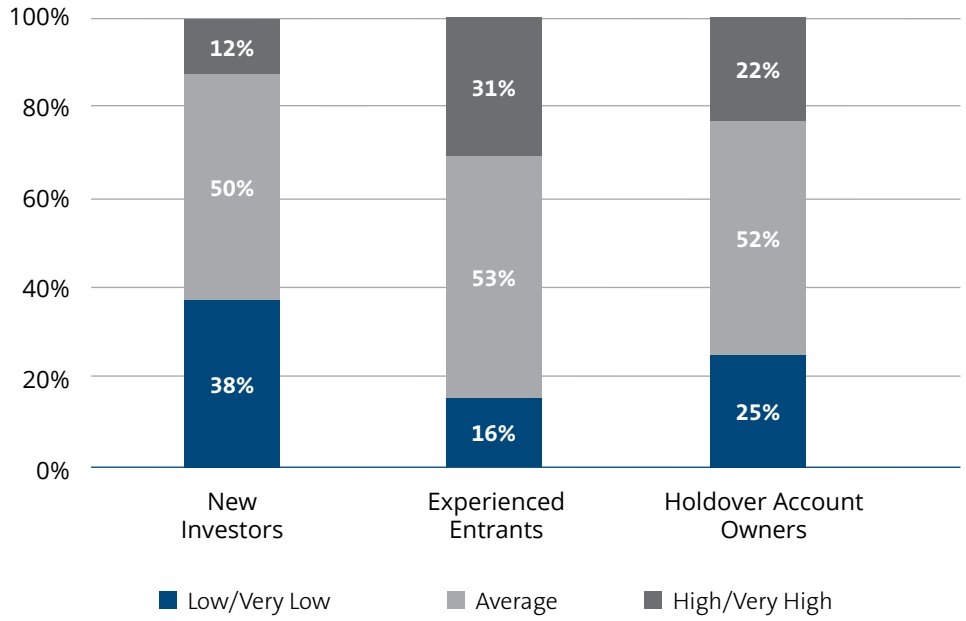
Past performance and performance expectations

The majority of New Investors (56 percent) and Experienced Entrants (63 percent) reported the market value of the holdings in their new account had either increased substantially or increased somewhat. This is unsurprising given the performance of the stock market during the timeframe addressed by the study. However, under half (47 percent) of Holdover Account Owners indicated the holdings in their account had increased either substantially or somewhat during the same period. The plurality of New Investors and Experienced Entrants, along with the majority of Holdover Account Owners, reported they expected their investment accounts to perform about the same as the stock market as a whole over the next 12 months. However, a larger proportion of both New Investors (38 percent) and Experienced Entrants (39 percent) reported they expected their accounts to perform either substantially better or better than the stock market as a whole over the next 12 months compared to Holdover Account Owners (29 percent).

Investment knowledge

This study measured investment knowledge in two ways. First, respondents were asked to self-assess their overall knowledge about investing (from very low to very high). For measurement purposes, high and very high were collapsed, as were low and very low, to create three categories: high/very high, average, and low/very low. New Investors reported considerably lower levels of self-assessed investment knowledge when compared to either Experienced Entrants (who most frequently reported high/very high levels of knowledge) or Holdover Account Owners.

Figure 15: Self-Assessed Investment Knowledge by Investor Type



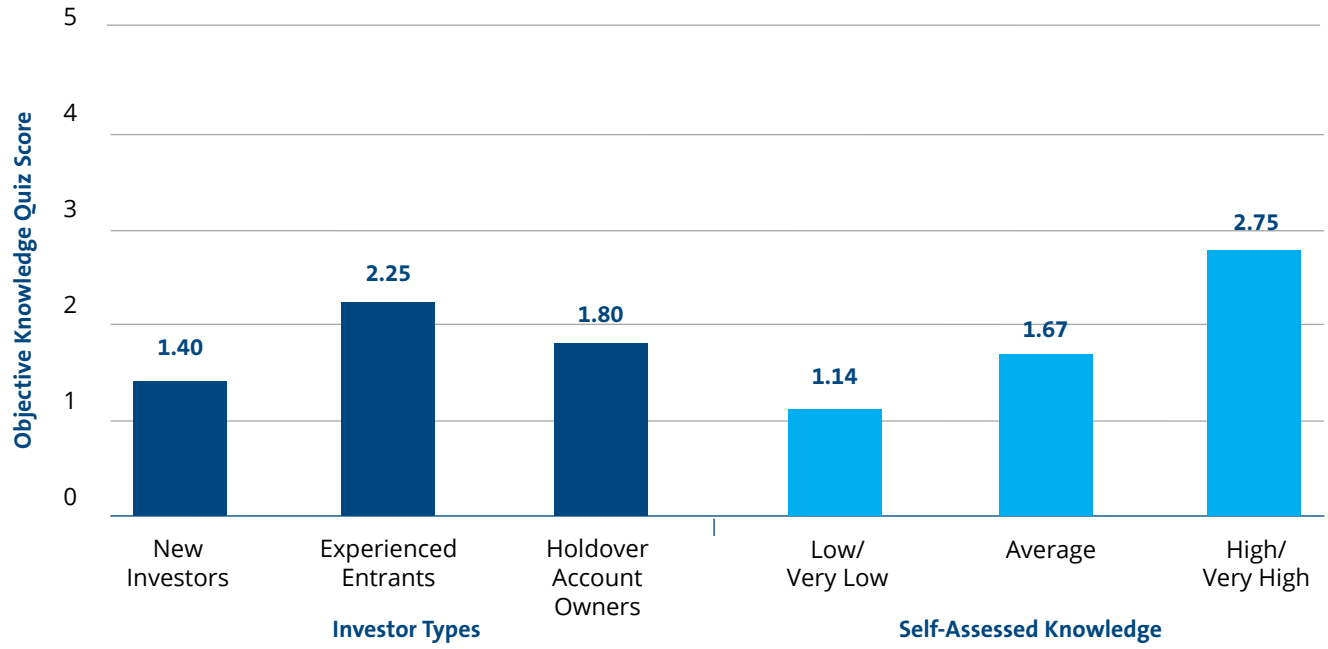
Second, the survey asked five questions related to investment knowledge. These questions ranged from basic topics (such as the definition of a company's stock and whether past performance is a good indicator of future results) to more challenging questions (such as calculating the value of a call option and a question about investments bought using margin). From these questions, a five-point index was created to measure investment knowledge, with each correct response worth one point. To examine differences in investment knowledge, we looked at the mean number of correct responses.

There was considerable variation in the objective financial knowledge of the different investor types. Experienced Entrants had the highest levels of investment knowledge, with a mean score of 2.3. Holdover Account Owners scored half a point below the Experienced Entrants (mean of 1.8), and New Investors scored almost an entire point lower (1.4). These results suggest investment knowledge, as measured by the five questions in the survey, is low for all groups, but particularly low for New Investors, making them potentially unprepared to make sound investment decisions in their new accounts.

When we looked at self-assessed and objective investment knowledge together, we saw that investors were generally good at predicting their relative knowledge (those with higher self-assessed knowledge scored comparatively higher objectively). Investors who self-assessed high/very high answered 2.8 questions out of five correctly. Investors reporting average investment knowledge had a mean score of 1.7. And those reporting low/very low knowledge answered, on average, only 1.1 of the five knowledge questions correctly.

Although it is concerning that those with high/very high self-assessed knowledge still score low when knowledge is measured objectively, New Investors, who may have only just begun to learn about investing, had both lower objective knowledge scores and low/very low self-assessed knowledge, potentially making them more likely to seek out information when making investment decisions.

Figure 16: Mean Objective Investment Knowledge by Investor Type and Self-Assessed Investment Knowledge



Accessing and monitoring accounts

Ways of accessing accounts

Nearly half (48 percent) of New Investors indicated they accessed their account primarily through a mobile app, while three-quarters (75 percent) of Holdover Account Owners indicated they accessed their account primarily through a website. Experienced Entrants were more divided, with 40 percent who reported accessing their account primarily through a mobile app and 54 percent who gained access primarily through a website.

Frequency of monitoring accounts

At the outset of the study, we hypothesized that New Investors and Experienced Entrants, given that they recently opened accounts, would monitor their accounts more frequently than Holdover Account Owners. Results confirmed this. The plurality (21 percent) of New Investors and Experienced Entrants (22 percent) reported monitoring their investments a few times a week, while the plurality (24 percent) of Holdover Account Owners reported monitoring their investment accounts about once a month.

The majority of investors (60 percent) who reported monitoring their account multiple times a day did so using a mobile app, while the majority (69 percent) of investors who monitored their investments less than once per month accessed their account primarily through a website. The plurality (26 percent) of investors who accessed their account primarily through a mobile app checked their account a few times per week, while the plurality (23 percent) of investors who accessed their account through a website checked their account about once per month.

Account statements

The majority (68 percent of New Investors, 69 percent of Experienced Entrants, and 54 percent of Holdover Account Owners) of all investor groups preferred to receive account statements electronically; however, a larger proportion (19 percent) of Holdover Account Owners preferred to receive statements by regular mail, compared to New Investors (11 percent) and Experienced Entrants (12 percent).

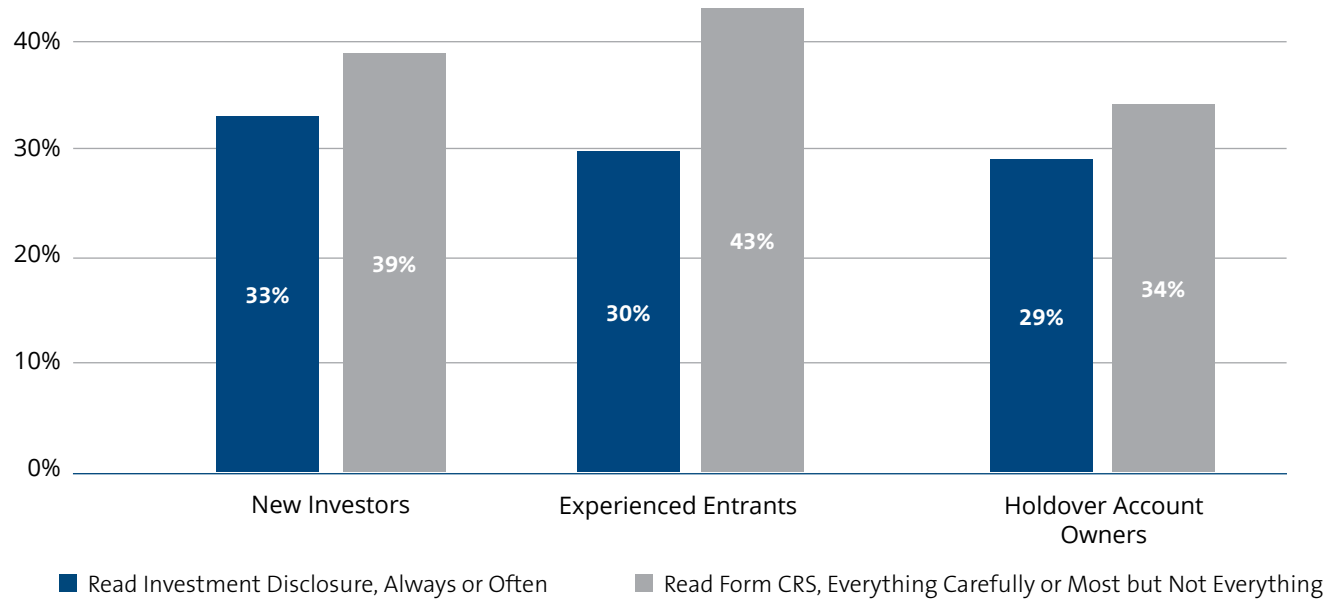
Form CRS

As of June 30, 2020, the Securities and Exchange Commission requires brokerage firms to provide retail investors with a two-page (or less) customer relationship summary, known as Form CRS, describing the firm's services and any related fees and costs, conflicts of interest, and standards of conduct, as well as reportable legal or disciplinary history. Form CRS also tells investors how to obtain more information about the firm.

The plurality of all investors (33 percent of New Investors, 37 percent of Experienced Entrants, and 40 percent of Holdover Account Owners) reported skimming Form CRS. Further, a greater percentage of Experienced Entrants (18 percent) and New Investors (17 percent) reported reading everything carefully when compared to Holdover Account Owners (14 percent). Interestingly, 14 percent of Holdover Account Owners reported not reading any of the form, while just 8 percent of both New Investors and Experienced Entrants reported not reading any of it.

The study allows us to roughly compare the level of attention investors give to Form CRS to the level of attention they give to investment disclosures. Approximately one-third of all investor groups (33 percent of New Investors, 30 percent of Experienced Entrants, and 29 percent of Holdover Account Owners) reported they either always or often reviewed disclosure information about specific investments prior to making a purchase. By comparison, 39 percent of New Investors, 43 percent of Experienced Entrants, and 34 percent of Holdover Account Owners reported they either read everything carefully or read most (but not all) of Form CRS.

Figure 17: Investor Attention to Investment Disclosure and Form CRS



Conclusion

The COVID-19 pandemic and associated market and income volatility during 2020 were accompanied by a surge in the number of retail investors who entered the markets using taxable, non-retirement investment accounts via online brokers. This occurred at a time when the barriers to entry for retail investing have fallen, allowing greater access than ever before. To learn more about these new account openers, the FINRA Investor Education Foundation and NORC at the University of Chicago conducted a study with a nationally representative sample of U.S. households.

Consistent with narratives surrounding new market entrants, New Investors in our sample tended to be younger, earned lower incomes, and were more racially/ethnically diverse than Experienced Entrants and Holdover Account Owners. In general, New Investors owned taxable investment accounts with smaller balances compared with investors in the other two categories. While several investment vehicles currently exist for retirement savings, including accounts that offer tax advantages, saving for retirement was the most frequently reported goal for taxable investment accounts among all respondents, and the most frequently cited primary reason that prompted both New Investors and Experienced Entrants to open an account in 2020. Why investors opted to use a taxable investment account for retirement savings is beyond the scope of our study, but may include some combination of ready access to retirement savings, the relative ease of opening a taxable account, lack of knowledge about the tax implications of investing, and other factors.

The majority of investors in our study reported making a few trades per month in their account, and all three investment groups most frequently reported they were willing to take average financial risks expecting to earn average returns. Additionally, Experienced Entrants, not New Investors, more frequently reported trading options, and the majority of options traders indicated they made between one and three trades of any kind (options or other types of investments) per month.

While all investors reported relying on a variety of information sources when making financial decisions, Holdover Account Owners more frequently relied upon financial professionals, while Experienced Entrants more frequently conducted their own personal research, and New Investors more frequently relied on the advice of friends and family.

A large number of all investors in our sample reported not knowing whether their investment account charged commissions on trades or whether their account allowed purchasing on margin. Investment knowledge was lowest among New Investors (both self-assessed and objectively measured). Given differences in awareness of account features and investment knowledge, coupled with the various information sources investors reported relying upon for decision-making, it may be the case that different investor groups have quite distinct needs when it comes to disclosure, information sources, and investing in general. Additionally, because New Investors and Experienced Entrants differ markedly along racial/ethnic and age groups, these needs may be further impacted by cultural differences and familiarity with investing, as well as disparities in investor education.

Appendices

About the data

This study uses data collected between October 26 and November 13, 2020, using the AmeriSpeak® Panel. Funded and operated by NORC at the University of Chicago, AmeriSpeak is a probability-based panel designed to be representative of the U.S. household population. Randomly selected U.S. households are sampled using area probability and address-based sampling, with a known, non-zero probability of selection from the NORC National Sample Frame. These sampled households are then contacted by U.S. mail, telephone, and field interviewers (face to face). The panel provides sample coverage of approximately 97 percent of the U.S. household population. Those excluded from the sample include people with P.O. Box only addresses, some addresses not listed in the USPS Delivery Sequence File, and some newly constructed dwellings. While most AmeriSpeak households participate in surveys by web, non-internet households can participate in AmeriSpeak surveys by telephone. Households without conventional internet access but having web access via smartphones are allowed to participate in AmeriSpeak surveys by web. AmeriSpeak panelists participate in NORC studies or studies conducted by NORC on behalf of governmental agencies, academic researchers, and media and commercial organizations.

1,291 U.S. adults ages 18 and older participated in the study. The study was fielded in English only, and was administered online. Respondents were considered eligible for the study if they were either the primary decision-maker or shared in the decision-making related to finances in the household, and completed a set of screening questions that classified them as New Investors, Experienced Entrants, or Holdover Account Owners. The screener completion rate was 30.7 percent. 14.3 percent of screened respondents were eligible for the study, and 98.9 percent of eligible respondents completed the survey. The final AAPOR response rate (RR3) for the study was 5.2 percent, and the margin of error was 3.84 percentage points. AmeriSpeak participants self-identified their age, sex, education, and race/Hispanic ethnicity. Because some of the statistics for the Asian Investor group are based on small samples, results pertaining to Asian investors should be interpreted with caution. Similarly, given that few respondents reported making 11 or more trades per month, statistics involving this subset of the sample should be also be interpreted with caution.

Imputation

Fifty-seven observations were unable to be classified as either New Investors or Experienced Entrants due to missing data. To classify these observations, a multiple imputation technique utilizing a random forest model was used to estimate the investor status for these 57 observations. Specifically, the investor group for each respondent was estimated five times using the following independent indicators:

- Investment knowledge score (range 0–5)
- Age (60+/18–59)
- Race (African American/other)
- Primary reason for opening (non-retirement/other)
- Primary reason for opening (start with small amounts/other)
- Have experience in options trading (yes/no)

Final investor group classifications for respondents were obtained by calculating the mode of investor group classifications from the five-model imputation.

Weighting

Statistical weights for the study-eligible respondents were calculated using panel-base sampling weights to start. The base sampling weights are further adjusted to account for unknown eligibility and nonresponse among eligible housing units. The household-level nonresponse adjusted weights are then post-stratified to external counts for number of households obtained from the Current Population Survey. Then, these household-level post-stratified weights are assigned to each eligible adult in every recruited household. Furthermore, a person-level nonresponse adjustment accounts for nonresponding adults within a recruited household. Finally, panel weights are raked to external population totals associated with age, sex, education, race/Hispanic ethnicity, housing tenure, telephone status, and Census Division. The external population totals are obtained from the Current Population Survey. Study-specific base sampling weights are derived using a combination of the final panel weight and the probability of selection associated with the sampled panel member. The screener nonresponse adjusted weights for the study are adjusted via a raking ratio method to general population age 18 and older population totals associated with the following socio-demographic characteristics: age, sex, education, race/Hispanic ethnicity, and Census Division.

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The Financial Industry Regulatory Authority (FINRA) is a not-for-profit organization dedicated to investor protection and market integrity. It regulates one critical part of the securities industry—brokerage firms doing business with the public in the United States. FINRA, overseen by the Securities and Exchange Commission, writes rules, examines for and enforces compliance with FINRA rules and federal securities laws, registers broker-dealer personnel and offers them education and training, and informs the investing public. In addition, FINRA provides surveillance and other regulatory services for equities and options markets, as well as trade reporting and other industry utilities. FINRA also administers a dispute resolution forum for investors and brokerage firms and their registered employees. For more information, visit www.finra.org.

The FINRA Investor Education Foundation supports innovative research and educational projects that give underserved Americans the knowledge, skills, and tools to make sound financial decisions throughout life. For more information about FINRA Foundation initiatives, visit www.finrafoundation.org.

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NORC at the University of Chicago is an independent research institution that delivers reliable data and rigorous analysis to guide critical programmatic, business, and policy decisions. Since 1941, NORC has conducted groundbreaking studies, created and applied innovative methods and tools, and advanced principles of scientific integrity and collaboration. Today, government, corporate, and nonprofit clients around the world partner with NORC to transform increasingly complex information into useful knowledge.

Notes

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FINRA Investor Education FOUNDATION | NORC at the University of Chicago

Consumer Insights: Money & Investing

October 2020

Consumer Insights on Money and Investing: A Collaboration between the FINRA Foundation and NORC at the University of Chicago.

What's Inside:

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The Impact of Pandemic-Related Volatility on Stock Market Expectations and Participation

Despite dramatic financial market volatility in the first half of 2020 and perceptions of market unfairness, many Americans remain interested in investing.

Summary

During the first half of 2020, the COVID-19 pandemic and associated market and income volatility dramatically altered the financial well-being of many U.S. households. To measure awareness of, and reactions to, these events, the FINRA Investor Education Foundation and NORC at the University of Chicago surveyed 1,795 households from NORC's probability-based AmeriSpeak Panel©, including oversamples of African-American and Hispanic/Latino households.[1] The survey was fielded between May 29, 2020, and June 16, 2020.[2]

Respondents were grouped into one of three categories:

- Non-investors who had no investments in the stock market or accounts where they could choose how their money was invested (29 percent);
- Retirement-only investors who held investments in retirement accounts but no other types of accounts (27 percent); and
- Taxable account investors who held investments in non-retirement accounts (and may have also held investments in retirement accounts) (43 percent).

1. While this report touches on some important results related to race and ethnicity, please also see the companion report, *African-American and Hispanic/Latino Responses to Pandemic-Related Volatility in the Stock Market*.
2. Sample characteristics can be found in the Appendices.

The study found widespread awareness of stock market volatility during the first half of 2020 among investors and non-investors, but respondents made few transactions in response. Trades were not prevalent, and most households did not report strong negative emotions or high levels of pessimism about the market's ability to return to pre-pandemic levels. While some respondents reported less willingness to take financial risk in the wake of market turmoil, objective comparisons with pre-pandemic measures indicated very little change in risk tolerance for most households. Respondents reported low levels of confidence in the fairness of financial markets to the average investor, particularly among investors reporting larger losses in the market downturn in early 2020. A lack of confidence in the fairness of markets was related to decreased purchase behavior, but not with increased purchase behavior.

Background

While the scale and velocity of market disruption resulting from the COVID-19 pandemic in the first half of 2020 were remarkable, extreme market fluctuations are not new. Research on the 2008/09 financial crisis indicates that investor perceptions—including willingness to take risk and expectations for returns—were impacted early in the crisis, but changes in perceptions abated over time (Hoffman, Post, & Pennings, 2012). And research on individual investor reactions to Black Monday in 1987 supports the idea that market volatility impacts investors' perceptions, but has less impact on changes in holdings (Shiller, 1987). Given the unique events of early 2020, the current study sought to identify the relationship between pandemic-related stock market volatility and investment perceptions among households with and without investment accounts.

Widespread Awareness of the Pandemic-Related Stock Market Volatility

News of stock market volatility in early 2020 was hard to avoid. Fifty-five percent of all respondents indicated they were following the stock market at least somewhat closely in early 2020. Eighty percent of those surveyed characterized the market during this time as somewhat, very, or extremely volatile. Not surprisingly, there was a strong relationship between closely following the market and characterizing the market as volatile, with respondents who followed the market more closely characterizing the market as somewhat to extremely volatile.

Figure 1: Awareness of Pandemic-Related Market Volatility

How would you characterize the stock market since the beginning of 2020?

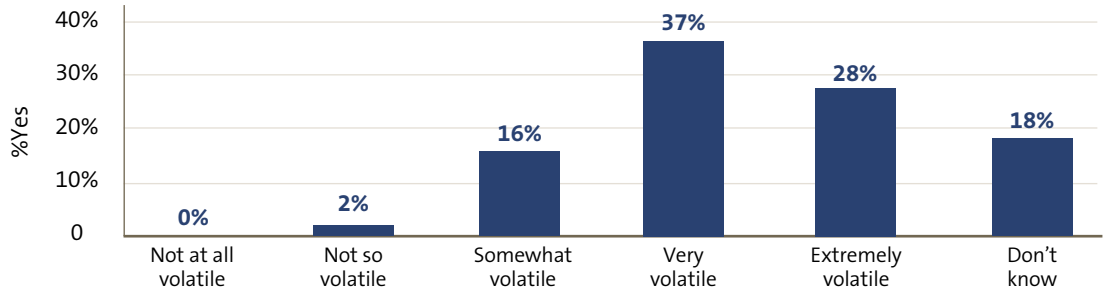
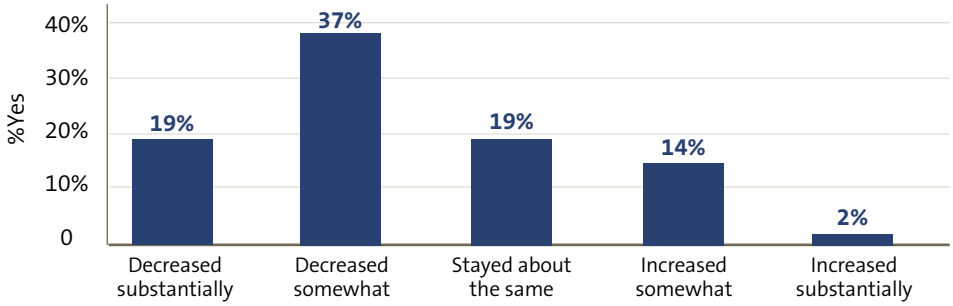


Figure 2: Investor Perceptions of the Impact of Pandemic-Related Volatility

Since the beginning of 2020, has the value of your personal investments in the stock market increased, decreased, or stayed about the same?



Respondents who followed the markets and characterized it as having greater levels of volatility also tended to have taxable investment accounts, higher levels of education, and higher income. They were also older and more frequently male. In addition, we found dramatic differences in investment knowledge for those respondents who followed the market closely and reported greater levels of volatility. For example, while 92 percent of (investor and non-investor) respondents who achieved the highest score on an investment knowledge battery followed the market, only 18 percent of those with the lowest levels of investment knowledge did so. Even among non-investors, those with higher investment knowledge scores more frequently reported following the market.

Although many respondents reported that their investments had been affected by pandemic-related market volatility, not all households were affected negatively. Nineteen percent of households with investments (in taxable and/or retirement accounts) reported their investment values had decreased substantially, while 17 percent reported a slight or substantial increase. Not surprisingly, investors who reported substantial decreases to their investments also indicated a greater awareness of market volatility. Eight percent of all investors indicated they did not know how the pandemic-related volatility had impacted their investments, suggesting that investors in this segment do not monitor their portfolios. The vast majority (80 percent) of these households owned retirement accounts only.

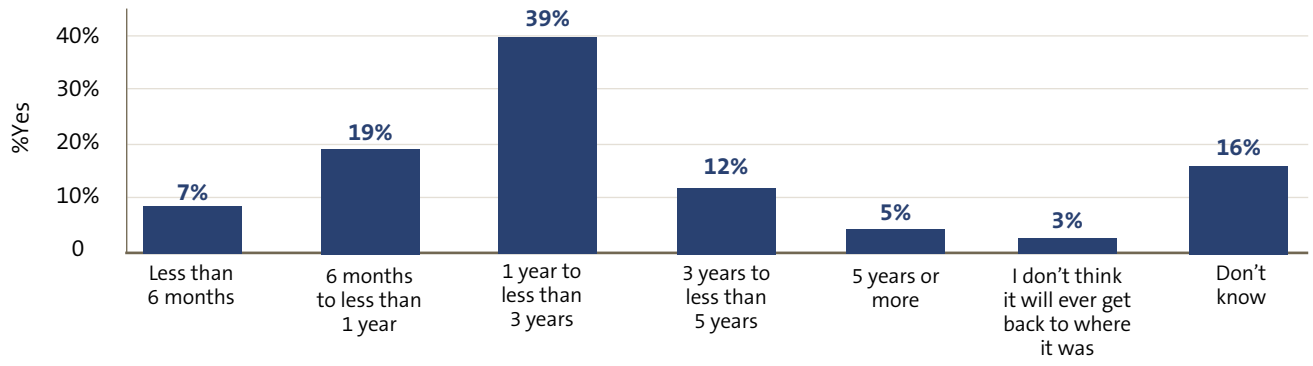
Several demographic characteristics were related to more closely following the market and characterizing it as having greater levels of volatility, including educational attainment, income, age, and race/ethnicity. However, when investor categories were examined, many of these relationships disappeared, indicating volatility awareness is related to investor status, rather than demographic characteristics.

Generally Optimistic Market Expectations

In spite of the pandemic-related volatility, respondents were generally optimistic about market recovery. The vast majority of respondents (82 percent) anticipated the stock market would return to its pre-2020 value at some point, with only three percent indicating they did not expect the market to ever recover. Almost half (47 percent) of respondents expected positive stock market returns in the coming twelve months, and a quarter (26 percent) believed the market would return to its January 2020 peak within the next twelve months.

Figure 3: Recovery Expectations

How long do you think it will take for the stock market to get back to where it was in January of 2020?



Despite negative impacts from the pandemic-related market volatility, investors (retirement-only and taxable account) had greater levels of optimism in the market compared to non-investors. Most taxable account investors expected the market to rebound in the next twelve months (57 percent), while non-investors reported the least positive expectations, with only 30 percent anticipating the market to rise in that time period. Investors (retirement-only and taxable account) whose portfolios had substantially decreased more frequently expected the market to improve in the next year; 64 percent of investors whose portfolios had substantially decreased expected markets to improve in the next year, compared to only 52 percent of investors whose portfolios had not substantially decreased.

Increased Interest in Investing

While the negative stock market returns in the first quarter of 2020 impacted many investors, interest in investing remained high. Two out of every five respondents in the study (40 percent) reported that now is a good time to invest, while only 24 percent viewed it as a bad time to invest. This finding was primarily driven by households with taxable investment accounts, half (50 percent) of whom believed now is a good time to invest (compared to 41 percent of retirement-only investors, and 24 percent of non-investors).

Although falling stock prices may lower the value of investments for those already invested in the market, it may provide attractive buying opportunities. When asked whether their interest in investing in the stock market had increased, decreased or remained the same, roughly one-fifth (21 percent) of all respondents (investors and non-investors) indicated their interest had substantially or somewhat increased since the beginning of 2020, compared to one-quarter (24 percent) who indicated their interest had decreased.

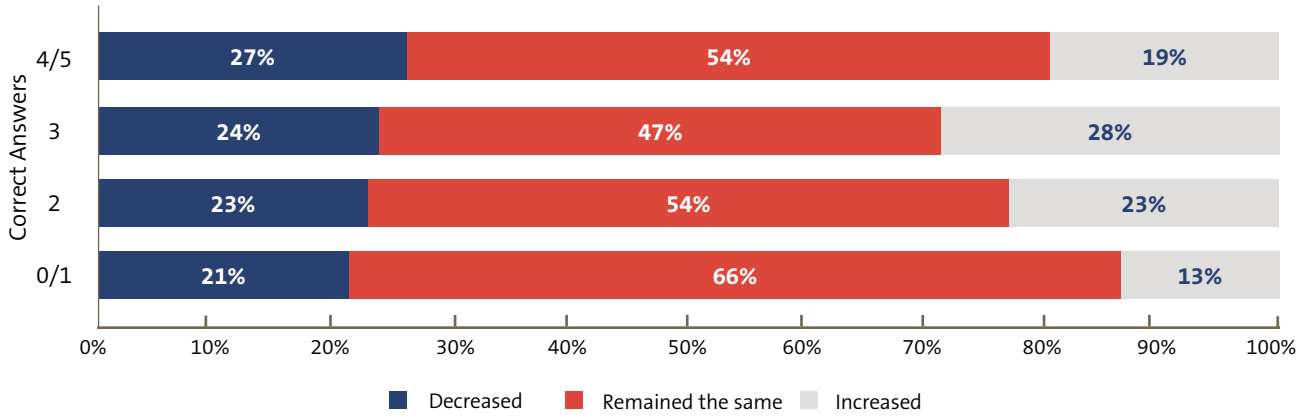
Those with increased interest in investing included:

- **Households with taxable investment accounts.** More than twice as many taxable account investors (29 percent) reported an increased interest in investing compared to retirement-only investors (13 percent). Eighteen percent of non-investors reported increased interest.
- **Younger individuals.** Interest decreased with age; twice as many respondents under the age of 30 (32 percent) reported increased interest in investing, compared to those over the age of 60 (15 percent). Respondents aged 45 – 59 had the greatest proportion of individuals reporting a decreased interest in investing (28 percent).
- **Higher income households.** Those with annual incomes over $60,000 more frequently reported an increased interest in investing.

- **Asian, African-American, and Hispanic/Latino households.** Asian respondents reported increased interest in investing at more than twice the rate of white respondents (49 percent vs. 19 percent). African-American and Hispanic/Latino respondents (both 24 percent) also reported increased interest in investing at rates greater than white respondents.
- **Employed individuals.** Employed (including self-employed) respondents more frequently (26 percent) reported an increased interest in investing compared to those not working (16 percent).
- **Have confidence in the fairness of financial markets.** Respondents with greater confidence in the fairness of financial markets more often indicated an increased interest in investing (23 percent), compared to those who perceived markets as being less fair (18 percent).
- **Less financially impacted by pandemic-related volatility.** Investors (retirement-only and taxable account) who reported substantial decreases in their portfolio values reported decreased interest at almost twice the rate of investors whose portfolios did not lose substantial value (41 percent vs. 22 percent). Conversely, investors without substantial losses more frequently reported increased interest in investing (25 percent vs. 15 percent).

Respondents with the highest levels of investment knowledge most frequently reported their interest in investing had decreased, compared to those with lower levels of investment knowledge. Increased interest in investing was greatest (28 percent) among respondents who correctly answered only three of the five investment knowledge questions. This suggests that those respondents whose interest in investing has increased the most may not have the knowledge to make good investment decisions.

Figure 4: Changes in Interest in Investing by Investment Knowledge

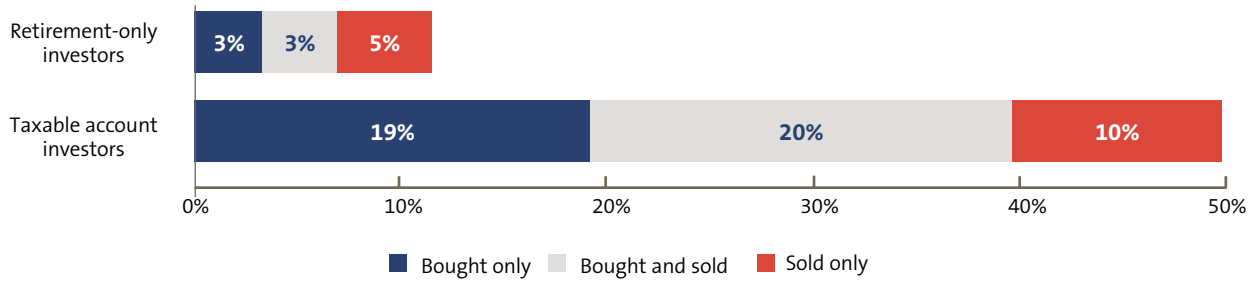


Limited Pandemic-Related Trading Activity

As a result of the pandemic-related market volatility, only about one-third (34 percent) of all investors (retirement-only and taxable account) reported making a trade of some kind (either buying or selling) in their portfolios. While most investors (retirement-only and taxable account) reported they neither sold nor bought investments, more investors (retirement-only and taxable account) bought (26 percent) than sold (21 percent), with considerably more trades in taxable accounts compared to retirement accounts.

Figure 5: Transactions as a Result of Pandemic-Related Market Volatility

As a result of the stock market volatility we've experienced since early 2020, have you done any of the following?



Of the 67 percent of investors (retirement-only and taxable) who did not make a trade, just over one-third (35 percent) considered buying investments, while only 11 percent considered selling.

Other Responses to Market Volatility

Objective and Subjective Risk Tolerance

The majority of all respondents in the sample (52 percent) reported they were willing to take average financial risks expecting to earn average returns. Thirty-six percent of respondents either somewhat or strongly agreed with the statement, "I prefer investments with little or no fluctuation in value."

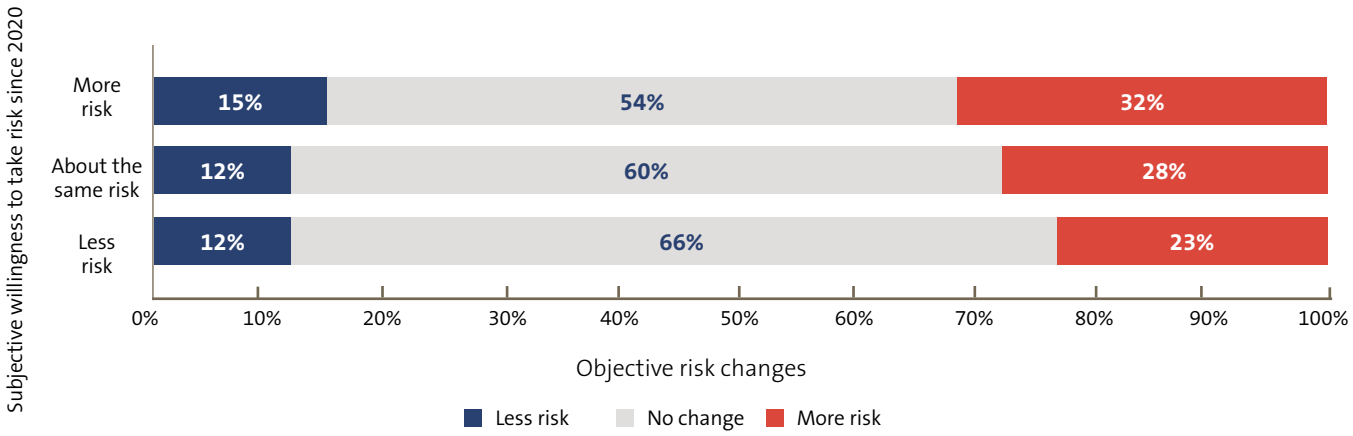
With the increased levels of market volatility in the first half of 2020, we may see changes in peoples' willingness to take financial risk, although previous research into changes in risk tolerance during times of increased market volatility suggests change may be minimal (Rabbani, Grable, Heo, Nobre & Kuzniak, 2017). When asked if they were willing to take more or less financial risk since the beginning of 2020, 42 percent of respondents reported they were willing to take less risk, while 39 percent reported that they were willing to take about the same level of risk as before the market volatility of early 2020. Although this measure provides insight in to how people believe their willingness to take financial risk has changed, it may not reflect genuine changes to risk tolerance.

To assess changes in objective risk tolerance, we compared responses to a four-item risk tolerance question from the Survey of Consumer Finances collected from our study of participants in 2018 and 2019 with responses collected in the recent survey. Negative scores indicate a decreased willingness to take risk, and positive numbers indicate an increased willingness to take risk, with larger numbers representing a greater difference between 2018/2019 and 2020. For example, a respondent who indicated willingness to take average risk (3) in 2018/2019 and no financial risk (4) in 2020 would receive a score of -1. Unlike subjective reports of changes in willingness to take financial risk, the majority of all respondents (62 percent) showed no change in their objective risk tolerance as a result of the pandemic-related market volatility. In total, a quarter of all respondents exhibited an increased risk tolerance (albeit generally by one category), and only 12 percent of respondents exhibited lower levels of risk tolerance.

Our analysis suggests that while respondents may believe their willingness to take risk decreased since the market volatility of 2020, little has changed in their objective risk tolerance.

Among respondents who reported their willingness to take financial risk was *lower* than before, 66 percent had no change to their objective risk tolerance, and almost one in four (23 percent) experienced an increase. Our analysis suggests that while respondents may believe their willingness to take risk decreased since the market volatility of 2020, little has changed in their objective risk tolerance.

Figure 6: Perceived (Subjective) vs Real (Objective) Changes in Willingness to Take Risk since the Beginning of 2020



Emotional Responses

In addition to attitudes about risk, we investigated the emotional responses, both positive and negative, to the pandemic-related market volatility of 2020. When asked to think about the stock market performance since the beginning of 2020 and how frequently they had felt any one of nine different emotions, respondents most frequently reported feeling "indifferent" (21 percent), "optimistic" (20 percent), and "fearful" (20 percent) either fairly often or very often. Emotion frequency differed among taxable account investors, retirement-only investors, and non-investors. Investors (both taxable account and retirement-only) reported feeling negative emotions such as "fearful" and "angry" more frequently than non-investors. Further, investors (both taxable account and retirement-only) whose portfolios had substantially decreased reported more than twice as many negative emotions as investors whose portfolios had not substantially decreased.

Not surprisingly, emotions were related to increased (among those with more positive emotions) and decreased (among those with more negative emotions) interest in investing. Respondents who indicated they had little confidence in the fairness of markets (see next section) reported twice as many negative emotions as those with greater perceptions of fairness.

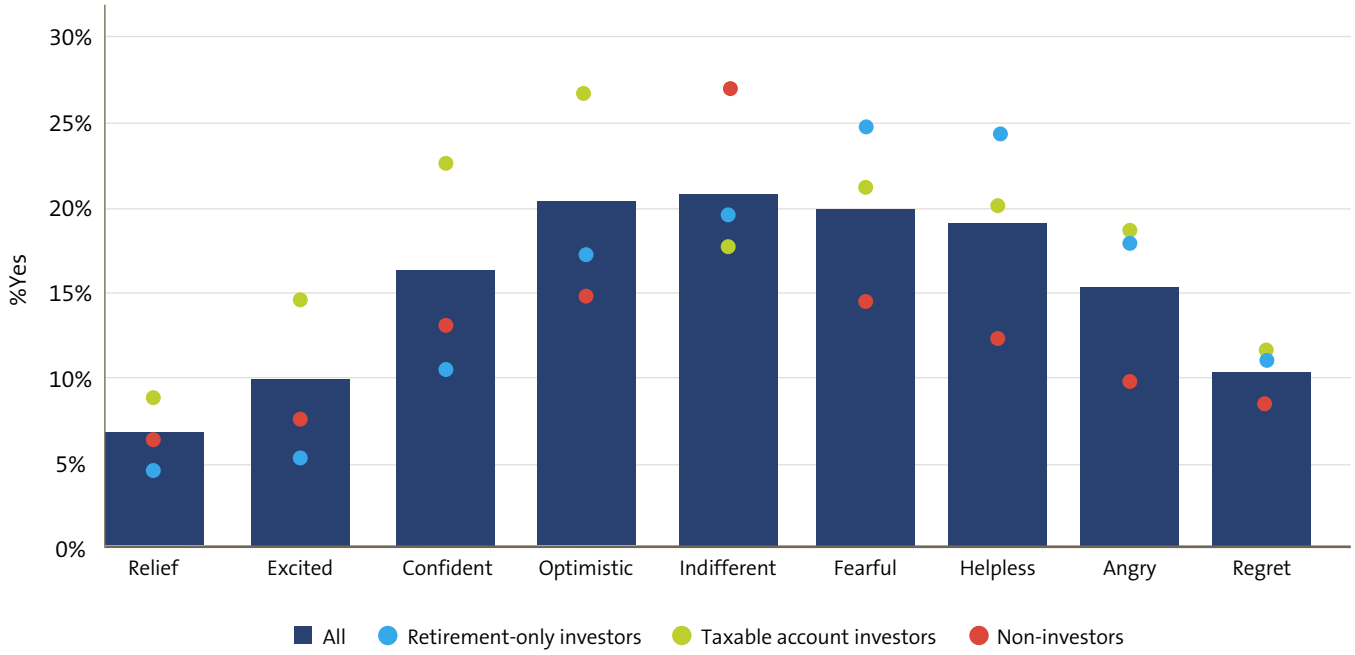
Perceptions of Fairness

Dramatic movements in stock market prices, particularly downward, and recent high-profile accusations of insider trading may leave investors and potential investors questioning the fairness of financial markets in the U.S. for the average investor. In fact, our analysis indicates low levels of confidence that U.S. financial markets are fair to the average investor. Only 11 percent of respondents indicated they were extremely or very confident that financial markets are fair to the average investor, and 33 percent were not at all or not very confident in the fairness of financial markets.

The proportion of respondents with confidence in the fairness of financial markets was slightly higher among taxable account investors compared to retirement-only investors and non-investors, but there appeared to be few other demographic or financial differences among those who believed markets are more or less fair. However, perceptions of fairness differed based on respondents' interest in investing and the extent to which investor portfolios were impacted by pandemic-related market volatility. Respondents whose interest in investing had decreased since the market volatility of 2020 more frequently reported a lack of confidence in the fairness of markets (45 percent), along with investors (retirement-only and taxable account) whose portfolios had decreased in value (41 percent).

Figure 7: Emotions Felt Often by Investors and Non-Investors

Thinking about the stock market since the beginning of 2020, how frequently have you felt the following?



Conclusion

The COVID-19 pandemic and associated market volatility have had far-reaching effects on the financial well-being of many households. To investigate the awareness of, and reactions to, recent events, the FINRA Foundation and NORC at the University of Chicago conducted a study with a nationally representative sample of U.S. households.

This study indicates that, while some investors reported substantial negative impacts to their investment portfolios in early 2020, optimism about investing and belief in the resilience of the stock market remain high, with one in five Americans indicating an increased interest in investing. This increased interest in investing may well benefit these households, but a lack of investment knowledge may result in suboptimal investment decisions. As new investors enter the stock market, it will be important to make educational opportunities readily and widely available to help them understand risks and manage market volatility.

Our research into risk tolerance found that 42 percent of respondents reported a decreased subjective willingness to take risk. Yet two-thirds of these respondents—66 percent—in fact had no change to their objective risk tolerance, suggesting that while respondents believed their willingness to take risk had decreased, their objective risk tolerance remained unchanged. This mismatch points to the possibility that many investors may not adequately assess or understand their own risk tolerance. During periods of volatility, this may weigh on the decision-making and market outlook of investors who are especially attentive to market swings.

While this report provides an overview of the investor and non-investor reactions to market volatility associated with the COVID-19 pandemic, it is critically important to understand any differential impacts among sub-segments of U.S. households. This is the topic of a companion report, *African-American and Hispanic/Latino Responses to Pandemic-Related Volatility in the Stock Market*, based on the same research study.

Appendices

Demographic Characteristics of the Sample by Investor Type

Characteristic	Total	Non-investors	Retirement-only investors	Taxable account investors
Gender (%)				
Male	51%	45%	50%	56%
Female	49%	55%	50%	44%
Age (mean; SD)	**50 (16.75)**	**47 (15.67)**	**50 (14.33)**	**52 (18.88)**
Race/ethnicity (%)				
White	64%	52%	68%	70%
Hispanic/Latino	16%	25%	14%	12%
African-American	12%	18%	12%	8%
Asian	4%	2%	3%	6%
Two or more	3%	2%	3%	3%
Other	1%	2%	1%	1%
Education (%)				
No HS diploma	7%	12%	3%	6%
HS grad/GED	23%	38%	22%	14%
Some college	30%	32%	31%	27%
BA or above	40%	17%	44%	53%
Income (%)				
Less than $35,000	26%	51%	18%	15%
$35,000–$59,999	22%	23%	20%	22%
$60,000–$99,999	29%	19%	37%	30%
$100,000 or more	23%	7%	26%	33%
Region (%)				
Northeast	18%	12%	25%	18%
Midwest	20%	20%	20%	20%
South	37%	40%	34%	36%
West	25%	27%	21%	26%
Metro (%)				
Non-metro area	17%	16%	17%	17%
Metro area	84%	84%	83%	83%
Housing (%)				
Homeowner	70%	51%	76%	79%
Renter	28%	45%	22%	20%
Other	2%	4%	2%	1%

About the Data

This study uses data collected between May 29, 2020, and June 16, 2020, using the AmeriSpeak® Panel. Funded and operated by NORC at the University of Chicago, AmeriSpeak is a probability-based panel designed to be representative of the U.S. household population. Randomly selected U.S. households are sampled using area probability and address-based sampling, with a known, non-zero probability of selection from the NORC National Sample Frame. These sampled households are then contacted by U.S. mail, telephone, and field interviewers (face to face). The panel provides sample coverage of approximately 97 percent of the U.S. household population. Those excluded from the sample include people with P.O. Box only addresses, some addresses not listed in the USPS Delivery Sequence File, and some newly constructed dwellings. While most AmeriSpeak households participate in surveys by web, non-internet households can participate in AmeriSpeak surveys by telephone. Households without conventional internet access but having web access via smartphones are allowed to participate in AmeriSpeak surveys by web. AmeriSpeak panelists participate in NORC studies or studies conducted by NORC on behalf of governmental agencies, academic researchers, and media and commercial organizations.

1,795 U.S. adults ages 18 and older participated in the study, including oversamples of African-American and Hispanic/Latino households. The study was fielded in English only, and was administered online. Individuals were considered eligible for the study if they were either the primary decision-maker or shared in the decision-making related to finances in the household, and completed a set of screening questions that classified them as investors (retirement-only or taxable account) or non-investors. The screener completion rate was 47.5 percent. 80.5 percent of screened respondents were eligible for the study, and 98.9 percent of eligible respondents completed the survey. The final AAPOR response rate (RR3) for the study was 9.4 percent, and the margin of error was 3.37 percentage points.

Weighting

Statistical weights for the study-eligible respondents were calculated using panel-base sampling weights to start. The base sampling weights are further adjusted to account for unknown eligibility and nonresponse among eligible housing units. The household-level nonresponse adjusted weights are then post-stratified to external counts for number of households obtained from the Current Population Survey. Then, these household-level post-stratified weights are assigned to each eligible adult in every recruited household. Furthermore, a person-level nonresponse adjustment accounts for nonresponding adults within a recruited household. Finally, panel weights are raked to external population totals associated with age, sex, education, race/Hispanic ethnicity, housing tenure, telephone status, and Census Division. The external population totals are obtained from the Current Population Survey. Study-specific base sampling weights are derived using a combination of the final panel weight and the probability of selection associated with the sampled panel member. The screener nonresponse adjusted weights for the study are adjusted via a raking ratio method to general population age 18 and older population totals associated with the following socio-demographic characteristics: age, sex, education, race/Hispanic ethnicity, and Census Division.

About FINRA and the FINRA Foundation

The Financial Industry Regulatory Authority (FINRA) is a not-for-profit organization dedicated to investor protection and market integrity. It regulates one critical part of the securities industry — brokerage firms doing business with the public in the United States. FINRA, overseen by the Securities and Exchange Commission, writes rules, examines for and enforces compliance with FINRA rules and federal securities laws, registers broker-dealer personnel and offers them education and training, and informs the investing public. In addition, FINRA provides surveillance and other regulatory services for equities and options markets, as well as trade reporting and other industry utilities. FINRA also administers a dispute resolution forum for investors and brokerage firms and their registered employees. For more information, visit *www.finra.org*.

The FINRA Investor Education Foundation supports innovative research and educational projects that give underserved Americans the knowledge, skills, and tools to make sound financial decisions throughout life. For more information about FINRA Foundation initiatives, visit *www.finrafoundation.org*.

About NORC at the University of Chicago

NORC at the University of Chicago is an independent research institution that delivers reliable data and rigorous analysis to guide critical programmatic, business, and policy decisions. Since 1941, NORC has conducted groundbreaking studies, created and applied innovative methods and tools, and advanced principles of scientific integrity and collaboration. Today, government, corporate, and nonprofit clients around the world partner with NORC to transform increasingly complex information into useful knowledge.

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