2019 PIABA Mid-Year Meeting

Current Issues in Securities Arbitration

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

2019 © PIABA

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

2019 PIABA Mid-Year Meeting

Table of Contents

PAGE

2019 PIABA Mid-Year Meeting Speaker Biographies v
2019 PIABA Mid-Year Meeting Board of Director Biographies xii

§ 1 FINRA Expungement Proceedings: Party Perspectives, Ethics and Recent Regulatory Developments, Robert J. Girard II, Moderator; Darlene Pasieczny, Katherine McGrail, Jordan Thomas, Panelists

FINRA Expungement Proceedings: Party Perspectives, Ethics and Recent Regulatory Developments 1
I. Introduction 1
A. FINRA's Position is Clear: Expungement Should Be An "Extraordinary Remedy" 2
II. What is Expungement in the Securities Industry? 4
A. The Current FINRA Process 6
1. Expanded Expungement Guidance 6
B. Expungement After Settlement 7
III. Ethical Concerns Regarding Fighting Expungement Requests After Settlement 9
Scenarios to Consider 9
IV. Regulatory Notice 17-42 and Its Implications 10
V. Conclusion 12

Attachments:
FINRA-Award Information Sheet – Sole Topic is Determination of Expungement of Customer Dispute Resolution, October 2017 13
FINRA-Code of Arbitration Procedure 12805. Expungement of Customer Dispute Information under Rule 2080 25
FINRA-Examples of Expungement Orders 26
FINRA-Expungement Training, October 2016 28
FINRA-Rule 2080. Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD) System 54
FINRA-Rule 2081. Prohibited Conditions Relating to Expungement of Customer Dispute 55
Cleaning up Tainted Broker Records Becomes a Cottage Industry for One Law Firm, Jeff Benjamin, Investment News, January 3, 2019 56
FINRA Arbitrators Let Thousands of Brokers Purge Infraction Records, Jean Eaglesham and Coulter Jones, The Wall Street Journal, November 17, 2018 64
FINRA Award 13-01522, Sandra L. Liebhaber vs. Royal Alliance Associates, Inc., September 10, 2014 67
Royal Alliance Associates, Inc. v. Sandra L. Liebhaber et al., Court of Appeals, August 30, 2016 75
FINRA Regulatory Notice 17-42, Expungement of Customer Dispute Information, December 6, 2017 95

§ 2 Claims Against Registered Investment Advisers (RIAs) – a Practice Guide
Alan Rosca, Moderator; Bart Goplerud, Howard Prossnitz, Panelists

Registered Investment Advisors: Regulatory Structure, Liability Theories, and Recent Developments, Howard B. Prossnitz, J. Barton Goplerud 117
Introduction 117
I. Regulatory Structure 118
A. What statute controls? 118
B. Who is an investment advisor? 118
C. Who must register? 118
D. What requirements attach to being a registered investment advisor? 118
(i) Fiduciary Duties 118
(ii) Substantive requirements 119
(iii) Contractual duties 120
(iv) Record keeping requirements 120
(v) Administrative oversight 120
II. Claims Against Investment Advisers 120
A. Actions Under the Investment Advisors Act 120
B. Breach of Contract 121

C. Breach of Fiduciary Duty 121
D. Negligence and Negligent Supervision 121
E. State Statutory Liability 121
F. Rule 10b-5 Liability 122
G. Common Law Fraud 122
H. Control Person Liability 122
III. Recent Developments 122
A. Pleading valid claims against an advisor 122
B. Pitfalls of pursuing insurer 123
C. RICO claims upheld when securities transaction was incidental to fraud 123
Conclusion 123
IV. Mass/Class Cases and Insurance Coverage Issues 124
A. Mass/Group vs. Class Action Cases 124
B. Fed. R. Civ. P. 23(b)(1)(B) – Non-opt-out Class Action 125
C. Attorney-Client Fee Agreement Considerations 125
D. Federal vs. State Court 126
E. Arbitration Agreements and Class-Action Waivers 127
F. Insurance Coverage Issues 127

Attachments:
Exhibit A – Class Action Complaint 129
Exhibit B – Plaintiffs' Class Action Complaint and Jury Demand 158
Exhibit C – Stott v. Capital Financial Services, Inc., 277 F.R.D. 316 (2011) 201
Exhibit D – Plaintiff's Motion for Class Certification and Request for Discovery on Certification Issues 242
Exhibit E – Plaintiff's Motion for Class Certification and to Stay Resolution Pending Class Discovery 257
Exhibit F – Complaint for Declaratory Judgment 268
Exhibit G – Amended Complaint for (1) Breach of Contract Under California or, Alternatively, New York Law, (2) Breach of the Implied Covenant of Good Faith and Fair Dealing Under California Law, (3) Declaratory Judgment Under 28 U.S.C. Section 2201, (4) Unfair Business Practices Under California Law – Cal. Bus. And Prof. Code Section 17200 et seq. 384

§ 3 From the Regulators
Lisa Braganca and Debra Speyer, Moderators; Joey Brady, Kevin Goodman, Jordan Thomas, Panelists

Securities & Exchange Commission Exams, FINRA Oversight, and Whistleblower Office,
Celiza Braganca 459
SEC Office of Compliance Inspections and Examinations (OCIE) 459
I. OCIE has staff of about 1,000 in 11 SEC regional offices and headquarters 459
II. OCIE is responsible for overseeing over 13,200 investment advisers, 10,000 mutual funds and exchange Traded funds, 3,800 broker-dealers, 330 transfer agents, 7 active clearing agencies, 21 national securities Exchanges, nearly 600 municipal advisors, FINRA, MSRB, SIPC, and the Public Company Accounting Oversight Board 459
III. OCIE Communications and Risk Alerts 459
IV. OCIE's 2019 Examination Priorities – Six themes 459
SEC Oversight of FINRA – 2019 Risk Monitoring and Examination Priorities 450
I. Online Distribution Platforms 450
II. Sales Practice Risks 461
SEC Office of the Whistleblower 461
I. Who is a Whistleblower? 461
II. Reporting a Tip – Potential Monetary Award 462
III. Confidentiality and Restrictions on Whistleblowing – *de facto* gag clauses 464
IV. Proposed amendments to the Whistleblower Rules were published in the Federal Register on July 20, 2018. https://www.sec.gov/rules/proposed/2018/34-83557.pdf. The public comment period ended in mid-September 2018. The SEC received about 100 unique letters and two form letters from commentators. 465

Attachments:
2018 Enforcement Report, Based on 2017 Date 466
NASAA Initial Comment Letter, Reg. BI-8-7-18 480
NASAA Letter to Chair Waters and Ranking Member McHenry re: H.R. 624, January 23, 2019 482
NASAA Reg. BI Comment Letter, 8-23-2018 506
NASAA's Legislative Agenda for the 116th Congress .....

SEC JNJ Arbitration Letter, January 30, 2019 508
2018 Annual Report to Congress on SEC Whistleblower Program 512
2019 Examination Priorities, Office of Compliance Inspections and Examinations 552
2019 Risk Monitoring and Examination Priorities Letter, January 2019 568
De Facto Gag Clauses: The Legality of Employment Agreements That Undermine Dodd-Frank's Whistleblower Provisions, Richard Moberly, Joran A. Thomas & Jason Zuckerman, ABA J. Labor & Employment Law, Vol. 30, No. 1, 2014 575
BNA Daily Labor Report, A Primer for Employment Lawyers, Tammy Marzigliano and Jordan A. Thomas 609
Reporting Without Regrets: The SEC Whistleblower Handbook 613
Happy Anniversary, Dodd-Frank, Jordan A. Thomas, New York Law Journal, Vol. 258-No. 14, July 21, 2017 635
The Limitations of Corporate Compliance, Jordan A. Thomas, New York Law Journal, November 7, 2011 637
Once an S.E.C. Regulator, Now Thriving as a Lawyer for Whistle-Blowers, Randall Smith, The New York Times, March 20, 2018 639
Wall Street's New Enforcers Aim to Muzzle Whistleblowers, Jordan Thomas and Tom Devine, The New York Times, July 21, 2014 642
National Exam Program Risk Alert, Office of Compliance Inspections and Examinations 644
The Street, The Bull and The Crisis: A Survey of the US & UK Financial Services Industry, University of Notre Dame and Labaton Sucharow LLP, May 2015 647
Column: How Wall Street Creates Criminals, Lynn Stout and Jordan Thomas, USA Today 658

§ 4 Practical Application and Strategies of FINRA Discovery Practice

Jeff Kaplan, Moderator; Sam Edwards, Logan Fisher, Panelists

Confidentiality Agreements in FINRA Arbitration – Do Broker-Dealers' Documents Warrant Confidential Treatment?, Jeffrey B. Kaplan 676
Introduction 676
Courts Disfavor Confidentiality 676
The Party Seeking Confidentiality Must Prove Confidentiality is Warranted 677
Demonstrating a Need for Confidentiality is a Steep Burden 678
Demonstrating a Trade Secret is a Strict Standard 679
Documents Produced to Regulators Are Not Confidential 680
Counsel Have the Right to Share Discovery Materials 681
Discovery in Arbitration is Not Confidential 682
Many Confidentiality Agreements May Be Unethical 683
Conclusion 684

§ 5 Congressional Process: How A Bill Becomes A Law

Sean Sweeney and Tom Wagner, Moderators; Peter Hyun, Panelist

How Laws Are Made, Compilation of Materials, Robin S. Ringo 685
Introduction 685
The Congress 685
How Does A Bill Become Law? 688
How Federal Laws Are Made 689
Steps in Making a Law 689
Differences Between the House and Senate Procedures 690
Find Federal Laws 695
Federal Regulations 695
The Rulemaking Process 695
Federal Court Decisions 695
State Laws and Regulations 695
Executive Orders and Other Presidential Actions 695
Find Presidential Actions 696
Steps to a Bill Becoming a Law 697
Glossary 700

§ 6 Effectively Representing Your Clients in Public Forums
Sean Sweeney and Tom Wagner, Moderators

"A Lawyer Shall Make Reasonable Efforts to Expedite Litigation Consistent With the Interests of the Client" 703
1. Know the background information 703
2. Have a clear objective 703
3. Be persistent and personal 703
4. Listen 703
5. Find allies 704
6. Remember the power of positive reinforcement 704
7. Don't get discouraged 704

2019 PIABA Mid-Year Meeting Speaker Biographies

Joey Brady, Esq.
Executive Director, NASAA
Washington, DC

Brady had been serving as NASAA's Acting Executive Director, in addition to his duties as General Counsel, since the September 2014 departure of former Executive Director Russ Iuculano.

Brady joined NASAA in 2005 as Associate Counsel and was named General Counsel in 2011. In his role as General Counsel, he supervised the efforts of NASAA's Legal Department in its support of all aspects of NASAA's mission, including internal governance, member support, and external advocacy and outreach. He also served as a liaison to the NASAA Broker-Dealer Section, Corporation Finance Section and other committees. He has led several initiatives undertaken by NASAA to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act affecting the regulation of investment advisers and the development and implementation of NASAA's Electronic Filing Depository system.

Prior to joining NASAA, Brady served as Chief Counsel to the Securities Division of the Mississippi Secretary of State. He is admitted to the bars of Mississippi and the District of Columbia and is a graduate of the Mississippi College School of Law and the University of Southern Mississippi.

Celiza Braganca, Esq.
Braganca Law LLC
Chicago, Illinois

Celiza (Lisa) Bragança is the founder of Bragança Law LLC. For more than two decades, Lisa has successfully represented individuals and businesses in recovering losses from brokers, investment advisers, and insurance companies.

As Branch Chief in the SEC Division of Enforcement, Lisa investigated broker-dealer and investment adviser misconduct including offering fraud, churning, unsuitable investments, as well as insider trading and financial fraud. Lisa played a key part in obtaining record-breaking results for clients including a federal court jury award of almost $15 million in compensatory and punitive damages against an insurer for bad faith denial of claims, and an $85 million settlement from insurers of directors and officers of LTV Steel for innovative legal claims arising out of misconduct occurring during LTV Steel's operation as debtor-in-possession. As Legal Director of Access Living, Lisa served as class counsel in statewide class actions that are allowing people with disabilities to be able to live in the community, rather than in institutions, with necessary supports and services.

Lisa is author of "Dipping Your Analog Toe into Digital Coins" in the ABA Law Practice Magazine (Jan 1, 2019), co-author with Louis Straney of "Cryptocurrencies and Tokens: What are they and who regulates them," PIABA B.J., Vol 25, No. 1 (2018), and is a speaker on cryptocurrency regulation at the ABA TechShow 2019. She organized and spoke at a January 2019 program on preventing elder financial exploitation sponsored by Concordia University Business School and Gerontology Institute. Lisa is a NITA trial practice and deposition skills instructor, a member of the Women's White Collar Defense Association, the Chicago Bar Association's Financial & Emerging Tech and Securities Law Committees, and several PIABA committees. Lisa has an M.B.A., J.D., and A.B. from the University of Chicago.

Samuel Edwards, Esq.
2019 Executive Vice President/President Elect
Shepherd, Smith, Edwards & Kantas
Houston, Texas

Sam Edwards is a partner in the Houston based firm of Shepherd, Smith, Edwards & Kantas. Sam and his firm focus exclusively on representing investors in securities arbitration and litigation, all across the country. Sam and his firm have represented thousands of investors in cases involving basic unsuitability, fraud, complex product failures, firm trading flaws and many other issues. Sam is a member of the PIABA Board of Directors and past Editor-in-Chief of the PIABA Bar Journal. Sam is also a member of FINRA's National Arbitration and Mediation Committee, where he works with other PIABA members as well as defense lawyers to level the playing field for FINRA arbitration.

Logan S. Fisher, Esq.
Bressler Amery & Ross
Florham Park, New Jersey

Logan Fisher is a principal in the firm's Securities practice group, passionately and effectively advocating on behalf of broker-dealers, financial advisors, private equity, crowdfunding and other financial services professionals.

Logan's practice is primarily devoted to representing broker-dealers and registered representatives in securities litigation, including customer-initiated complaints with self-regulatory organizations such as the Financial Industry Regulatory Authority (FINRA). He has successfully handled numerous arbitrations involving a variety of claims, including fraud, misrepresentation, unsuitability, unauthorized trading and churning. Logan also has experience counseling individual financial advisors regarding Form U4 and U5 disclosures.

In his securities regulatory practice, Logan has represented broker-dealer and registered investment advisor clients in a variety of state and industry investigations, including those related to selling away and alleged violations of the Investment Advisers Act. He has also counseled registered investment advisor clients concerning required disclosures under Form ADV.

Logan also represents individual entrepreneurs and business organizations in connection with the formation of corporate entities, crowdfunding ventures, and litigation before state and federal courts in New Jersey and New York.

Logan is also a member of Bressler's Senior and Vulnerable Investor Group. The lawyers in this group have a shared interest in providing counsel to corporate clients who confront issues affecting seniors.

A *magna cum laude* graduate of Duquesne University School of Law, Logan served as Executive Editor of the *Duquesne Law Review*. While in law school, Logan co-authored an article on Election Law that was published in the *Harvard Journal on Legislation*. He received his undergraduate degree in Business Administration from Temple University's Fox School of Business & Management.

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

Robert J. Girard II, a founding partner of Girard Bengali, APC, represents victims of the securities industry in arbitration and litigation. For 18 years, he has built a reputation as a powerful and effective advocate for his clients and recovered millions for investors from most of the major Wall Street brokerage firms. Mr. Girard's representations include victims of financial elder abuse, securities fraud, unsuitable investment strategies, misrepresentations and account mismanagement.

Mr. Girard also represents financial industry professionals, brokers and advisors in securities-related employment disputes against major broker-dealers and advisory firms. His representative matters include wrongful discharge, unfair business practices, retaliation, discrimination and Form U5 defamation claims.

From 2015 through 2019, 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 designation earned by less than 2.5% of attorneys under the age of forty.

Kevin Goodman, Esq.
U.S. Securities and Exchange Commission
Associate Director, FINRA and Securities Industry Oversight
Washington, DC

Kevin W. Goodman leads the U.S. Securities and Exchange Commission's FINRA and Securities Industry Oversight group ("FSIO"), which is responsible for comprehensive oversight of FINRA, including conducting oversight examinations of broker-dealers to assess the quality of FINRA's examinations, as well as inspecting all areas of FINRA's operations. FSIO also oversees the MSRB. In addition, Mr. Goodman serves as a member of the Executive and Operating Committees for the SEC's National Examination Program. Prior to assuming his current role, Mr. Goodman led the SEC's National Broker-Dealer Examination Program for over three years. Mr. Goodman's SEC experience also includes having served for six years as Associate Regional Director of the SEC's Denver Regional Office, where he managed the examination program for the office. Mr. Goodman joined the SEC staff in Los Angeles in 1992 as an Attorney-Adviser, and later served as Branch Chief, Senior Special Counsel, and Assistant Director, all with the Investment Adviser/Investment Company Examination Program. Mr. Goodman graduated from Purdue University in 1982 with a degree in accounting and received his law degree from Indiana University in 1985. Prior to joining the SEC staff, Mr. Goodman practiced corporate and securities law in the private sector with an emphasis on mergers and acquisitions.

Bart Goplerud, Esq.
Shindler, Anderson, Goplerud & Weese, P.C.
West Des Moines, Iowa

Bart Goplerud focuses its practice on representing clients in class action cases arising out of securities violations, antitrust, wage and hour, product liability, and violations of consumer statutes. Bart has represented investors in "secondary liability" class actions against entities involved in assisting in the perpetration of investment fraud, ranging from underwriters to law firms and other aiders and abettors. He is licensed to practice in Iowa state and federal courts and is a member of the American Bar Association, the Iowa State Bar Association, and the American Association for Justice.

Bart earned his bachelor's degree from the University of Iowa in 1982 and his law degree from Drake University in 1990.

He is an adjunct professor of negotiations and pre-trial advocacy and mediation at Drake Law School.

Peter Hyun, Esq.
Wiley Rein LLP
Washington, DC

Peter's practice focuses on representing individuals and entities in criminal and civil government enforcement actions, congressional investigations, and State Attorneys General investigations. A former Assistant U.S. Attorney in the Eastern District of Virginia's U.S. Attorney's Office, Assistant Attorney General in the New York Attorney General's office, and Chief Counsel to U.S. Senator Dianne Feinstein on the U.S. Senate Committee on the Judiciary, Peter provides strategic advice to companies and individuals navigating multifront, parallel investigations.

Prior to joining Wiley Rein, Peter served as chief counsel to Senator Dianne Feinstein, advising her on law enforcement issues, including asset forfeiture, False Claims Act (FCA) enforcement, bank fraud, money laundering, cybercrime, white collar fraud, firearms, juvenile justice, domestic violence, child exploitation, sexual violence, and human trafficking. In addition, he has worked on bipartisan, bicameral legislation, and assisted on oversight of the U.S. Departments of Justice and Homeland Security, and the Federal Bureau of Investigation.

Peter also has experience advising on cutting-edge law enforcement-related policy matters on Capitol Hill, including cryptocurrencies, blockchain and distributed ledger technology, cybersecurity, facial recognition, drone use, and electronic data privacy.

Jeffrey B. Kaplan, Esq.
Dimond Kaplan & Rothstein, P.A.
Coconut Grove, Florida

Jeff is a founding shareholder of Dimond Kaplan & Rothstein, P.A. He is an AV-rated lawyer who focuses his practice on securities arbitration and plaintiff-side class action litigation. He also represents securities-industry professionals in U-4, U-5, compensation, and promissory note disputes. Jeff routinely has been named a "Top Lawyer" by the *South Florida Legal Guide* and has been named a Top Rated Lawyer in Southern California by ALM (formerly American Lawyer Media). From 2012 through 2015, he served on the National Arbitration and Mediation Committee, an advisory committee that makes recommendations and drafts rules, regulations, and procedures governing FINRA arbitration. Jeff has extensive experience handling FINRA, NYSE, and AAA securities arbitration matters. He has authored a number of articles on stockbroker misconduct issues and often serves as a guest lecturer to investor groups, accountants, and other professionals regarding securities fraud and stockbroker misconduct.

Katherine McGrail, Esq.
Murphy & McGonigle
Glen Allen, Virginia

Ms. McGrail's practice focuses on serving financial services firms and public companies facing civil litigation and regulatory enforcement matters, as well as counseling clients on compliance with industry regulations. A significant portion of Ms. McGrail's practice has been dedicated to counseling and defending broker-dealers and investment advisors. She has experience in matters involving equity, fixed income, and derivative trading; broker/dealer and investment adviser compliance system design and review; fiduciary investment issues; regulatory registration issues; transactional disclosure issues; cybersecurity compliance; employing big data analytics, and litigation in federal and state courts, administrative proceedings, disciplinary hearings and arbitrations. She handles all stages of complex commercial litigation, from pre-suit investigations and counseling to motions practice, discovery and trial.

Ms. McGrail has also defended mortgage originators and residential mortgage backed securities sponsors in litigation and government investigation spawned by the 2008 financial crisis. She was a member of a team that had numerous big wins, including the dismissal of monoline bond insurer plaintiffs from a $1.8B lawsuit, favorable settlements, and protection of sensitive client information in discovery.

In addition, Ms. McGrail advises companies concerning compliance with the emergent regulatory structure surrounding cybersecurity, including as it relates to policies and procedures, vendor due diligence, information governance, and incident response. She has experience advising broker-dealers and advisors on efficient ways to use big data analytics to avoid and respond to regulatory inquiries. In January 2017, she spoke on a SIFMA Conference Panel entitled, "Responding to Regulatory Inquiries in the Big Data Age: Is Your Firm Ready?"

Ms. McGrail is the firm's Chief Diversity and Inclusion Officer, where she is charged with attracting, retaining, and championing top-flight, diverse, legal talent. She is also the founder of the firm's Women's Initiative and hosts, sponsors, and participates in several efforts that advance the development of women in law.

Ms. McGrail graduated from Brooklyn Law School in 2005 and obtained a B.A. in Economics from Johns Hopkins University in 1999.

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

Darlene Pasieczny (pronounced "Pah-shetch-nee") is a securities and fiduciary litigator and FINRA arbitrator, and leads the Investor Defenders practice group at Samuels Yoelin Kantor LLP, based in Portland, Oregon. Darlene works all stages of securities litigation and FINRA arbitration, fiduciary litigation in trust and estate disputes, elder financial abuse, and complex civil litigation. She represents investors nationwide to recover investment losses caused by financial advisor misconduct or defective securities products.

Darlene brings a particular sensitivity to working with the all-too frequent targets of securities fraud and financial abuse retirees and women investors. She helps her clients not only recover financial losses, but also rebuild trust in a professional advisor.

She serves on the Board of Directors of the Public Investors Arbitration Bar Association (PIABA) and is sought after as a speaker on securities law, FINRA arbitration, trust and estate matters. Other professional affiliations include the Oregon State Bar, Washington State Bar, U.S. District Court for the State of Oregon, Multnomah Bar Association, and the Gus J. Solomon American Inn of Court. Darlene earned a B.A. from Reed College, Phi Beta Kappa, an M.A. from Columbia University, and J.D. from Lewis and Clark Law School, magna cum laude. www.InvestorDefenders.com

---

Howard Prossnitz, Esq.
Law Offices of Howard Prossnitz
Oak Park, Illinois

Over his 40 year career, Howard Prossnitz has helped victims of financial fraud and negligence recover millions of dollars. He started his career at what is now the world's largest law firm, Dentons, and then became a litigation partner at a 50 person Chicago firm, Antonow and Fink. He launched his own niche litigation practice in 1994 concentrating on securities claims and class actions.

He has tried FINRA cases in Illinois, New York, Massachusetts, the District of Columbia, New Hampshire, North Carolina, Ohio, Florida, Arizona, Colorado, Washington, Wisconsin, Alabama, Virginia, Texas and Arkansas with close to 40 published awards. He is a frequent speaker at the Public Investor Arbitration Bar Association including presentations at meetings in California, Texas, Colorado and Florida. He was on a panel at the 2014 meeting in Palm Springs, California on the subject of representing institutional investors as claimants. He will also be a presenter at the fall 2016 meeting in San Diego. He was an editor and contributor for the PIABA Law Journal, including an article he authored entitled *Who Wins FINRA Cases and Why?* (Vol. 19. No. 2 2012).

He received his J.D. from Stanford University in 1976 where he was member of the Law Review. He graduated *Phi Beta Kappa* and with High Honors from Haverford College in 1973 with a double major in economics and political science. He has been a member of the Chicago Literary Club since 1987 where he has presented seven papers and short essays.

Alan Rosca, Esq.
Goldman Scarlato & Penny, PC
Beachwood, Ohio

Alan focuses his legal practice on complex financial and commercial matters, particularly in the areas of securities litigation, investment fraud, antitrust/index manipulation, cryptocurrencies, ICOs, and international disputes. He often represents institutional and individual investors in disputes with financial industry members arising out of investment fraud or misconduct. He prosecutes claims on behalf of investors through class actions and FINRA arbitrations.

Alan is an adjunct professor of Securities Regulation at Cleveland-Marshall College of Law, Cleveland State University. His upcoming securities course includes a section on cryptocurrencies, blockchain, initial coin offerings ("ICOs") and smart contracts.

Alan received his Juris Doctor degree summa cum laude from Cleveland-Marshall College of Law in May 2008. While in law school he served as a Managing Editor of the Cleveland State Law Review, received the Dean's (full) scholarship for the entire Juris Doctor program, and won the "Best Oralist" award in the Jessup Moot Court competition, Pacific Region. Prior to law school, Alan was an investment analyst for a major financial data corporation and prepared investment research for fund managers.

He is licensed to practice law in the Ohio state and federal courts, and other federal courts nationwide.

Alan also holds a Master of Business Administration degree from Baldwin-Wallace College, Ohio.

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

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

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

Debra holds a law degree, a master's degree in finance with a thesis on program trading and stock markets, and a bachelor's degree in accounting. Prior to entering law school, she was an accountant. She has been listed in Philadelphia Magazine's Best Lawyers, SuperLawyers, Suburban Magazine and Mainline Magazine for her work handling securities fraud and elder law matters. She is also listed in Who's Who in American Law and Who's Who in America. She was honored by the National Organization of Women Business Owners with their "Women Making History" award. Debra is a member of the Million Dollar Advocates Forum for her securities arbitration work. The Million Dollar Advocates Forum is limited to attorneys who have won million - and multi-million-dollar verdicts and settlements.

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

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

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

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

Sean Sweeney, Esq.
Halling & Cayo SC
Milwaukee, Wisconsin

Attorney Sean M. Sweeney helps individual and institutional investors who have been the victim of Securities Fraud or Stock Broker misconduct recover their funds. Sean also represents stockbrokers for investigations by FINRA and disputes with their employers regarding non-competes, promissory notes, and allegations of breach of contract made by their employers. He is a shareholder at the law firm of Halling & Cayo, S.C. in Milwaukee WI focusing his practice on commercial litigation and FINRA Arbitration. Sean earned his Juris Doctor (JD) and Masters of Business Administration (MBA) from Marquette University. He earned his Bachelor of Science degree in Business Economics from Attorney Sean M. Sweeney helps individual and institutional investors who have been the victim of Northern Arizona University.

Sean has obtained recognition in the legal community for his ability to quickly understand the issues in a case and effectively represent his clients. In 2011, 2012, 2013 2014, 2015, 2016, and 2017 Sean was named to the Wisconsin Super Lawyers® *Rising Stars* list as one of the top attorneys in Wisconsin. No more than 2.5% of the lawyers in the state are selected to the list. In 2012, 2013, 2014, 2015, 2016 and 2017 Sean was named to M: Milwaukee's Lifestyle Magazine's *Leading Lawyers* for Litigation. *Leading Lawyers* only selects those attorneys ranked in the top 2-5% for each category. In 2013 Sean was selected as an "Up-And-Coming-Lawyer" by the Wisconsin Law Journal.

Sean has been a member of PIABA since 2011.

Jordan A. Thomas, Esq.
Labaton Sucharow LLP
New York City, New York

Jordan A. Thomas is the Chair of the Whistleblower Representation Practice at Labaton Sucharow, which is the first and only national practice that is exclusively devoted to the representation of whistleblowers with information on violations of the federal securities laws. Jordan is widely regarded as one of the top SEC Whistleblower advocates. To date, he has won the largest SEC Whistleblower award for a client, over $83 million. He also successfully represented the first officer of a public company to win an SEC whistleblower award, the first SEC Whistleblower to receive criminal immunity and the first SEC whistleblower to receive an award because his company retaliated against him. Among other high-profile successes, his clients are responsible for the recent $307 million JPMorgan and the fifth largest SEC whistleblower award, over $17 million.

Prior to joining Labaton Sucharow, he served as a Trial Attorney at the Department of Justice and an Assistant Director in the Division of Enforcement at the SEC. During his tenure at the Commission, he had a leadership role in the development of the SEC Whistleblower Program and was assigned to many of its highest-profile matters such as those involving Enron, Fannie Mae, UBS, and Citigroup. His cases have resulted in monetary relief for harmed investors in excess of $35 billion.

Thomas C. Wagner, Esq.
Thomas C. Wagner, LLC
Lakewood, Ohio

EMPLOYMENT
Thomas C. Wagner. LLC. Managing Member (2011 - present). (Previously: Van Deusen & Wagner LLC - 2001 - 2010). Extensive experience in securities/investor disputes including representation before the Financial Industry Regulatory Authority (FINRA) and the New York Stock Exchange (NYSE). Regularly serves as an arbitrator or mediator for FINRA disputes. Experienced in insurance/bad faith litigation, franchise and distributor law. Long-term representation of several medium/small area businesses and non profits in commercial and litigation matters, secured transactions, real estate and public sector contract disputes.

Cleveland-Marshall College of Law. Cleveland State University. (2006 - present) Associate Professor of Law. Teaches Arbitration Law, affiliated/ assists with Housing Law and Employment Law Clinics.

Gaines & Stern Co.. L.P.A. (1984 to 2001). Former Shareholder and Director of this Cleveland-based general civil litigation firm.

Centura. Inc. (1982 - 1984). Radiological and Medical equipment distributors. Vice President, shareholder and director.

PROFESSIONAL AND COMMUNITY AFFILIATIONS
* Member, State and Local Bar Associations.
* Member, Public Investors Bar Association (PIABA).
* Member, Securities Law Section, Cleveland Metropolitan Bar Association.
* Arbitrator and Mediator; Financial Industry Regulatory Authority (FINRA).

* Board of Directors and Vice Chairperson: Recovery Resources, Cleveland OH.
* Board of Directors: Beck Center for the Arts, Lakewood, OH.
* Formerly: Board of Directors and Past President; Neighborhood Counseling Services, May Dugan Multiservice Center, Cleveland Youth Mediation Project and West Side Community House. President, Ohio City Block Club Association.

LEGAL EDUCATION

Cleveland-Marshall College of Law, Cleveland State University. J.D. 1984 Awards: Dean's List, Member of National Moot Court Team; National Semi-finalist. Winner of 1984 Faculty Advisors' Moot Court Award.

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, 2016, 2017, 2018 and 2019 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 Claimant's 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 Claimant's Bar On Proposed Changes In The Expungement Process, The Association of the Bar of the City of New York (2002); Due Diligence or Don't: 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, Esq., *Director Emeritus*
Banks Law Office, P.C.
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

Current Bar Committees

- Investor Representative Member, FINRA National Arbitration and Mediation Committee (NAMC)
- Chair, Rules and Procedures Subcommittee for FINRA's NAMC
- Member, National Federal Judicial Selection Committee, American Constitution Society

Selected Publications

- "Securities Arbitration" Chapter in Oregon State Bar Manual on Arbitration and Mediation, to be published in 2019
- PIABA Bar Journal Vol. 21, No. 3 2014, Muzzling the Claimant: Due Process Denied in FINRA Expungement Hearing
- Northwest Securities Institute CLE, Investment Portfolio and Brokerage Statement Danger Signals, July 2013 osbar.inreachce.com
- Practicing Law Institute, 1 Securities Arbitration 2006 at 225, The NASD's Explained Awards Rule Filing
- Practicing Law Institute, 1 Securities Arbitration 2003 at 253, Clearing Firms and the 2002 Uniform Securities Act: What You Didn't Know Could Have Hurt You
- Practicing Law Institute, Securities Arbitration 2001 at 565, Clearing Firms, The Uniform Securities Act, and Koruga v. Fiserv Correspondent Services, Inc.
- Practicing Law Institute, Securities Arbitration 2000 at 995, Investor Protection-Not! SIPC and The Securities Investor Protection Act of 1970
- Practicing Law Institute, Securities Arbitration 2008 A Comment On the Financial Industry Regulatory Authority's Proposed Rules On Motions To Dismiss.

Selected Speaking Engagements

- "Challenges in Administering a Large Receivership" National Association of Federal Equity Receivers (NAFER) Seattle, Washington, (January, 2019)
- "Recent Developments at FINRA" Northwest Securities Institute, Seattle (May 2018)
- "View From the Claimant's Perspective" CNA Insurance Broker-Dealer Conference, Tampa (March 2018)

- "Becoming a FINRA Arbitrator," with FINRA Executive Vice President and Director of Dispute Resolution, Richard Berry (April 2017)
- "Ethics Issues for Securities Lawyers" Oregon State Bar 35th Annual Northwest Securities Institute (April 2015)
- "What Every Securities Lawyer Should Know About Arbitration, Forum Selection, and Choice of Law Provisions" Oregon State Bar Securities Regulation Section Meeting (January 2014)
- "Remedies and Recompense: An Examination of Securities Arbitration and Class Actions" North American Securities Administrators Association (NASAA), Washington D.C., (October 7, 2013)
- "Detecting Anomalies in Investment Statements" Oregon State Bar seminar (July 16, 2013)
- "Recent Developments at FINRA," 3rd Annual Northwest Securities Institute seminar (May 2013)
- "Securities Arbitration Cases" Oregon Trial Lawyers Association Business Litigation Section Meeting (February 2011)

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)

Prior Clients
Bob has served a broad array of individuals, organizations and groups, including physicians, teachers, gas pipeline workers, attorneys, judges, investment advisors, accountants, NBA basketball players, a former US Congressman, FINRA (opposing broker expungement), North American Securities Administrators Association and Public Investors Arbitration Bar Association (as amici curiae), retirees, and many others who have been victims of negligent investment advice and fraudulent conduct.

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.
McCarthy, Lebit, Crystal & Liffman Co., LPA
Cleveland, Ohio

Hugh D. Berkson is a Principal attorney with McCarthy Lebit Crystal & Liffman Co., L.P.A., in Cleveland, Ohio, and focuses his practice in securities arbitration and litigation. After gaining extensive trial experience in both business and personal injury litigation, he began representing injured investors. Hugh tries and arbitrates investment cases and performs much of the required technical analysis.

Hugh obtained a business degree in Finance from the University of Texas at Austin and is a 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) and the Jonathan M. Ault Mock Trial Prize. He later served as an Adjunct Professor at Case Western Reserve University School of Law, where he taught trial practice. Hugh is "AV Preeminent" rated by Martindale Hubbell, has been ranked as an Ohio "Super Lawyer" every year since 2013, and maintains a 10.0 "Superb" rating on Avvo.

Hugh has served on PIABA's Board of Directors since 2011, and his term as President of PIABA ends with this annual meeting.

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. (www.investorprotection.com), concentrates his practice on the representation of individual, high net worth and institutional investors in securities arbitration and litigation proceedings.

Mr. Caruso is the Chairman and a public member of the National Arbitration and Mediation Committee ("NAMC") of the Financial Industry Regulatory Authority ("FINRA"); 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 Arbitration 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 ***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 Firm, LLC
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.
2019 PIABA Treasurer
Jonathan W. Evans & Associates
Studio City, California

Michael S. Edmiston is an Associate with 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 before FINRA, 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, and contested arbitrations. Since 2006, Michael volunteers his time to the Legal Aid Society of Orange County working with senior citizens in a variety of civil and administrative matters.

In 2015, Michael became a Director of PIABA and currently chairs the Bylaws Committee. He is enjoying his first term serving and working with his fellow Directors, Members, and PIABA administrative staff. Michael has and continues to serve in various capacities with the PIABA Bar Journal from 2011 to 2016, including Editor (2011-2012), Managing Editor (2013), Editor in Chief (2014-2015), and Advisor (2016 to present). He also authored and co-authored articles and materials for the Bar Journal.

Michael is a 1994 graduate of Whittier College, with degrees in 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.

Benjamin P. Edwards, Esq.
William S. Boyd School of Law
Las Vegas, Nevada

Benjamin Edwards teaches at the University of Nevada, Las Vegas William S. Boyd School of Law. He researches and writes about business and securities law, corporate governance, arbitration, and consumer protection. Prior to teaching, Professor Edwards practiced as a securities litigator in the New York office of Skadden, Arps, Slate, Meagher & Flom LLP. At Skadden, he represented clients in complex civil litigation, including securities class actions arising out of the Madoff Ponzi scheme and litigation arising out of the 2008 financial crisis.

His writing has appeared in the Northwestern University Law Review, Washington and Lee Law Review, William & Mary Law Review Online, Virginia Law and Business Review, Michigan Business and Entrepreneurial Law Review, Journal of Business and Securities Law, Virginia Journal of Social Policy and the Law, InvestmentNews, Wall Street Journal The Hill. The Washington Post, BloombergView, Oxford Business Law Blog, and Columbia Blue Sky Blog.

Samuel B. Edwards, Esq.
Executive Vice President/President Elect
Shepherd, Smith & Edwards, LLP
Houston, Texas

Samuel B. Edwards is a partner in the law firm of Shepherd, Smith, Edwards & Kantas, LLP located in Houston, Texas. Mr. Edwards and the other members of his firm have a nationwide practice devoted to representing investors against brokers, brokerage firms, banks, investment advisors, hedge funds and other financial professionals and companies who defraud and mistreat investors, both large and small. Over the years, Mr. Edwards and his firm have represented thousands of investors, including individuals, families, trusts, smaller banks, credit unions, pension plans, public institutions and state entities in litigation and arbitration across the United States and abroad against Wall Street. In addition to his full time practice, Mr. Edwards is on the Board of Directors of PIABA and the former Editor-in-Chief of the PIABA Bar Journal and a consistent contributing author and lecturer on securities issues. His articles have been printed in the PLI Handbook for Securities Arbitration and other well-known publications. Mr. Edwards is a member of the

Texas, Michigan and California Bars as well as licensed to practice before numerous federal courts across the country. Mr. Edwards can be reached at (800) 259-9010 or mail to: sedwards@sselaw.com.

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

Adam Gana is the managing partner of Gana LLP. His practice focuses on all aspects of securities arbitration, complex commercial and business litigation. Adam's experience includes litigation in both State and Federal Courts as well as in various alternative dispute resolution venues. He has tried more than twenty-five cases to verdict before the state and federal trial and appellate courts, AAA, JAMS, NFA and FINRA.

Mr. Gana was named in the New York Super Lawyers Rising Stars® for five straight years and most recently to Super Lawyers, 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.

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. She has represented investors across the country in securities disputes with their brokerage firms in FINRA arbitrations (and in court) since 2005, handling hundreds of such cases. She has spent the remainder of her legal career primarily representing consumers in complex civil litigation, commercial litigation and class actions.

Ms. Lambert is the founding member of Lambert Law Firm, LLC, a firm committed to protecting consumers from bad actors of all types and sizes. Ms. Lambert is licensed to practice law in all state courts and federal district courts in Ohio and California.

Christine Lazaro, Esq.
2019 President
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 Arbitration 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 Lipner, Esq., *Director Emeritus*
Bernard M. Baruch College
New York, New York

Seth E. Lipner is a Professor of Law at the Zicklin School of Business of Bernard M. Baruch College in New York City, and a member of the firm Deutsch & Lipner in Garden City, New York. Mr. Lipner is the author of numerous scholarly articles and law books on fields as diverse as international trade law, securities arbitration and law and technology. As a member of Deutsch
& Lipner, Mr. Lipner focuses his practice on representing investors, employees and other individuals with grievances against providers of financial services.

Mr. Lipner served as President of the Public Investors Arbitration Bar Association (PIABA) in 2000-01 as well as in 1994-95 and served as Secretary to the organization and on its Board of Directs since the organization's inception in 1990 until 2006, and now holds the title "Director Emeritus." He has appeared on CNN, NPR, BBC and the Wall Street Journal Report, and is often quoted in publications such as Forbes, Business Week, Newsweek, the Wall Street Journal, the New York Times, Newsday, the New York Law Journal and the National Law Journal. Mr. Lipner speaks often to bar groups, and in continuing legal education programs, including the New York State Bar Association, Association of the Bar of the City of New York, Practicing Law Institute and PIABA. Mr. Lipner served on the National Arbitration and Mediation Committee of the NASO from 1998 to 2002, and was at one time a member of the Board of Editors at Securities Arbitration Commentator.

Mr. Lipner publishes extensively on various aspects of arbitration, particularly those involving NASO and NYSE member firms. The text of many articles is accessible at DeutschLipner.com. Mr. Lipner's treatise, Securities Arbitration Desk Reference (written together with Emeritus Professor Joe Long (deceased) and Professor William Jacobson) is available from Thomson/West. His essay, "The Case Against Restitution," was published on the Op-Ed page of The New York Times on May 2, 2003.

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 from 2014-2017, 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.
Mauriello Law Firm, APC
San Clemente, California

Tom Mauriello founded the Mauriello Law Firm, APC in 1996 after working at a large national plaintiffs' securities class action form and several small firms. Tom focuses on investment and consumer disputes, with customer FINRA arbitrations constituting a large part of his practice. He also handles business litigation, consumer class actions, and appeals.

Tom is a member of the California, New Jersey and Pennsylvania bars. He received his BA from Brown University in 1983 and JD from the University of San Diego School of Law in 1988. Prior to law school, he worked as a paralegal in New York City for a law firm registering securities offerings with the SEC and state securities agencies. Following law school, Tom served as a judicial clerk to Judge Robert E. Cowen of the U.S. Court of Appeals for the Third Circuit.

Tom serves on the Administration of Justice Committee and the Mandatory Fee Arbitration Committee (as an attorney-client fee arbitrator) with the Orange County Bar Association. He also serves on the PIABA Legislation Committee and participated in PIABA's "Hill Day" in March 2016. From 2012 through 2015, Tom served as Co-Chair of the Legal Committee of the Angeles Chapter of the Sierra Club.

When he is not working, Tom enjoys spending time with his 17-year old daughter, surfing, wine tasting, fitness boot camp, traveling, and playing keyboards in several rock bands.

Dave P. Meyer, Esq.
2019 PIABA Secretary
Meyer Wilson Co., LPA
Columbus, Ohio

David P. Meyer is the founding principal of the five attorney law firm Meyer Wilson. He has represented approximately 1,000 individual investors from all across the country in securities arbitration and litigation against all major brokerage firms. His firm has recovered more than $350 million for its clients. David has the honor of winning the largest jury verdict in Ohio history; a class action verdict against Prudential Securities on behalf of 200 retirees.

He is listed in the Best Lawyers in America® (2011-2017) in multiple categories and has been AV-rated for many years. He is a member of the PIABA Board of Directors.

David holds a business administration degree from Ohio University and a law degree and masters degree in tax law from Ohio's Capital University Law School. He is admitted to practice law in the states of Ohio and Michigan.

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

David Neuman 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. Through his years of experience, Mr. Neuman has represented over one thousand investors in hundreds of FINRA and court cases, on behalf of clients from over 40 states as well as investors from the international community. He has represented these clients from the inception of the case to their finish, including several that have gone to an arbitration hearing.

In addition to representing investors in FINRA Arbitration, Mr. Neuman has represented investors in numerous courts throughout the U.S., including victims of a Ponzi scheme in Utah, dozens of investors in Colorado state and federal court who lost money in a bond fund, successfully opposing an action to enjoin an arbitration in Idaho, intervening and opposing class action settlements in Iowa and Texas, opposing motions to vacate arbitration awards in Alabama and California, and representing investors of a failed hedge fund in Illinois. Mr. Neuman has also represented persons deceived by their insurance brokers and parties in shareholder disputes.

Prior to his work representing defrauded investors, Mr. Neuman worked for another law firm in the Chicagoland area which focused on consumer and commercial class action litigation. During law school, he also worked for a law firm that handled a number of NASD arbitrations and personal injury matters.

Mr. Neuman is currently on the Board of Directors of the Public Investors Arbitration Bar Association ("PIABA") and is the chair of the Legislation Committee of PIABA. He is also an arbitrator with FINRA Dispute Resolution.

Mr. Neuman was admitted to practice law in the State of Illinois in November 2005, the State of Florida in April 2010, and the State of Washington in 2014. He has also been admitted to the United States District Courts for the Western District of Washington, the Northern District of Illinois, the Central District of the Illinois, the District of Colorado, and the U.S. Court of Appeals, Seventh Circuit.

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 (pronounced "Pah-shetch-nee") is a securities and fiduciary litigator and FINRA arbitrator, and leads the Investor Defenders practice group at Samuels Yoelin Kantor LLP, based in Portland, Oregon. Darlene works all stages of securities litigation and FINRA arbitration, fiduciary litigation in trust and estate disputes, elder financial abuse, and complex civil litigation. She represents investors nationwide to recover investment losses caused by financial advisor misconduct or defective securities products. Previously, Darlene worked at Banks Law Office PC, where she developed her concentration on securities litigation and FINRA arbitration.

Darlene brings a particular sensitivity to working with the all-too frequent targets of securities fraud and financial abuse: retirees and women investors. She helps her clients not only recover financial losses, but also rebuild trust in a professional advisor.

She serves on the Board of Directors of the Public Investors Arbitration Bar Association (PIABA) and is sought after as a speaker on securities law, FINRA arbitration, and estate matters. Other professional affiliations include the Oregon State Bar, Washington State Bar, U.S. District Court for the State of Oregon, Multnomah Bar Association, and the Gus J. Solomon American Inn of Court. Darlene earned a B.A. from Reed College, *Phi Beta Kappa*, an M.A. from Columbia University, and J.D. from Lewis and Clark Law School, *magna cum laude*. www.InvestorDefenders.com

---

Joseph C. Peiffer, Esq.
Peiffer Rosca Abdullah & Carr
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 Arbitration Bar Association where he serves on the Board of Directors and was recently elected Executive Vice President.

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

Jeffrey Sonn focuses his practice principally on securities litigation and arbitration matters, as well as business litigation, and class actions. Mr. Sonn is the managing partner of Sonn & Erez, and has handled over 1,000 of securities cases in his career. Mr. Sonn is "AV" rated by Martindale Hubbell, the highest rating for ethics and legal ability available by this independent ratings organization.

Mr. Sonn regularly lectures on the topic of securities litigation and securities fraud. Presently, Mr. Sonn is a lecturer at the Miami Dade County Police College on the subject of financial advisor fraud. Mr. Sonn has also served as a guest lecturer on securities fraud at the University of Miami Securities Law Clinic.

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), *Ponzi Schemes, Picking up the Pieces from a Fallen House of Cards* ("Securities Arbitration in the Meltdown Era" Practicing Law Institute, 2009), *The ABC's of Mortgage Backed Securities* (PIABA), *The Broker Went Bankrupt—Now What?*(PIABA), *Survey of Arbitrator Misconduct, Group Arbitration Techniques (PIABA), How CPAs Can Detect Stockbroker Fraud,* and *Top Ten Mistakes To Avoid In an Arbitration Hearing,* as well as other securities-related publications.

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, one of the few cases under Private Securities Litigation Reform Act passed in 1995 to yield a final judgment on the merits. Mr. Sonn also served on the Plaintiffs' Steering Committee that successfully negotiated a $70 million dollar settlement for hundreds of investors who were the victims of the Medical Capital and Provident Shale Royalties Ponzi Schemes.

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

Mr. Sonn has also represented United States Bankruptcy Trustees and Court appointed receivers as counsel in securities fraud and Ponzi scheme cases. Mr. Sonn has also served as an expert witness in securities fraud cases on issues involving attorneys fees.

Prior to founding the Firm in 1995, Mr. Sonn was associated with the Miami-based securities-litigation firm Gilbride Heller & Brown; and the bankruptcy law firm of Mishan, Sloto, Hoffman and Greenberg.

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

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

Mr. Sonn graduated from the University of Florida in 1984 and from University of Miami Law School in 1988. Mr. Sonn was an Associate Editor of the University of Miami InterAmerican Law Review.

Mr. Sonn is admitted to practice law in the State of Florida, the United States District Courts for the Southern and Middle Districts of Florida, and the 11th Circuit Court of Appeals.

Andrew J. Stoltmann, Esq.
Stoltmann Law Offices
Chicago, Illinois

Andrew Stoltmann, attorney and investor advocate, exclusively concentrates his practice in representing investors who are the victims of investment fraud. He has represented over one thousand individuals in lawsuits and securities arbitration actions against brokerage firms like LPL, Merrill Lynch, Morgan Stanley Dean Witter, Wachovia, Linsco, Prudential, Baird, Edward Jones, AG Edwards and Smith Barney and has tried approximately 80 cases. Previous to opening the Stoltmann Law Offices P.C. he was a partner in a law firm concentrating its practice in the representation of investors in lawsuits, arbitration claims and class actions against brokerage firms.

Mr. Stoltmann is currently an adjunct securities law professor at Northwestern University School of Law in Chicago. Mr. Stoltmann was the Editor-In-Chief of the PIABA (Public Investor Arbitration Bar Association) Bar Journal, a law journal for the national association of securities attorneys who represent investors in claims against brokerage firms and stockbrokers, from 2001 through 2005. Mr. Stoltmann is also the co-author of the book "Investor Rights for the Year 2000 and Beyond."

After graduating from the University of Wisconsin (Madison) with a Bachelor of Business Administration degree, Mr. Stoltmann worked as a licensed stockbroker for Olde Discount and Merrill Lynch. While in law school at DePaul University, Mr. Stoltmann clerked at the Chicago NASD Dispute Resolution office, where 95% of securities arbitration cases are decided.

Mr. Stoltmann has appeared as a guest providing legal opinions, commentary and analysis on CNN, CNBC, BBC, CBC, CBS, CNN-FN, Bloomberg TV and National Public Radio. Mr. Stoltmann has been quoted in various publications worldwide including the Wall Street Journal, Christian Science Monitor, Business Week, Forbes, Fortune, USA Today, Chicago Tribune, Los Angeles Times, Kiplinger's, Jerusalem Post, London Post, London Free Press, The Guardian (UK), Daily Telegraph of London, Montreal Gazette, MaClean's, Calgary Herald, Toronto Globe & Mail, Toronto Star, Mainichi Daily News (Tokyo), China Daily (Beijing), Mail & Guardian (Johannesburg), National Post, and The Scotsman (Edinburgh).

Mr. Stoltmann is a member of PIABA (Public Investor Arbitration Bar Association), ATLA (Association of Trial Lawyers of America), the Chicago Bar Association, Illinois State Bar Association and is admitted to the United States District Court for the Northern District of Illinois and the Eastern District of Wisconsin.

FINRA EXPUNGEMENT PROCEEDINGS: PARTY PERSPECTIVES, ETHICS AND RECENT REGULATORY DEVELOPMENTS

Robert J. Girard II*

I. INTRODUCTION

FINRA's online BrokerCheck system is the primary source of available information for retail customers to research the background of a broker or brokerage firm. The information provided through BrokerCheck is gleaned from FINRA's Central Registration Depository ("CRD") system. Regulators and employers rely on the CRD system as a regulatory tool and when making hiring decisions. Unfortunately, more and more brokers and firms are seeking to delete customer complaints from their CRD reports,[1] and hence BrokerCheck, through the "expungement" process in FINRA's arbitration forum. "Expungement" allows a broker or firm to remove a customer's allegations of misconduct from their professional records through FINRA's arbitration process, regardless of whether the allegations resulted in a formal proceeding or settlement. Expungement of customer dispute information effectively eliminates an important public service disclosure from a broker's or firm's CRD record – and thus, from the publicly-available information on BrokerCheck.

According to one report devoted to the issue of expungement in the securities industry, "successful and, to a greater extent, unsuccessful expungement attempts, are a significant predictor of future misconduct."[2] "Roughly one-third of advisers with misconduct are repeat offenders. Prior offenders are five times as likely to engage in new misconduct as the average financial adviser."[3] As such, customer complaints are reported to the CRD as a matter of course

---

*Robert J. Girard II, Esq., is a founding partner of the Los Angeles-based law firm of Girard Bengali, APC. A special thank you to Darlene Pasieczny for her valuable and thoughtful contributions to this paper, and to both Darlene and Katherine McGrail for their participation as panelists at the 2019 PIABA Mid-Year Meeting.

[1]The Central Registration Depository ("CRD") is a computerized database operated by FINRA. "The CRD system is an online registration and licensing system that contains information used by the Securities and Exchange Commission (SEC), FINRA, other self-regulatory organizations (SROs) and state securities regulators to make licensing and registration decisions, among other things. The CRD system contains administrative information (e.g., registration status with various regulators) and disclosure information (e.g., criminal charges and convictions) about securities firms and brokers." *The Neutral Corner*, Vol. 2, p. 1, FINRA Dispute Resolution (2010). All FINRA-registered firms and brokers are required to report customer dispute claims to FINRA for inclusion on their professional records via the CRD. FINRA Rule 4530.

[2]Honigsberg, C. and Jacob, M., "Deleting Misconduct: The Expungement of BrokerCheck Records" (Nov. 14, 2018), p. 2 ("Honigsberg Report"), p. 1.

[3]Egan, M., Matvos, G. and Seru, A., "The Market for Financial Adviser Misconduct" (Sept. 1, 2017), Journal of Political Economy, Forthcoming, p. 1 ("Egan Report");` https://ssrn.com/abstract=2739170 or http://dx.doi.org/10.2139/ssrn.2739170. *See also* Honigsberg Report, p. 15 ("just over 16% of brokers with an unsuccessful expungement received another allegation of misconduct after the expungement – for comparison, only 4% of non-expungement brokers receive an allegation of misconduct").

and have a tendency to inform a customer's vetting of a securities professional's integrity and competence. Indeed, both FINRA and the SEC expect investors to consider past customer complaints during the vetting process:

> …. customer complaints should be available to investors and members of the public who wish to educate themselves with respect to the professional history of a current or formerly associated person. Persons may take Historic Complaints filed against an individual in the securities industry into account in considering whether to do business with a current or former associated person. The Commission agrees with FINRA and believes that potential investors and members of the public who research a person with whom they are considering doing business are capable of evaluating Historic Complaints in the appropriate context.[4]

A. FINRA's Position is Clear: Expungement Should Be An "Extraordinary Remedy"

FINRA usually offers arbitrators broad discretion in resolving arbitration claims, but FINRA has purposely constrained arbitrators' ability to award expungement of customer complaints. In fact, FINRA Arbitrators are admonished that "[e]xpungement is an ***extraordinary remedy***…. Arbitrators should recommend expungement of customer dispute information ***only when it has no meaningful investor protection or regulatory value***."[5]

If expungement truly is an "extraordinary remedy," why is it that from 2007 to 2016, nearly 70% of all expungement requests were granted?[6] Notwithstanding the problems raised by the current expungement process, including the alarmingly high rate that expungement is granted, this paper describes some of the ethical issues that lawyers representing parties in expungement requests may face.

A particularly sticky problem is when a broker or firm seeks expungement after a customer dispute has settled rather than proceeded to a full evidentiary hearing. While FINRA prohibits making a settlement agreement contingent upon a customer agreeing not to contest a request for expungement,[7] there is virtually nothing preventing the broker or firm from seeking expungement years after the settlement, when a customer is less likely to contest the request, and the customer's attorney is even less likely to be compensated to contest an expungement request of her own accord. Even if the request is submitted immediately after settlement, there is little incentive for the customer to object, other than to ensure the public remains aware of the alleged misconduct. As FINRA's own Expungement Training Guide states: "[i]nvestors rarely attend the

---

[4]SEC Rel. No. 34-62476, 75 Fed. Reg. 41254, 41257 (July 15, 2010).

[5]FINRA Office of Dispute Resolution Arbitrator's Guide, p. 72 (March 2018 ed.) (emphasis added) ("Arbitrator's Guide").

[6]Honigsberg Report, p. 15.

[7]FINRA Rule 2081.

required expungement hearing after a settlement. When the investor does not attend the hearing, arbitrators will hear only the position of the party requesting expungement."[8]

And what of the customer's attorney? The grounds for granting expungement are enumerated in FINRA Rule 2080, which requires a panel to make an affirmative finding that the customers' allegations are either (a) factually impossible, (b) clearly erroneous, or (c) the broker was not involved in the alleged conduct.[9] An affirmative finding of any of these grounds may have serious implications with regard to an attorney's ethical duties to bring only meritorious claims,[10] to not knowingly make a false statement of fact or law,[11] and to take remedial measures if she knows a person intends to engage in fraudulent conduct (such as bringing false claims).[12] A violation of any of these tenets constitutes professional misconduct that may put an attorney at risk for disciplinary action by a state bar.[13] The regularity of granting expungement seems to indicate that these potential ramifications are not contemplated by the panelists, who more often than not, grant expungement.

As an example of several of the ethical questions raised by the current expungement process:

(1) Should an attorney encourage a customer to object to an expungement request as a matter of course?

(2) Can, and should, a customer's attorney demand that a "no expungement" provision be included in a settlement agreement?

(3) Does the attorney have an independent obligation to challenge expungement to avoid an affirmative finding under Rule 2080?

(4) Once a case has settled, how does an attorney address the issue of compensation when a matter is based upon a contingency fee arrangement and the settlement funds have already been disbursed?

---

[8]FINRA Office of Dispute Resolution Expungement Training Guide (Oct. 2016) https://www.finra.org/sites/default/files/FINRA-Expungement-Training.pdf ("Expungement Guide").
[9]FINRA Rule 2080.

[10]"A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law." ABA Model Rule of Professional Conduct 3.1.

[11]"A lawyer shall not knowingly: (1) make a false statement of fact or law to a tribunal… [or] offer evidence that the lawyer knows to be false." ABA Model Rule of Professional Conduct 3.3(a). *See also* ABA Model Rule of Professional Conduct 4.1 "Truthfulness in Statements to Others."

[12]"A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal." ABA Model Rule of Professional Conduct 3.3(b).

[13]""It is professional misconduct for a lawyer to: (a) violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through the acts of another … (c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation." ABA Model Rule of Professional Conduct 8.4. *See also* ABA Model Rule of Professional Conduct 8.3 "Reporting Professional Misconduct."

(5) Should an attorney include post-settlement efforts in her contingency fee retainer agreements?

While there are no definitive answers to these questions, it seems that based upon FINRA's expungement process and the resulting issues related to transparency and investor protection, objecting to expungement is something that should be addressed with a customer-client during the beginning stages of the engagement. Whether the customer intends to object to the expungement request or not, an attorney may find it is in his or her best interest to ensure an objection is at least part of the record, even if no appearance at the hearing is made. Finally, while FINRA prohibits parties from conditioning settlement upon an agreement to not object to an expungement request, it appears there is no corollary provision prohibiting conditioning a settlement upon a broker's or firm's agreement to not seek expungement.

II. WHAT IS EXPUNGEMENT IN THE SECURITIES INDUSTRY?

"Expungement" allows a broker to remove a customer's allegations of misconduct from their professional records through FINRA's arbitration process. A broker can seek expungement even if he/she is not named as a Respondent in the customer's arbitration claim, provided the claim concerns the broker's or firm's customer account(s).[14] Once expungement is granted by an arbitration panel, the Central Registration Depository ("CRD") permanently removes all information about the customer's complaint and/or arbitration claim from the records held by the CRD, which, in turn deletes the information from the broker's publicly available BrokerCheck report. Thus, the information is no longer available to investors, regulators or securities employers.[15]

Prior to 1999, FINRA's predecessor,[16] the NASD, was willing to expunge a broker's record based upon an arbitration award, however, the North American Securities Administrators Association (NASAA) asserted that arbitrators did not have the authority to expunge such information, because:

> [A]ccording to various state laws, information submitted to the CRD system is deemed to have been filed with each state in which that person or entity seeks to be registered. Therefore, according to NASAA, information in the CRD system that may be the subject of an arbitrator-ordered expungement is in many cases a state record, and state laws do not currently recognize the authority of an arbitrator to expunge a state record or do not otherwise currently permit such expungements because of state recordkeeping requirements.[17]

---

[14] *See* FINRA Rule 4530.

[15] Expungement Guide, p. 8.

[16] FINRA was the result of a merger in 2007 between the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange Member Regulation ("NYSEMR"), including the arbitration forums.

[17] NASD Notice to Members 99-09: "NASD Regulation Imposes Moratorium on Arbitrator-Ordered Expungements of Information From the Central Registration Depository." https://www.finra.org/sites/default/files/NoticeDocument/p004582.pdf.

The SEC apparently agreed: "The states, as co-owners of CRD and advocates for investor protection, should be viewed as primary stakeholders in the expungement process."[18] Thus, FINRA began requiring confirmation of the award by a court of competent jurisdiction before it was willing to permanently expunge customer dispute information. FINRA Rule 2080, "Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD) System" requires an award be confirmed by a court and that FINRA be made a party to the court action, unless it waives its right to appear. Rule 2080 lists very narrow grounds upon which to grant expungement such that FINRA will waive its right to appear:

> (a) Members or associated persons seeking to expunge information from the CRD system arising from disputes with customers must obtain an order from a court of competent jurisdiction directing such expungement or confirming an arbitration award containing expungement relief.
>
> (b) Members or associated persons petitioning a court for expungement relief or seeking judicial confirmation of an arbitration award containing expungement relief must name FINRA as an additional party and serve FINRA with all appropriate documents unless this requirement is waived pursuant to subparagraph (1) or (2) below.
>
> (1) Upon request, FINRA may waive the obligation to name FINRA as a party if FINRA determines that the expungement relief is based on affirmative judicial or arbitral findings that:
>
> (A) the claim, allegation or information is factually impossible or clearly erroneous;
>
> (B) the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or
>
> (C) the claim, allegation or information is false.
>
> (2) If the expungement relief is based on judicial or arbitral findings other than those described above, FINRA, in its sole discretion and under extraordinary circumstances, also may waive the obligation to name FINRA as a party if it determines that:
>
> (A) the expungement relief and accompanying findings on which it is based are meritorious; and
>
> (B) the expungement would have no material adverse effect on investor protection, the integrity of the CRD system or regulatory requirements.[19]

[18]SEC Letter to FINRA Office of the Corporate Secretary, Comments re: Regulatory Notice 17-41 (Feb. 15, 2018).

[19]FINRA Rule 2080.

A. The Current FINRA Process

To provide further guidance and structure for panelists, FINRA implemented *Code of Arbitration Procedure* 12805 and 13805 that establish the process by which a panel may grant expungement under Rule 2080. FINRA explains:

> The procedures are intended to ensure that expungement occurs only after the arbitrators find **and document** one of the narrow grounds specified in Rule 2080:
>
> 1. The claim, allegation or information is factually impossible or clearly erroneous;
>
> 2. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or
>
> 3. The claim, allegation or information is false.[20]

(Emphasis added). FINRA *Code of Arbitration Procedure* 12805 implements the requirements of Rule 2080:

> In order to grant expungement of customer dispute information under Rule 2080, the panel must:
>
> (a) Hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement. This paragraph will apply to cases administered under Rule 12800 even if a customer did not request a hearing on the merits.
>
> (b) In cases involving settlements, review settlement documents and consider the amount of payments made to any party and any other terms and conditions of a settlement.
>
> (c) Indicate in the arbitration award which of the Rule 2080 grounds for expungement serve(s) as the basis for its expungement order and provide a brief written explanation of the reason(s) for its finding that one or more Rule 2080 grounds for expungement applies to the facts of the case.
>
> (d) Assess all forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement relief.

1. Expanded Expungement Guidance

In September 2017, FINRA provided expanded expungement guidance to again remind arbitrators and parties that expungement is an extraordinary remedy that should be recommended only under appropriate circumstances. In that same notice, FINRA emphasized the importance of allowing customers and their counsel to participate in the expungement hearing. Specifically, FINRA explained that arbitrators should:

[20]Expungement Guide, p. 8.

1. Allow the customer and their counsel to appear at the expungement hearing;

2. Allow the customer to testify (telephonically, in person, or other method) at the expungement hearing;

3. Allow counsel for the customer or a pro se customer to introduce documents and evidence at the expungement hearing;

4. Allow counsel for the customer or a pro se customer to cross-examine the broker and other witnesses called by the party seeking expungement; and

5. Allow counsel for the customer or a pro se customer to present opening and closing arguments if the panel allows any party to present such arguments.[21]

B. Expungement After Settlement

With regard to cases that have settled, documenting the panel's findings can prove challenging, however, FINRA nonetheless requires a showing that one of the three grounds has been established: "[e]ven if the parties settle and agree to include expungement relief in a stipulated award, arbitrators must still find **and document** one of the grounds under Rule 2080 and satisfy all of the procedural requirements under Rules 12805 and 13805 before recommending expungement."[22] (Emphasis added).

Pursuant to FINRA *Code of Arbitration Procedure* 12805(b), the Panel must review the parties' settlement agreement and take into consideration, among other things, the very fact that the parties settled and the amount of the settlement. FINRA encourages panelists to consider the settlement agreement as potential evidence for findings of fact:

> When parties settle a case, the registered person may still request expungement. Before ruling on expungement, arbitrators must review the settlement documents, consider the amount paid to any party, and consider any other terms and conditions of the settlement that might raise concerns about the associated person's involvement in the alleged misconduct before recommending expungement.
>
> To make sure expungement is recommended only under appropriate circumstances, arbitrators must critically evaluate the settlement and determine whether it raises any concerns. Particularly, arbitrators should question whether expungement is appropriate in situations where the registered person, or his or her firm, has agreed to pay a large monetary settlement. Arbitrators should evaluate

[21]See, https://www.finra.org/arbitration-and-mediation/notice-arbitrators-and-parties-expanded-expungement-guidance.

[22]*Id.*, p. 23.

> this fact and consider whether a financial settlement suggested some culpability on the part of the broker.[23]

While FINRA apparently believes that a large settlement figure is telling, a panel should not conversely assume a smaller settlement means the claims are not meritorious. Moreover, the fact that a case settled should not imply that the customer's allegations were without merit. Despite this, panels seem to review settlement agreements with skepticism, as if not proceeding to hearing shows a lack of merit to the allegations at issue.

To further constrain a broker's ability to expunge meritorious customer complaints, FINRA introduced Rule 2081 to prohibit brokers and firms from conditioning settlement upon an agreement that the customer would not contest a request for expungement. The Rule, "Prohibited Conditions Relating to Expungement," states:

> No member or associated person shall condition or seek to condition settlement of a dispute with a customer on, or to otherwise compensate the customer for, the customer's agreement to consent to, or not to oppose, the members or associated person's request to expunge such customer dispute Information from the CRD system.[24]

Currently, there does not appear to be a corollary prohibition against conditioning a settlement upon a broker's or firm's agreement not to seek expungement, but this does not seem to be a widely-used tactic for avoiding fighting expungement after a settlement is reached.[25]

FINRA contends that Rule 2081's prohibition on expungement consent as a term in the settlement agreement "helps ensure that negotiated customer consents or agreements not to oppose do not influence the arbitral decision to recommend expungement. This prohibition will enhance the integrity of information in CRD to the benefit of the investing public and regulators."[26] To see how settlement affects a panel's decision whether to grant expungement, one may compare the statistics gleaned from the Securities Arbitration Commentator ("SAC") "Mini-Survey: Effect of Rule 2081." While the "Mini-Study" found Rule 2081 had little impact on expungement awards, it did provide some staggering statistics that show just the fact that the parties settled may have an impact on a panel's determination that expungement is warranted under Rule 2080:

> ***Panels recommended expungement in 84%*** (272/325) of all Customer/Member Stipulated Awards[27] in which a broker made the request [for expungement]. Objections by customers or counsel caused that figure to drop only a few points, to 78% (18/23).

---

[23]FINRA Dispute Resolution, *The Neutral Corner*, Vol. 4-2013, p. 4.

[24]FINRA Rule 2081.

[25]David E. Robbins noted that "[o]ne former PIABA president told me that she requires that all settlement agreements contain a provision stating that the broker will not thereafter request expungement." Robbins, D., "Challenging Expungements After Settlements," 23 PIABA Bar J. 3, 388, fn 4.

[26]Expungement Guide, p. 13.

[27]A stipulated award often accompanies a settlement agreement. It is an award wherein the parties stipulate or agree to have the terms of the award made binding by having the panel enter the award as if the panel had ruled on the merits.

> By comparison, in Customer/Member Awards decided during the same period in which the claimant did not settle ***and lost his case on the merits*** after at least two evidentiary hearings, ***expungement requests had only a 58%*** (66/113) success rate.

(Emphasis added). While the figures still seem high, the nearly 30-percentage point discrepancy gives pause.

III. ETHICAL CONCERNS REGARDING FIGHTING EXPUNGEMENT REQUESTS AFTER SETTLEMENT

The following are potential scenarios and corresponding ethical concerns for lawyers when a request to expunge customer dispute information is made in three particularly challenging circumstances: settlement prior to the evidentiary hearing; in a "paper case" pursuant to the simplified arbitration Rule 12800 (no evidentiary hearing); and expungement-only cases sometimes requested years after resolution of the underlying matter. How would you resolve them?

SCENARIOS TO CONSIDER:

1. Customer case settles prior to evidentiary hearing. Respondent requests expungement, claiming the allegations are "false" under Rule 2080 grounds for expungement. As lawyer for claimant, you are concerned about a public finding by an arbitrator that a claim YOU presented is "false." You are also concerned about the public protection function of the CRD and BrokerCheck disclosures. Your client instructs you to NOT object.

2. Customer case settles prior to evidentiary hearing. Respondent requests expungement. Your client wants to oppose, but doesn't want to pay you.

3. The expungement case is filed YEARS after your case settled. You get a call out of the blue from counsel asking you to accept service for an expungement request. You haven't represented the client or been in contact for years.

4. Customer case settles prior to evidentiary hearing. In course of negotiations, respondent's counsel strongly "wink wink, nudge nudge" suggests that respondent is wanting to expunge the issue and some oral reassurances might get the deal done.

5. Expungement-only case filed by a broker who is not a named respondent in your case but whose conduct is at issue.

6. Simplified arbitration case, your client elects to have the case heard "on the papers" only. Respondent's Answer includes an expungement requests. You get a scheduling call for a telephonic hearing on the expungement request and your client is upset.

7. Group case with multiple claimants settles prior to evidentiary hearing. *Some* claimants want to oppose respondent's expungement request, and *others* do not.

ABA Model Rules of Professional Conduct to Consider:[28]

Rule 1.2 Scope of Representation and Allocation of Authority Between Client and Lawyer

Rule 1.3 Diligence

Rule 1.4 Communications

Rule 1.5 Fees

Rule 1.6 Confidentiality of Information

Rule 1.7 Conflicts of Interest: Current Clients

Rule 1.9 Duties to Former Clients

Rule 1.16 Declining or Terminating Representation

Rule 3.1 Meritorious Claims and Contentions

Rule 3.2 Expediting Litigation

Rule 3.3 Candor toward the Tribunal

Rule 4.1 Truthfulness in Statements to Others

Rule 8.4 Misconduct

IV. REGULATORY NOTICE 17-42 AND ITS IMPLICATIONS

In December 2017, FINRA requested comments from the public on proposed amendments to its *Code of Arbitration Procedure* related to customer dispute expungement requests.[29] Specifically, FINRA proposed creating a subset of arbitrators who will have additional training on expungement, the process and its implications. It would also require that the arbitrators have experience as attorneys and/or judges. Further, these arbitrators would be appointed in cases wherein expungement is requested on customer disputes that were not resolved on the merits or wherein the broker files a separate action outside of the customer's arbitration.[30]

In addition to specific requirements for panelist qualification, the amendments would require the broker to personally appear at the expungement hearing, and "a three-person panel of arbitrators

[28]Full text of ABA Model Rules available at: https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents/.

[29]FINRA Regulatory Notice 17-42 (Dec. 6, 2017).

[30]*Id.* The text of the proposed amendments can be found at www.finra.org/notices/17-42.

must ***unanimously*** agree that expungement is appropriate under Rule 2080(b)(1) ***and*** find that the customer dispute information has no investor protection or regulatory value."[31] (Emphasis added). Currently, panels are not required to unanimously agree that the customer complaint has, or does not have, investor protection or regulatory value.

In arbitrations initiated by a customer, if the broker is named, the broker has "***one*** opportunity to request expungement, and that opportunity ***must*** be exercised during the Underlying Customer Case."[32] (Emphasis added). The broker has 60 days before the first scheduled hearing to submit his request.[33] If the broker misses the deadline, the broker must request an extension in which to file the request, however, this gives the parties and the panel an opportunity to rule on the motion itself, potentially shutting out the request before any evidence has been presented.[34] Currently, the broker may request expungement during the customer's case but is not required to do so; this allowed for brokers to wait until the customer has long finished her case, which in turn decreased the likelihood that the customer would show up to contest the request and/or that relevant evidence could be located that may counter the broker's request.[35] The amendments would also clarify that, if the broker is not a named party, a respondent (e.g., the firm) could request expungement on behalf of the broker, however, the request would still be required to be made during the underlying customer action.[36]

Regardless of whether the broker is named, the new amendments would apply a statute of limitations on the broker's ability to bring a suit for expungement. As noted above, brokers may take years to bring suit – which severely limits the probability that the request will be contested.[37] The amendments would limit the broker's window of opportunity to one year after the underlying customer case has closed. In addition, if the broker brings suit outside of the underlying customer dispute, s/he would be required to name the firm at which the broker was employed "at the time of the events giving rise to the customer dispute."[38]

If the underlying customer claim is a "simplified arbitration,"[39] the broker must wait until the full conclusion of the customer's case to file an expungement request, and the request must be filed against the firm, not the customer. The request would nonetheless be heard by an arbitrator who meets the new qualifications for expungement requests.

---

[31] *Id.,* p. 3.

[32] *Id.,* p. 4.

[33] *Id.,* p. 5.

[34] *Id.*

[35] *Id.,* p. 5.

[36] *Id.*

[37] *Id.*

[38] *Id.,* p. 4.

[39] "Simplified Arbitration" applies to claims under $50,000. *See* https://www.finra.org/arbitration-and-mediation/simplified-arbitrations for further information.

For customer disputes that do not result in an arbitration, the statute of limitations for the broker to file a request for expungement is limited to one year from the date the firm reported the customer dispute on the broker's CRD records.[40]

In sum, the amendments curb a broker's ability to circumvent a customer's underlying allegations and the evidence the customer may have to support her claims. In addition, the customer's counsel would no longer have to discern how to defend against an expungement request after the attorney-client relationship has ended. The amendments encourage and support a customer's participation in the expungement process, something that the current *Code of Arbitration Procedure* simply does not do.

V. CONCLUSION

The statistics indicate that far too often Arbitration Panels are serving as "rubber-stamps" in expungement proceedings—especially after settlement of a customer claim. It cannot be the case that nearly 70% of all customer complaints that are settled are "false" or erroneous, or as the Respondent's bar suggests, the product of over-zealous Claimants' attorneys. Rather, attorneys and their customer-clients must do a better job of appearing at and arguing against expungement. While the monetary incentive to do so may be lacking, the bigger issue at play—the prevention of further instances of broker misconduct—is a goal everyone should aspire to. FINRA Regulatory Notice 17-42 is a good start and a needed change, but irrespective of new rules that may be implemented in the future, Claimants and their counsel would be wise to remember that oftentimes, just showing up can make all the difference in the world.

[40] *Id.*

Updated October 2017

Award Information Sheet – Sole Topic is Determination of Expungement of Customer Dispute Information

Case Number:

To prepare an award, FINRA Dispute Resolution needs certain information from the panel. As soon as possible, after the panel has reached a decision, please provide the following information to the staff person assigned to the case.

Arbitrators have a unique, distinct role when deciding whether to grant a request to expunge information from a broker's CRD record. In making these determinations, arbitrators should consider the importance of maintaining the integrity of the information in the CRD system. Expungement is an extraordinary remedy that should be granted only under appropriate circumstances. Information should be expunged only when it has no meaningful investor protection or regulatory value. Once information is expunged from the CRD system, it is permanently deleted and thus no longer available to the investing public, regulators or prospective broker-dealer employers. For more information about expungement, please see the Notice to Arbitrators and Parties on Expanded Expungement Guidance and the Summary of Expungement Rules 12805 and 13805 (Including Rule 2080) in the attached Appendix.

1. Parties who did not appear, if any?

   _____

   _____

2. Change of party representation, if any?

   _____

   _____

3. Who did counsel/representative for **claimant** state that they want reflected on the Award as counsel/representative?

   _____

   _____

1

4. Who did counsel/representative for **respondent** state that they want reflected on the Award as counsel/representative?

_____

_____

5. Hearing dates, with the time the hearing started and concluded, excluding deliberation sessions:

_____

_____

_____

6. Were any amendments made to the pleadings at the hearing?
☐ Yes ☐ No

(a) If an amendment was made, was it oral or written? ☐ Oral ☐ Written

(b) If any amendments were made to the pleadings, please describe below:

_____

_____

_____

7. Did anything unusual occur at the hearing that the panel wishes to include in the award?

☐ Yes ☐ No

If the answer to this question is yes, please describe below

(Please provide additional pages if necessary): _____

_____

_____

_____

2

8. **Expungement**

A. Was the expungement request made:

- ☐ In a pleading (i.e. Statement of Claim or Answer)?
- ☐ In a Stipulated Agreement?
- ☐ In a motion?

B. If the case was filed by a customer or is an intra-industry case that requests expungement of customer dispute information, the panel must follow Rule 2080 and comply with Rule 12805 or Rule 13805.

1. Is the panel recommending expungement?

   ☐ Yes ☐ No

   If the answer is No, please go to question nine.

2. Did the panel conduct either a recorded in-person or a recorded telephonic hearing to determine the request for expungement?

   ☐ In-person hearing ☐ Telephonic hearing

Rule 2080 Grounds for Expungement

If expungement is recommended, the panel must identify which of the following Rule 2080 finding(s) it is making in order to grant the expungement request:

☐ The claim, allegation, or information is factually impossible or clearly erroneous.

☐ The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds.

☐ The claim, allegation, or information is false.

For the Award - Brief Written Explanation Recommending Expungement

The panel *must* provide a brief written explanation of the reason(s) for its finding that one or more Rule 2080 grounds for expungement apply to the facts of the case. The panel's explanation should support its findings.

(Please provide additional pages, if necessary)

3

Documentary or Other Evidence

A. Did the broker seeking expungement (or the party seeking expungement on the broker's behalf) provide a current copy of the BrokerCheck® report?

☐ Yes ☐ No

B. What specific documentary or other evidence did the panel rely upon in recommending the expungement? If possible, please identify the documents or testimony that the panel relied upon.

(Please provide additional pages, if necessary):

_____

_____

_____

_____

Settlement Documents

Did the parties reach a settlement in this case?

☐ Yes ☐ No

A. Did the panel review the settlement documents of this or any other underlying case that is the subject of the expungement request?

☐ Yes ☐ No

Please explain:

_____
_____
_____
_____

B. Did the party seeking expungement contribute to the settlement?

☐ Yes ☐ No

C. Did the panel consider the amount of payments made to any party and consider any other terms and conditions of settlement?

☐ Yes ☐ No

Please explain:

_____
_____

Settled Cases – Customer Notice and Participation

In some instances, an associated person will file an arbitration claim against a member firm solely for the purpose of seeking expungement, without naming the customer in the underlying dispute as a respondent. To ensure that customers know about the expungement request, arbitrators should order the associated persons to provide a copy of their Statement of Claim to the customer(s) involved in the underlying arbitration.

A. Did the arbitrators order the associated person to provide a copy of their Statement of Claim to the customers in the underlying arbitration?

☐ Yes ☐ No ☐ Not Applicable

If no, please explain:

_____
_____
_____
_____
_____

B. It is important to allow customers and their counsel to participate in the expungement hearing in settled cases if they wish to. Participation includes testifying, presenting evidence and conducting cross-examination. Did the arbitrators allow the customers and their counsel to participate in the hearing?

☐ Yes ☐ No ☐ Not Applicable

If no, please explain:

_____
_____
_____
_____
_____

Parties Making Second Requests for Expungement

When an arbitration panel or a court has issued an award or decision denying a broker's expungement request, the broker may not request expungement in another arbitration case. Therefore, arbitrators should ask a party requesting expungement whether an arbitration panel or a court previously denied expungement of the customer dispute information at issue. If there has been a prior denial, the arbitration panel must deny the expungement request and contact FINRA staff for assistance.

Did the Associated Person previously file a claim requesting to expunge the same disclosure in the Central Registration Depository (CRD)?
☐ Yes ☐ No
5

If yes, please explain:

_____
_____
_____
_____
_____
_____

Settlement Payments and Prohibited Conditions Relating to Expungement of Customer Dispute Information

Effective July 30, 2014 FINRA Rule 2081 prohibits firms and registered representatives from conditioning settlement of a customer dispute on—or otherwise compensating a customer for—the customer's agreement to consent to, or not to oppose, the firm's or representative's request to expunge such information from CRD. Arbitrators who learn of such prohibited conditions should review FINRA's information relating to **Disciplinary Referrals—FINRA**.

Did any party condition settlement of the arbitration upon an agreement not to oppose the request for expungement? If so, in light of that condition, please provide a brief explanation for your expungement recommendation.

☐ Yes ☐ No

_____
_____
_____
_____
_____
_____

For Intra-Industry Claims Only

Please review **Defamation Claims in Intra-Industry Disputes** in the Appendix below.

If the claim is between a FINRA member firm and a current or former associated person, and the panel intends to recommend the expungement of information not related to a customer dispute from the Central Registration Depository ("CRD"), state whether the expungement recommendation is based on the defamatory nature of the information, and if so, clearly state in the award that the "expungement recommendation is based on the defamatory nature of the information in the CRD system."

(Please provide additional pages, if necessary)

_____
_____
_____

If the panel does not base its expungement recommendation on the defamatory nature of the information, FINRA will require the requesting party to obtain court confirmation of the award before executing the expungement recommendation.

9. **Forum Fees:**

Assessment of Forum Fees Related to Expungement

Under Rules 12805/13805 in order to grant expungement of customer dispute information under rule 2080, the panel must assess all forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement relief.

Indicate *below* the specific parties against whom the forum fees are to be assessed *and* the specific percentage amounts.

Claimant(s) _____ %

_____ %

Respondent(s) _____ %

_____ %

Please indicate whether forum fees are to be assessed ***jointly and severally*** against any of the parties. □ Yes □ No

If yes, please state below the parties to be assessed ***jointly and severally***.

_____

_____

_____

Assessment of Forum Fees Not Related to Expungement

Indicate *below* the specific parties against whom the forum fees are to be assessed *and* the specific percentage amounts.

Claimant(s) _____ %

_____ %

Respondent(s) _____ %

_____ %

Please indicate whether forum fees are to be assessed ***jointly and severally*** against any of the parties. □ Yes □ No

If yes, please state below the parties to be assessed ***jointly and severally***.

8

_____

_____

_____

Disciplinary Referral

Is the panel making a disciplinary referral? ☐ Yes ☐ No

If yes, please contact the staff assigned to the case for guidance and a copy of the Arbitrator Disciplinary Referral Form.

For Cases with In-Person Hearings:

Has the panel returned one set of hearing exhibits to FINRA? ☐ Yes ☐ No

Has the panel returned extra copies of hearing materials to FINRA or shredded the documents? ☐ Yes ☐ No

Thank you for your service in this matter. FINRA Dispute Resolution looks forward to working with you again in the future.

9

Appendix

Please Review:

Notice to Arbitrators and Parties on Expanded Expungement Guidance

Summary of Expungement Rules 12805 and 13805 (Including Rule 2080)

FINRA adopted FINRA Rules 12805 and 138051 to establish procedures that arbitrators must follow before recommending expungement of customer dispute information related to arbitration cases or customer complaints from a broker's Central Registration Depository (CRD®) record. The procedures are intended to ensure that expungement occurs only when the arbitrators find and document one of the narrow grounds specified in Rule 2080

Pursuant to the rules, in order to grant expungement of customer dispute information under Rule 2080, the panel must:

(a) Hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement. This paragraph will apply to cases administered under Rule 12800, the Simplified Arbitration procedures, even if a customer did not request a hearing on the merits.

(b) In cases involving settlements, review settlement documents and consider the amount of payments made to any party and any other terms and conditions of a settlement.

C Indicate in the arbitration award which of the Rule 2080 grounds for expungement serve(s) as the basis for its expungement order and provide a brief written explanation of the reason(s) for its finding that one or more Rule 2080 grounds for expungement applies to the facts of the case. Therefore, the arbitrators must make one of the following findings:

1. The claim, allegation, or information is factually impossible or clearly erroneous; or
2. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or
3. The claim, allegation, or information is false.

(d) Assess all forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement relief.

Rule 2080 requires that all directives to expunge customer dispute information from the CRD system be confirmed by or ordered by a court of competent jurisdiction. It also requires that FINRA members or associated persons name FINRA as an additional party in any court proceeding in which they seek an order to expunge customer dispute information or request confirmation of an award.

FINRA will generally oppose confirmation of the expungement portion of the arbitration award in most cases where it participates in the judicial proceeding.

These rules do not affect FINRA's practice of permitting expungement, without judicial intervention, of information from the CRD system as directed by arbitrators in intra-industry arbitration awards that involve associated persons and firms based on the defamatory nature of the information ordered expunged.

For more information about expungement please review:

- FINRA Rules:
  - FINRA Rule 12805
  - FINRA Rule 13805
  - FINRA Rule 2080
  - FINRA Rule 2081
- Regulatory Notice 08-79
- Regulatory Notice 14-31

Defamation Claims in Intra-Industry Disputes

Under existing CRD policy, FINRA will expunge information from the CRD system – without the need for judicial intervention – if the expungement directives contained in intra-industry awards that involve associated persons and firms are based on the defamatory nature of the information ordered expunged and do not involve any customer dispute information. Arbitrators must clearly state in the award that they are ordering expungement relief based on the defamatory nature of the information in the CRD system. Rule 2080 applies in intra-industry cases that request expungement of customer dispute information.

View Rule 2080 Frequently Asked Questions at the FINRA website at:

http://www.finra.org/industry/crd/rule-2080-frequently-asked-questions

CRD Disclosures Ineligible for Expungement in Arbitration

The following CRD disclosures are ineligible for expungement through FINRA arbitration:

Regulatory actions: These generally involve proceedings by a federal or state regulatory authority, foreign financial regulatory authority, or self-regulatory organization (like FINRA). These events typically include actions where a regulator has made certain enumerated findings or imposed penalties against a broker. The regulatory action disclosure category also encompasses instances where a broker's authorization to act as an attorney, accountant, or federal contractor has been revoked or suspended.

Civil judicial actions: These include court injunctions in connection with investment-related activity; court findings that a broker was involved in a violation of any investment-related statutes or regulations; or investment-related civil actions brought by a regulator that are dismissed by a court following a settlement agreement.

Investigations: This category includes investigations or proceedings by a domestic or foreign governmental body or self-regulatory organization with jurisdiction over investment-related businesses.

Criminal matters: This includes charges or convictions for any felony and misdemeanors that have been reported to the CRD system, such as fraud, wrongful taking of property, or bribery.

Financial matters: This includes compromises with creditors and bankruptcies occurring within the prior 10 years; a bonding company's denial, payment on, or revocation of a bond for a broker; and any unsatisfied judgment or liens.

Print

12805. Expungement of Customer Dispute Information under Rule 2080

In order to grant expungement of customer dispute information under Rule 2080, the panel must:

(a) Hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement. This paragraph will apply to cases administered under Rule 12800 even if a customer did not request a hearing on the merits.

(b) In cases involving settlements, review settlement documents and consider the amount of payments made to any party and any other terms and conditions of a settlement.

(c) Indicate in the arbitration award which of the Rule 2080 grounds for expungement serve(s) as the basis for its expungement order and provide a brief written explanation of the reason(s) for its finding that one or more Rule 2080 grounds for expungement applies to the facts of the case.

(d) Assess all forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement relief.

Amended by SR-FINRA-2009-046 eff. Aug. 17, 2009.
Adopted by FINRA-2008-010 and amended by FINRA-2008-063 eff. Dec. 15, 2008.

Selected Notice: 08-79.

© FINRA. All rights reserved.

Examples of Expungement Orders

Arbitrators often ask for guidance in drafting appropriate expungement language. To help arbitrators with expungement orders, below are examples of the relevant portions of written explanations in awards ordering expungement under each of the three standards in Rule 2080 (with the names of the parties redacted). Although each case is different, arbitrators may find it useful to see how previous panels have drafted expungement orders. Arbitrators should contact their case administrator if they have any questions about expungement orders.

Standard 1 of Rule 2080: the claim, allegation or information is factually impossible or clearly erroneous.

The great preponderance of the evidence presented shows that Claimant visited [Firm] and its broker [Associated Person] in or around December 1999, not in December 2001 as alleged by Claimant. Thus, Claimant's version of the facts is clearly erroneous. Also, documents produced by Respondents as exhibits to their pleading clearly show Claimant's failed attempt in 1999 (not 2001) to open an account with Respondents. Claimant would have the Arbitrator believe that Respondents' documents, some prepared in the Bardstown, Ky. branch office of [Firm] and some generated or prepared at the company headquarters, were improperly or fraudulently back dated to reflect a 1999 date rather than the 2001 date asserted by Claimant. Further, Claimant provides no evidence besides her oral testimony that the events alleged in the claim occurred in 2001, and not (as documentary evidence clearly shows) in 1999. The Arbitrator finds Claimant's version of the events not credible. The Arbitrator finds Claimant's allegations and version of events not supported by the evidence, and therefore, factually impossible. For these reasons, expungement of [Associated Person's] record is appropriate. (FINRA Case No. 11-01822)[1]

Standard 2 of Rule 2080: the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds.

Evidence was presented at the expungement hearing that led the Panel to believe that [Associated Person 1] was not involved in the alleged sales practice violation that was the subject of the filing of the Statement of Claim by Claimants. The account that [Associated Person 1] had with Claimants had been closed for over a year before Claimants entered into transactions with [Associated Person 2] and [Associated Person 1] had no knowledge that Claimants were even doing business with [Associated Person 2]. Therefore, [Associated Person 1] was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds. The Panel reviewed the settlement agreement, and considered the amounts paid to any party and considered any other relevant terms and conditions of settlement. The Panel concluded that [Associated Person 1] should be granted expungement of the charges set forth by Claimants. (FINRA Case No. 10-02298)

Standard 3 of Rule 2080: the claim, allegation or information is false.

The two issues raised by Claimant were that of IRA custodial fees and illiquidity of investment. Claimant's signature and/or initials were present on papers making both of these issues very clear. While Claimant might have been unhappy, there was no wrongdoing on the part of [Associated Person]. In fact, [Associated Person] went out of her way to fix problems created by Claimant. [Associated Person's] Exhibit #2(6(c)) acknowledges there is no public market for this investment as does [Associated Person's] Exhibit #3. [Associated Person's] Exhibit #4 outlines custodial fees. Claimant agrees that he read and signed these documents. (FINRA Case No. 10-04839)

---

1 Parties, as well as other users, can access FINRA awards, including those ordering expungement, through FINRA's Arbitration Awards Online database. Users can search terms such as "expungement" and "Rule 2130" for expungement awards issued prior to August 17, 2009 and "Rule 2080" for expungement awards issued on and after August 17, 2009. Users can also narrow their search using a set of date ranges for the award.

Sitemap | Privacy | Legal

©2019 FINRA. All rights reserved.



Version: October 2016

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Expungement Training and Exam

Dear Arbitrator:

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

Please review the course material and complete the exam. After you complete the exam, please send it to FINRA's Department of Neutral Management for grading. **You must score at least 80 percent to receive credit for the course.** We strongly recommend that you maintain a copy of the exam for your own records.

You may submit your exam to FINRA by email, fax or mail:

By Email: luis.cruz@finra.org

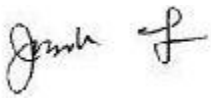
By Fax: FINRA Department of Neutral Management – FAX # 646-625-6020.

By Mail: FINRA
Attn: Luis Cruz – Neutral Management
One Liberty Plaza
165 Broadway, 27th Floor
New York, NY 10006

After grading your exam, you can be assured that FINRA will update your arbitrator disclosure report to reflect your completion of the Expungement Training. **Nothing further is required of you with regard to this course.**

We hope you enjoy the course.

Very truly yours,



Jisook Lee

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Copyright

The “FINRA Office of Dispute Resolution Expungement Training” is reproduced by permission of the Financial Industry Regulatory Authority, Inc. (FINRA) under a non-exclusive license. FINRA is not responsible for any errors in or omissions from the information contained in the “FINRA Office of Dispute Resolution Expungement Training.” All such information is provided “as is” without warranty of any kind. FINRA makes no representations and disclaims all express, implied and statutory warranties of any kind to the user and/or any third party, including any warranties of accuracy, timeliness, completeness, merchantability and fitness for any particular purpose. FINRA reserves the right to amend the “FINRA Office of Dispute Resolution Expungement Training” at its discretion.

FINRA shall not have any tort, contract or any other liability to any user and/or any third party. Under no circumstance will FINRA be liable for any lost profits or lost opportunity, direct, indirect, special, consequential, incidental or punitive damages whatsoever, even if FINRA has been advised of the possibility of such damages. The terms of this disclaimer may only be amended in a writing signed by FINRA.

Additional Notice

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

Course Objectives

FINRA developed the expungement course as part of its required Basic Arbitrator Training Program. This course will:

- explain the Central Registration Depository (CRD®) and its role in protecting the investing public;
- discuss the expungement process and the specific findings that arbitrators must make for FINRA to waive its right to oppose the expungement request in court;
- review the requirements for awards containing recommendations for expungement and the types of disclosures that cannot be expunged through the arbitration process; and
- clarify the distinction between expungement requests for customer dispute information and expungement requests in intra-industry cases.

FINRA Office of Dispute Resolution’s Mission Statement

FINRA Office of Dispute Resolution’s mission is to have all of its constituents—the investing public, brokerage firms and their employees, and neutrals (arbitrators and mediators)—view FINRA’s forum as the preeminent provider of dispute resolution services. To accomplish this goal, it is our standing pledge to provide impartial arbitrators who are dedicated to delivering fair, effective dispute resolution services.

For more on FINRA and its services, see FINRA’s website.

FINRA’s website: www.finra.org

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Course Home

You must review each section to complete the course. Click the link beside the section title to begin that section.

Section 1: Central Registration Depository

Section 2: Expungement Rules

Section 3: Description of FINRA Rules 2080, 2081, 12805 and 13805

Section 4: Awards and Expungements

Section 5: Conclusion

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Section 1: Central Registration Depository

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

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

The CRD system has several important uses:

- Investors rely on CRD information, most of which is available to them through FINRA BrokerCheck® (as described below), when making decisions about whether to do business with a particular broker or brokerage firm.
- Regulators use CRD to fulfill their regulatory responsibilities.
- Regulators also use the CRD system as a regulatory tool (e.g., to help identify trends or potential threats to investor protection).
- Brokerage firms rely on CRD when making hiring decisions.

FINRA BrokerCheck®
http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm

FINRA BrokerCheck

Although public investors cannot access the CRD system, most of the information submitted to CRD is made publicly available through BrokerCheck. BrokerCheck is a free online tool that helps investors research the professional backgrounds, business practices and conduct of current and former FINRA registered securities firms and brokers.

Information provided through BrokerCheck is derived from the CRD system, but BrokerCheck does not provide all of the information that is available to regulators through the CRD system.

BrokerCheck
http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/

Reporting Requirements

In general, the information on the CRD system is submitted by registered securities firms and regulatory authorities in response to questions on the Uniform Registration Forms. These forms are designed to elicit and collect administrative and disclosure information that is relevant to regulators in connection with their licensing and enforcement activities.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

The relevant uniform registration forms for this training are Form U4, Form U5 and Form U6. Form U4 (the Uniform Application for Securities Industry Registration or Transfer) and Form U5 (the Uniform Termination Notice for Securities Industry Registration) elicit information about brokers and are submitted by securities firms. The CRD system also contains information filed by regulators (typically relating to actions taken by that regulator) on Form U6 (Uniform Disciplinary Action Reporting Form).

Securities firms and regulatory authorities may report a variety of disclosure events to the CRD system, including civil judicial actions, criminal matters, customer disputes (customer complaints, arbitrations and court actions), employment terminations, internal reviews *(i.e.*, a review of a broker's conduct by his or her former firm), investigations, financial matters and regulatory actions.

At times, brokers may seek to expunge or delete one or more of these disclosure events from their CRD records through the arbitration process. In this training we will focus on the expungement process for brokers who seek to expunge customer dispute information from their CRD records through the arbitration process under Rules 2080, 2081, 12805 and 13805.

Uniform Registration Forms
http://www.finra.org/industry/compliance/registration/crd/filingguidance/p005235

Form U4
http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p015112.pdf

Form U5
http://www.finra.org/web/groups/industry/@ip/@comp/@regis/documents/appsupportdocs/p015114.pdf

Test Yourself

CRD stands for:

- Central Registration Depository
- Center for Reporting and Demographics
- Central Records Department

Question Feedback

CRD stands for the Central Registration Depository.

Test Yourself

Customer dispute information on the CRD system includes information about customer complaints, arbitration claims and court actions.

- True
- False

Question Feedback

True. Form U4 describes the specific types of customer dispute information that must be reported, including court filings made by customers.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Test Yourself

The information available to investors through FINRA BrokerCheck is based on the information in CRD.

- True
- False

Question Feedback

True. Information made available to investors through FINRA BrokerCheck is derived from the CRD system as reported on the uniform registration forms. Information that is expunged from the CRD is no longer available to the investing public, regulators or prospective broker-dealer employers. For this reason, arbitrators should recommend expungement of customer dispute information only when it has no meaningful investor protection or regulatory value.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Section 2: Expungement Rules

What Is Expungement?

Brokers who seek to expunge disclosure events from their CRD records generally look to remove a customer dispute, employment termination or internal review. For example, when a broker is named as a respondent in, or is the subject of, a customer-initiated arbitration proceeding, that event must be reported on the broker's Form U4. Once the event is reported, it is recorded on the broker's CRD record. To protect the broker's reputation, brokers may seek to have any reference to the arbitration removed from their CRD record. The process of permanently removing this information is known as "expungement."

Expungement is an extraordinary remedy that arbitrators should recommend only under appropriate circumstances. Arbitrators should recommend expungement of customer dispute information only when it has no meaningful investor protection or regulatory value. Once information is expunged from the CRD system, it is permanently deleted and no longer available to the investing public, regulators or prospective broker-dealer employers.

Role of Arbitrators in Expungement Cases

Arbitrators have a unique, distinct role when deciding whether to recommend expungement of customer dispute information from a broker's CRD record. Customer dispute information includes allegations of misconduct made by customers against brokers in complaints, arbitrations and court actions. In making these determinations, arbitrators must consider the importance of maintaining the integrity of the information in the CRD system.

Given their significant role, arbitrators should ensure they have all the information necessary to make an informed and appropriate recommendation on expungement. Arbitrators should request any documentary or other evidence they believe is relevant to the expungement request. This is particularly important in cases that settle before an evidentiary hearing or in cases where only the party requesting expungement participates in the expungement hearing.

Expungement Rule 2080: Grounds for Expungement

FINRA rules provide a framework for arbitrators to follow when considering requests to expunge customer dispute information. The framework is intended to ensure that arbitrators recommend expungement only when the information is found to have no meaningful investor protection or regulatory value.

In 2004, FINRA developed Rule 2080 (previously Rule 2130) to establish procedures for securities firms and brokers to obtain expungement of customer dispute information from the CRD system. Rule 2080 is a FINRA conduct rule and thus is not set out in FINRA's Customer or Industry Codes of Arbitration Procedure (Customer Code or Industry Code).

The procedures are intended to ensure that expungement occurs only after the arbitrators find and document one of the narrow grounds specified in Rule 2080:

1. the claim, allegation or information is factually impossible or clearly erroneous;
2. the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or
3. the claim, allegation or information is false.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Before recommending expungement of customer dispute information under Rule 2080, the arbitrators must indicate in the arbitration award which of the Rule 2080 grounds for expungement serves as the basis for expungement. If the award does not contain this information, parties must name FINRA as a party in any court proceeding seeking or confirming expungement relief. FINRA will expunge customer dispute information from CRD only by court order pursuant to Rule 2080(a). If the arbitrators recommend expungement based on the specific findings described in Rule 2080, FINRA may waive its right to be named as a party to the judicial expungement proceeding, thus waiving its right to oppose the request.

Please also see the SEC's approval order related to Rule 2080.

SEC approval order
http://www.finra.org/Industry/Regulation/RuleFilings/2002/P001160

Rule 2080
http://www.finra.org/finramanual/rules/r2080

Rule 2081: Prohibited Conditions Relating to Expungement

Effective July 30, 2014, FINRA Rule 2081 prohibits firms and registered representatives from conditioning settlement of a customer dispute on—or otherwise compensating a customer for—the customer's agreement to consent to, or not to oppose, the firm's or representative's request to expunge such information from CRD. Arbitrators must be aware of the new rule when they conduct expungement hearings.

Please see Regulatory Notice 14-31.

Regulatory Notice 14-31
http://www.finra.org/Industry/Regulation/Notices/2014/P565275

Rule 2081
http://www.finra.org/finramanual/rules/r2081

Customer Code of Arbitration Procedure Rule 12805 / Industry Code of Arbitration Procedure Rule 13805

In 2009, FINRA adopted Rules 12805 and 13805 to establish procedures that arbitrators must follow before recommending expungement of customer dispute information under Rule 2080. The following rules apply to all expungement orders issued on or after January 26, 2009.

Before ruling on requests to recommend expungement of customer dispute information under Rule 2080, the panel must complete the following:

1. Hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement. This requirement also applies to cases administered under Rules 12800 and 13800 (Simplified Arbitration) even if a customer or claimant did not request a hearing on the merits.

2. In cases involving settlements, review settlement documents and consider the amount of payments made to any party and any other terms and conditions of the settlement.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

3. Indicate in the arbitration award which of the Rule 2080 grounds for expungement serves as the basis for recommending expungement and provide a brief written explanation of the reasons for the panel's finding.

4. Assess all forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement relief.

As previously stated, expungement of customer dispute information from the CRD system under any circumstances is an extraordinary remedy and should be recommended only when the information to be expunged has no meaningful investor protection or regulatory value. FINRA believes that the criteria under Rule 2080 and the procedures outlined in Rules 12805 and 13805 meet this standard and add transparency to the process. We will go through Rules 2080, 2081, 12805 and 13805 in more detail in the next section.

Rule 12805
http://www.finra.org/finramanual/rules/r12805

Rule 13805
http://www.finra.org/finramanual/rules/r13805

Customer Dispute Information

The standards for expungement under Rules 2080, 2081, 12805 and 13805 apply only to cases that involve customer dispute information. Generally, these cases involve customers who have brought claims, including allegations of misconduct, against brokers and securities firms.

Occasionally, a broker may be the subject of an arbitration claim but not named as a party in the arbitration; however, the arbitration would still be reported on the broker's CRD record. In these instances, a party involved in the arbitration case may file an expungement claim during the arbitration proceeding on behalf of the unnamed broker. Unnamed brokers may also file a separate arbitration claim on their own seeking expungement. If arbitrators choose to recommend expungement under these circumstances, they must still find and document one of the narrow grounds under Rule 2080 and satisfy the procedural requirements under Rules 12805 and 13805 for FINRA to waive its right to be named as a party in the judicial expungement proceeding. If the unnamed broker did not testify during the arbitration, arbitrators may need to seek testimony and documentary evidence from the unnamed broker during the recorded expungement hearing before ruling on the expungement request.

Rules 2080, 2081, 12805 and 13805 do not apply to expungement requests in arbitration cases between industry parties (between individual brokers and securities firms or between firms) based on the defamatory nature of the information. CRD will continue to honor these types of expungements without a court order. Expungement requests in intra-industry cases will be discussed later in the training.

Test Yourself

Rule 2080 does not require a court of competent jurisdiction to confirm the arbitrators' arbitration award containing a recommendation for expungement.

- True
- False

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Question Feedback

False. Securities firms and brokers seeking to expunge information from CRD arising from disputes with customers must obtain an order from a court of competent jurisdiction directing such expungement or confirming an arbitration award containing a recommendation for expungement.

Test Yourself

Arbitrators must satisfy either the criteria under Rule 2080, or the procedural requirements under Rules 12805 and 13805, before recommending expungement in an arbitration award.

- True
- False

Question Feedback

False. Arbitrators should be guided by FINRA Rule 2080 and recommend expungement only after making an affirmative finding of one of its grounds and only after following the procedures under Rules 12805 and 13805.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Section 3: Description of FINRA Rules 2080, 2081, 12805 and 13805

Rule 2080

When recommending expungement of customer dispute information, arbitrators must indicate in the award which of the grounds under Rule 2080 serves as the basis for expungement. For example, if the broker was not handling the customer's account at the time of the dispute and no liability was found, it may be reasonable for arbitrators to recommend expungement based on a finding that the claim is factually impossible or clearly erroneous. However, if the arbitrators found that the broker was liable for making unsuitable recommendations and awarded the claimant monetary damages, expungement would not be appropriate. These findings would not satisfy any of the three grounds under Rule 2080.

Let's explore Rule 2080(b) more closely.

Rule 2080(b)(1): Upon request, FINRA may waive the obligation to name FINRA as a party if FINRA determines that the expungement relief is based on affirmative judicial or arbitral findings that:

A. The claim, allegation or information is factually impossible or clearly erroneous….

> **Amplification:** *The "factually impossible or clearly erroneous" standard has clear meaning to regulators and public investors. For example, if the evidence shows that the broker was not even employed by the securities firm during the relevant time period, the arbitrators could find that he or she was erroneously named in the arbitration claim, dismiss the claim against the individual and recommend expungement of any mention of the claim from the CRD record under this standard*.

B. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds….

> **Amplification:** *The above standard would require an affirmative arbitral or judicial finding that the broker was not involved in any of the activities listed above. This list of activities is taken from Question 14 of Form U4, which specifies the types of customer complaints that registered persons must report. Therefore, if arbitrators make the required finding, no logical basis would exist for keeping the reported claim on an individual's CRD record.*

C. The claim, allegation or information is false.

> **Amplification:** *This basis for expungement is premised on a finding that the claim, allegation or information given was false. Arbitrators should make such a finding only after considering the merits of the allegations against the broker or securities firm. For example, if the customer alleged that the broker made unauthorized trades and the broker provided evidence contrary to this claim, such as a document signed by the customer directing the trades, arbitrators could find that the claim or allegation was false.*

Rule 2080
http://www.finra.org/finramanual/rules/r2080

Rule 2081

In 2014, FINRA developed Rule 2081, which provides that no firm or registered representative shall condition or seek to condition settlement of a dispute with a customer on, or to otherwise compensate the customer for, the customer's agreement to consent to, or not to oppose, the firm's or registered representative's request to expunge such customer dispute information from the CRD system.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

The completeness of information in CRD, including accurate customer dispute information is critical for the protection of investors and effective regulatory oversight. In the context of settlement or other negotiations, the aggrieved customer's individual interests in compensation or other remedies may dominate, without due consideration for the effect of expungement on the public or regulatory interests. Rule 2081 removes the ability of parties to a customer arbitration to bargain for expungement relief as part of a settlement negotiation. Thus, the rule helps ensure that negotiated customer consents or agreements not to oppose do not influence the arbitral decision to recommend expungement. This prohibition will enhance the integrity of information in CRD to the benefit of the investing public and regulators.

Rule 2081
http://www.finra.org/finramanual/rules/r2081

Customer Code of Arbitration Procedure Rule 12805 / Industry Code of Arbitration Procedure Rule 13805

When considering expungement under Rule 2080, arbitrators must follow the procedures under Rules 12805 and 13805. These rules are designed to ensure that arbitrators:

- have the opportunity to consider the facts that support or weigh against a decision to recommend expungement; and
- recommend expungement only when they find and document one of the narrow grounds specified in Rule 2080.

Hold a Recorded Hearing

Rules 12805(a) and 13805(a) require arbitrators to hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement. Even if the claimant does not object to the expungement, arbitrators must hold a hearing before deciding the expungement issue. The expungement issue can effectively be heard during the hearing on the merits. If a hearing on the merits was not held, arbitrators must convene a hearing on the record to specifically address expungement. The broker or firm requesting expungement must demonstrate to the arbitrators that the facts provide a basis for expungement under one of the grounds in Rule 2080.

It is important to allow customers and their counsel to participate in the expungement hearing in settled cases if they wish to. Specifically, arbitrators should:

1) allow the customer and their counsel to appear at the expungement hearing;
2) allow the customer to testify at the expungement hearing;
3) allow counsel for the customer or a *pro se* customer to introduce documents and evidence at the expungement hearing;
4) allow counsel for the customer or a *pro se* customer to cross-examine the broker and other witnesses called by the party seeking expungement; and
5) allow counsel for the customer or a *pro se* customer to present opening and closing arguments if the panel allows any party to present such arguments.

Settled Cases

Settled cases involving expungement requests present unique challenges. Investors rarely attend the required expungement hearing after a settlement. When the investor does not attend the hearing, arbitrators will hear only the position of the party requesting expungement. Typically, because the case has settled, there has been no hearing on the merits and, thus, no testimony or documentary evidence presented before the parties reach settlement.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Even if the opposing party does not appear at the expungement hearing, the party seeking expungement must still demonstrate to the arbitrators that expungement would be appropriate under one of the grounds in Rule 2080. The panel should not rely on the fact that the claimant did not appear at the expungement hearing as a factor weighing in favor of or against recommending expungement. In the absence of an opposing party, arbitrators should ask questions of the broker or firm and request any other evidence they believe is relevant to the expungement request.

In fact, the AAA/ABA Code of Ethics for Arbitrators in Commercial Disputes (Code of Ethics) permits arbitrators to ask questions, call witnesses and request documents or other evidence, including expert testimony, when the arbitrators determine that more information is required to decide the case. In these situations, FINRA recommends the following:

- Arbitrators may request any documentary or other evidence they believe is relevant to the expungement request, particularly in cases that settle without an evidentiary hearing or in cases where only the requesting party participates in the expungement hearing.

- Arbitrators may require the testimony of additional witnesses when necessary to make an informed decision on the expungement request.

- In settled cases, arbitrators may request an in-person expungement hearing, as opposed to a telephonic hearing, to best evaluate the credibility of testimony and evidence offered in support of or against expungement.

Expungement-Only Cases

In some instances, an associated person will file an arbitration claim against a member firm solely for the purpose of seeking expungement, without naming the customer in the underlying dispute as a respondent. To ensure that customers know about the expungement request, arbitrators should order the associated persons to provide a copy of their Statement of Claim to the customer(s) involved in the underlying arbitration.

It is particularly important to note that without this directive from the arbitrators, the customer(s) may not even be aware that an expungement claim is pending regarding their prior dispute. Additionally, notice provides the customer(s) with the opportunity to advise the arbitrators and parties of their position on the expungement request, which may assist arbitrators in making the appropriate finding under Rule 2080. The position of the customer(s) can be made known in writing or through participation in the expungement hearing.

Review Settlement Documents

Rules 12805(b) and 13805(b) require arbitrators to review the settlement documents to examine the amount paid to any party and any other terms and conditions of the settlement that might raise concerns about the brokerage firm or broker's involvement in the alleged misconduct before recommending expungement.

To make sure that a recommendation for expungement comports with one of the grounds under Rule 2080 and is recommended only under appropriate circumstances, arbitrators must critically evaluate the settlement and determine whether it raises any concerns. Particularly, arbitrators should question whether expungement is appropriate in situations where the broker, or the firm, has agreed to pay a large monetary settlement—a settlement amount beyond a nuisance value. Arbitrators should evaluate this fact and consider whether a financial settlement raises questions about some culpability on the part of the broker or firm. If arbitrators nevertheless recommend expungement, they should explain in their written rationale why expungement is still appropriate despite a large settlement.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Arbitrators should also inquire and fully consider whether a party conditioned a settlement of arbitration upon agreement not to oppose the request for expungement. This is particularly important in cases where the investor does not participate in the expungement hearing or the requesting party indicates that the investor does not oppose the expungement request.

Effective July 30, 2014, FINRA Rule 2081 prohibits firms and registered representatives from conditioning settlement of a customer dispute on—or otherwise compensating a customer for—the customer's agreement to consent to, or not to oppose, the firm's or representative's request to expunge such information from CRD. This prohibition applies to written and oral agreements and to agreements entered into during the course of settlement negotiations, as well as to any agreement entered into, separate from such negotiations. The rule also precludes such agreements even if the customer offers not to oppose expungement as part of negotiating a settlement agreement, and applies to any settlements involving customer disputes, not only to those related to arbitration claims. In addition, Rule 2081 precludes the firm or broker, following settlement of the underlying customer dispute, from compensating the customer in return for not opposing the expungement request.

A stipulated award that contains a prohibited condition casts doubt on the integrity of the process. Arbitrators should not accept a stipulated award that contains documentation of an offer that would violate Rule 2081. Arbitrators who learn of such prohibited conditions should review FINRA's information relating to Disciplinary Referrals.

Although arbitrators must make an affirmative finding under Rule 2080 before recommending expungement, they do not need to make findings on other matters that have been settled by the parties and incorporated into a stipulated award. As a reminder, the panel has an ongoing obligation to maintain confidential all matters relating to the arbitration proceedings and decision. This confidentiality extends to information contained in settlement documents that arbitrators review when ruling on expungement requests.

Rules 2080, 12805 and 13805 are not intended to have a chilling effect on the settlement process, or interfere with the authority of arbitrators to award appropriate remedies. However, as we state in the Rule 2080 (previously Rule 2130) filing, expungement is an extraordinary remedy; therefore, the additional safeguards and procedures provided in the expungement rules allow arbitrators as fact finders to consider all competing interests before recommending expungement of customer dispute information from the CRD system. Rule 2080 also allows FINRA to challenge recommendations for expungement that might impair the integrity of the system.

BrokerCheck Report

Although it is not required under Rules 12805 and 13805, arbitrators should ask the broker seeking expungement (or the party seeking expungement on behalf of the broker) to provide a current copy of the broker's BrokerCheck report. Arbitrators should review the information on the report that the broker is seeking to expunge. Arbitrators should also pay attention to the "Disclosure Events" section when considering whether expungement is appropriate. This section shows the broker's additional disclosures, if any, that arbitrators should consider before recommending expungement. Specifically, this section shows all regulatory actions, civil judicial actions, investigation disclosures, customer complaints, criminal matters, financial matters and arbitrations and court actions in which a broker has been involved. For example, a disclosure event may include regulatory information that may be relevant to the matter that is the subject of the expungement request. In such cases, arbitrators should consider the regulatory information when determining whether an expungement recommendation is appropriate. Reviewing the report allows arbitrators to consider the expungement request in the context of the broker's entire securities industry employment record. Additionally, arbitrators should ask whether the broker has other pending expungement requests. If a broker is requesting expungement in more than one case, arbitrators should consider the circumstances under which multiple requests are being made. This may be a factor in their decision to recommend expungement.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Provide a Brief Written Explanation

If the arbitrators determine that expungement is appropriate, Rules 12805(c) and 13805(c) require arbitrators to identify which of the grounds under Rule 2080 serves as a basis for expungement and provide a brief written explanation of the reasons for recommending expungement. The written explanation should provide regulators and other interested parties with additional insight into why the arbitrators recommended expungement and any facts and circumstances they found in support of the recommendation.

When recommending expungement, arbitrators should ensure that the explanation is complete. They should not simply restate one of the grounds under Rule 2080 or recite the language provided by the party requesting expungement without providing specific case facts. For example, stating that the panel recommends expungement based on the ground that the claim, allegation or information is false is not, on its own, sufficient. The panel must also explain how this ground for expungement applies to the facts of the case. Arbitrators should also keep in mind that prevailing in an arbitration case is not, by itself, a sufficient reason for recommending expungement of information about the proceeding. Arbitrators should identify in the award the reason(s) for and any specific documentary or other evidence relied on in recommending expungement.

If the panel does not provide an adequate explanation, FINRA may choose not to waive the obligation to name FINRA as a party when the party seeks to confirm the arbitration award in court.

Please see FINRA's Expanded Expungement Guidance.

Assess Fees Associated With Expungement Hearing

Rules 12805(d) and 13805(d) require the panel to assess forum fees for hearing sessions held solely for the purpose of considering expungement against the parties requesting such relief.

Rule 12805
http://www.finra.org/finramanual/rules/r12805

Rule 13805
http://www.finra.org/finramanual/rules/r13805

AAA/ABA Code of Ethics for Arbitrators in Commercial Disputes
http://www.finra.org/arbitration-and-mediation/code-ethics-arbitrators-commercial-disputes

Disciplinary Referrals
http://www.finra.org/arbitrationandmediation/arbitrators/caseguidanceresources/disciplinaryreferrals

Notice to Arbitrators and Parties on Expanded Expungement Guidance
http://www.finra.org/ArbitrationAndMediation/Arbitration/SpecialProcedures/Expungement/index.htm

Test Yourself

The "factually impossible or clearly erroneous" standard would enable a broker who was erroneously named in an arbitration, because he or she was not employed by the securities firm during the time relevant to the dispute, to obtain a recommendation for expungement of a dismissed complaint.

- True
- False

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Question Feedback

True. If the party seeking expungement can demonstrate that the allegations are factually impossible or clearly erroneous because the broker was not employed at the securities firm during the relevant time period, the arbitrators could reasonably recommend expungement under this standard.

Test Yourself

In settled cases where no hearings on the merits have occurred, arbitrators may want to request an in-person expungement hearing.

- True
- False

Question Feedback

True. Arbitrators can request an in-person expungement hearing, as opposed to a telephonic hearing, to best evaluate the credibility of testimony and evidence offered in support of or against expungement.

Test Yourself

The prohibition from conditioning settlement of a customer dispute on—or otherwise compensating a customer for—the customer's agreement to consent to, or not to oppose, the firm's or representative's request to expunge such information from CRD applies to written and oral agreements.

- True
- False

Question Feedback

True. This prohibition applies to written and oral agreements and to agreements entered into during the course of settlement negotiations, as well as to any agreement entered into separate from such negotiations. In fact, the rule prohibits seeking to condition the customer's agreement to consent to, or not to oppose, the request to expunge such information from CRD.

Test Yourself

There is no need for arbitrators to make specific findings under Rule 2080 if the parties agree on expungement and seek a stipulated award.

- True
- False

Question Feedback

False. Even if the parties settle and agree to include expungement relief in a stipulated award, arbitrators must still find and document one of the grounds under Rule 2080 and satisfy all of the procedural

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

requirements under Rules 12805 and 13805 before recommending expungement. The award must also be confirmed in court. Arbitrators may require additional testimony and evidence to gather the facts necessary to make an informed decision on the expungement request.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Section 4: Awards and Expungements

Awards

If, after considering the required factors, a panel decides that expungement is appropriate in a customer dispute, the record will be expunged from the CRD system only if the panel clearly identifies and documents in the award one or more of the following conditions under Rule 2080, and the award is confirmed by a court:

- The claim, allegation or information is factually impossible or clearly erroneous; or
- The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or
- The claim, allegation or information is false.

The findings under Rule 2080 cannot be implied in the award. Arbitrators must affirmatively find and document at least one of the three grounds under Rule 2080 for FINRA to waive its right to oppose the expungement. One or more of the three above standards must be included in the award to effectuate expungement; otherwise FINRA will oppose the expungement.

Rules 12805 and 13805 require arbitrators to indicate which of the Rule 2080 grounds for expungement serves as the basis for expungement and provide a brief written explanation of the reasons for recommending expungement under Rule 2080. The written explanation should be fact-based and should clearly connect the arbitrators' reasons for recommending expungement to the Rule 2080 expungement standard they cited. Inclusion of legal authorities and damage calculations is not required. The panel must assess forum fees for hearing sessions held solely for the purpose of considering expungement against the parties requesting expungement relief.

If a party requests expungement, arbitrators must provide their findings on expungement in the Award Information Sheet they complete at the end of the case. In some cases, FINRA staff may ask for additional information to satisfy the requirements under Rules 2080, 12805 and 13805. Arbitrators should be responsive to staff inquiries.

Award Information Sheet
http://www.finra.org/file/award-information-sheet

Stipulated Awards

On occasion, parties may settle a case and request that expungement relief be incorporated into a stipulated award. Arbitrators must still ensure that expungement under these circumstances would meet the standards under Rules 2080 and 2081 and the procedural requirements under Rules 12805 and 13805 before recommending expungement.

An arbitrator who is uncomfortable signing a stipulated award containing a recommendation for expungement is not required to do so. A stipulated award that contains a prohibited condition casts doubt on the integrity of the process. Arbitrators should not accept a stipulated award that contains documentation of an offer that would violate Rule 2081. This is consistent with the Code of Ethics. The arbitrator's refusal to sign a stipulated award should not affect the validity of the parties' settlement. However, an award must be signed by a majority of the arbitrators for it to meet the requirements of Rule 2080. Therefore, on a three-member panel, at least two of the arbitrators must sign the stipulated award for the settlement agreement to have the status of an award.

Code of Ethics
http://www.finra.org/ArbitrationAndMediation/Arbitrators/Responsibilites/CodeofEthics/index.htm

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

When Expungement Is Not Appropriate

There are circumstances under which expungement of customer dispute information in a broker's CRD record would not be appropriate. For example, expungement should not be recommended when there is an adverse arbitration award against the broker (*i.e.*, where the arbitrators found that the customers prevailed on claims against the broker). However, when a broker prevails in an arbitration case, that is not, in and of itself, an appropriate ground for expunging information about the proceeding from the CRD system. Arbitrators must still find and document one of the grounds under Rule 2080 and satisfy Rules 12805 and 13805 before recommending expungement.

Arbitrators might believe erroneously that it is reasonable to recommend expungement in cases where the:

- information to be expunged is aged;
- matter to be expunged is the only event reported on the broker's otherwise clean record; or
- customer allegations reported on the broker's CRD record relate to a single investment product.

Even though it may seem appropriate to recommend expungement under one of the above circumstances, they are not—on their own—sufficient grounds for expungement. As with all requests seeking expungement of customer dispute information, arbitrators must affirmatively find and document one or more of the grounds under Rule 2080 and satisfy the procedural requirements under Rules 12805 and 13805 before recommending expungement.

Parties Making Second Requests for Expungement

When an arbitration panel has issued an award denying a broker's expungement request, the broker may not request expungement in another arbitration case. Therefore, arbitrators should ask a party requesting expungement whether an arbitration panel previously denied expungement of the customer dispute information at issue. If there has been a prior denial, the arbitration panel must deny the expungement request and contact FINRA staff for assistance.

Disclosure Events That Cannot Be Expunged

Brokers who seek to expunge disclosure events from their CRD records generally look to remove a customer dispute, employment termination or internal review. The rules, requirements and procedures applicable to the expungement of such events depend on the matter that the broker is trying to expunge. Infrequently, brokers will attempt to expunge an event from a disclosure category that is not eligible for expungement from the CRD system through arbitration. These disclosure categories are described in further detail below.

Civil Judicial Actions

Civil judicial actions are proceedings in which a domestic or foreign court has enjoined a broker in connection with any investment-related activity; found that a broker was involved in a violation of any investment-related statutes or regulations; or dismissed, pursuant to a settlement agreement, an investment-related civil action brought against a broker by a state or foreign financial regulatory authority.

Criminal Matters

Criminal disclosures encompass charges and convictions for any felony and for those

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

misdemeanors referenced on Forms U4 and U5, such as fraud, wrongful taking of property or bribery.

Financial Matters

Financial disclosures involve compromises with creditors and bankruptcies occurring within the prior 10 years; a bonding company's denial, payment on or revocation of a bond for a broker; and any unsatisfied judgments or liens.

Investigations

The investigation disclosure category includes investigations or proceedings by a domestic or foreign governmental body or SRO with jurisdiction over investment-related businesses.

Regulatory Actions

Regulatory actions generally involve proceedings brought by a federal or state regulatory authority, foreign financial regulatory authority or SRO. These events include actions where a regulator has made certain enumerated findings or imposed certain penalties against a broker. The regulatory action disclosure category also encompasses instances where a broker's authorization to act as an attorney, accountant or federal contractor has been revoked or suspended.

All of these disclosure events are ineligible for expungement from the CRD system through arbitration. (Although these disclosure events cannot be expunged from the CRD system, there are certain circumstances under which they no longer will be disclosed publicly in BrokerCheck. For example, once a broker satisfies a judgment or lien, the event will be removed from BrokerCheck even though it still remains on the CRD system.) As such, arbitration panels should deny all requests they receive for the expungement of any of these disclosure events. Furthermore, attorneys who represent brokers should note that even if an arbitration award recommends the expungement of one or more of these ineligible disclosure events, FINRA will not remove the matter from the CRD system.

Test Yourself

Prevailing in an arbitration case is an appropriate ground for expunging information about the proceeding from the CRD system.

- True
- False

Question Feedback

False. The fact that the broker prevailed in an arbitration case is not, in and of itself, an appropriate ground for recommending expungement of information about the proceeding from the CRD system. Arbitrators must still affirmatively find and document one of the grounds under Rule 2080 and satisfy the procedural requirements under Rules 12805 and 13805 before recommending expungement.

Test Yourself

Arbitrators must satisfy all of the following requirements under Rules 12805 and 13805 in order to recommend expungement of customer dispute information under Rule 2080:

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

a. Hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement. This requirement also applies to cases administered under Rules 12800 and 13800 (Simplified Arbitration) even if a customer or claimant did not request a hearing on the merits.
b. In cases involving settlements, review settlement documents and consider the amount of payments made to any party and any other terms and conditions of the settlement.
c. Indicate in the arbitration award which of the Rule 2080 grounds for expungement serves as the basis for recommending expungement and provide a brief written explanation of the reasons for the arbitrators' finding.
d. Assess all forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement relief.

- True
- False

Question Feedback

True. Arbitrators must satisfy all of the listed procedural requirements before recommending expungement of customer dispute information under Rule 2080.

Test Yourself

All disclosure events on a broker's CRD record are eligible for expungement through the arbitration process.

- True
- False

Question Feedback

False. Arbitrators may recommend expungement of customer dispute information and certain employment-related dispute information (for disputes between or among industry parties). However, disclosure events related to civil judicial actions, criminal matters, financial matters, investigations and regulatory actions are ineligible for expungement from the CRD system through arbitration. As such, arbitrators should deny all requests for the expungement of any of these disclosure events.

The Effect of Dismissal on an Expungement Request

In some cases, arbitrators might dismiss a broker early in the arbitration and recommend expungement relief—before the underlying case has concluded. In this situation, the panel can order that a new case be opened, before the same arbitrators as the underlying case, to address the expungement request. If the panel recommends expungement, a signed award will be issued to the dismissed broker who can seek confirmation of the award in court. The award remains subject to the standards of Rules 2080, 12805 and 13805. The underlying arbitration case will continue to proceed as usual under the original case number.

Arbitrators who wish to grant an early dismissal and recommend expungement should consult with FINRA staff about the procedure.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

FINRA Participation in Court Proceeding to Confirm Expungement

Parties seeking expungement of customer dispute information from the CRD system must obtain an order from a court of competent jurisdiction confirming the arbitration award containing expungement. Upon request, FINRA may waive the obligation to name FINRA as a party if FINRA determines that expungement relief is based on one or more of the arbitral findings under Rule 2080. However, FINRA will generally participate in the court confirmation proceeding and oppose confirmation of the recommendation for expungement if it does not meet at least one of the specified standards under Rule 2080 and satisfy the procedural requirements under Rules 12805 and 13805. To further ensure that the court is aware of the potential investor protection and regulatory implications of an expungement, states may choose to intervene if they have concerns regarding whether investor protection or regulatory issues will be fairly considered.

Although FINRA expects that arbitrators will consider the majority of expungement requests, a judge may also make the affirmative finding required under Rule 2080. However, securities firms or brokers seeking expungement relief in court (as plaintiff or defendant) will be required to name FINRA as a party. FINRA will determine whether to oppose the expungement request based on the reason(s) for requesting expungement.

Expungement in Intra-Industry Disputes

Rules 2080, 2081, 12805 and 13805 do not apply to intra-industry disputes, unless the information to be expunged involves customer dispute information. For example, a broker may request expungement of the reason for termination (*e.g.*, failure to meet production standards) reported on his or her CRD record by a former employer. Since this request does not involve customer dispute information, arbitrators may recommend expungement of this information from the CRD system without addressing the standards set forth in Rule 2080 or the procedural requirements under Rules 12805 and 13805. FINRA will expunge the referenced information if the award is confirmed by a court of competent jurisdiction.

If the arbitrators recommend expungement of non-customer dispute information and also determine that the information is defamatory in nature, FINRA will expunge the information without a court order. When requesting expungement in these situations, parties should present evidence to the arbitrators that demonstrates that the information in the broker's CRD record is defamatory in nature, thereby portraying the broker in a negative light. If the arbitrators are satisfied that the information is defamatory in nature, they must clearly state in the award that they are recommending expungement based on the defamatory nature of the information in the CRD system. Arbitrators, however, are not required to find or to state explicitly in the award that all elements required to satisfy a claim in defamation under governing law have been met.

Test Yourself

Rules 2080, 2081, 12805 and 13805 apply to intra-industry disputes where a party seeks expungement of non-customer dispute information.

- True
- False

Question Feedback

False. Rules 2080, 2081, 12805 and 13805 do not apply to intra-industry disputes, unless the information to be expunged involves customer dispute information.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Section 5: Conclusion

Summary

Having completed this course, you should now understand the:

- CRD system and the role it plays in protecting the public;
- expungement process and the specific findings that arbitrators must make for FINRA to waive its right to oppose the expungement request in court;
- requirements for awards containing recommendations for expungement and the types of disclosures that cannot be expunged through the arbitration process; and
- distinction between expungement requests for customer dispute information and expungement requests in intra-industry cases.

Next Steps

To test your understanding of the course material, please take the Assessment: DR – Expungement. To successfully complete the expungement training and receive credit, you must score at least 80 percent on the exam.

You may access the exam by following these instructions:

- Click the “X” (Exit) button in the upper right hand corner to close the course window.
- Return to your Current Learning tab.
- Launch Assessment: DR – Expungement.
- Click the “Next” arrow button to start the exam.

After answering all of the questions, click on the “view your results” link for your score. Click on the “exit” link to return to the learning center.

If you prefer, you may complete the attached Expungement Training Exam and mail or fax it to FINRA for grading. To successfully complete the expungement training and receive credit, you must score at least 80 percent on the exam. Thereafter, FINRA will update your Arbitrator Disclosure Report to reflect that you have completed this course.

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

FINRA Office of Dispute Resolution

Expungement Training Exam

Name: _____ Arbitrator ID#: A_____

After reviewing the course, you must complete and submit the following exam. **You must score at least 80 percent to receive credit for completing the course.** Upon successful completion of the course and exam, FINRA will automatically update your disclosure profile to reflect that you completed the course. If, however, you do not receive the minimum score of 80 percent, FINRA will notify you, and you may attempt the exam again.

CLEARLY mark your answer.

✍ Include your name and arbitrator ID# on EVERY page.

When you have completed the exam, please FAX your pages to FINRA – Neutral Management Department at 646-625-6020 or email to luis.cruz@finra.org.

---

1. The information in CRD is submitted by regulatory authorities (for example, state securities regulators and SROs) and by registered securities firms, most of which is provided to investors through BrokerCheck.

   TRUE FALSE

2. When considering an expungement request, arbitrators should ask the broker seeking expungement to provide a current copy of the broker's BrokerCheck report to review both the information that the broker is seeking to expunge as well as all Disclosure Events.

   TRUE FALSE

3. The fact that a party prevailed in an arbitration case is, in and of itself, an appropriate ground for expunging information about the proceeding from the CRD system.

   TRUE FALSE

4. Arbitrators should not recommend expungement in cases where the broker was found liable to a customer for an investment-related sales practice violation.

   TRUE FALSE

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Name: _____ Arbitrator ID#: A_____

5. When drafting the award, arbitrators can simply restate one of the grounds under Rule 2080 or recite the language provided by the party requesting expungement without providing specific case facts to justify a recommendation for expungement.

   TRUE FALSE

6. Expungement is an extraordinary remedy that arbitrators should recommend only under appropriate circumstances. Arbitrators should recommend expungement of customer dispute information only when it has no meaningful investor protection or regulatory value.

   TRUE FALSE

7. The expungement standards under Rule 2080 may be implied in the award.

   TRUE FALSE

8. FINRA may rely on arbitrators' findings and waive participation in the court confirmation process if arbitrators have appropriately awarded expungement; that is, if arbitrators have made affirmative findings based upon one or more of the standards in Rule 2080 and satisfied the procedural requirements under Rules 12805 and 13805.

   TRUE FALSE

9. If the customer does not appear at the expungement hearing to oppose the expungement request, the arbitrators can issue an award recommending expungement without conducting a hearing.

   TRUE FALSE

10. Arbitrators should inquire and consider fully whether a party conditioned a settlement of arbitration upon agreement not to oppose the request for expungement.

    TRUE FALSE

© 2016 Financial Industry Regulatory Authority, Inc. All rights reserved.

Print

2080. Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD) System

(a) Members or associated persons seeking to expunge information from the CRD system arising from disputes with customers must obtain an order from a court of competent jurisdiction directing such expungement or confirming an arbitration award containing expungement relief.

(b) Members or associated persons petitioning a court for expungement relief or seeking judicial confirmation of an arbitration award containing expungement relief must name FINRA as an additional party and serve FINRA with all appropriate documents unless this requirement is waived pursuant to subparagraph (1) or (2) below.

(1) Upon request, FINRA may waive the obligation to name FINRA as a party if FINRA determines that the expungement relief is based on affirmative judicial or arbitral findings that:

(A) the claim, allegation or information is factually impossible or clearly erroneous;

(B) the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or

(C) the claim, allegation or information is false.

(2) If the expungement relief is based on judicial or arbitral findings other than those described above, FINRA, in its sole discretion and under extraordinary circumstances, also may waive the obligation to name FINRA as a party if it determines that:

(A) the expungement relief and accompanying findings on which it is based are meritorious; and

(B) the expungement would have no material adverse effect on investor protection, the integrity of the CRD system or regulatory requirements.

(c) For purposes of this Rule, the terms "sales practice violation," "investment-related," and "involved" shall have the meanings set forth in the Uniform Application for Securities Industry Registration or Transfer ("Form U4") in effect at the time of issuance of the subject expungement order.

Amended by SR-FINRA-2009-016 eff. Aug. 17, 2009.
Amended by SR-NASD-2003-200 eff. April 12, 2004.
Adopted by SR-NASD-2002-168 eff. April 12, 2004.

Selected Notice: 04-16, 09-33.

© FINRA. All rights reserved.

Print

2081. Prohibited Conditions Relating to Expungement of Customer Dispute

No member or associated person shall condition or seek to condition settlement of a dispute with a customer on, or to otherwise compensate the customer for, the customer's agreement to consent to, or not to oppose, the member's or associated person's request to expunge such customer dispute information from the CRD system.

Adopted by SR-FINRA-2014-020 eff. July 30, 2014.

Selected Notice: 14-31

© FINRA. All rights reserved.

AMFS
AMERICAN MEDIC
FORENSIC SPECIALIS
AN ONTELLUS COMPA

Cleaning up tainted broker records becomes a cottage industry for one law firm

Doc Kennedy leverages Finra's arbitration system to expunge hundreds of customer complaints



Jan 3, 2019 @ 4:24 pm
By **Jeff Benjamin**

12
Shares

Critics may take Dochtor Kennedy to task for helping brokers clean up their disciplinary records, but no one can argue with his success.

The 39-year-old president and founder of AdvisorLaw, which specializes in removing customer complaints from brokers' online profiles, handles more broker expungement cases than anyone else in the business.

Related stories



Duke University settles 403(b) lawsuit for $10.7 million

Have 403(b)

the Financial Industry Regulatory Authority Inc. The next closest law firm had handled just 26 such requests.

On the homepage of its website, **AdvisorLaw features a pie chart** showing an 89% success rate.

"AdvisorLaw is the 800-pound gorilla in this field right now," said Andrew Stoltmann, immediate past president of the Public Investors Arbitration Bar Association, which represents plaintiff's attorneys.

"What they're doing has really clouded investors' views of what's happening out there," he added. "They have cleaned up hundreds of complaints from brokers' records, and some of those brokers are bad guys."

While Mr. Kennedy is often painted by plaintiff's lawyers and investor advocates as the one wearing the dark hat, he makes no apologies for **capitalizing on the cottage industry** that was created by the **regulatory system**.

"We're handling between a third and half of all the expungement cases," he said. "But, in our due diligence, if we see something that puts the viability of the case at risk we will give you your money back, and tell you to go find another lawyer."

Mr. Kennedy, who founded AdvisorLaw in early 2016, said his success rate is due to a strict adherence to

Content Connection

Sponsored Partner Content



Resilience, Not Reliance

The basic expungement-qualification criteria require that the claim is false, impossible, or the registered representative was not involved in the alleged investment-related sales practice violation.

Based on that, Mr. Kennedy and his team of three dozen lawyers won't take cases in which the broker was found guilty or admitted guilt, even if only in the form of an apology letter to the customer.

"You have to tell a story, and show the lines of one or more of those criteria," he said. "The arbitrators when ruling on the expungement requests have a blank check. They don't have to explain why they're denying it."

Blank check or not, expungement-request denials are rare, with arbitration panels approving them 93% of the time.

For its part, Finra has acknowledges some **cracks in the system** and has worked on making improvements, including a recent **announcement that enhanced guidance for arbitrators** that is being sent the Securities and Exchange Commission for approval.

The guidance, which was originally proposed in September 2017, does not address the heated issue of how far back a broker's record can be expunged, but it does remind arbitrators that expungements should be rare exceptions.

Exceptional
Experience


Independent Perspective: Why Reza Zamani Chose Independence

Most popular


1 **Blackrock exposed data on 12,000 financial advisers**


2 **Advisers throw cold water on FIRE movement**


3 **Business owners get IRS rules on pass-through deduction**

Upcoming Event

proposals to clarify when and how expungements are made in the arbitration system. And Finra continues to work with the SEC, state regulators and others regarding expungement matters brought through the courts."

Mr. Kennedy, who realizes his business model is under constant scrutiny from those who are critical of the expungement process, plans to ride the wave for as long as he can.

By his own calculations, about 10% of the industry's 600,000 brokers have at least one disclosure mark on their record.

And of those 60,000 brokers, he said half have multiples marks.

"Everybody is always taking aim at us because nobody advocates for the individual brokers," he said. "The bottom line is, we're not going away."

Mr. Kennedy justifies his taking the side of brokers by explaining that any customer dispute, no matter how unlikely or illogical, becomes a part of a broker's online record.

"A lot of times the investors maybe have a stock-picking club or are talking to somebody about their portfolio and decide to make complaint," he said. "Another thing is maybe dear old dad passes away and one of the kids files a complaint that one of the investments wasn't suitable for the dead dad. I've seen ex-girlfriends call and complain just to get back at somebody."

When it comes to a broker with multiple disclosures, Mr. Kennedy said it is sometimes related to a particular asset, where a bunch of investors might be upset about

WATCH
InvestmentNews is honoring female financial advisers and industry executives who are distinguished leaders at their firms. These women have advanced the business of providing advice through their passion, creativity, inclusive approach and... **Learn more**

InvestmentNews WOMEN to WATCH

"Even if the case goes to arbitration and the broker wins and the client has to pay the attorney fees, the disclosure stays on the broker's record," Mr. Kennedy said.

Adam Gana, managing partner at law firm Gana Weinstein, recognizes that brokers can be victims in customer dispute cases, but when he sees more than **90% of expungement requests being approved by Finra arbitration panels** he questions the validity of the system, and how some might be taking advantage of it.

"I don't believe that 93% of the customer complaints are false, and that's what it says when 93% of requests are expunged," he said. "I understand that in some circumstances where a complaint could be so frivolous that it should be expunged, but that should be rare. When you have cases where people are making a cottage industry and getting hundreds of awards annually, and hiding claims against brokers, you don't have a system any more that protects investors."

Mr. Gana pins the blame on the system that lets lawyers argue before what he describes as under-qualified arbitration panels that rarely hear from the customers that filed the original complaints.

In a lot of cases, the customers will receive a settlement from a brokerage firm, and then move on, which is something Mr. Gana said leads to a higher percentage of expungements.

"After a settlement, the customer usually doesn't want to be involved anymore," he said. "They would have to go to the hearing at their own expense and get cross examined, which is why they usually don't get involved."

contest a broker's request to have the record expunged.

7 COMMENTS

What do you think?

View comments

Recommended for you



Mandatory arbitration isn't just for brokers — some investment advisers rely on it



Widow awarded $4.2 million by Finra panel for theft by ex-Royal Alliance broker



Crackdown showdown: Serious cybersecurity enforcement is coming in 2019, but are advisers ready?

Featured video



INTV

Why advisers are pessimistic about the economy



Recommended Video

Keys to a successful deal

Channels

INTV

whom see a recession ahead before the next presidential election.

Latest news & opinion



Blackrock exposed data on 12,000 financial advisers

The data appeared in three spreadsheets, linked on one of the New York-based company's web pages dedicated to its iShares exchange-traded funds



Advisers throw cold water on FIRE movement

Millennials love it, advisers don't: Turns out, extreme early retirement is a suitable goal for almost nobody.



10 universities with the most billionaire alumni

These 10 American schools have the greatest number of alumni who are billionaires.



Top-performing ETFs of 2018

The markets took a beating last year, but these exchange-traded funds bucked the trend



Morningstar says investors rushed the exits in 2018

Net flows into mutual funds and ETFs were the lowest since the 2008 financial crisis, while money-market funds captured inflows.

Now in print



This week's issue

To download the full contents of this week's issue, click here.

Past Issues
January 12, 2019
January 5, 2019
December 15, 2018

SUBSCRIBE

Get daily news & intel

The pulse of the financial advisory industry.

Your E-mail Sign up

Breaking news and in-depth coverage of essential topics delivered straight to your inbox.

VIEW ALL NEWSLETTERS

Connect with us

Register to access our archive of leading investment information and data

Follow @newsfromIN

Follow @eventsfromIN

Follow @statsfromIN

Copyright © 2019 InvestmentNews LLC. Use of editorial content without permission is strictly prohibited. *Privacy Policy* and *Terms & Conditions* are applicable to you. All rights reserved.

DOW JONES, A NEWS CORP COMPANY

DJIA 25415.54 0.19% ▲ S&P 500 2748.10 0.16% ▲ Nasdaq 7306.85 0.21% ▲ U.S. 10 Yr 6/32 Yield 3.036% ▲ Crude Oil 51.50 2.41% ▲

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit https://www.djreprints.com.

https://www.wsj.com/articles/finra-arbitrators-let-thousands-of-brokers-purge-infraction-records-1542459600

FINANCIAL REGULATION

Finra Arbitrators Let Thousands of Brokers Purge Infraction Records

Brokers with scrubbed records are more likely to generate complaints, two academics found



The Financial Industry Regulatory Authority, or FINRA, is considering a plan to make it harder for brokers to scrub their records clean. PHOTO: BRENDAN MCDERMID/REUTERS

By Jean Eaglesham and Coulter Jones
Nov. 17, 2018 8:00 a.m. ET

Thousands of brokers have scrubbed their records clean of complaints by customers and employers, allowing them to hide information from potential investors, according to a new study.

These brokers were more likely than other ones to receive additional complaints or other allegations of misconduct after their records were cleaned, according to the academic paper, which analyzed public regulatory records from 2007 to 2016.

The scrubbing process, known as expungement, is overseen by the Financial Industry Regulatory Authority, the industry-funded brokerage regulator. Under Finra rules, arbitrators are expected to allow a record to be deleted from the public "BrokerCheck" website only if an allegation against a broker is factually impossible, "clearly erroneous" or the broker wasn't involved in an alleged misconduct.

Expungement is meant to be a rare event, regulators say. But the study, which analyzed BrokerCheck records and other regulatory information, found that arbitrators granted requests nearly 70% of the time.

Scrubbing so many records — 4,572 of the 6,700 requests were agreed to— makes it hard to track bad actors and harms "the ability for regulators and consumers to monitor brokers," according to the study by Colleen Honigsberg, an assistant law professor at Stanford University, and Matthew Jacob, an economics pre-doctoral research fellow at Harvard University.

Last year, Finra proposed changes to make it harder for brokers to scrub records but has yet to issue a final rule. A spokeswoman said the regulator is still reviewing and considering comments received and that it looks forward to reviewing the final version of the study. The spokeswoman added that the regulator is "committed to ensuring that Finra arbitration is a fair dispute resolution system for all parties."

There are about 630,000 active brokers registered with Finra. Most don't have any complaints or expungement requests.

One who did was Stuart Siegel. The Florida broker in 2013 declared on his BrokerCheck page that he had enjoyed an "unblemished record over a 35 year career in the securities industry

with never having been accused of misconduct by any customer."

Newsletter Sign-up

Potential clients wouldn't know by looking at the page that Mr. Siegel got approval in 2011 to delete an earlier complaint by an investor that alleged he'd given the client poor investment advice, arbitration records show. The matter was settled for $14,500; Mr. Siegel was dismissed as a party to the claim before it settled.

Two years after the complaint was scrubbed, Finra filed unrelated civil charges against Mr. Siegel alleging he had used tens of thousands of dollars of charitable funds he oversaw for his personal benefit. Mr. Siegel repaid the money and in 2014 agreed to be barred from the securities industry without admitting or denying the allegations, according to Finra records.

Finra declined to comment on the matter, while Mr. Siegel couldn't be reached for comment. His lawyer during the expungement claim, Marc Dobin, said, "at the time the expungement was granted, there was no indication of any hint of a regulatory problem."

A state regulators' group this year called for changes to the expungement system, which it says is "broken" and removes valuable information from the records.

The Securities Industry and Financial Markets Association, an industry body, said in its response to Finra's proposals that the "existing rules ... provide sufficient safeguards."

Finra urges investors to check brokers' disciplinary records, using its BrokerCheck system. But these records don't show attempts to scrub complaints, even though such requests are a red flag, according to the study.

Mr. Dobin says it has gotten much harder for brokers to clean records in recent years. In particular, brokers can no longer make offers to settle complaints that hinge on the client agreeing not to fight an expungement. "Finra's demonstrated a growing hostility to expungements," he added.

A recent surge in brokered sales of private stakes in companies, known as private placements, could fuel new requests to scrub records. Brokers who sold these deals were four times more likely to seek expungement than the industry average, according to an analysis of arbitrators' records by Ms. Honigsberg and Mr. Jacob. Their success rate – 62% -- is slightly worse than the industry average, the analysis found.

More than one in five brokers who were denied requests to scrub red flags went on to rack up additional allegations of misconduct, the study found. That compares with only 4% of all brokers who received any allegation of misconduct from 2007 to 2017, according to the study.

Former stockbroker Anastasios Belesis, known as Tommy, tried eight times to scrub complaints filed between 2012 and 2015 -- none passed, according to regulatory records. He's now barred permanently and the firm where he served as CEO, John Thomas Financial, has been expelled from the industry.

Mr. Belesis, whose firm sold penny stocks to investors, declined to comment on the expungement process, saying he had "nothing to do with the industry any more, it's irrelevant to me." He added that "these are all past events that occurred in another lifetime to me and a lot of that was sensationalized from the regulators."

Award
FINRA Dispute Resolution

In the Matter of the Arbitration Between:

Claimant
Sandra L. Liebhaber

Case Number: 13-01522

vs.

Respondent
Royal Alliance Associates, Inc.

Hearing Site: Los Angeles, California

Nature of the Dispute: Customer vs. Member

This case was decided by an all-public panel.

REPRESENTATION OF PARTIES

For Claimant Sandra L. Liebhaber, hereinafter referred to as "Claimant": Robert S. Banks, Jr., Esq., Banks Law Office, PC, Portland, Oregon.

For Respondent Royal Alliance Associates, Inc., hereinafter referred to as "Respondent": Kasumi L. Takahashi, Esq., Jones, Bell, Abbott, Fleming & Fitzgerald, L.L.P., Los Angeles, California.

CASE INFORMATION

Statement of Claim filed on or about: May 23, 2013.

Claimant signed the Submission Agreement: May 23, 2013.

Statement of Answer filed by Respondent on or about: August 20, 2013.

Respondent signed the Submission Agreement: August 28, 2013.

CASE SUMMARY

Claimant asserted the following causes of action: negligence; breach of fiduciary duty; and California Securities Law Violations. The causes of action relate to Claimant's investments in Ohio National Life Insurance Variable Annuity, Hartford Director M Outlook Variable Annuity, Hartford Leaders Outlook Variable Annuity, SunAmerica Annuity and Life Assurance Variable Annuity and Inland American Real Estate Trust, Inc.

Unless specifically admitted in its Answer, Respondent denied the allegations made in the Statement of Claim.

RELIEF REQUESTED

In the Statement of Claim, Claimant requested:

1. Recovery of the amounts Claimant paid for her investments, less any distributions she may have received up to the time of the award, plus statutory and pre-judgment interest, and for investments no longer held by Claimant, recovery of damages plus interest, all in an amount to be proved at the hearing but not less than $325,000.00;
2. Claimant's costs in bringing this case, including filing fees, expert witness fees, and hearing fees; and
3. Such other relief as the Panel may deem appropriate at the conclusion of the hearing.

In the Statement of Answer, Respondent requested:

1. Denial of Claimant's claims;
2. An award be entered in favor of Respondent;
3. Claimant be required to pay all costs and non-attorney fees incurred in these proceedings;
4. A recommendation that all references to this matter be expunged from Kathleen Tarr and Richard McCollam's Central Registration Depository ("CRD") records; and
5. Such other and further relief as the Panel deems appropriate.

OTHER ISSUES CONSIDERED AND DECIDED

The Arbitrators acknowledge that they have each read the pleadings and other materials filed by the parties.

On May 14, 2014, Claimant's counsel advised FINRA Dispute Resolution that the case settled. On May 15, 2014, Respondent requested FINRA Dispute Resolution keep the case open as it will be seeking expungement.

On June 9, 2014, Respondent submitted a Request for Expungement on behalf of non-party Kathleen Tarr. On June 30, 2014, Claimant's counsel advised that he will not be filing a pre-hearing brief regarding Respondent's Request for Expungement, but planned to call Claimant and non-party Kathleen Tarr as witnesses at the expungement hearing.

On July 10, 2014, the Panel issued an Order requesting a copy of non-party Kathleen Tarr's BrokerCheck report and CRD for purposes of the expungement hearing.

On July 15, 2014, in response to the Panel's request, Claimant submitted a letter with a copy of non-party Kathleen Tarr's Form U5. On July 18, 2014, in response to the Panel's request, Respondent submitted a letter with copies of non-party Kathleen Tarr's BrokerCheck and CRD reports.

The Panel conducted a recorded telephonic hearing on August 12, 2014 regarding the appropriateness of expungement of customer dispute information from the CRD system as requested by non-party Kathleen Tarr. The request for expungement was opposed by Claimant. After oral statements and arguments by non-party Kathleen Tarr, Respondent, and Claimant, the Panel held its deliberations immediately after the hearing.

The Panel reviewed and relied upon the following documents:

a. Claimant's Statement of Claim and Respondent's Statement of Answer;
b. The expungement hearing brief filed by Respondent;
c. The expungement hearing documents submitted by Claimant;
d. Non-party Kathleen Tarr's BrokerCheck report as of the date of the hearing;
e. Non-party Kathleen Tarr's CRD records (Form U5) as of August 6, 2012, submitted by Claimant who received the Web CRD from the Respondent during discovery; and
f. The parties' settlement agreement.

The Panel noted that the agreement to settle Claimant's customer dispute was not conditioned on compensation paid to or an agreement made by Claimant to consent to or not to oppose a request for expungement of the customer dispute information from the CRD system. The Panel also noted that Ms. Tarr did not contribute to the settlement amount.

The Panel has agreed that the Award in this matter may be executed in counterpart copies or that a handwritten, signed Award may be entered.

AWARD

After considering the pleadings, statements, oral arguments and evidence presented at the August 12, 2014 expungement hearing, the Panel has decided in full and final resolution of the issues submitted for determination as follows:

1. The Panel noted that Respondent's Statement of Answer includes a request for expungement on behalf of Richard McCollam. Respondent did not reiterate the request for expungement on behalf of Richard McCollam. As such, the Panel made no determination with respect to the request for expungement on behalf of Richard McCollam.

2. The Panel recommends the expungement of all references to the above-captioned arbitration from non-party Kathleen Tarr's (CRD #4215307) registration records maintained by the CRD, with the understanding that pursuant to Notice to Members 04-16, non-party Kathleen Tarr must obtain confirmation from a court of competent jurisdiction before the CRD will execute the expungement directive.

   Unless specifically waived in writing by FINRA, parties seeking judicial confirmation of an arbitration award containing expungement relief must name FINRA as an additional party and serve FINRA with all appropriate documents.

   Pursuant to Rule 12805 of the Code of Arbitration Procedure (the "Code"), the

Panel has made the following Rule 2080 affirmative findings of fact:
The claim, allegation, or information is factually impossible or clearly erroneous; and

The claim, allegation, or information is false.

The Panel has made the above Rule 2080 findings based on the following reasons:

a. Claimant requested compensatory damages in the sum of $325,000.00, and Claimant agreed to accept $30,000.00 in settlement of her claim. The argument of Respondent was that the decision to offer Claimant $30,000.00 to settle her claim reflected a business decision regarding the continuing costs of defending the case through a full-panel evidentiary hearing. Claimant argued that the $30,000.00 settlement reflected Claimant's net out of pocket losses ("NOP").

   Paragraph 4 of the Settlement Agreement states in pertinent part: "The Parties are entering into this Agreement solely for the purpose of avoiding the burdens, inconvenience, and expenses of further litigation. This Agreement does not constitute, and shall not be construed as … an admission … of any wrongdoing, liability, or culpability."

   There was no information presented which disputed this portion of the Settlement Agreement. Therefore, as required under Rule 12805(b), the Panel has found that with respect to the amount of payment made pursuant to the Settlement Agreement, the argument of Respondent is more persuasive and is factually correct.

b. The Settlement Agreement was not conditioned upon an agreement by Claimant not to oppose a request for expungement by non-party Kathleen Tarr of Claimant's customer dispute from the CRD system. There was no information presented regarding the settlement negotiations.

   Accordingly, the Panel finds that neither non-party Kathleen Tarr nor Respondent conditioned or sought to condition the settlement on an agreement not to oppose non-party Kathleen Tarr's expungement request.

   Further, the Panel finds that the compensation paid to Claimant was not for the purpose of not opposing non-party Kathleen Tarr's request for expungement.

   Finally, Claimant did, in fact, oppose expungement, was present during the telephonic hearing, provided the Panel with opposing documents and gave a full argument to the Panel requesting that expungement relief not be awarded.

c. In late 2007, Claimant opened an Individual Retirement Account with Respondent with an initial deposit of $315,000.00. Claimant was approximately 47 years of age. Non-party Kathleen Tarr was her broker of record. Stating that her investment objectives were long-term growth and income, with a moderate

investment risk, Claimant purchased four separate variable annuities and a real estate investment trust ("REIT") paying over 6% per annum. Almost 15% of her investable monies remained in cash.

Claimant stated in her Statement of Claim that these investments were not suitable for her. The statement of non-party Kathleen Tarr was that the annuities were invested in a broad-based portfolio which matched Claimant's investment objectives and risk tolerance. This information was not disputed by Claimant.

Claimant did not add any additional monies to her IRA. Claimant regularly received or took distributions from her IRA. Claimant sold one variable annuity in December 2011.

At the time of the expungement hearing, non-party KathleenTarr stated that it was her understanding and belief that Claimant still owns the same three variable annuities as well as the REIT. This information was not disputed by Claimant.

No other evidence or information regarding suitability was offered by Claimant.

d. Respondent argued that any losses incurred by Claimant were "paper" losses due to the economic downturn of 2008 – 2009. By continuing to hold her assets, Respondent argued that Claimant no longer has incurred losses, and, to the contrary, has benefited from the upturn in the economy. This argument was not disputed by Claimant.

e. The Panel finds that the statements offered by non-party Kathleen Tarr during the telephonic hearing were credible. The Panel finds that the investments were suitable for Claimant, and that the claim or allegation of unsuitability is clearly erroneous.

f. The Panel finds that based upon the documents described above, the statements and other information presented at the telephonic hearing, and the Settlement Agreement, Claimant's argument that the $30,000.00 payment reflected NOP losses is not true. In addition, there is no documentation or other evidence to support a claim that Claimant suffered losses as a result of non-party Kathleen Tarr's actions, or Respondent's actions or inactions.

FEES

Pursuant to the Code, the following fees are assessed:

Filing Fees

FINRA Dispute Resolution assessed a filing fee* for each claim:

Initial Claim Filing Fee	=$ 1,425.00

**The filing fee is made up of a non-refundable and a refundable portion.*

Member Fees

Member fees are assessed to each member firm that is a party in these proceedings or to the member firm(s) that employed the associated person(s) at the time of the event(s) giving rise to the dispute. Accordingly, as a party, Royal Alliance Associates, Inc. is assessed the following:

Member Surcharge	=$ 1,700.00
Pre-Hearing Processing Fee	=$ 750.00
Hearing Processing Fee	=$ 2,750.00

Adjournment Fees

Adjournments granted during these proceedings for which fees were assessed:

April 7-9, 2014, adjournment by parties	=$ 1,125.00
May 5-7, 2014, adjournment by parties	=$ 1,125.00
Total Adjournment Fees	=$ 2,250.00

The Panel has assessed $2,250.00 of the adjournment fees to Respondent.

Discovery-Related Motion Fees

Fees apply for each decision rendered on a discovery-related motion.

Five (5) Decisions on discovery-related motions on the papers with (1) one arbitrator @ $200.00	=$ 1,000.00
Claimant submitted one discovery-related motion	
Respondent submitted four discovery-related motions	
Total Discovery-Related Motion Fees	=$ 1,000.00

The Panel has assessed $1,000.00 of the discovery-related motion fees to Respondent.

Hearing Session Fees and Assessments

The Panel has assessed hearing session fees for each session conducted. A session is any meeting between the parties and the arbitrator(s), including a pre-hearing conference with the arbitrator(s), that lasts four (4) hours or less. Fees associated with these proceedings are:

One (1) Pre-hearing session with the Panel @ $1,125.00/session	=$1,125.00
Pre-hearing conference: October 21, 2013 1 session	
One (1) Hearing session on expungement request @ $1,125.00/session	
Hearing Date: August 12, 2014 1 session	=$1,125.00
Total Hearing Session Fees	=$2,250.00

The Panel has assessed $2,250.00 of the hearing session fees to Respondent.

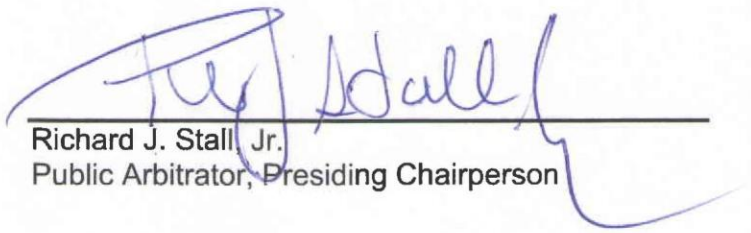
All balances are payable to FINRA Dispute Resolution and are due upon receipt.

ARBITRATION PANEL

Richard J. Stall, Jr.	-	Public Arbitrator, Presiding Chairperson
June McLaughlin	-	Public Arbitrator
Carole Helfert Aragon	-	Public Arbitrator

I, the undersigned Arbitrator, do hereby affirm that I am the individual described herein and who executed this instrument which is my award.

Concurring Arbitrators' Signatures



Richard J. Stall, Jr.
Public Arbitrator, Presiding Chairperson

Sept. 5, 2014
Signature Date

June McLaughlin
Public Arbitrator

Signature Date

Carole Helfert Aragon
Public Arbitrator

Signature Date

September 10, 2014
Date of Service (For FINRA Dispute Resolution office use only)

ARBITRATION PANEL

Richard J. Stall, Jr.	-	Public Arbitrator, Presiding Chairperson
June McLaughlin	-	Public Arbitrator
Carole Helfert Aragon	-	Public Arbitrator

I, the undersigned Arbitrator, do hereby affirm that I am the individual described herein and who executed this instrument which is my award.

Concurring Arbitrators' Signatures

Richard J. Stall, Jr.
Public Arbitrator, Presiding Chairperson

Signature Date

June McLaughlin
Public Arbitrator

9/4/14
Signature Date

Carole Helfert Aragon
Public Arbitrator

Signature Date

September 10, 2014
Date of Service (For FINRA Dispute Resolution office use only)

ARBITRATION PANEL

Richard J. Stall, Jr.	-	Public Arbitrator, Presiding Chairperson
June McLaughlin	-	Public Arbitrator
Carole Helfert Aragon	-	Public Arbitrator

I, the undersigned Arbitrator, do hereby affirm that I am the individual described herein and who executed this instrument which is my award.

Concurring Arbitrators' Signatures

Richard J. Stall, Jr.
Public Arbitrator, Presiding Chairperson

Signature Date

June McLaughlin
Public Arbitrator

Signature Date

Carole Helfert Aragon

Carole Helfert Aragon
Public Arbitrator

Sept. 5, 2014

Signature Date

September 10, 2014
Date of Service (For FINRA Dispute Resolution office use only)

Filed 8/30/16

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION FOUR

ROYAL ALLIANCE ASSOCIATES, INC. Plaintiff and Appellant, v. SANDRA L. LIEBHABER et al., Defendants and Respondents.	B264619 (Los Angeles County Super. Ct. No. BS151127)

APPEAL from a judgment of the Superior Court of Los Angeles County, Susan Bryant-Deason, Judge. Affirmed.

Jones Bell Abbott Fleming & Fitzgerald, G. Thomas Fleming, III, William M. Turner and Kasumi Laura Takahashi for Plaintiff and Appellant.

Steiner & Libo, Leonard Steiner for Defendant and Respondent Sandra L. Liebhaber.

Greenberg Glusker Fields Claman & Machtinger, Norman H. Levine and Lori L. Werderitch; Terri L. Reicher for Defendant and Respondent Financial Industry Regulatory Authority, Inc.

Appellant Royal Alliance Associates, Inc., a securities brokerage firm, petitioned to confirm an arbitration award recommending expungement of an allegation of misconduct from the record of one of its employees, Kathleen J. Tarr. The individual who made the allegation of misconduct, Sandra Liebhaber, petitioned to vacate the same arbitration award. Liebhaber argued that the arbitrators violated the rules applicable to the arbitration and refused to hear evidence she sought to introduce and cross-examination she sought to elicit. The Financial Industry Regulatory Authority, Inc. (FINRA), under whose auspices and rules the arbitration at issue was performed, also petitioned to vacate the award on similar grounds.

The trial court denied Royal Alliance's petition to confirm the award and granted Liebhaber's and FINRA's petitions to vacate, ruling that the arbitrators exceeded their powers and that Liebhaber's rights were substantially prejudiced by the arbitrators' misconduct and refusal to hear material evidence. Royal Alliance appealed, and we affirm. The arbitrators denied Liebhaber a full and fair opportunity to introduce and challenge evidence material to the expungement proceedings to which she was a party. The arbitrators' refusal to hear Liebhaber's evidence and cross-examination deprived Liebhaber of a fair hearing and substantially prejudiced her rights within the meaning of Code of Civil Procedure section 1286.2.

BACKGROUND

I. Underlying Action

Royal Alliance is a securities broker-dealer. It employed Tarr as a financial advisor from July 2002 to July 2010. Liebhaber was a client of Royal Alliance who obtained financial advice from Tarr in 2007.

Royal Alliance is a member of FINRA, a self-regulatory organization (15 U.S.C. §§ 78c(a)(26), 78s(b)) that is "'"responsible for regulatory oversight of all securities firms that do business with the public; professional training, testing and licensing of registered persons; [and] arbitration and mediation" [citation]'" of disputes that arise between investors and securities firms. (*Lickiss v. Financial Industry Regulatory Authority* (2012) 208 Cal.App.4th 1125, 1128; see also 72 Fed. Reg. 42169, 42170

(Aug. 1, 2007).) In its capacity as a self-regulatory organization, FINRA has promulgated a variety of rules governing the conduct of its members and persons associated with them. (See FINRA Rule 0140(a).) Royal Alliance and Liebhaber both agreed to be bound by FINRA's rules, including those pertinent to dispute resolution. We granted Royal Alliance's request for judicial notice of several FINRA rules and related materials.

In May 2013, Liebhaber filed a statement of claim against Royal Alliance with FINRA. Liebhaber alleged that Tarr sold her "illiquid, high-risk investments" that were "inappropriate and unsuitable" for her individual retirement account. Liebhaber further claimed that Royal Alliance was negligent, breached its fiduciary duty to her, and violated state securities laws. She sought $325,000 in compensatory damages.

Liebhaber and Royal Alliance agreed to submit to binding arbitration of Liebhaber's claims "in accordance with FINRA By-Laws, Rules, and Code of Arbitration Procedure." Liebhaber and Royal Alliance ultimately settled the case for $30,000 after an arbitration panel was convened but before an arbitration hearing was held.

II. Expungement Proceedings

In accordance with FINRA rules and regulations, Liebhaber's allegations against Tarr were documented in FINRA's Central Registration Depository (CRD), an electronic database containing "'information reported in connection with the registration or licensing of brokers and dealers and their associated persons, including disciplinary actions, regulatory, judicial, and arbitration proceedings. . . .' (15 U.S.C. § 78*o*-3(i)(1)(A) & (i)(5).)" (*Lickiss v. Financial Industry Regulatory Authority*, *supra,* 208 Cal.App.4th at p. 1128.) Information contained in the CRD is accessible to securities firms and regulators. Certain customer complaints and allegations of misconduct documented in the CRD also are available to the public via FINRA's "BrokerCheck" website. Liebhaber's allegations against Tarr were publicly accessible and remained so after the case was settled.

After Liebhaber's claims were settled, Royal Alliance requested that the arbitrators keep the case open because it intended to seek expungement of Liebhaber's

allegations from Tarr's CRD record. FINRA rules require requests for expungement to be presented to either a court of competent jurisdiction or a FINRA arbitration panel. (See FINRA Rules 2080(a), 12805.) Royal Alliance submitted a request for expungement on behalf of Tarr to the previously convened FINRA arbitration panel on June 9, 2014. Liebhaber remained a party to the case, but Tarr was not named as a party.

On June 30, 2014, Liebhaber's counsel advised the arbitration panel that he did not intend to file a pre-hearing brief but planned to call Liebhaber and Tarr as witnesses at the arbitration hearing. The record does not indicate whether Royal Alliance or the arbitration panel responded to this advisement. Also absent is the written evidence the parties submitted prior to the hearing.

The three-member panel of arbitrators held a telephonic arbitration proceeding on August 12, 2014. Liebhaber and her counsel, Robert S. Banks, Jr., were on the call, as were Royal Alliance and its counsel, Kasumi L. Takahashi. Takahashi informed the arbitrators that Tarr was on the line as well; "[s]he's here to offer any additional testimony and answer any questions that the panel may have of her . . . ."

Takahashi argued that expungement was warranted because Liebhaber's allegations against Tarr were false. She contended that the investments Tarr recommended were suitable for Liebhaber, and Liebhaber's alleged net losses could be attributed to her large withdrawals from her retirement account and "the 2008 market crash." Takahashi also noted that a complaint similar to Liebhaber's previously had been expunged from Tarr's record

At the conclusion of her argument, Takahashi informed the arbitrators that Tarr had "a couple things [*sic*] that she would like to say to the panel before we kick it over to the claimant's counsel." The presiding arbitrator said that Tarr could speak, and Liebhaber's counsel did not object. No oath was administered to Tarr, who presented a lengthy narrative description of her interactions with and advice to Liebhaber. Tarr also noted that she was "the daughter and granddaughter of ministers" and emphasized the "vigorous" nature of her opposition to Liebhaber's allegations. No one interrupted Tarr

with questions or objections. When Tarr concluded her remarks, Takahashi informed the panel that Royal Alliance had nothing further to present.

In his response argument, Banks contended that Royal Alliance failed to show that Liebhaber's complaints against Tarr were false or factually impossible. He also emphasized the importance of making complete (i.e., not expunged) CRD and BrokerCheck records available to brokerage firms and the general public.

At the conclusion of his argument, Banks told the arbitrators, "I guess I would like to ask some questions of Ms. Tarr and I would also like to ask some questions of Ms. Liebhaber so that you can have a little bit more information before you make the decision that they're asking you to make." Takahashi objected to "counsel's proposed procedure for this hearing." She argued, "This is a hearing on a request for expungement, it's not a hearing on the merits of the case. The underlying case was settled. The only question before the panel right now is whether or not the claim should be expunged based on the falsity of allegations, so I would request that we not hear from the claimant at this time and that we have a chance to rebut the opposition."

The presiding arbitrator commented, "I believe Ms. Tarr didn't say anything substantive that is not already on the record on her behalf with respect to the declaration. I listened carefully to Mr. Banks and I think he, based on the documents that I've seen, has covered all the important points. [¶] I don't see that any testimony as such is necessary, setting aside whether it's proper and has not been in effect perhaps prepared for by everybody here, so I'm inclined to think that we should leave it at that, unless Mr. Banks has further argument by himself and go from there." He then asked for input from his fellow panel members. One of them commented that she would like to hear from Liebhaber and Tarr. She thought it was "important to hear the questioning," and commented that "the guidelines are pretty clear that we're supposed to be looking at everything because this was a settled case, and that the more information we have, the easier it is for us to make what I would consider to be a fair and well reasoned decision

regarding expungement."[1] She then added, "[t]hat's just my thought as long as we're not going to be here for another two hours."

The presiding arbitrator responded, "Well, how can we make sure we're not going to be here for another two hours? That's the problem. [¶] I appreciate your comments and I think that's in the best of all possible worlds how it should be." The third arbitrator then commented that she agreed with the presiding arbitrator. "[W]ith the greatest respect, I think that allowing claimant's counsel to question Ms. Tarr is out of order, and . . . I do think that that's not the purpose of this hearing, and if it is and the panel needs to be corrected on that, because some of the -- this is kind of a new process that has not been well defined, then we can be corrected on that, but I would be very comfortable with the information, and I'm comfortable with us asking Ms. Tarr questions, but I am uncomfortable with claimant's counsel cross-examining her in any way." The second arbitrator stated that she was "good with that." The presiding arbitrator then denied Banks's "request to take testimony from the claimant and to allow questioning by counsel of the respondent."

Banks stated for the record that he "must vigorously object to the panel's denying me an opportunity to question Ms. Tarr about the very events that she is asking you to expunge her record on." He further stated that he "had a number of questions for Ms. Tarr that went into how she came to meet Ms. Liebhaber, what advice she gave her,

[1] The "guidelines" the arbitrator mentioned are not regulations or rule interpretations promulgated through formal administrative procedures. They consist of a numbered list that appears on a FINRA webpage entitled "Notice to Arbitrators and Parties on Expanded Expungement Guidance" and within FINRA's "Expungement Training" materials. In both places, the list reads as follows: "It is important to allow customers and their counsel to participate in the expungement hearing in settled cases if they wish to. Specifically, arbitrators should: 1) allow the customer and their counsel to appear at the expungement hearing; 2) allow the customer to testify at the expungement hearing; 3) allow counsel for the customer or a *pro se* customer to introduce documents and evidence at the expungement hearing; 4) allow counsel for the customer or a *pro se* customer to cross-examine the broker and other witnesses called by the party seeking expungment; and 5) allow counsel for the customer or a *pro se* customer to present opening and closing arguments if the panel allows any party to present such arguments."

questions about the suitability of the investments, whether she considered certain factors about these investments she was recommending, how much time she spent giving her the advice she gave her and what she told her about whether she should take this early retirement at age 47." The presiding arbitrator thanked Banks for his comments and asked Takahashi to proceed with her rebuttal, which consisted primarily of argument that Banks's comments were not relevant to the issue of expungement.

After the arbitrators asked a few questions, Banks asked the presiding arbitrator if he could "have a few words, please?" Takahashi objected, and the presiding arbitrator sustained her objection after confirming that the other panel members did not want any more information.

The presiding arbitrator thanked counsel for "the very high degree of advocacy on both sides" and indicated that the panel intended to commence deliberations. Banks asked if he could make his record, and despite the presiding arbitrator's response that "I don't think there's any necessity on my behalf to have it on the record here," Banks commented, "I feel like I have not been given a full and fair opportunity to respond to this, the claims that have been made in the hearing." Banks continued, "my client is here prepared to testify, there have been statements about expungements previously granted, information has been admitted about expungements that have been denied, and I think that those are all important matters, but if you don't -- if you won't let me talk about them, I won't." The presiding arbitrator asked the others for their thoughts, and one of them said to Banks, "I think that you may add more information in your mind's eye, but again, I don't think it's going to dramatically impact my part, my participation in the deliberations, and really with a lot of respect I say that to you." The third arbitrator echoed these comments, adding, "we've followed the process and the procedure and the rule as it's stated and I'm very confident that -- and I do appreciate, Mr. Banks, how strongly you feel opposing respondent's request for expungement, but I'm confident that we've allowed all the information that we need to make a good decision."

The arbitration panel issued an award recommending expungement on September 10, 2014. The panel, tracking the language of FINRA Rule 2080, found that Liebhaber's

"claim, allegation, or information" against Tarr was "factually impossible or clearly erroneous; and [¶] The claim, allegation, or information is false."[2] The panel cited several reasons for its findings, including the sizable difference between the damages Liebhaber alleged ($325,000) and the amount she accepted from Royal Alliance to settle her claims ($30,000). The panel concluded the amount of the payment reflected a business decision by Royal Alliance rather than Liebhaber's actual net out-of-pocket losses. The panel also made the following findings (emphases added):

"In late 2007, Claimant [Liebhaber] opened an Individual Retirement Account with Respondent [Royal Alliance] with an initial deposit of $315,000.00. Claimant was approximately 47 years of age. Non-party Kathleen Tarr was her broker of record. Stating that her investment objectives were long-term growth and income, with a moderate investment risk, Claimant purchased four separate variable annuities and a real estate investment trust ('REIT') paying over 6% per annum. Almost 15% of her investable monies remained in cash. [¶] Claimant stated in her Statement of Claim that these investments were not suitable for her. The statement of non-party Kathleen Tarr was that the annuities were invested in a broad-based portfolio which matched Claimant's investment objectives and risk tolerance. *This information was not disputed by Claimant.* [¶] Claimant did not add any additional monies to her IRA. Claimant regularly received or took distributions from her IRA. Claimant sold one variable annuity in December 2011. [¶] At the time of the expungement hearing, non-party Kathleen Tarr stated that it was her understanding and belief that Claimant still owns the same three variable

[2]FINRA Rule 12805(c) requires arbitrators presiding over expungement proceedings to "Indicate in the arbitration award which of the Rule 2080 grounds for expungement serve(s) as the basis for its expungement order and provide a brief written explanation of the reason(s) for its finding that one or more Rule 2080 grounds for expungement applies to the facts of the case." The pertinent Rule 2080 grounds are "(A) the claim, allegation, or information is factually impossible or clearly erroneous; (B) the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or (C) the claim, allegation, or information is false." (FINRA Rule 2080(b)(1).)

annuities as well as the REIT. *This information was not disputed by Claimant. No other evidence or information regarding suitability was offered by Claimant.*

"Respondent argued that any losses incurred by Claimant were 'paper' losses due to the economic downturn of 2008-2009. By continuing to hold her assets, Respondent argued that Claimant no longer has incurred losses, and, to the contrary, has benefited from the upturn in the economy. *This argument was not disputed by Claimant.*

"*The Panel finds that the statements offered by non-party Kathleen Tarr during the telephonic hearing were credible.* The Panel finds that the investments were suitable for Claimant, and that the claim or allegation of unsuitability is clearly erroneous.

"The Panel finds that based upon the documents described above, the statements and other information presented at the telephonic hearing, and the Settlement Agreement, Claimant's argument that the $30,000.00 [settlement] payment reflected [net out-of-pocket] losses is not true. *In addition, there is no documentation or other evidence to support a claim that Claimant suffered losses as a result of non-party Kathleen Tarr's actions, or Respondent's actions or inactions.*"

The panel charged Royal Alliance with all applicable fees. (See FINRA Rule 12805(d).)

III. Petitions to Confirm and Vacate

FINRA Rule 2080(a) requires parties seeking expungement of customer complaints from a CRD record to "obtain an order from a court of competent jurisdiction directing such expungement or confirming an arbitration award containing expungement relief." (FINRA Rule 2080(a).) In accordance with this rule, Royal Alliance filed a petition under Code of Civil Procedure section 1285[3] to confirm the arbitration award. Royal Alliance included with its petition the parties' signed consent forms agreeing to arbitration and a copy of the expungement award. Pursuant to FINRA Rule 2080(b), parties "seeking judicial confirmation of an arbitration award containing expungement relief must name FINRA as an additional party and serve FINRA with all appropriate

[3]All further statutory references are to the Code of Civil Procedure unless otherwise indicated.

documents unless this requirement is waived . . . ." Royal Alliance named both Liebhaber and FINRA as respondents in its petition.

In her answer opposing the petition, Liebhaber requested that the award be vacated pursuant to sections 1286.2 and 1286.4. She asserted three grounds for vacation: "(a) Liebhaber's rights were substantially prejudiced by misconduct of the arbitrators; (b) the arbitrators exceeded their powers in denying Liebhaber's request to present evidence at the hearing; and (c) Liebhaber's rights were substantially prejudiced by the refusal of the arbitrators to hear evidence material to her claims." Liebhaber attached several exhibits to her filing, including her statement of claim, a transcript of the arbitration hearing, Tarr's BrokerCheck report, and FINRA publications titled "Neutral Corner," "Dispute Resolution Expungement Arbitrator Training Manual," and "Notice to Arbitrators and Parties on Expanded Expungement Guidance."

In her accompanying memorandum, Liebhaber argued that the arbitration panel "failed to hold an adequate hearing on expungement in violation of FINRA Rule 12805 by refusing Liebhaber's request to testify, and to cross-examine the broker Tarr." She further contended that the arbitrators "allowed Royal Alliance to present its case for expungement in its entirety" but did not allow her to question either of the witnesses she wanted to call, herself and Tarr. Liebhaber emphasized that the arbitrators' award repeatedly stated that she failed to offer evidence or dispute Royal Alliance's evidence, and contended that "no evidence was presented or information not disputed [*sic*] *because the arbitrators did not allow Ms. Liebhaber to present any evidence at the hearing* despite her appearance and multiple requests to do so."

FINRA also opposed Royal Alliance's petition and sought to vacate the arbitration award. FINRA took "no position on the merits of the underlying case," but "oppose[d] expungement of the arbitration from FINRA's regulatory database because the arbitrators failed to follow FINRA rules governing such expungements," specifically Rules 2080 and 12805. FINRA argued that the expungement hearing "was fatally defective because Tarr, the broker seeking expungement, was permitted to testify unsworn without cross examination, while her customer Liebhaber, who opposed expungement, was denied the

right even to speak, with or without cross examination. As a result, the award's findings were not properly made under FINRA Rule 2080 (which governs arbitrator-ordered expungements)." FINRA further contended that the arbitrators exceeded their powers by violating applicable FINRA rules, and substantially prejudiced Liebhaber by disallowing her testimony.

In reply, Royal Alliance argued that Liebhaber could not establish substantial prejudice because hearings need not include an opportunity to present live testimony and Liebhaber failed to take advantage of the opportunity to submit written statements. It further contended that Liebhaber failed to demonstrate that cross-examination of Tarr would have changed the outcome of the hearing, and that neither FINRA's nor Liebhaber's interests were affected by the award. Royal Alliance also refuted Liebhaber's and FINRA's contentions that the arbitrators violated FINRA rules and exceeded their powers.

The trial court held a hearing on the petitions on May 18, 2015. The court indicated at the outset that its tentative decision was to vacate the award. It explained, "Not only did they [the arbitrators] not permit live testimony, but they also permitted Ms. Tar[r] to testify unsworn. She got to go into the fact that her father was a minister. She got to talk about what a good person she was and all that. Ms. Liebhaber's attorney didn't get a chance to ask her questions. Ms. Liebhaber didn't even get a chance to testify. Somehow that just doesn't sound right, does it?"

Royal Alliance denied that Tarr was "offered as a witness to give testimony un-rebutted," claiming that "[s]he was there to answer questions posed if any by the arbitrators." It also argued that Liebhaber had "no substantial rights in the outcome" of the expungment hearing, since her claims already had been resolved. Royal Alliance additionally asserted that the arbitration award satisfied the requirements of FINRA Rule 12805, and contended that "[i]f FINRA's position is there needs to be live testimony in hearings like that, they need to amend their rule because the rule doesn't require that."

Liebhaber argued that she had an "absolute interest" in the expungement proceedings, because the award deemed her complaints against Tarr false and therefore

found her "essentially to have been a liar without anyone hearing from her or giving her a right to cross-examine the principle [*sic*] witness against her, which is a basic fundamental due process right." She further argued that she was "actually representing the interests of FINRA and the general public" by attempting to ensure that Tarr's CRD and BrokerCheck reports were accurate. In her view, "if she's not permitted to cross-examine the broker, then the CRD system -- this whole system becomes a farce." FINRA likewise contended that it had an interest in the proceedings, namely "protecting the integrity of the CRD system and the information contained in it." It further argued that the arbitrators violated FINRA Rule 12805 by not allowing Liebhaber to testify or cross-examine Tarr, despite having advance notice that she wished to do both.

The trial court ultimately adopted its tentative ruling and vacated the arbitration award "on the ground that Liebhaber's rights were substantially prejudiced by misconduct of the arbitrators, the arbitrators exceeded their powers, and Liebhaber's rights were substantially prejudiced by refusal of the arbitrators to hear evidence material to the controversy." The court found that the arbitrators violated FINRA Rule 2080 "by allowing Ms. Tarr to provide an unsworn statement in support of expungement while also preventing Liebhaber's attorney from cross-examining Ms. Tarr in order to determine if the requirements of Rule 2080 were met."

Royal Alliance timely appealed. (See § 1294, subds. (b) & (c); *Cinel v. Christopher* (2012) 203 Cal.App.4th 759, 765-766.)

DISCUSSION

I. General Arbitration Principles[4]

"Title 9 of the Code of Civil Procedure, as enacted and periodically amended by the Legislature, represents a comprehensive statutory scheme regulating private arbitration in this state. (§ 1280 et seq.) Through this detailed statutory scheme, the Legislature has expressed a 'strong public policy in favor of arbitration as a speedy and relatively inexpensive means of dispute resolution.' [Citations.]" (*Moncharsh v. Heily & Blase* (1992) 3 Cal.4th 1, 9 (*Moncharsh*).) Accordingly, "it is the general rule that parties to a private arbitration impliedly agree that the arbitrator's decision will be both binding and final." (*Ibid.*) Likewise, "it is the general rule that, 'The merits of the controversy between the parties are not subject to judicial review.' [Citations.] More specifically, courts will not review the validity of the arbitrator's reasoning. [Citations.] Further, a court may not review the sufficiency of the evidence supporting an arbitrator's award. [Citations.] [¶] Thus, it is the general rule that, with narrow exceptions, an arbitrator's decision cannot be reviewed for errors of fact or law." (*Id*. at p. 11.)

"On the other hand, arbitration procedures that interfere with a party's right to a fair hearing are reviewable on appeal." (*Hoso Foods, Inc. v. Columbus Club* (2010) 190

---

[4]Security brokerage agreements involve interstate commerce and therefore are governed by the Federal Arbitration Act (9 U.S.C. § 1 et seq.). (*Mastick v. TD Ameritrade, Inc.* (2012) 209 Cal.App.4th 1258, 1263.) However, the parties sought confirmation and vacation of the arbitration award in California state court pursuant to the California Arbitration Act (CAA). (See § 1280 et seq.) "[T]he presence of interstate commerce [is] not sufficient, by itself, to make the FAA's procedural provisions, including its provisions regarding judicial review (9 U.S.C. §§ 10, 11), applicable in California state courts. This is so because a state court applies its own procedural law—here, the procedural provisions of the CAA—absent a choice-of-law provision expressly mandating the application of the procedural law of another jurisdiction." (*Mave Enterprises, Inc. v. Travelers Indemnity Company of Connecticut* (2013) 219 Cal.App.4th 1408, 1429; see also *SWAB Financial v. E*Trade Securities* (2007) 150 Cal.App.4th 1181, 1195 [noting the FAA "does not preempt California's statutory grounds for vacating an arbitration award"].) We accordingly consider the matter under the CAA, including the provisions governing judicial review, namely section 1286.2. (*Mave Enterprises, Inc. v. Travelers Indemnity Company of Connecticut, supra,* 219 Cal.App.4th at p. 1430.)

Cal.App.4th 881, 888.) "Precisely because arbitrators wield such mighty and largely unchecked power, the Legislature has taken an increasingly more active role in protecting the fairness of the process. (*Moncharsh, supra*, 3 Cal.4th at pp. 12-13.)" (*Azteca Construction, Inc. v. ADR Consulting, Inc.* (2004) 121 Cal.App.4th 1156, 1165.) Indeed, one of the reasons "why we tolerate the risk of an erroneous decision" by arbitrators is the existence of statutes permitting judicial review of the fairness of the arbitration process. (*Moncharsh, supra*, 3 Cal.4th at p. 12.)

One such statute is section 1286.2, which enumerates "grounds which will justify vacating an arbitration award." (*California Faculty Association v. Superior Court* (1998) 63 Cal.App.4th 935, 944.) Section 1286.2 provides in pertinent part that a trial court "shall vacate" an arbitration award if it finds that "[t]he rights of the party were substantially prejudiced by misconduct of a neutral arbitrator"; "[t]he arbitrators exceeded their powers and the award cannot be corrected without affecting the merits of the decision upon the controversy submitted"; or "[t]he rights of the party were substantially prejudiced by the refusal of the arbitrators . . . to hear evidence material to the controversy or by other conduct of the arbitrators contrary to the provisions of this title." (§ 1286.2, subds. (a)(3), (a)(4), (a)(5).) The party seeking to vacate an arbitration award bears the burden of establishing that one of the six grounds listed in section 1286.2 applies and that the party was prejudiced by the arbitrator's error. (See *Comerica Bank v. Howsam* (2012) 208 Cal.App.4th 790, 826.)

We review the trial court's order vacating the arbitration award de novo. (*SWAB Financial v. E*Trade Securities, supra*, 150 Cal.App.4th at p. 1196.) We review for substantial evidence any determinations of disputed factual issues. (*Ibid.*)

II. Analysis

A. Violation of the forum rules is not necessary for prejudice.

The parties devote a substantial portion of their briefing to the questions of which portions of the FINRA Code of Arbitration Procedure for Customer Disputes apply, what the applicable provisions require, and whether the arbitrators complied with these

requirements.[5] Prior to oral argument, we asked the parties to be prepared to discuss whether "a finding of substantial prejudice within the meaning of Code of Civil Procedure section 1286.2, subdivision (a)(5) [can] be made absent a finding that the rules of the arbitral forum were violated." All three parties addressed this issue at oral argument.[6]

Royal Alliance maintained that a party's rights can never be prejudiced—and therefore an arbitral award can never be vacated under section 1286.2, subdivision (a)(5)—if the rules of the arbitral forum are followed. We disagree.

The CAA, under which Royal Alliance sought confirmation of the expungement award, "seeks to enhance both the appearance and reality of fairness in arbitration proceedings." (*Ovitz v. Schulman* (2005) 133 Cal.App.4th 830, 853.) To that end, it provides the basic parameters of arbitration proceedings unless the parties specifically agree otherwise; "such parameters include limited judicial review of the arbitration award." (*Corona v. Amherst Partners* (2003) 107 Cal.App.4th 701, 705.) Sections 1285 and 1286.2, respectively govern the confirmation and vacation of arbitration awards. Unlike §§ 1281.6, 1282, 1282.2, and 1283.8, these sections are not by their terms modifiable or avoidable by consent of the parties. Indeed, courts have characterized section 1286.2, subdivision (a)(5) as a "safety valve in private arbitration that permits a court to intercede when an arbitrator has prevented a party from fairly presenting its case." (*Hall v. Superior Court* (1993) 18 Cal.App.4th 427, 439 [discussing section 1286.2, subdivision (e), the predecessor statute to section 1286.2, subdivision (a)(5)] (*Hall*); see also *Burlage v. Superior Court* (2009) 178 Cal.App.4th 524, 529.) Section 1286.2, subdivision (a)(5) does not mention forum rules, or require courts to make a

---

[5] The parties are in agreement only that Rules 2080 ("Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD) System") and 12805 ("Expungement of Customer Dispute Information under Rule 2080") apply. They dispute the meaning and breadth of those rules, as well as the applicability of other rules contained in the FINRA Code of Arbitration Procedure for Customer Disputes.

[6] None argued that the federally applicable FINRA rules should be given supremacy or precedence over state statutes or decisional law.

finding that such rules were violated before assessing prejudice and vacating an award. The effectiveness of this "safety valve" and other CAA provisions designed to ensure fairness would be substantially reduced if a party's rights could be prejudiced only in proceedings in which an explicit rule of the forum was violated.

Accordingly, we find it unnecessary in this case to resolve the parties' substantial disagreements regarding the scope of (and degree of arbitrator compliance with) the FINRA rules. The pertinent question for us is not what the FINRA rules provided or whether the arbitrators adhered to them; it is whether the trial court correctly concluded that the arbitrators prevented a party from fairly presenting its case and prejudiced her rights as a result. (*Hall*, *supra*, 18 Cal.App.4th at p. 439.) We therefore focus our analysis on whether the trial court properly vacated the award under section 1286.2, subdivision (a)(5).

B. The arbitrators refused to hear evidence material to the controversy.

Section 1286.2, subdivision (a)(5) provides that the trial court "shall vacate" an arbitration award if "The rights of the party were substantially prejudiced by . . . the refusal of the arbitrators to hear evidence material to the controversy or by other conduct of the arbitrators contrary to the provisions of this title." The statute thus presents a two-part inquiry: (1) Did the arbitrators refuse to hear evidence material to the controversy or engage in other conduct contrary to the provisions of the CAA? (2) If so, were the rights of the party seeking to vacate the award substantially prejudiced? We consider the threshold inquiry regarding the arbitrators' conduct first.

Section 1286.2, subdivision (a)(5) includes "refusal of the arbitrators to hear evidence material to the controversy" among the grounds for vacating an arbitration award. Another provision of the CAA, section 1282.2, subdivision (d), provides that, unless they agree otherwise, "[t]he parties to the arbitration are entitled to be heard, to present evidence, and to cross-examine witnesses appearing at the hearing, but rules of evidence and rules of judicial procedure need not be observed. On request of any party to the arbitration, the testimony of witnesses shall be given under oath." Section 1282.2, subdivision (d) is incorporated into section 1286.2, subdivision (a)(5) by the phrase

"other conduct of the arbitrators contrary to the provisions of this title." Both statutes codify within the CAA the fundamental principle that "[a]rbitration should give both parties an opportunity to be heard." (*Cheng-Canindin v. Renaissance Hotel Associates* (1996) 50 Cal.App.4th 676, 689.) The parties may be heard on the papers rather than at a live hearing (*Schlessinger v. Rosenfeld, Meyer & Susman* (1995) 40 Cal.App.4th 1096, 1105), but the opportunity to be heard must be extended to all parties equitably. That requirement was violated here. Both parties to the expungement were permitted to submit written evidence, but only Royal Alliance was given the opportunity to offer oral evidence at the expungement proceeding. The arbitrators barred Liebhaber from doing so.

The arbitrators also foreclosed Liehaber's efforts to question Tarr. Regardless of whether the FINRA rules applicable to expungement hearings expressly contain or somehow incorporate the right to cross-examination, section 1282.2, subdivision (d) "entitles a party to cross-examine witnesses *if* they appear at a hearing." (*Schlessinger v. Rosenfeld, Meyer & Susman*, *supra*, 40 Cal.App.4th at p. 1106; see § 1282.2, subd. (d).) Liebhaber was a party to the proceeding, and Tarr appeared at opposing party Royal Alliance's behest to "offer any additional testimony" for the arbitrators. Although she did not technically "testify" for purposes of California law, as she was not under oath (see § 17, subd. (b)(5)(B)), Tarr appeared and acted as a witness by submitting oral evidence for the arbitrators' consideration. (Cf. § 1282.2, subd. (d) [suggesting that a person may be a witness during an arbitration without being sworn: "On request of any party to the arbitration, the testimony of witnesses shall be given under oath."].) Yet the arbitrators denied Liebhaber any opportunity to question Tarr.

Although section 1282.2, subdivision (d) also provides that "rules of evidence and rules of judicial procedure need not be observed," the procedural flexibility of the arbitral forum does not override participants' fundamental, common law right to a fair proceeding. (See *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807, 826, fn. 23.) It is one thing to establish reasonable time limits for the parties' presentation and rebuttal of evidence, which is well within an arbitrator's discretion. It is another to curtail one

party's oral presentation and exploration of evidence because the arbitration panel does not want "to be here for another two hours." (Cf. *In re Marriage of Carlsson* (2008) 163 Cal.App.4th 281, 290-291 [finding reversible error where trial judge "display[ed] ill-disguised impatience" with a litigant, "repeatedly threaten[ed] a mistrial if the proceedings were not concluded quickly enough," and "abruptly ended the trial before [the litigant] had finished his presentation"].) Liebhaber initiated the proceedings that culminated in Tarr's expungement request and was named as a party to the expungement proceedings; she had an interest in the outcome of the proceedings and the right to be treated fairly and in accordance with statutory law during their pendency.

C. Liebhaber's rights were substantially prejudiced.

The second question presented by section 1286.2, subdivision (a)(5) is whether the rights of a party to the arbitration "were substantially prejudiced." This prejudice criterion was satisfied here.

"Where, as here, a party complains of excluded material evidence, the reviewing court should generally focus first on prejudice, not materiality." (*Hall, supra*, 18 Cal.App.4th at p. 439.) A party's mere disappointment with an arbitration decision is not sufficient to prove substantial prejudice. (*Taheri Law Group, A.P.C. v. Sorokurs* (2009) 176 Cal.App.4th 956, 964.) "To find substantial prejudice, the court must accept, for purposes of analysis, the arbitrator's legal theory and conclude that the arbitrator might well have made a different award had the evidence been allowed." (*Hall, supra*, 18 Cal.App.4th at p. 439.) The prejudice query under section 1286.2, subdivision (a)(5) is not, as Royal Alliance suggests, "ultimately a question of the sufficiency of evidence," an inquiry generally outside the permissible scope of review of arbitration awards. Rather, it is an examination of the proffered but rejected evidence to determine the impact of its omission under the theory adopted by the arbitrators.

The arbitrators' legal theory in this case was that Liebhaber's contentions were false and clearly erroneous because Royal Alliance and Tarr said they were, and Liebhaber failed to refute these claims or offer any evidence to the contrary. However, the arbitrators did not afford Liebhaber the opportunity to present evidence orally, despite

extending such an opportunity to Royal Alliance. Although the arbitrators told Liebhaber that her oral evidence and proposed cross-examination were unlikely to "dramatically impact" their deliberations, they nonetheless relied on the absence of such evidence to support their ruling, mentioning the inadequacy of Liebhaber's presentation at least four times in the written award. The arbitrators also relied on the credibility of the statements Tarr made at the hearing, even though they acknowledged that "Ms. Tarr didn't say anything substantive that is not already on the record on her behalf with respect to the declaration." Accordingly, we conclude that "the arbitrator[s] might well have made a different award" (*Hall*, *supra*, 18 Cal.App.4th at p. 439) if they had allowed Liebhaber to tell her side of the story or question Tarr's.

Royal Alliance correctly notes that the arbitration panel received documentary evidence from both sides. It fails to acknowledge, however, that only Liebhaber was deprived of the opportunity to supplement that cold record with contemporaneous oral comments. The arbitrators permitted Royal Alliance to present Tarr's oral statements, deemed them credible, and relied on them to conclude that she recommended appropriate investments for Liebhaber. But the arbitration panel could not fully weigh the credibility of Tarr's statements due to the absence of cross-examination; "'[o]ne cannot "consider" what one has refused to "hear."'" (*Burlage v. Superior Court*, *supra*, 178 Cal.App.4th at p. 531.) During the expungement proceedings, Liebhaber's counsel placed on the record several lines of questioning he intended to explore with Tarr: "how she came to meet Ms. Liebhaber, what advice she gave her, questions about the suitability of the investments, whether she considered certain factors about these investments that she was recommending, how much time she spent giving her the advice she gave her and what she told her about whether she should take this early retirement at age 47." All of these areas of inquiry were aimed at the ultimate question of whether expungement was warranted because Liebhaber's complaints against Tarr were false or erroneous, and could well have affected the arbitrators' perfunctory conclusion that "the statements offered by non-party Kathleen Tarr during the telephonic hearing were credible." As

Liebhaber argued to the trial court, she was not given the opportunity "to show to the panel that . . . what [Tarr] is saying is not exactly accurate."

Simply put, the hearing was not fair. The arbitrators gave Royal Alliance an unfettered opportunity to bolster the written record but denied Liebhaber even a limited chance to do the same. Liebhaber's rights as a party to the arbitration proceedings were substantially prejudiced within the meaning of section 1286.2, subdivision (a)(5), and the arbitration order properly was vacated as a result.

DISPOSITION

The judgment of the trial court is affirmed. Liebhaber and FINRA shall recover their costs on appeal.

CERTIFIED FOR PUBLICATION

COLLINS, J.

We concur:

EPSTEIN, P. J.

MANELLA, J.

Regulatory Notice 17-42

Expungement of Customer Dispute Information

FINRA Requests Comment on Proposed Amendments to the Codes of Arbitration Procedure Relating to Requests to Expunge Customer Dispute Information

Comment Period Expires: February 5, 2018

Summary

FINRA seeks comment on establishing a roster of arbitrators with additional training and specific backgrounds or experience from which a panel would be selected to decide an associated person's request for expungement of customer dispute information.[1] The arbitrators from this roster would decide expungement requests where the underlying customer-initiated arbitration is not resolved on the merits or the associated person files a separate claim requesting expungement of customer dispute information. The *Notice* also proposes additional changes to the expungement process that would apply to all requests for expungement of customer dispute information.

This proposal is one in a series of regulatory initiatives that FINRA is considering related to the expungement process. For example, the FINRA Board of Governors has approved filing with the Securities and Exchange Commission (SEC) proposed amendments to the Codes of Arbitration Procedure for Customer and Industry Disputes (Codes) to make the best practices from the Notice to Arbitrators and Parties on Expanded Expungement Guidance[2] (Guidance) rules that arbitrators must follow when considering expungement requests. In addition, FINRA staff has been working with the North American Securities Administrators Association (NASAA) on various expungement issues, including potential amendments to the existing regulatory review process.

The text of the proposed amendments can be found at *www.finra.org/notices/17-42*.

December 6, 2017

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Legal
- Operations
- Registered Representatives
- Senior Management

Key Topics

- Arbitration
- Associated Person
- Code of Arbitration Procedure
- Dispute Resolution

Referenced Rules & Notices

- Code of Arbitration Procedure for Customer Disputes, Rule 12000 Series
- Code of Arbitration Procedure for Industry Disputes, Rule 13000 Series
- FINRA Rule 12100
- FINRA Rule 12805
- FINRA Rule 13805
- FINRA Rule 13806

Questions concerning this *Notice* should be directed to:

- Kenneth L. Andrichik, Senior Vice President and Chief Counsel, Office of Dispute Resolution, at (212) 858-3915;
- Victoria Crane, Associate General Counsel, Office of General Counsel, at (202) 728-8104; or
- Mignon McLemore, Assistant Chief Counsel, Office of Dispute Resolution, at (202) 728-8151.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by February 5, 2018.

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Marcia E. Asquith
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments as they are received.[3]

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).[4]

Background & Discussion

Through the expungement process, associated persons may seek to remove allegations made by customers from the Central Registration Depository (CRD ®) system and hence from the FINRA BrokerCheck (BrokerCheck ®) system.[5] It has been FINRA's long-held position that expungement of customer dispute information is an extraordinary measure, but it may be appropriate in certain circumstances.

CRD is the central licensing and registration system for the U.S. securities industry. In general, registered securities firms and regulatory authorities submit information in CRD in response to questions on the uniform registration forms.[6] These forms collect administrative, disciplinary and other information about registered personnel, including customer complaints, arbitration claims and court filings made by customers, and the arbitration awards or court judgments that may result from those claims or filings (*i.e.*, customer dispute information).[7] The SEC, FINRA, state and other regulators use this information in connection with their licensing and regulatory activities. Most of the CRD information is made publicly available through BrokerCheck. Associated persons may seek to have customer dispute information removed from CRD (and thereby, from BrokerCheck) pursuant to FINRA Rule 2080 because the claim or allegation is factually impossible, clearly erroneous or false, or if the associated person was not involved in the alleged investment-related sales practice violation.[8]

Critics of expungement have raised specific concerns about expungement hearings held after a settlement in the customer's arbitration case that gave rise to the customer dispute information (Underlying Customer Case). In these instances, critics argue that the panel from the Underlying Customer Case has not heard the full merits of that case and, therefore, may not have any special insights in determining whether to grant a request for expungement of customer dispute information under Rule 2080. Further, claimants and their counsel have little incentive to participate in an expungement hearing after the Underlying Customer Case settles and typically do not participate in such hearings. Thus, during these expungement hearings, the panel may receive information that is one-sided, which may favor the associated person requesting expungement.

The proposed amendments to the Codes would make a number of important changes to the current framework related to the expungement of customer dispute information. Among other things, the proposed amendments would:

All Requests for Expungement of Customer Dispute Information

- amend the Codes to require that for all requests for expungement of customer dispute information:
  - the associated person who is seeking to have his or her CRD record expunged must appear at the expungement hearing; and
  - to grant expungement, a three-person panel of arbitrators must unanimously agree that expungement is appropriate under Rule 2080(b)(1) and find that the customer dispute information has no investor protection or regulatory value.

Expungement Requests During the Underlying Customer Case

- limit an associated person who is named as a party to one opportunity to request expungement, and that opportunity must be exercised during the Underlying Customer Case;
- create limitations on requests for expungement of customer dispute information, including a one-year limitation period after the Underlying Customer Case closes for an associated person to file an expungement request that was not decided during the Underlying Customer Case;
- codify a party's ability to request expungement on behalf of an associated person not named as a respondent in the Underlying Customer Case (hereinafter referred to as an unnamed person)[9] during the Underlying Customer Case, and establish procedures for such requests;
- require associated persons who file expungement requests outside of the Underlying Customer Case to file the request under the Industry Code against the firm at which he or she was associated at the time of the events giving rise to the customer dispute;
- remove the option to file an expungement request outside of the Underlying Customer Case against a customer; and
- specify a minimum filing fee of $1,425 for expungement requests.

Expungement Arbitrator Roster

- establish a roster of public chairpersons with additional qualifications to decide expungement requests (Expungement Arbitrator Roster) filed against a firm under the Industry Code.

Expungement Requests in Simplified Arbitration Cases

- require that an associated person or an unnamed person wait until the conclusion of a customer's simplified arbitration case to file an expungement request, which must be filed against the firm not the customer and would be heard by a panel selected from the Expungement Arbitrator Roster.

Expungement Requests relating to Customer Complaints that Do Not Result in an Arbitration Claim

- require that the associated person seek expungement of the customer dispute information relating to a customer complaint within one year of the member firm initially reporting the customer complaint to CRD.

I. Requesting Expungement Relief During the Underlying Customer Case

Current FINRA Rule 12805 provides a list of requirements that arbitrators must meet before they may grant expungement.[10] The rule does not, however, provide any guidance for associated persons on how and when an associated person may request expungement relief during the Underlying Customer Case. As discussed further below, the proposal would amend Rule 12805 to set forth requirements for expungement requests filed by an associated person as a party as well as on behalf of an unnamed person.

A. Expungement Requests by an Associated Person Named as a Party

1. Applicability

Currently, under FINRA Rule 12805, an associated person who is a named party in an arbitration may request expungement during that arbitration, but is not required to do so. Some associated persons have filed requests seeking to expunge customer dispute information years after FINRA closed the Underlying Customer Case. Given the length of time between case closure and filing of the request, in many of these instances, the customers cannot be located and any documentation that could explain what happened in the case is not available or cannot be located. Thus, under the proposal, an associated person who is named as a party would be required to request expungement in the Underlying Customer Case. If the associated person does not request expungement in the Underlying Customer Case, the associated person would be prohibited from seeking to expunge the customer dispute information arising from the customer's statement of claim during any subsequent proceeding under the Codes. Requiring an associated person who is named in an arbitration to request expungement of the customer dispute information during the Underlying Customer Case would eliminate expungement requests filed years after the Underlying Customer Case concludes.

2. Method of Request and Fees

The proposed amendments would permit the associated person to file an expungement request or include such request in the answer or any pleading.[11] The associated person would be permitted to file the request no later than 60 days before the first scheduled hearing session,[12] otherwise, the associated person would be required to file a motion[13] to seek an extension to file the expungement request. Thus, if an associated person files an expungement request after the 60-day timeframe, the non-moving parties could object and the panel would be required to decide the associated person's motion.

Along with the expungement request, the associated person would be required to pay a filing fee of $1,425 or the applicable filing fee provided in Rule 12900(a)(1), whichever is greater.[14] In addition, consistent with existing provisions under the Codes, there would be an assessment of a member surcharge[15] and process fee[16] against each member that is named as a party or respondent, or that employed the associated person named as a respondent or party at the time of the events giving rise to the dispute, as applicable.[17]

3. Underlying Customer Case Closes by Award

If the Underlying Customer Case closes by award, the panel would be required to consider and decide the expungement request during the Underlying Customer Case. The panel must, among other things, agree unanimously to grant expungement and in the arbitration award: (1) identify at least one of the Rule 2080(b)(1) grounds for expungement that serves as the basis for expungement and provide a brief written explanation of the reasons for its finding that one or more Rule 2080(b)(1) grounds for expungement applies to the facts of the case; and (2) find that the customer dispute information has no investor protection or regulatory value.

The unanimity requirement would apply to all requests for expungement of customer dispute information. Thus, when a panel decides an associated person's expungement request during the Underlying Customer Case, the panel would be required to agree unanimously to grant expungement. In deciding the customer's claims, however, a majority agreement of the panel would continue to be sufficient.

4. Underlying Customer Case Closes Other than by Award

If the Underlying Customer Case closes other than by award (*e.g.*, the parties settle the arbitration), the panel in the Underlying Customer Case would not decide the associated person's expungement request. In this situation, the associated person would be permitted to file the expungement request as a new claim under the Industry Code against the firm at which he or she was associated at the time of the events giving rise to the customer dispute.[18] Under the proposal, an associated person would not be permitted to file the new expungement request against the customer because the customer should not be asked to participate in another arbitration hearing that could increase the customer's costs and expenses. Instead, the associated person would be required to name the firm at which he or she was associated at the time of the events giving rise to the customer dispute with the goal of having a more robust expungement proceeding that will help the panel determine whether to grant expungement. As discussed in further detail below, this new claim would be decided by a three-person panel selected from the Expungement Arbitrator Roster.

5. Limitations on Expungement Requests

For the expungement request to be considered after the Underlying Customer Case closes other than by award, the associated person would be required to file the request within one year after FINRA closes the Underlying Customer Case, provided the expungement request is not barred. Under the proposal, an associated person would be barred from requesting expungement relief if: (1) a panel or arbitrator in the Underlying Customer Case issued a decision on the expungement request for the same customer dispute information; (2) the associated person requested expungement of the same customer dispute information in court and the court denied the request; (3) the Underlying Customer Case has not concluded; (4) it has been more than a year since FINRA closed the Underlying Customer Case; or (5) if there was no Underlying Customer Case involving the customer dispute information, more than one year has elapsed since the date that the member firm initially reported the customer complaint to CRD.[19]

The first two limitations would prevent an associated person from forum shopping to garner a favorable outcome on his or her expungement request. Under the proposal, these limitations would apply to all requests for expungement of customer dispute information filed in the forum, including requests decided prior to the effective date of the proposal.

With respect to the third limitation, if an associated person's expungement request was not decided during the Underlying Customer Case, the associated person would be required to wait until the Underlying Customer Case concludes before filing a request for expungement. Thus, under the proposal, if the Underlying Customer Case has not concluded and an associated person has filed a request for expungement of the customer dispute information at issue in the Underlying Customer Case, FINRA would stay the associated person's expungement request until the Underlying Customer Case concludes and permit the associated person to refile it under the Industry Code so that it could be heard by a panel from the Expungement Arbitrator Roster.

With respect to the fourth limitation, if the expungement request is not filed within a year after the Underlying Customer Case closes, the associated person would forfeit his or her right to request expungement. The one-year limitation period would ensure that the expungement hearing is held close in time to the Underlying Customer Case, when information regarding the Underlying Customer Case is available and in a timeframe that would increase the likelihood for the customer to participate if he or she chooses to do so.

Under the proposal, the one-year limitation period would apply where the Underlying Customer Case closes after the effective date of the proposal. If the Underlying Customer Case closes on or prior to the effective date of the proposal, the associated person would have six months from the effective date to file the expungement request.

The fifth limitation would establish a one-year period for associated persons to expunge customer dispute information that arose from a customer complaint and did not result in an arbitration claim. Under the proposal, the associated person would have a year from the date that a member firm initially reported a customer complaint to CRD to file an expungement request.[20] If a member firm initially reports a customer complaint to CRD on or prior to the effective date of the proposal, the associated person would have six months from the effective date of the proposal to file the expungement request.

B. Expungement Requests by a Party on Behalf of an Unnamed Person

1. Applicability

The proposal would define an unnamed person to mean an associated person or formerly associated person who is identified in Forms U4 or U5 as having been the subject of an investment-related customer-initiated arbitration that alleged that he or she was involved in one or more sales practice violations, but who was not named as a respondent in the arbitration.[21]

Currently, unnamed persons have three arbitration avenues to pursue expungement under the Codes: (1) a party to an arbitration may request expungement on their behalf during the Underlying Customer Case; (2) the unnamed persons may try to intervene in the Underlying Customer Case; and (3) the unnamed persons may file a separate arbitration case seeking expungement after the Underlying Customer Case closes.

As explained further below, the proposed amendments would codify the ability of a party in the Underlying Customer Case to request expungement on behalf of an unnamed person with the written approval of the unnamed person. The proposed amendments would also codify procedures regarding when and how an unnamed person may file a separate case seeking expungement of customer dispute information after the Underlying Customer Case closes.

As these would be the only avenues by which an unnamed person may request expungement of customer dispute information under the Codes, the proposed amendments would foreclose the option for an unnamed person to intervene in the Underlying Customer Case and thereby remove the potential for the unnamed person to become a party in the Underlying Customer Case.

2. Procedural Similarities to Expungement Requests by an Associated Person Named as a Party

The proposed procedures discussed above that would apply to expungement requests by an associated person named as a party (*i.e.*, method of request and fees, customer case closure either by award or otherwise, and one-year limitation period) would also apply to expungement requests by a party on behalf on an unnamed person, with some modifications as explained below.

First, a party requesting expungement relief on behalf of an unnamed person would be required to file with the Director of the Office of Dispute Resolution[22] (Director) and serve on all parties no later than 60 days before the first scheduled hearing session: (1) a Form Requesting Expungement Relief on Behalf of an Unnamed Person, signed by the unnamed person whose CRD record would be expunged;[23] and (2) a statement requesting expungement relief.[24] The signed form would represent an acknowledgement by the unnamed person that he or she agrees to be bound by the panel's decision on the request for expungement relief. If the party does not request expungement within the 60-day timeframe, the party would be required to file a motion seeking an extension to file the expungement request.

Second, if the Underlying Customer Case closes other than by award, FINRA would notify the unnamed person in writing that the case has closed. This milestone in the customer's case would start the one-year limitation period for the unnamed person to seek expungement of the customer dispute information against the firm at which he or she was associated at the time of the events giving rise to the customer dispute, in a separate action under the Industry Code (as discussed in further detail below).

Finally, if a party from the Underlying Customer Case does not request expungement relief on behalf of the unnamed person, the unnamed person would be permitted to file an expungement request under the Industry Code against the firm at which he or she was associated at the time of the events giving rise to the customer dispute, within one year of the Underlying Customer Case closure, provided the expungement request is not barred.[25]

II. Proposed Changes that Apply to All Requests for Expungement of Customer Dispute Information

Currently, the Codes provide criteria that a panel must follow before it may decide an expungement request.[26] As explained in further detail below, under the proposal, the current requirements to hold a hearing session and to provide a basis for expungement in an arbitration award would be expanded to clarify the process and guide further the arbitrators' decision-making. The proposed changes would apply to all requests to expunge customer dispute information filed under the Codes.

A. Hold a Hearing Session

Currently, the Codes require a panel that is deciding an expungement request to hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement.[27] The proposed amendments would require that an associated person who is seeking to have his or her CRD record expunged appear at the expungement hearing, either in person or by videoconference; appearance by telephone would not be an option. As the associated person is requesting the permanent removal of information from CRD, FINRA believes that the associated person should be available in person or by videoconference to present his or her case and respond to questions from the panel.

B. Unanimity and Additional Finding Required to Grant Expungement of Customer Dispute Information

Currently, the Codes require that the panel indicate in the arbitration award which of the Rule 2080 grounds for expungement serves as the basis for its expungement order and provide a brief written explanation of the reasons for its finding that one or more Rule 2080 grounds for expungement applies to the facts of the case.[28]

The proposed amendments would require that the panel agree unanimously to grant expungement and in the arbitration award: (1) identify at least one of the Rule 2080(b)(1) grounds for expungement that serves as the basis for expungement and provide a brief written explanation of the reasons for its finding that one or more Rule 2080(b)(1) grounds for expungement applies to the facts of the case; and (2) find that the customer dispute information has no investor protection or regulatory value.

The proposal would clarify for arbitrators that the standard for granting the permanent removal of customer dispute information from CRD is a finding that the customer dispute information has no investor protection or regulatory value. Since Rule 2080 has been in effect, FINRA has implemented policies and procedures to strengthen the expungement process. For example, in 2008, FINRA adopted Rule 12805 to require arbitrators to perform additional fact finding before granting expungement of customer dispute information.[29] After the approval of FINRA Rule 12805, FINRA staff updated the arbitrator training materials and all arbitrators were required to certify that they had familiarized themselves with the requirements of the expungement rules.[30] In 2013, in response to FINRA staff's concerns about the number of expungement requests granted after the Underlying Customer Case settles, FINRA published the Guidance for arbitrators to use when considering expungement requests.[31]

Based on FINRA's review of awards where expungement has been granted, arbitrators appear to be following the practices identified in the Guidance and have a heightened awareness that expungement is an extraordinary remedy. FINRA has noticed a marked improvement in the quality of the awards in which expungement is granted. Notwithstanding these positive results, FINRA believes that expanding the findings that arbitrators must make before granting expungement of customer dispute information would help FINRA maintain the accuracy of the data that appears in CRD by ensuring that only information that is not valuable to regulators and investors is expunged from CRD.[32]

III. Requests for Expungement of Customer Dispute Information Under the Industry Code and the Expungement Arbitrator Roster

As explained above, if an expungement request is not decided during the Underlying Customer Case, the proposal would permit an associated person to file the expungement request as a new claim against the firm33 at which he or she was associated at the time of the events giving rise to the customer dispute, provided the claim is not barred.[34] A three-person panel selected from the Expungement Arbitrator Roster would decide this new claim.

A. Selection of Panel

Under the proposal, the Neutral List Selection System[35] (NLSS) would randomly select three public chairpersons[36] from the Expungement Arbitrator Roster to decide an expungement request.[37] To be on the Expungement Arbitrator Roster, the public chairpersons would be required to have the following additional qualifications:

(1) completed enhanced expungement training;[38]
(2) admitted to practice law in at least one jurisdiction; and
(3) five years' experience in any one of the following disciplines:

(a) litigation;
(b) federal or state securities regulation;
(b) administrative law;
(c) service as a securities regulator; or
(d) service as a judge.

The proposed changes to the expungement framework would help arbitrators on the Expungement Arbitrator Roster better understand the unique nature of this extraordinary remedy and the importance of maintaining the integrity of the public record. The proposed roster composition and the proposed additional requirements to grant expungement, taken together, should help FINRA maintain the integrity of its CRD records and ensure that expungement is only granted in appropriate circumstances.

B. Expungement Hearing

Under the proposal, once the panel is selected from the Expungement Arbitrator Roster, it must hold a recorded hearing session regarding the appropriateness of the associated person's request for expungement of customer dispute information. With respect to the hearing session, the proposal provides that: (1) the associated person whose CRD record would be expunged must appear at the expungement hearing either in person or by videoconference;[39] (2) the Director would notify the parties from the Underlying Customer Case or the customer complaint of the time and place of the expungement hearing; and (3) all customers in the Underlying Customer Case or customers who filed a customer complaint are entitled to appear at the expungement hearing. At the customer's option, the customer may appear by telephone.

As discussed above in connection with expungement hearings in the Underlying Customer Case, FINRA believes that as the associated person is requesting the permanent removal of information from CRD, the associated person should be available in person to present his or her case and respond to questions from the panel. In addition, FINRA believes that allowing customers to appear by telephone would make it easier for them to participate in the expungement hearing and, therefore, could encourage them to participate.

C. Unanimity and Additional Finding Required to Grant Expungement

Consistent with requests for expungement relief considered by a panel under the Customer Code, a panel selected from the Expungement Arbitrator Roster under the Industry Code may grant expungement of customer dispute information only if the panel agrees unanimously. In addition, in the arbitration award the panel must: (1) identify at least one of the Rule 2080(b)(1) grounds for expungement that serves as the basis for expungement and provide a brief written explanation of the reasons for its finding that one or more Rule 2080(b)(1) grounds for expungement applies to the facts of the case; and (2) find that the customer dispute information has no investor protection or regulatory value.

IV. Expungement Requests in Simplified Arbitrations

Under the Codes, arbitrations involving $50,000 or less are decided by a single arbitrator without a hearing, also referred to as a decision "on the papers," and are called simplified arbitrations.[40] The Codes provide that the requirement to hold a hearing to decide an expungement request applies to expungement requests made in simplified arbitrations.[41]

Under the proposal, an associated person or unnamed person would be required to file an expungement request under the Industry Code against the firm at which he or she was associated at the time of the events giving rise to the customer dispute, and only at the conclusion of the simplified case. Thus, a panel from the Expungement Arbitrator Roster would consider and decide the expungement request.[42]

The proposed amendments would address a concern raised by customers that when an associated person requests expungement during a simplified case, the arbitrator holds a hearing during the simplified case to decide the appropriateness of expungement. When the arbitrator conducts a hearing in this situation, the customer is forced to participate in a hearing that he or she did not request, which delays the customer's case and the rendering of an award in the customer's simplified case. The proposed amendments would ensure that expungement requests would not be heard during a simplified case.[43]

V. Preliminary Economic Impact Analysis

A. Regulatory Need

Associated persons can request expungement of customer dispute information from CRD. As discussed above, some critics have raised concerns about arbitration panels granting requests for expungement of customer dispute information when the panel has not heard the full merits of the Underlying Customer Case. Claimants and their counsel may not have the incentive to participate in expungement hearings. Panels, therefore, may receive information that is one-sided, which could favor the associated person seeking expungement. The proposed amendments would provide for an increased opportunity for customer participation in expungement decisions, make information regarding the Underlying Customer Case more readily available, make the expungement decision more timely relative to the Underlying Customer Case, and establish an Expungement Arbitrator Roster to decide expungement requests when expungement has not been decided as part of the Underlying Customer Case.

B. Economic Baseline

The economic baseline for the proposed amendments is the current rules under the Codes that address the process for associated persons to expunge customer dispute information from CRD. The proposed amendments are expected to affect associated persons; firms; customers to complaints or arbitration cases; customers that publicly view CRD information through BrokerCheck; and the SEC, FINRA, state and other regulators that use CRD.

Associated persons have incentive to file for expungement relief to remove customer dispute information from CRD. By removing customer dispute information from CRD, associated persons would also remove customer dispute information from BrokerCheck. Customer dispute information on CRD and BrokerCheck may impact the business of associated persons and reduce their professional opportunities. Investors (including current and prospective customers) use BrokerCheck to learn about the professional background and conduct of associated persons. Current and prospective customers may be less likely to select or remain with associated persons who have customer dispute information on their records. Current and future employers can also consider customer dispute information when making employment decisions.

Although panels that decide expungement requests receive information related to the expungement request from associated persons, they may not receive such information from customers. Panels are likely to receive information from customers if the panel decides the expungement request during the Underlying Customer Case. Panels are less likely to receive such information if the Underlying Customer Case is settled or withdrawn. Panels may also not receive information from customers if associated persons file separate claims requesting expungement and the customers are unwilling or unable to participate. In these instances, customers and their counsel may not have the incentive to participate in the separate expungement hearing. Associated persons may also request expungement of customer dispute information long after the Underlying Customer Case closes, making it potentially more difficult for customers to participate and the panel to verify or validate the information provided.

One-sided information could favor the associated persons seeking expungement, which has the potential to reduce the integrity and reliability of the information on CRD and BrokerCheck. As noted above, investors use that information to make decisions about associated persons with whom they may wish to do business. The SEC, FINRA, state and other regulators use CRD information for licensing and regulatory activities. Accordingly, the integrity and reliability of CRD information is critical to the needs of these stakeholders.

FINRA staff is able to identify 5,482 customer claims in arbitration that were filed from 2014 to 2016, and that were closed as of June 30, 2017. FINRA staff is also able to identify 12,849 customer complaints that were filed against associated persons and closed during the same time period but did not result in an arbitration claim. These customer claims and complaints are available in the CRD system and disclosed through BrokerCheck and, therefore, could be the subject of an expungement request by an associated person.

FINRA staff is able to identify 2,232 customer arbitration cases involving an expungement request that were filed from 2014 to 2016 and closed as of June 30, 2017. Among the 2,232 cases, 1,738 (78 percent) were closed by settlement or mediation. Another 384 (17 percent) of the 2,232 cases were closed by hearing or on the papers; another 92 (4 percent) were withdrawn; and 18 (less than 1 percent) were closed by other means. In addition to the 2,232 customer arbitration cases, FINRA staff is also able to identify 183 intra-industry arbitration cases that involve an expungement request of customer dispute information.

Among the cases containing a request for expungement of customer dispute information that were filed from 2014 to 2016 and closed as of June 30, 2017, arbitrators made a determination regarding the expungement of customer dispute information in 808 of these cases. The 808 cases include decisions regarding expungement requests as part of the Underlying Customer Case as well as decisions regarding expungement requests when associated persons filed a separate claim for expungement following the close of the Underlying Customer Case.

Arbitrators recommended expungement for at least one associated person in 608 (75 percent) of the 808 cases. In another 213 (26 percent) of the 808 cases, arbitrators did not grant expungement for at least one associated person. In a few of the 808 cases where more than one associated person sought expungement relief, arbitrators both granted and did not grant expungement relief for at least one associated person. Among the 808 cases in which arbitrators made a determination regarding the expungement of customer dispute information, the Underlying Customer Case closed by settlement in 436 of the cases. Arbitrators recommended expungement for at least one associated person in 88 percent of these 436 cases.

If an arbitration panel grants expungement of customer dispute information, the associated person must obtain an order from a court of competent jurisdiction confirming the arbitration award containing expungement relief. In the experience of FINRA staff, courts typically confirm arbitration awards containing expungement relief. Associated persons that obtain a court order confirming the arbitration award must then serve the confirmed award on FINRA to have the customer dispute information expunged. Not all panel expungement recommendations result in the expungement of customer dispute information from CRD and BrokerCheck. Some associated persons may determine not to confirm the award in court. As of June 30, 2017, FINRA had expunged customer dispute information in connection with 391 (64 percent) of the 608 cases pursuant to a court order. As of that date, associated persons may have not yet sought or obtained a court order for the remaining 217 of the 608 cases. Other associated persons may have not yet served the confirmed award on FINRA.

Lastly, the current fee structure for filing a request to expunge customer dispute information provides incentives for associated persons to file a request separately from the Underlying Customer Case and add a small monetary claim, thus making it a simplified claim, to reduce the filing fee to $50 from $1,575 (*i.e.*, the filing fee for a non-monetary/unspecified claim). Further, by making the request a simplified claim, the case can be heard by one arbitrator as opposed to the default of a three-arbitrator panel for non-monetary or unspecified claims.[44]

C. Economic Impacts

The proposed amendments are designed, among other things, to improve the quality and timeliness of the information available to panels determining requests for expungement. The panels assigned to the Underlying Customer Case would be more likely to decide expungement requests, if any. In addition, expungement decisions would occur soon after the Underlying Customer Case closes or a member firm initially reports a customer complaint to CRD. The proposed amendments would therefore increase the opportunity for or likelihood that panels would receive information from customers when considering expungement requests. The information is therefore less likely to be one-sided and favor associated persons. The proposed amendments would also establish qualifications for those arbitrators on the Expungement Arbitrator Roster who decide expungement requests when customers are less likely to provide information in connection with an expungement request. With these additional qualifications, the arbitrators should be better able to evaluate the information they receive in a more judicious and discerning manner.

The proposed amendments would benefit investors, member firms, and regulators by helping to ensure that the customer dispute information on CRD and, therefore, BrokerCheck more accurately reflects those customer disputes that have investor protection or regulatory value. Stakeholders would be more confident in the reliability of the customer dispute information contained on CRD and BrokerCheck. The customer dispute information contained on CRD and BrokerCheck would also be more meaningful and valuable to stakeholders.

Customers would benefit from the proposed amendments that restrict the manner and timing of associated persons' requests for expungement of customer dispute information. Associated persons would have one year after a customer complaint was initially reported to CRD to request expungement of the information. For customer complaints that result in an arbitration claim, associated persons named in an Underlying Customer Case would be required to request expungement during the Underlying Customer Case. Associated persons whose expungement request is not determined during the Underlying Customer Case would then have one year following the close of the Underlying Customer Case to request expungement of the customer dispute information. Customers would therefore have a greater ability to participate in the expungement hearings, if they so choose. In addition, if a separate expungement case were filed, the associated person would no longer be able to name the customer as the opposing party. Customers would therefore no longer incur the costs and inconvenience to be a party to these claims. Lastly, expungement requests would not be heard during a simplified case. As a result, customer claimants in simplified cases would no longer experience delays in the resolution of their cases as a result of expungement hearings, and would not be forced to attend a hearing in a case that the customer chose to be decided on the papers.

The proposed amendments would impose costs on associated persons, primarily by restricting how and when they could file an expungement request and, in some cases, by increasing the cost of filing an expungement request. The stricter requirements for requesting expungement of customer dispute information are meant to improve the quality and timeliness of the information that the panel hearing the request receives. The information that panels receive is less likely to be one-sided from associated persons only. The information is therefore less likely to favor the associated persons requesting expungement.

The requirement that the decision be unanimous, rather than a majority decision, could also increase the difficulty for an associated person to obtain expungement. To the extent that customers and firms use customer dispute information to make business and employment decisions, if customer dispute information is not expunged as frequently, associated persons could experience a loss of business and professional opportunities, loss of employment at their current firm, and thus, decreased income.[45]

Associated persons could also incur additional fees to file expungement requests. The associated person would be required to pay a filing fee of $1,425 or the applicable filing fee provided in Rule 12900(a)(1), whichever is greater. This aspect of the proposed amendments would end the practice of associated persons adding a monetary claim of less than $1,000 to separately filed expungement requests to reduce their filing fee to the minimum of $50.[46]

Associated persons would also be required to attend expungement hearings in person, either by traveling to the hearing location or by videoconference, depending on the method permitted by the arbitration panel. Traveling to the hearing location could significantly increase the cost of having their request heard, by increasing both transportation and room and board costs as well as lost time in transit. Attendance by videoconference would eliminate many of these costs.

The potential decrease in the frequency in which panels recommend expungement and the potential increase in costs to file and to attend hearings could reduce the incentive of associated persons to request expungement of customer dispute information. Associated persons could continue to request expungement relief if they believe that the request is likely to be granted and that any reduction to their income potential is greater than any costs that they could incur. Accordingly, the types of expungement cases that arbitration panels would consider under the proposed amendments would likely be more meritorious.

The proposed amendments would also impose additional costs on member firms. If associated persons file a separate claim for expungement, they would be required to file the claim against the firm at which he or she was associated at the time of the events giving rise to the customer dispute, rather than against the customer. To the extent that member firms would become a party to the expungement case more frequently, they could experience higher costs associated with those cases.

The magnitude of the benefits and costs of the proposed amendments depends on the change in the number of associated persons requesting expungement of customer dispute information, the number of arbitration awards that grant expungement, and the number of expungement awards confirmed by the courts. The extent to which awards granting expungement become more informed would enhance the integrity and reliability of the customer dispute information on CRD and, therefore, BrokerCheck and the ability of customers and regulators to rely on the information as an accurate description of the conduct of associated persons. The magnitude of the benefits and costs also depends on the extent to which the record of associated persons decreases their business or professional opportunities. A greater decrease in business or professional opportunities would result in a greater economic transfer between associated persons. The proposed amendments would have no effect on associated persons that do not have future customer claims or complaints.

D. Alternatives Considered

As noted above, FINRA staff has been working with NASAA on various expungement issues, including potential amendments to the existing regulatory review process. The proposed amendments in this *Notice* reflect just one approach. FINRA requests comment below to inform subsequent revisions to the proposed amendments, including other approaches that could reduce the potential that panels receive information that is one-sided, which may favor the associated person requesting expungement.

Request for Comment

FINRA is interested in receiving comments on all aspects of the proposed amendments. In particular, FINRA seeks comment on the following questions:

1. FINRA Rules 12805 and 13805 provide, in relevant part that, in order to grant expungement of customer dispute information under Rule 2080, the panel must comply with the requirements stated in the rule. (Emphasis added.) FINRA notes, however, that if a panel issues an arbitration award containing expungement relief, the award must be confirmed by a court of competent jurisdiction and FINRA could decide to oppose the confirmation. Thus, as the associated person is required to complete additional steps after the arbitrators make their finding in the award before FINRA will expunge the customer dispute information, FINRA believes the word "grant" may not be an appropriate description of the panel's authority in the expungement process. FINRA is considering changing the word to "recommend." Please discuss whether the rule should retain "grant" or change to "recommend" or some other description to more accurately reflect the panel's authority in the expungement process.
2. Would named associated persons request expungement in every case to preserve the right to have the expungement claim heard and decided, either in the Underlying Customer Case or as a new claim under the Industry Code? If so, what would be the potential costs and benefits of a named person requesting expungement in every case?
3. Should FINRA consider bifurcating the expungement request from the customer's claim in all cases relating to customer disputes? What would be the costs and benefits of such an approach?
4. What are the costs and benefits of requiring the unanimous consent of a three-person panel to grant all requests for expungement of customer dispute information?
5. Is the one-year limitation on being able to request expungement of customer dispute information appropriate? Should the time period be longer or shorter? Please discuss.

6. Should the associated person who is requesting expungement be required to appear in person or by videoconference, rather than by phone, at the expungement hearing?
7. Should the arbitrators on the Expungement Arbitrator Roster have specific qualifications? If so, are the proposed additional qualifications appropriate or should FINRA consider other qualifications?
8. Should the arbitrators on the Expungement Arbitrator Roster be lawyers only or could the experience of serving on three arbitrations through award be a sufficient substitute?
9. How would the proposed amendments affect the granting or denying of expungement requests? Which aspect of the proposed amendments would have the largest impact on expungement determinations? Why?
10. The proposal would establish a one-year limitation period for associated persons to expunge customer dispute information that arose from a customer complaint. The limitation period would start on the date that the member firm initially reported the customer complaint to CRD. Should the one-year limitation period be based on a different milestone? If so, what should it be?
11. The proposal would clarify for arbitrators that the standard for granting the permanent removal of customer dispute information from CRD is a finding that at least one of the Rule 2080(b)(1) factors applies and that the customer dispute information has "no investor protection or regulatory value." Are there specific factors that arbitrators should consider when making a finding that the customer dispute information has "no investor protection or regulatory value"?
12. In a simplified arbitration case, if a customer requests a hearing, should the single arbitrator be permitted to decide an expungement request, if a request is filed?

Endnotes

1. On December 16, 2015, the FINRA Dispute Resolution Task Force (Task Force) issued its Final Report and Recommendations (Final Report). One of the recommendations was that FINRA create a special arbitrator roster to handle expungement requests in settled cases and in cases when a claimant did not name the associated person as a respondent. A list of the Task Force members is available at http://www.finra.org/arbitration-and-mediation/finra-dispute-resolution-task-force. The Final Report is available at http://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf.

2. *See* Expanded Expungement Guidance (September 2017), available at http://www.finra.org/arbitration-and-mediation/notice-arbitrators-and-parties-expanded-expungement-guidance.

3. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (Online Availability of Comments) (November 2003) for more information.

4. *See* Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

5. FINRA operates the CRD system pursuant to policies developed jointly with NASAA. FINRA works with the SEC, NASAA, other members of the regulatory community, and member firms to establish policies and procedures reasonably designed to ensure that information submitted and maintained on the CRD system is accurate and complete. These procedures, among other things, cover expungement of customer dispute information from the CRD system in narrowly defined circumstances.

6. For example, broker-dealers use the Uniform Application for Securities Industry Registration or Transfer, referred to as Form U4, to register or transfer the registrations of, associated persons with self-regulatory organizations (SROs), and with states, commonwealths and territories. Also, broker-dealers use the Uniform Termination Notice for Securities Industry Registration, referred to as Form U5, to terminate the registrations of associated persons with SROs, and with states, commonwealths and territories.

7. *See Notice to Members 04-16* (March 2004).

8. FINRA Rule 2080 requires members or associated persons seeking expungement of customer dispute information to obtain an order from a court of competent jurisdiction directing expungement or confirming an arbitration award recommending expungement relief and requires the member or associated person to name FINRA as a party in any judicial proceeding seeking expungement relief. FINRA may, however, waive the requirement to name it as a party if it determines that the requested expungement relief is based on affirmative judicial or arbitral findings that: (1) the claim, allegation or information is factually impossible or clearly erroneous, (2) the associated person was not involved in the alleged investment-

©2017. FINRA. All rights reserved. Regulatory Notices attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

related sales practice violation, forgery, theft, misappropriation or conversion of funds, or (3) the claim, allegation, or information is false. In addition, FINRA has sole discretion "under extraordinary circumstances" to waive the requirement if the expungement request is meritorious and expungement would not have a material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.

9. In 2009, Forms U4 and U5 were amended to add questions that required registered persons to report allegations of sales practice violations made in customer-initiated arbitrations even if they were not named as a respondent in the arbitration. *See* Securities Exchange Act Release No. 59916 (May 13, 2009), 74 FR 23750 (May 20, 2009) (Order Approving SR-FINRA-2009-008); *see also* Regulatory Notice 09-23 (May 2009). Such persons may believe these allegations are unfounded and seek to have them expunged. Because they are not parties to the customer-initiated arbitration, they are unable to seek expungement relief in the Underlying Customer Case.

10. FINRA Rule 12805 provides that a panel must comply with the following criteria before granting expungement: (1) hold a hearing to decide the issue of expungement; (2) review settlement documents, and consider the amount of payments made to any party, and any other terms and conditions of the settlement; (3) indicate in the award which of the grounds in FINRA Rule 2080 is the basis for expungement and provide a brief written explanation of the reasons for granting expungement; and (4) assess all forum fees for hearing sessions in which the sole topic is the determination of the appropriateness of expungement against the parties requesting expungement relief. *See also* FINRA Rule 13805.

11. Under the Codes, a pleading is a statement describing a party's causes of action or defenses (*e.g.*, statement of claim, answer, or counterclaim). *See* FINRA Rule 12100(v).

12. A hearing session is any meeting between the parties and the arbitrator(s) of four hours or less, including a hearing or prehearing conference. *See* FINRA Rules 12100(p) and 13100(p).

13. *See* FINRA Rule 12503.

14. Currently, if an associated person requests expungement relief only in a claim filed separately, the filing fee would be the non-monetary/unspecified claim amount, or $1,575. *See* FINRA Rules 12900(a) and 13900(a). Associated persons have been adding a monetary claim of less than $1,000 to a request for expungement relief to reduce the filing fee to $50. By converting the non-monetary/unspecified claim into a simplified claim, the associated person reduces the number of arbitrators who would hear and consider a complex matter like expungement from three to one. *See* FINRA Rules 12401 and 13401.

15. A surcharge is assessed against each member that is named as a respondent in or employed, at the time the dispute arose, an associated person who is named as a respondent in a claim, counterclaim, cross claim, or third party claim filed and served under the Codes. *See* FINRA Rules 12901(a)(1)(B) and 12901(a)(1)(C) and FINRA Rules 13901(a)(2) and 13901(a)(3).

16. Each member that is a party to an arbitration claim in which more than $25,000 is in dispute is required to pay a process fee based on the amount of the claim. In addition, if an associated person of a member is a party, the member that employed the associated person at the time the dispute arose is charged the process fee, even if the member is not a party. *See* FINRA Rules 12903(a) and (b) and FINRA Rules 13903(a) and (b).

17. Under the Codes, no member is assessed more than a single surcharge or one process fee in any arbitration. *See* FINRA Rules 12901(a)(4) and 12903(b) and FINRA Rules 13901(d) and 13903(b).

18. The proposed amendments would not allow an associated person named in the Underlying Customer Case to file the claim requesting expungement relief against the customer from the Underlying Customer Case.

19. *See* proposed FINRA Rule 13805(a)(3).

20. A customer complaint can be reported to the CRD system via a Form U4 or Form U5. Pursuant to the requirements of FINRA Rule 1010, an associated person should be aware of the filing of a Form U4 by the associated person's member firm, as well as any amendments to the Form U4 to report a customer complaint involving that person. Article V, Section 3 of FINRA's By-Laws requires that a member firm provide an associated person a copy of an amended Form U5, including one reporting a customer complaint involving the associated person. Moreover, FINRA provides several methods for associated persons and former associated persons to check their records (*e.g.*, by requesting an Individual Snapshot or by checking BrokerCheck).

21. *See* proposed FINRA Rule 12100(dd). *See also supra* note 9.

22. The term "Director" means the Director of the Office of Dispute Resolution. Unless the Codes provide that the Director may not delegate a specific function, the term includes staff to whom the Director has delegated authority. *See* FINRA Rules 12100(m) and 13100(m).

23. The text of the form can be found at www.finra.org/notices/17-42.

24. Under the proposal, the party may include the request for expungement relief in an answer or pleading.

25. *See* proposed FINRA Rule 13805(a)(3). The unnamed person also would be prohibited from filing an expungement request against a customer.

26. *See supra* note 10.

27. *See* FINRA Rules 12805(a) and 13805(a).

28. *See* FINRA Rules 12805(c) and 13805(c).

29. *Id.*

30. In 2014, FINRA staff revamped the arbitrator training materials and amended them again in 2016.

31. *See supra* note 2.

32. *See* Securities Exchange Act Release No. 48933 (Dec. 16, 2003), 68 FR 74667, 74672 (Dec. 24, 2003) (Order Approving File No. SR-NASD-2002-168).

33. A firm, named as a respondent, would be assessed a member surcharge and process fee as provided under the Codes. *See supra* notes 15, 16 and 17.

34. *See* proposed FINRA Rule 13805(a)(3).

35. *See* FINRA Rule 13400.

36. A public arbitrator is an individual who does not have significant ties to the securities industry. *See* FINRA Rule 13100(x). Arbitrators are eligible to serve as chairpersons if they have completed chairperson training and: (1) have a law degree and are a member of a bar of at least one jurisdiction and have served as an arbitrator through award on at least one arbitration administered by an SRO in which hearings were held; or (2) have served as an arbitrator through award on at least three arbitrations administered by an SRO in which hearings were held. *See* FINRA Rule 13400(c).

37. The first arbitrator selected by NLSS would be the chairperson of the panel. The parties would not be permitted to strike any arbitrators selected by NLSS, but would be permitted to challenge any arbitrator selected for cause, pursuant to FINRA Rule 13410. If an arbitrator is removed, NLSS would randomly select a replacement subject only to a challenge for cause. The parties would not be permitted to agree to fewer than three arbitrators on the panel, and the parties would not be permitted to stipulate to the use of pre-selected arbitrators. Finally, if the associated person withdraws the claim after a panel is appointed, the case would be closed with prejudice, unless the panel decides otherwise. *See* proposed FINRA Rule 13806.

38. The Task Force suggested that the arbitrators be chair-qualified. In addition, it suggested that the arbitrators who would serve on the special arbitrator panel complete enhanced expungement training. FINRA agrees that the training for arbitrators selected for the Expungement Arbitrator Roster should be expanded. Thus, FINRA would create training for these arbitrators, which would emphasize that, if there is no party opposing the associated person's request for expungement relief, the panel would need to review more proactively the request and documentation and, if necessary, ask questions and for more information, before making a decision. The training would also focus on the need to identify one or more of the grounds for expungement in FINRA Rule 2080(b)(1) as the basis for expungement.

39. The panel would determine the method of appearance.

40. *See* FINRA Rules 12800(a) – (c); *see also* FINRA Rules 13800(a) – (c).

41. *See* FINRA Rules 12805(a) and 13805(a).

42. *See* proposed FINRA Rule 12800. FINRA Rule 13800 would also be amended to require that an associated person may only request expungement of customer dispute information under Rule 2080 by filing the request pursuant to Rule 13805(a) at the conclusion of the simplified arbitration case.

43. FINRA Rule 12800(c)(1) permits a customer to request a hearing. Under the proposal, if a customer requests a hearing, the arbitrator would decide the customer's case and at the conclusion of the customer's case, the associated person could file the expungement request against the firm and a panel from the Expungement Arbitrator Roster would decide the request. *See also* FINRA Rule 13800(c)(1).

44. Among the 2,232 customer arbitration cases and 183 intra-industry arbitration cases (mentioned above) that involve an expungement request of customer dispute information, 67 (3 percent) of the cases had an initial filling fee of $50.

45. Researchers find a negative relationship between misconduct disclosures on CRD and the employment opportunities of associated persons. The misconduct disclosures in their analysis, however, include more than just customer allegations. *See* Mark Egan, Gregor Matvos, and Amit Seru, *The Market for Financial Adviser Misconduct*, 2016.

46. Among the 2,232 customer arbitration cases and 183 intra-industry arbitration cases (mentioned above) that involve an expungement request of customer dispute information, approximately one-fifth of the expungement filing fees would have increased to $1,425 under the proposed amendments. The increase in fees would range from $450, for claims greater than $50,000 but less than or equal to $100,000 which currently have a filing fee of $975, to $1,375, for claims with a monetary value of less than or equal to $1,000 which currently have a filing fee of $50.

REGISTERED INVESTMENT ADVISORS: REGULATORY STRUCTURE, LIABILITY THEORIES, AND RECENT DEVELOPMENTS

Howard B. Prossnitz, J. Barton Goplerud

INTRODUCTION

Claims against registered investment advisors are getting increased attention as more advisors are getting caught up in scams and Ponzi schemes. Promissory notes, private placements and alternative investments are often at the heart of these scams. Many registered investment advisors are small operations. They are not subject to the supervision of a larger operation. In 2018, there were a total of 17,688 state registered investment advisors according to *NASAA 2018*, *Investment Adviser Section Annual Report*. Of these, 78% were one to two-person shops. In contrast, FINRA reports that in 2017, there were 630,132 registered representatives.

Consider these recent headlines:

Advisor admits to running 13-year Ponzi scheme, defrauding 53 clients [of $6.1 million], financialplanning.com, October 17, 2018.

Former Next advisor pleads guilty to 14-year, $4.5 M fraud. financialplanning.com, November 6, 2018.

SEC Charges Advisor With Bilking Investors to Fund Lifestyle, ThinkAdvisor.com, February 1, 2019.

'Hoodoo' curse couldn't hide advisor's $20M Ponzi scheme. financialplanning.com, October 17, 2018. This case had some interesting features:

> Even the dark arts couldn't shroud it. Dawn Bennett, a former financial advisor and radio host who allegedly used "hoodoo" magic to evade investigators, was found guilty of defrauding investors in a $20 million Ponzi scheme, the Department of Justice said. After deliberating for under five hours Wednesday, a federal jury convicted Bennett on 17 charges, including false statements on a loan application and three kinds of fraud: securities, bank and wire. The case notably had some unusual elements for a securities fraud trial. FBI agents searching Bennett's penthouse found evidence of voodoo-type witchcraft, specifically instructions for how to put people under a "Beef Tongue Shut Up Hoodoo Spell." The curse was allegedly intended to silence individuals. https://www.financial-planning.com/news/ex-financial-advisor-dawn-bennett-found-guilty-in-20m-ponzi-scheme-case.

The question is how to pursue these advisors, what claims to plead, and which forum to file in. Registered investment advisors are usually not subject to FINRA arbitration clauses, and their investment advisory contracts may not have arbitration clauses. Instead, they may have to be sued in state or federal court. Further, because there is no private cause of action under the

*Special thanks to my colleagues Brian O. Marty and Brandon M. Bohlman for their assistance with this project.

Investment Advisors Act of 1940, Rule 10b-5 claims, common law claims, and state statutory claims must be plead.

I. REGULATORY STRUCTURE

A. What statute controls?

The Investment Advisor Act of 1940, 15 U.S.C. § 80b-1 et. seq., (Act) is the governing law for investment advisors. It was passed in response to the stock market crash of 1929. The SEC lobbied for regulation of persons who gave investment advice. The Act defines who is an advisor, and who must register with regulators. While broker dealers are subject to mandatory FINRA regulation, investment advisors can elect to have or not to have arbitration clauses. In the absence of an arbitration clause, claims must be brought in court. If the investor adviser opts for arbitration, the clauses typically require filing with the American Arbitration Association or the Judicial Arbitration and Mediation Services (JAMS) which are less favorable forums for investors than FINRA.

B. Who is an investment advisor?

An investment advisor is defined to be any person who, for compensation, engages in the business of advising others, either directly or through writings, as to the value of securities, the advisability of purchasing or selling securities, or who, for compensation, regularly issues reports, analyses, concerning securities. 15 U.S.C. §80b-2(a)(11). There are eight exceptions, such as banks, that act as an adviser to a registered investment company, family offices, and professionals such as lawyers or accountants whose giving of investment advice is incidental to the practice of their profession.

C. Who must register?

Most small advisers and mid- size advisors are subject to state regulation and are not allowed to register with the SEC. The Dodd Frank Act raised to $100 million the amount of assets under management at which an advisor may register with the SEC. Large advisors with $110 million or more in assets must register. After an advisor is registered with the SEC, it is not required to withdraw SEC registration and register with states unless its assets fall below $90 million. Exemptions from registration apply to intrastate advisors, private fund advisors, charitable organizations and others. See Section 203(a) and 203(A) of the Act for registration requirements and pre-emption of state law. The rationale of the registration structure is that the SEC is best able to regulate large national firms, while state regulators are best equipped to oversee smaller firms with a local or state-wide clientele.

D. What requirements attach to being a registered investment advisor?

Five types of obligations attach to registered investment advisors: (i) fiduciary duties to clients; (ii) substantive prohibitions; (iii) contractual duties; (iv) recordkeeping duties; and (v) administrative oversight by the SEC.

(i) Fiduciary Duties

In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 190-192 (1963), the U.S. Supreme Court wrote:

> [t]he Investment Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser - consciously or unconsciously – to render advice which was not disinterested.

The fiduciary duty entails an obligation to disclose all material facts including any conflicts of interest; to disclose material information about disciplinary history and financial condition; to provide suitable advice; to have a reasonable basis for investment recommendations; to achieve best execution of orders; and to vote proxies in the best interest of clients.

(ii) Substantive requirements

Registered advisors must comply with host of affirmative requirements. The primary requirements include:

a. An adviser, acting as principal for its own account, can not intentionally sell or purchase a security from a client without written disclosure of the capacity in which the adviser is acting and without the client's consent prior to the completion of the transaction. Section 206(3) of Act.

b. An adviser can not knowingly act as broker for both an advisory client and the party on the other side of the trade without obtaining its client's consent before the transaction. Section 206(3) of the Act.

c. Advisers can not aggregate customer orders if one client would be systematically advantaged or disadvantaged.

d. Advisors are subject to Section 206 of the Act which is the general anti-fraud provision. In addition, there are regulations such as rules about adviser advertising which must not contain any untrue statement of material fact or be misleading. See 17 CFR § 275.206(4)-1. State registered advisers, and even non-registered advisors, are subject to the general anti-fraud provisions of Section 206. SEC *General Information on the Regulation of Investment Advisers* (March 11, 2011.)

e. An adviser who has custody of client funds or securities must follow various rules including the keeping of assets with qualified custodians, providing quarterly account statements, providing proper notice to clients about the qualified custodian and being subject to surprise audits. 17 CFR § 275.206(4)-2.

f. Advisers must deliver to clients and prospective clients written material describing the adviser's business practices, conflicts of interest, background of the adviser and its personnel. 17 CFR §275.204-3.

g. An adviser has a continuing duty to supervise all persons acting on its behalf.

h. An adviser must have an internal compliance program. 17 CFR § 275.206(4)-7.

i. An adviser must a written code of ethics. 17 CFR § 275.206(4)-7(b).

j. Advisers who offer wrap fee programs must prepare wrap fee brochures that provide a full explanation of the program. 17 CFR § 275.204-3.

k. An adviser can not receive a performance fee calculated as a percentage of appreciation in the client's account. Exceptions exist for accounts with over $1 million in assets; exempt private investment companies; non- US residents; and certain qualified accounts. Section 205(a)(1) of the Act.

l. Investment advisers are barred from paying a cash fee to third parties for the referral of clients unless a number of requirements have been met including a written agreement between the adviser and the third party; written disclosure to the client; and written acknowledgement from the client of the disclosure.

(iii) Contractual duties

While contracts with advisors do not have to be in writing, there are requirements under Section 205 if there is a written agreement. For instance, there are restrictions on what performance fees can be charged. Advisory contracts cannot be assigned without the consent of the clients. Termination penalties are also limited.

(iv) Record keeping requirements

Advisors must keep ordinary financial records as well as additional detailed comprehensive records on securities holdings, orders and transactions. These additional records include all written communications on all investment recommendations; all circulars or advertisements sent to ten or more persons; copies of powers of attorney; list of accounts where the adviser had discretionary authority; documents evidencing any performance claims advertised; code of ethics, supervised persons written acknowledgment of receipt of code of ethics and other documents. Records must be kept for five years. 17 CFR § 275.204-2.

(v) Administrative oversight

All records are subject to SEC examinations which are confidential. See Section 210(b) of the Act.

II. CLAIMS AGAINST INVESTMENT ADVISERS

The good news about proceeding against registered investment advisors is that they have a clearly defined fiduciary duty to clients under the Investment Advisors Act. The bad news is that there is no private cause of action for damages under the Act. Claims must be made under Rule 10b-5, state statutes or the common law.

A. Actions Under the Investment Advisors Act

In *Transamerica Mortgage Advisors v. Lewis*, 444 U.S. 11 (1979), the U.S. Supreme Court held that the Act allowed a limited private right of action to void an investment advisor contract, but conferred no other private right of action. Courts have stated that an investor can only sue for rescission of the advisory agreement, and in doing so, may seek return of commissions or fees paid to the advisor. See *Douglass v. Beakley*, 900 F. Supp. 736, 746 (N.D. Tex. 2012).

B. Breach of contract

An investment advisory contract will usually provide that the investment advisor is to furnish investment planning and advice, to make recommendations with respect to the purchase and sale of securities, and to provide continuous advice in these areas. Therefore, claims can be made that the contract was breached by a failure to monitor investment accounts and a failure to properly supervise the accounts.

C. Breach of fiduciary duty

A fiduciary duty of the adviser arises both from the common law of agency and from the Investment Advisors Act. An adviser must "adopt the principal's goals, objectives or ends". Arthur B. Laby, *The Fiduciary Obligations as the Adoption of Ends*, 56 Buffalo Law Review 99 (2008). At all times, the advisor must serve the best interests of its clients and put those interests above its own. Investment Advisors Act Release 3060. The fiduciary duty imposes a duty of care, a duty to provide advice that is in the client's best interest, a duty to seek best execution, a duty to provide advice and monitoring over the course of the relationship, and a duty of loyalty. Investment Advisor Act Release No. 2016 (Jan. 31, 2003), and No. 1406 (March 16, 1994). The all-encompassing nature of an investment's fiduciary duties goes well beyond FINRA's suitability rule which is arguably limited to the time of purchase. The advisor fiduciary duty continues throughout the advisor-client relationship and includes the duty to monitor a client's accounts on an ongoing basis. For an excellent summary of an advisor's fiduciary duty, see SEC Release No. IA-4889 dated April 18, 2018, pp. 6 -20.

D. Negligence and Negligent Supervision

Courts will look to industry rules to define appropriate standards of care for negligence and negligent supervision. See *Garrison v. Sagepoint Financial Inc.*, 185 Wn. App 461, 486, 345 P. 3d 79 (Ct. App. Wash. 2015)("While NASD Rules do not create a private cause of action, courts have looked to the Rules to define the scope of a common law duty such as negligent supervision", citing *Craighead v. E,F. Hutton & Co.*, 899 F. 2d 485, 493 (6th Cir. 1990). In the *Garrison* case, the court reversed summary judgment for a broker dealer on claims that it had negligently supervised a registered investment advisor. Standards of care are also embodied in the Codes of Ethics and Professional Conduct for Chartered Financial Analysts and Certified Financial Planners.

E. State statutory liability

Section 509 of the Uniform Securities Act of 20012 creates civil liability to a purchaser or seller of a security where the transaction is effectuated by means of an untrue statement of a material fact, or an omission to state a material fact necessary in order to make the statement made not misleading. The purchaser can maintain an action to recover the consideration paid for the security, less income received, plus interest, costs and attorneys' fees, or actual damages if the security is no longer owned.

State regulations may define a standard of conduct for registered investment advisors. For instance, the Kansas Administrative Regulations state that an advisor "shall not fail to observe high standards of commercial honor and just and equitable principles of trade in the conduct of the person's business". Further, an investment adviser representative "is a fiduciary and shall act primarily for the benefit of its clients."
K.A.R. § 81-14-5 (c).

F. Rule 10b-5 liability

In cases of outright fraud, the wrongdoer will be subject to Rule 10b-5 liability. Ruble 10b-5 claims are routinely pled in Ponzi scheme and investment scam cases.

G. Common law fraud

If a fraudster acts as investment advisor, but fails to register, common law fraud claims can still be pursued. *Saunwin Int'l Equity Fund LLC v. Donville Kent Asset Mgmt.*, 2018 U.S. Dist. LEXIS 122205 (D. Mass. July 20, 2018), involved the classic hallmarks of an investment scam, but the defendants had never been properly registered or licensed. Plaintiffs invested in a hedge fund that failed due to speculative trading and outright theft. One of the two fund managers pled guilty to wire fraud. Both fund managers were sued by the SEC for fraud.

Plaintiffs filed an eleven-count complaint alleging Rule 10b-5 fraud; controlling person liability; state statutory violations; common law fraud under partnership liability; aiding and abetting fraud; conspiracy; breach of fiduciary duty; negligent misrepresentations and omissions; and negligence. The court did not even find it necessary to discuss whether an adequate claim for common law fraud had been pled, but instead focused on whether there was a basis for potential partnership liability. It concluded that there were sufficient allegations of partnership liability to withstand a motion to dismiss. However, the court dismissed the fiduciary duty claim finding no duty to individual investors from the hedge fund managers either under federal securities laws or common law.

H. Control person liability

Control person liability which is created under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t requires not only that one person controls another, but also that that the controlled person be liable under the Act. Further, the defendant must have been a culpable participant in the violation. *SEC v. J.W. Barclay & Co*., 442 F. 3d 834, 841 (3rd Cir. 2006). Culpable participation requires knowledge. Inaction by itself does not create liability. *Rochez Bros. v. Rhoades,* 527 F. 2d 880, 890 (3rd Cir. 1975).

Therefore, if a claim is being made against an investment advisory firm where one of its employees perpetrated a Ponzi scheme, there must be a showing of active involvement by the firm. This can be a difficult hurdle to overcome, particularly in cases where the fraudster has been successful in running the scheme for a lengthy period of time.

III. RECENT DEVELOPMENTS

A. Pleading valid claims against an advisor

The case of *Austin v. Regal Inv. Advisors*, LLC, 2018 NCBC LEXIS 3 (N.C. Superior Ct. January 8, 2018), offers a good primer for what to plead in an advisor case. Plaintiff investors signed investment advisory agreements with the defendant firm. One of the defendant's employees, a registered investment adviser representative, convinced plaintiffs to post their retirement accounts as collateral for promissory notes issued by a developer in which the employee was a co-owner. The plaintiffs lost all their money and filed suit against the advisory firm as well as the employee. They pled eleven different claims including negligence, breach of fiduciary duty,

negligent misrepresentation, violations of the North Carolina Securities Act and Investment Advisors Act, breach of contract, negligent supervision, and control person liability.

On a motion to dismiss, the Court upheld the contract claim which pled that the defendant firm failed to monitor plaintiffs' accounts and allowed their money to be put in investments which were inconsistent with their objectives. The Court refused to enforce an exculpatory clause. The breach of fiduciary duty claim was also sustained as was the negligence claim and the negligent misrepresentation claim, but not the negligent supervision claim. The Court noted that plaintiffs had not pled that the employee was incompetent and that the employer know of the incompetence prior to the alleged wrongful acts. As to the state security act claims, the Court dismissed the claim for primary liability against the firm. It upheld the control person allegations. It reached the same conclusions on the state investment advisor act claims.

B. Pitfalls of pursuing insurer

In *Morden v. XL Specialty Insurance*, 903 F. 3d 1145 (10th Cir. 2018), the Tenth Circuit reversed the denial of summary judgment for the insurance company and remanded with directions that summary judgment be entered in its favor. The advisor firm had a claims made liability policy. It sold various risky investments to the plaintiff investors without adequately disclosing risks, conflicts of interest, and it promised too much. An SEC investigation ensued. Plaintiffs filed a case in state court tracking the allegations of the SEC order. The advisor settled with the plaintiffs and as part of the settlement, the advisor assigned its policy rights to the plaintiffs. The Tenth Circuit interpreted as Interrelated Wrongful Acts Provision broadly to hold that the claims against the insurer accrued prior to the claims made policy period. The denial of coverage was upheld.

C. RICO claims upheld when securities transaction was incidental to fraud

ClassicStar Mare Lease Litig. v. ClassicStar, L.L.C., 2019 U.S. Dist. LEXIS 10451 (E.D. Ky. January 19, 2019) is an interesting recent case where plaintiffs pled RICO claims seeking treble damages and wanted to avoid having the claims characterized as allegations of securities fraud. Plaintiffs invested $10.5 million in a thoroughbred lease program offered by defendant. Defendant concealed the fact that it did not have enough mares to support the leases. Part of the scheme was to convince plaintiffs to exchange their lease interests for stock or a different investment. The RICO co-defendants included investment advisors. Rather than allege securities fraud, plaintiffs pursued a RICO theory. The court held that the Private Securities Litigation Reform Act did not bar the RICO claims and found that the purchase of securities was incidental to the fraud.

Conclusion

There are a multitude of claims that can be pled against registered investment advisors. Step one is to see if there is an arbitration clause and to determine the appropriate forum. Step two is to consider which actors have assets and potential liability. Step three is to see if there is an insurance policy. If the case involves an SEC registered investment advisor, review the multiple requirements of the Investment Advisor Act to see if they have been satisfied. If not, refer to them in drafting the breach of fiduciary duty claim and negligence claim.

IV. MASS/CLASS CASES AND INSURANCE COVERAGE ISSUES

A. Mass/Group vs. Class Action Cases

As you begin your investigation and pursuit of claims against an RIA, you may be confronted with the decision of whether to pursue the case as a mass/group action or a class action. See Exhibits A and B, RIA Class Action Complaints. There are many things to consider when making that decision.

Initially, you may only have the option of a mass/group case because the total number of investors or potential clients does not meet Fed. R. Civ. P. 23's numerosity requirement. If this is the case, your decision is easy—you proceed forward with a mass/group action. Alternatively, if you only have one client—a potential class representative—your only option is to pursue a class action. The real decision comes when you have a case involving approximately 50 or more potential clients. In that case, the decision is whether to sign up all the investors as individual clients and pursue a mass case, or whether to sign up one or two investors as class representatives and pursue a Rule 23 class action.

There are certain strengths associated with pursuing a mass/group case. First and most significant, you will not have to deal with any Rule 23 class certification issues. This is significant because Rule 23 class certification typically involves months—and sometimes more than a year—of briefing and argument, followed by more months of waiting for the district court to issue a ruling. Additionally, since discovery is often bifurcated between class and merits discovery, discovery in the class-certification phase may not allow you to obtain the information you will need to prove liability and damages. If discovery is bifurcated, only after the district court issues an order certifying the class will you be able to begin discovery regarding the merits of the case. And, even if the district court issues a favorable ruling on class certification, Rule 23(f) provides for a permissive appeal to the circuit court, again potentially delaying prosecution of your case by many months. Even if you are confident that the class will be certified, these possible delays warrant significant consideration.

Another strength associated with pursuing a mass/group case is the personalized nature of the litigation. The fact that you have dozens and dozens of clients, all whom suffered life-changing harms and losses, puts a 'human' face on the lawsuit. Alternatively, a class action lawsuit involving one or two class representatives is by its nature very impersonal.

Finally, a mass/group case is, as a procedural matter, much easier to settle than a class action. In a class action, you are required to obtain preliminary and final court approval of the settlement, which often takes up to a year. Class members who are dissatisfied with the proposed settlement can object to the settlement. And, you must submit an attorney fee application which the district court must approve (and which the district court typically scrutinizes closely). Again, these issues warrant significant consideration of a mass/group action.

Mass/group cases are not all sunshine and rainbows, however. The most difficult aspect of a mass/group case is the logistics of managing a case with dozens of clients. The time spent talking to investors, signing up clients, and obtaining documents can be very time-consuming and expensive. (This process becomes less intensive if the investors are concentrated geographically.) Then, once the case has been filed, you must be prepared for full discovery of all clients, including robust interrogatories, document requests, and requests for admissions.

Plaintiff's counsel cannot request, and the court cannot order, a sampling of discovery, such as in a Fair Labor Standards collective action.

These logistical challenges can be more easily managed through the use of detailed intake forms or questionnaires allowing for faster and more complete draft discovery answers.

Finally, be prepared for defense counsel to request depositions of all clients. This requires preparing your clients as a group, and then individually, for depositions. It also likely means significant travel and lodging expenses (though defense counsel will be forced to incur the same expenses). These logistical concerns are typically not present in a class action case involving one or two representative plaintiffs.

One final consideration is that in a mass/group action, you may not capture the entire universe of investors who suffered losses, leaving a portion of damages on the table. In a class action, the threat of class certification and the accompanying damages exposure often provides significant leverage when discussing settlement.

B. Fed. R. Civ. P. 23(b)(1)(B) – Non-opt-out Class Action

If you decide to pursue a class action case, you may want to consider the mythical Rule 23(b)(1)(B) non-opt-out class action. Rule 23(b)(1)(B) is not for the fainthearted—it will be procedurally challenging, and individual plaintiff's attorneys will push back on class certification, arguing that you should not be able to draw their individual clients unwillingly into a class action.

Rule 23(b)(1)(B) non-opt-out class actions deserve their own presentation. As a primer and roadmap for these cases, attached to this article as Exhibit C is Judge Royal Ferguson's final order granting Rule 23(b)(1)(B) certification. The benefit of a non-opt-out class action, in the case of a limited fund (such as a liability insurance policy with limits well below the defendant's exposure), is that the defendant can obtain world peace, which is a significant incentive to early resolution.

C. Attorney-Client Fee Agreement Considerations

Give careful consideration to the appropriate attorney-client fee agreement that you use in a mass or class action case. The two fee agreements should be separate and distinct in all but a few circumstances. For the mass case be sure to include language for conflicts, pro rata settlements, pro rata expenses and potential attorney fee lien if the client withdraws from representation. See Exhibit D, Mass Action Fee Agreement. Regarding the class action fee agreements, be sure to include the client duties as a class representative, specifically, the discovery responsibilities. Also, include a provision for an individual settlement and a contingency fee (and expenses) on that individual settlement. See Exhibit E, Class Action Fee Agreement.

Last, and as always, review the relevant state rules of civil procedure (and ethics) as well as local federal rules. At least one set of local federal rules has limitations of fee agreement of "named" class representatives.[1]

[1]*See* Georgia Northern District Local Rule 23.1(C)(3)(a): **(3) Restrictions Applicable to All Class Actions.** In all cases where class certification is sought or granted, the following shall apply: (a) All parties and counsel are forbidden to solicit fees and expenses or agreements to pay fees and expenses from prospective or actual class members who are not formal parties or who do not plan to become formal parties.

D. Federal vs. State Court

In addition to the mass-versus-class action question, you will also want to consider whether you want to litigate the case in federal or state court. If you have the option, you should consider the differences in the class certification and other procedural rules in the particular state court. Not all states rules of civil procedure mirror or mimic the federal rules, and the differences between the state rules and Rule 23 might benefit your case. As an example, the Iowa Rules of Civil Procedure have thirteen criteria to be considered for class certification.[2] These requirements are more flexible than Rule 23's, resulting in a greater likelihood of obtaining class certification.

You should also consider whether a "placeholder" motion is required. For example, see Exhibit F, Illinois Procedure Motion for Class Certification. This procedural step should be accomplished at the same time as drafting the complaint, so as not delay and potentially endanger your case. Similar considerations should be given to a Damasco motion in federal court if appropriate in a particular circumstance. (See Exhibit G, Berthel Fisher Damasco Motion.) Time considerations for the filing of class certification should also be determined. A number of state courts, and even

[2]*See* Iowa R. Civ. P. 1.263(1): In determining whether the class action should be permitted for the fair and efficient adjudication of the controversy, as appropriately limited under rule 1.262(3), the court shall consider and give appropriate weight to the following and other relevant factors:
a. Whether a joint or common interest exists among members of the class.
b. Whether the prosecution of separate actions by or against individual members of the class would create a risk of inconsistent or varying adjudications with respect to individual members of the class that would establish incompatible standards of conduct for a party opposing the class.
c. Whether adjudications with respect to individual members of the class as a practical matter would be dispositive of the interests of other members not parties to the adjudication or substantially impair or impede their ability to protect their interests.
d. Whether a party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making final injunctive relief or corresponding declaratory relief appropriate with respect to the class as a whole.
e. Whether common questions of law or fact predominate over any questions affecting only individual members.
f. Whether other means of adjudicating the claims and defenses are impracticable or inefficient.
g. Whether a class action offers the most appropriate means of adjudicating the claims and defenses.
h. Whether members who are not representative parties have a substantial interest in individually controlling the prosecution or defense of separate actions.
i. Whether the class action involves a claim that is or has been the subject of a class action, a government action, or other proceeding.
j. Whether it is desirable to bring the class action in another forum.
k. Whether management of the class action poses unusual difficulties.
l. Whether any conflict of laws issues involved pose unusual difficulties.
m. Whether the claims of individual class members are insufficient in the amounts or interests involved, in view of the complexities of the issues and the expenses of the litigation, to afford significant relief to the members of the class.

some federal courts via local rules, require the class certification motion to be filed "as soon as practicable"[3] or within a short timeframe such as 90 or 180 days from the filing of the complaint.[4,5]

E. Arbitration Agreements and Class-Action Waivers

Arbitration agreements and class action waivers are becoming more common in cases against RIAs. The first question you should ask when investigating a case is whether your client signed an agreement with their RIA that contains an arbitration agreement and/or class action waiver. Given the United States Supreme Court line of cases since *AT&T Mobility LLC v. Concepcion,* 563 U.S. 333 (2011), these provisions are likely enforceable, subject to narrow exceptions. You should research whether any of the exceptions may possibly apply, because if your client has entered into such an agreement and there is no applicable exception, your case is likely headed toward an individual or mass action arbitration as the sole remedy. However, do not dismiss the idea of a class action case immediately—a class action might benefit the defendant in that it allows for global resolution of all outstanding claims.

F. Insurance Coverage Issues

As soon as practicable, work to obtain the insurance policy and declarations page for any available insurance coverage. This information may affect your choice whether to pursue a mass versus class case from the very beginning. One way to potentially obtain the insurance policy is to research whether any declaratory judgment actions have been filed in any state or federal court concerning the same defendant. The insurance policy will likely be an exhibit to the declaratory judgment action. See Exhibits H and I, Declaratory Judgment Actions and Accompany RIA Insurance Policies. Alternatively, we will often provide a courtesy copy of the draft complaint to the defendant prior to filing, and work with the defendant and its counsel to obtain the insurance information. Unfortunately, it is all too common to see liability limits of $5 million, $2 million, or even $1 million with RIAs. And, even with coverage afforded, beware of the multitude of potential policy exclusions.

Exclusions may include but are not limited to the sale of securities (yes you read that correctly), "selling away", pre-coverage period sales, fraudulent procurement of coverage, prior wrongful acts, lack of coverage for claims arising out of bankruptcy and exclusions for class action.

These declaratory judgment actions do not have to be the end point of your claim. However, take time to work with your own coverage counsel and make your own determination on the likelihood of success of the declaratory action. The potential outcomes are, of course, no coverage, but do not forget the potential of a compromise while the declaratory judgment action is pending and or

---

[3]*See* Iowa R. Civ. P. 1.262(1): Unless deferred by a court, as soon as practicable after the commencement of a class action the court shall hold a hearing and determine whether or not the action is to be maintained as a class action.

[4]*See* Northern District of Georgia Local Rule 23.1b: The plaintiff shall move within ninety (90) days after the complaint is filed for determination under Fed. R. Civ. P. 23(c)(1) as to whether the suit may be maintained as a class action.

[5]*See* Southern District of Iowa Local Rule 23a: In any action brought as a class or representative action, the party seeking to maintain the action as a class or representative action must, within 180 days after commencement of the action, file a separate motion for class certification.

the assignment of the policy in a potential bad faith claim to your team in exchange for a settlement with RIA.

EXHIBIT A

David Sturgeon-Garcia. Esq. (State Bar No. 157390)
THE LAW OFFICES OF DAVID STURGEON-GARCIA
1042 Country Club Drive, Suite 1A
Moraga, CA 94556
Telephone: 925.235.7290
Facsimile: 925.235.7319

Charles D. Marshall (State Bar No. 236444)
MARSHALL LAW FIRM
2121 N. California Blvd., Suite 290
Walnut Creek, CA 92596
Telephone: (925) 575-7105
Facsimile: (855) 575-7105
cdm@marshall-law-firm.com

Attorneys for Plaintiffs Charlotte B. Milliner, Joanne Brem, and the putative class

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

CHARLOTTE B. MILLINER, as trustee of the Charlotte B. Milliner Trust dated January 30, 1997, and as owner and holder of the CHARLOTTE B. MILLINER SEP IRA; JOANNE BREM, as Trustee of the Van Santen-Brem Revocable Trust, for themselves and on behalf of all others similarly situated,

Plaintiffs,

v.

BOCK EVANS FINANCIAL COUNSEL, LTD, a Colorado corporation;

Defendant.

Case No.:

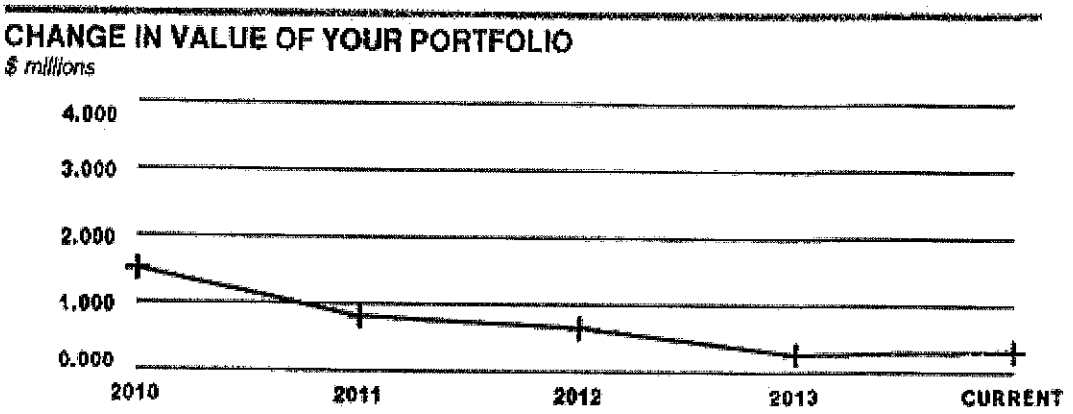
CLASS ACTION COMPLAINT

DEMAND FOR JURY TRIAL

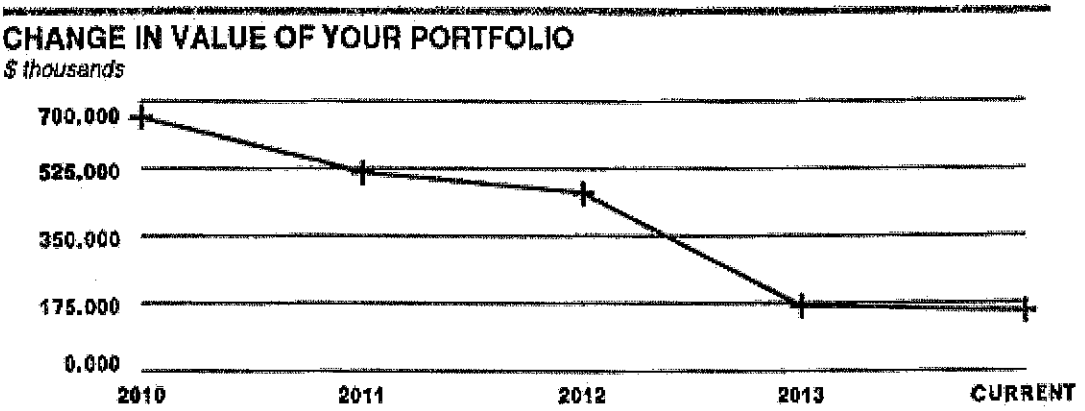
I. INTRODUCTION

1. This claim is brought by Charlotte Milliner and Joanne Brem, on their own behalf and on behalf of others similarly situated, who fell victim to the false written promises and "one size fits all" investment approach implemented by their investment advisor, Bock Evans Financial Counsel, Ltd ("Defendant" or "Bock Evans.") Contrary to its written representations and fiduciary duty of care, Bock Evans failed to diversify its clients' investment portfolio's by placing 100% or nearly 100% of their assets in high risk and highly speculative foreign mining stocks, including OTC and penny stocks. Bock Evans then failed in its duty to make any significant adjustment to its clients' portfolios in response to economic and market conditions, resulting in the decimation of its clients' portfolios, as demonstrated through the charts below:

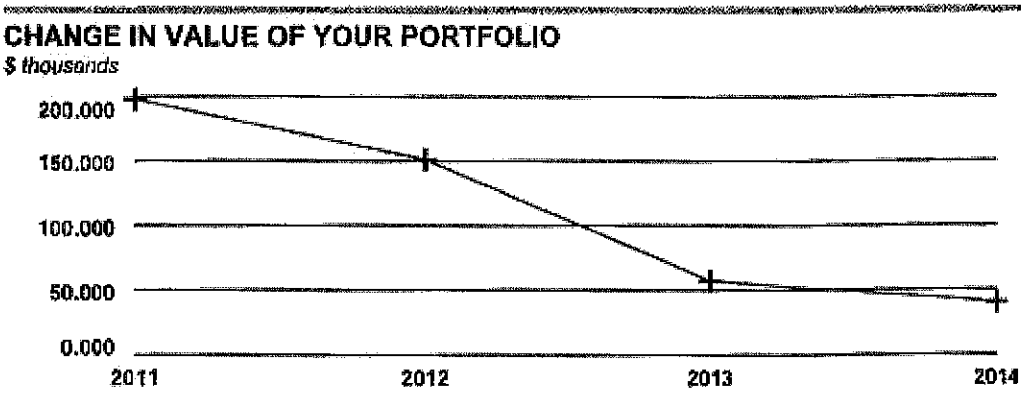
Ms. Milliner's Retirement Account:



Ms. Milliner's Trust Account:



Ms. Brem's Trust Account:



Defendants' other clients have suffered a similar fate. Accordingly to Defendant's ADV statements, which are required regulatory filings, Bock Evans has gone from $60 million in assets under management to $4.17 million in just a few years, a drop of roughly $55.83 million, or 93%.

II. OVERVIEW

2. Bock Evans provides continuous investment advice and equity portfolio management services to its clients. It manages investment accounts only on a "discretionary basis," meaning that Bock Evans seeks and obtains autho0rity from each client stating that Bock Evans will be solely responsible for the investment decisions affecting its clients' accounts, subject to the clients' designated investment objectives, risk tolerance, and other guidelines and limitations clients have furnished to the Bock Evans in writing. In this regard, Bock Evans

selects which and when securities are to be bought and sold in a client's account without consultation with the client. For all practical purposes, Bock Evans controlled the accounts.

3. In describing the strategy employed for discretionary accounts, Bock Evans supplies each prospective client, as well as each existing client on a yearly basis, with written brochures detailing how it intends to exercise its discretionary authority. Through these writings, Bock Evans represents that it generally employs a diversified investment strategy, that it limits investments in high risk stocks sold on over-the-counter markets, and that it continuously monitors economic and market conditions and makes timely adjustments to clients' portfolio's in response to those changing conditions.

4. Contrary to its written representations and its fiduciary duties, Bock Evans failed to employ a diversified strategy for its clients' portfolios, failed to avoid high risk and highly speculative over-the-counter stocks, and failed to make adjustments to its clients' portfolios to reflect current market conditions. Rather, Bock Evans engaged in an investment strategy counter to its own written representations and contrary to its fiduciary duties to its clients by implementing a systematic "one size fits all" investment strategy which consisted of uniformly investing clients' assets in high risk and highly speculative foreign mining stocks, and failing to adjust clients' portfolios to current market conditions.

5. In fact, most of the stocks Bock Evans purchased for Plaintiffs and the Class were over-the-counter stocks, and many were "penny stocks," which have been deemed by Congress to be of such high risk that it enacted the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Penny Stock Act.") The penny stock rules subsequently implemented by the SEC essentially make it "unlawful" to effect a penny stock transaction unless several conditions have been met, such as pre-approving specific investor's accounts for penny stock purchase, providing special disclosures to customers prior to the purchase of penny stocks, and obtaining signed acknowledgments from each client prior to the purchase of penny stock. Contrary to these rules, no penny stock disclosures were provided to Plaintiffs or to the Class, and clients did not provide their prior written consent.

6. Bock Evans' complete disregard of its fiduciary duties has resulted in tens of millions of dollars in investment losses to the Class. Indeed, the devastating effects of Bock Evan's conduct on its client base is demonstrated by public records which show that Bock Evans has gone from $60 million in assets under management to $4.17 million in just a few years, a drop of roughly $55.83 million, or 93%.

III. THE PARTIES

7. Plaintiff Charlotte B. Milliner is the trustee of the Charlotte B. Milliner Trust dated January 30, 1997, and is the owner and holder of the Charlotte Milliner SEP IRA (hereinafter "Ms. Milliner."). Ms. Milliner owned two investment accounts managed by Bock Evans as her investment advisor. Ms. Milliner has lived in Oakland, California, during all relevant times. Ms. Milliner is 62 years old.

8. Plaintiff Joanne Brem is the Trustee of the Van Santen-Brem Revocable Trust (hereinafter "Ms. Brem.") Ms. Brem owned one investment account managed by Bock Evans as her investment advisor. Ms. Brem has lived in San Rafael, California, during all relevant times. Ms. Brem is 61 years old.

9. Defendant Bock Evans Financial Counsel, Ltd. ("Bock Evans" or the "Firm") is a Registered Investment Advisor doing business in California with its principal place of business in Denver, Colorado. It provides continuous investment advice and equity portfolio management services to individuals solely on a discretionary basis.

IV. JURISDICTION AND VENUE

10. The Court has jurisdiction over any Federal claims under 28 U.S.C. § 1331 and over all other non-Federal claims asserted in this action under 28 U.S.C. § 1367. This Court also has subject matter jurisdiction pursuant to 28 U.S.C. § 1332 because the matter in controversy exceeds the sum of $5,000,000, and at least one member of the Class—namely both Plaintiffs—is a citizen of a State different than Defendant.

11. Venue is proper under 28 U.S.C. § 1391(b)(1) because Defendant Bock Evans resides in this District as defined under 28 U.S.C. § 1391(c)(2); and venue is proper under 28 U.S.C. § 1391(b)(2) because Plaintiffs' accounts at issue in this matter are maintained in California.

V. THE INVESTMENT ADVISOR'S DUTY OF CARE

12. As a Registered Investment Advisor ("RIA"), the duty of care owed by Bock Evans to its clients is that of a fiduciary. These fiduciary duties are imposed on advisers by operation of law because of the nature of the relationship between the two parties. *See Arleen W. Hughes*, Exchange Act Rel. No. 4048 (Feb 18, 1948), *affd. sub. Nom;. Hughes v. SEC*, 174 F.2d 969 (May 9, 1949). The relationship between an advisor and its clients is a special relationship of trust and confidence between agent and principal, and reflects the premise that the investment advisor will always do the right thing for the client. It is a special relationship that does not exist between most businesses providing services to their customers.

13. Justice Cardozo's opinion in *Meinhard v. Salmon,* is often cited in explaining the heightened duties of fiduciaries:

> Many forms of conduct permissible in the workaday world for those acting at arm's length are forbidden by those bound by fiduciary ties. A fiduciary is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. 164 N.E. 545, 546 (N.Y. 1928).

An adviser's fiduciary duty also emanates from federal law, including Section 206 of the Investment Advisers Act of 1940 ("Advisers Act"), an anti-fraud section which generally prohibits an adviser from engaging in any practice that is fraudulent, deceptive or manipulative. Federal Courts have also recognized that advisors must adhere to a strict fiduciary standard. In the seminal case of *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963), the U.S. Supreme Court recognized that the Advisers Act reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship." Advisors, the Court concluded, must adhere to a strict fiduciary standard, including a duty of "utmost" good faith, full and fair disclosure of all material facts, and an obligation to use reasonable care to avoid misleading

clients. Subsequent courts have interpreted *Capital Gains* to establish a federal fiduciary standard for investment advisors. *See Santa Fe industries, Inc. v, Green*, 430 U.S. 462 (1977); *Transamerica v. Lewis*, 444 U.S. 11 (1979).

As demonstrated below, Bock Evans repeatedly breached its established fiduciary duties and has decimated the investment portfolios of the clients it was charged to protect through its prudence and professed expertise.

VI. FACTUAL ALLEGATIONS

A. Bock Evans' Written Representations to Plaintiffs and the Class about its Business Practices and Investment Approach

14. Bock Evans provided Plaintiffs and each Class member with brochures "provid[ing] information about the qualifications and business practices of Bock Evans[.]" ("Brochures"). These Brochures were provided to Plaintiffs and each Class member both at the inception of the relationship and throughout the relationship at around the same time each year.

15. Plaintiffs are informed and believe that the sections of the Brochures referred to herein have not changed materially from year to year during the period relevant to this complaint.

16. Through its Brochures, Bock Evans made uniform representations to its clients and prospective clients, including Plaintiffs and the Class, regarding its qualifications, business practices, and investment approach. These representations were material in inducing Plaintiffs and the Class into hiring and maintaining Block Evans as their financial advisor.

17. As explained in more detail below, the uniform set of representations made by Bock Evans to Plaintiffs and the Class included representations that Bock Evans employs a diversified strategy for most portfolios under most market conditions, generally employs a growth investment strategy, trades in speculative securities only "on occasion" and "from time to time," and promises to continuously monitor economic and market conditions and make adjustments in customer accounts consistent with such changing conditions. As demonstrated below, these representations were false.

1. Bock Evans Failed to Diversify its Clients' Portfolios

18. Sound diversification is fundamental to the management of risk and investment advisors have a duty to diversify the investments if its clients. Diversification requires more than the common concept of diversification in terms of number of investments alone. It is not enough to invest in many securities. Rather, the advisor's duty is to avoid investing in securities with high covariances among themselves. Thus, effective diversification depends not only on the number of assets, but on the ways and degrees in which their responses to economic events tend to cancel or neutralize one another.

19. Bock Evans acknowledged its duty to diversify its clients' portfolios through its Brochures. Bock Evans represented to Plaintiffs and the class that its general practice was to employ a diversified investment strategy for most clients for most of the time: "[i]n general, [Bock Evans] will employ a ***diversified strategy*** for most portfolios under most market conditions. A diversified strategy is a strategy where portfolios are invested in a broad range of sectors or industries and spread out among numerous securities within those sectors or industries."

20. Contrary to its representations and fiduciary duty, Bock Evans invested the portfolios of Plaintiffs and the Class with no diversification at any point in time. For example, in Plaintiffs' portfolios, which upon information and belief is representative of the Class, Bock Evans invested 100% or nearly 100%, of their entire assets in foreign mining stocks. Moreover, Bock Evans maintained this lack of diversification for many years spanning the entire advisor-client relationship.

21. While Bock Evans does claim that it "*may*" engage in a "non-diversified" strategy, it qualifies that statement from the general objective of diversification by stating "non-diversified, concentrated accounts carry a higher risk for investment loss and . . . ***such investment strategy is not suitable for most investors***, particularly for investors who do not have other assets or those investors who are primarily dependent on these assets or their current income or retirement funds." In other words, Bock Evans represented that a non-diversified portfolio is the exception

from their normal investment strategy. In reality, a non-diversified portfolio was Bock Evans' *entire* strategy.

2. Bock Evans Failed to Monitor the Markets and Failed to Make Adjustments to its Clients' Portfolios

22. Bock Evans provides ongoing and continuous portfolio management services to its clients. It agreed to provide, and had a duty to provide, continuous and regular supervisory and management services with ongoing responsibility to buy and sell securities based on changing market conditions. An investment advisor's fiduciary duties apply not only to the initial investment process, but also to the fiduciary's duty to monitor the portfolio and make portfolio adjustments if and as appropriate in light of changing market conditions. By necessity, this asset allocation process must be dynamic to respond to changes in the market and the economy. This is especially true in the context of an advisor, like Bock Evans, with discretionary trading authority over clients' accounts. As stated by the Firm:

> Under our discretionary arrangements, the Firm is granted full power by the Client to supervise and direct the investment of assets in the Client's Account. In these relationships, ***we have complete investment authority*** without prior consultation with, or consent from, the Client. Such authority includes which securities to buy or sell but also includes the price, timing and quantity of the securities to be bought or sold.

In fact, the very purpose of retaining an investment advisor with discretionary authority is undermined if the advisor does not apply his expertise on behalf of the client to changing economic and market conditions.

23. Through its writings, Bock Evans acknowledged its duty to constantly monitor clients' accounts and to timely respond to changing market conditions. It specifically represented through its Brochures that:

> Professional investment advice means that you can be assured that Bock Evans ***constantly monitors*** the securities markets and economic conditions. We use a variety of analytical techniques to follow market movements, foreign and domestic market indices and individual companies including charting, fundamental, technical and cyclical methods....

> Bock Evans ***continuously monitors*** a broad range of securities. The selection of securities will depend upon the composition of the portfolio and market conditions…
> Investment strategies may change as markets and conditions change…

24. Contrary to its written representations and its duty of care, Bock Evans failed to make adjustments to its clients' portfolios to reflect market conditions. As demonstrated through Plaintiffs' portfolios in the sections below, the securities selected by Bock Evans for Plaintiffs and the Class had a continuous downward trend year, after year, after year. At no time did Bock Evans make any significant adjustment to Plaintiffs' or Class members' portfolios to reflect these market conditions. As a result of Bock Evans' failure to properly monitor the markets, and failure to properly adjust its clients' portfolios pursuant to its discretionary authority, Plaintiffs and the Class lost tens of millions of dollars in the midst of a powerful bull market.

3. Bock Evans Loaded Investors' Portfolios with OTC Stocks

Over-the-counter stock (or OTCs) are securities which are traded through a dealer network rather than through a centralized formal exchange, such as the NYSE or Nasdaq. OTC, or off-exchange trading, is done directly between two parties, without any supervision of an exchange. A stock exchange has the benefit of facilitating liquidity, mitigates all credit risk concerning the default of one party in the transaction, provides transparency, and maintains the current market price. Because they are not required to report to the SEC, many OTC stocks are either penny stocks or are offered by companies with bad credit records. In an OTC trade, the price is not necessarily published for the public. OTCs tend to be closely held, extremely small and/or thinly traded. As such, most of these issuers do not meet the minimum listing requirements for trading on a national securities exchange. Many of these companies do not file periodic reports or audited financial statements with the SEC, making it very difficult for investors to find current, reliable information about those companies. For these reasons, OTCs can be among the most risky investments.

25. Bock Evans represented to its clients through its written materials that it does "not trade on any foreign exchanges or over-the counter markets ("OTCs")" but they may "***from time to time***" own stocks which are traded on domestic OTCs[,] but get their bid and ask pricing from foreign markets." This representation is false. In reality, the stocks Bock Evans purchased for Plaintiffs and Class were overwhelmingly OTCs. Contrary to its representations, trading in high risk OTCs was the rule rather than the exception.

4. Bock Evans Purchased Penny Stocks for Clients Without Making Proper Disclosures or Providing Material Information

26. Penny stocks trade on the OTC market. The term "penny stock" generally refers to a security issued by a very small company that trades at less than $5 per share. In addition, the definition of penny stock can include the securities of certain private companies with no active trading market. The term Penny Stock is defined more specifically in Rule 3a51-1 of the Securities Exchange Act of 1934, 15 U.S.C § 78 *et seq. See,* 17 C.F.R. 240.3a51-1.

27. Penny stocks may trade infrequently, which means it may be difficult to sell the shares once you own them. Moreover, because it may be difficult to find quotations for certain penny stocks, they may be difficult, or even impossible, to accurately price. For these and other reasons, penny stocks are considered highly speculative and risky investments such that a special regulatory framework has been created with the goal of protecting consumers from abusive practices.

28. As a result of the risk associated with penny stock trading, Congress enacted the Securities Enforcement Remedies and Penny Stock Act requiring the SEC to enact rules requiring disclosures to customers effecting trades in penny stocks. The rules prohibit effecting transactions in penny stocks unless there is compliance with the requirements of Section 15(h) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the rules promulgated thereunder and, in particular, Exchange Act rules 15g-1 through 15g-100 (the "penny stock rules").

29. The form disclosure required by the SEC states, among other things, as follows:

> **Penny stocks can be very risky.**
>
> Penny stocks are low-priced shares of small companies. Penny stocks may trade infrequently - which means that it may be difficult to sell penny stock shares once you have them. Because it may also be difficult to find quotations for penny stocks, they may be impossible to accurately price. Investors in penny stock should be prepared for the possibility that they may lose their whole investment.
>
> While penny stocks generally trade over-the-counter, they may also trade on U.S. securities exchanges, facilities of U.S. exchanges, or foreign exchanges. You should learn about the market in which the penny stock trades to determine how much demand there is for this stock and how difficult it will be to sell. Be especially careful if your broker is offering to sell you newly issued penny stock that has no established trading market.

See, SEC Schedule 15G at 17 C.F.R. § 240.15g-100.

30. *Before* penny stock is purchased, the customer must, among other things, be provided with a risk disclosure document containing the information set forth on SEC Schedule 15G; must receive a signed and dated acknowledgement of receipt of the Schedule 15G disclosure from the customer; and the customer must be provided with a suitability statement reflecting that the customer's account has been approved for transactions in penny stocks.

31. Many of the securities purchased by Bock Evans for Plaintiff and the Class were penny stock. Despite this fact, Plaintiffs were never provided any of the required disclosures, and never signed any written acknowledgement as required by the penny stock rules. Plaintiffs are informed and believe and thereon allege that Bock Evans purchased penny stock for all of its clients as part of a uniform, one-size-fits-all investment approach, without regard for the penny stock rules.

32. In addition, the SEC penny stock disclosures are material and were within the knowledge and possession of Bock Evans. Bock Evans' failure to ensure that its clients received the benefit of penny stock disclosures, as well as information about the risks of OTC stocks in general, constitutes a breach of its duty.

5. The "Know Your Client" Obligations and Bock Evans' Contrary "One Size Fits All" Approach

33. As discussed above, among the duties owed by Bock Evans to its clients is the duty to learn essential information about each client and understand the investment objective and tolerance for risk for each individual client. Through its written materials, Bock Evans represented to Plaintiffs and the Class that it would evaluate each client individually and make investments based upon their individual investment needs:

> "We…make investments based upon your individual investment needs. We consider, among other factors, your personal and family obligations, financial goals, risk preferences and investment objectives when providing advisory services. Your assets are managed individually and not pooled with other client assets."
>
> "[w]hen managing a Client's portfolio, Bock Evans takes into consideration the Client's investment objectives, risk tolerance, time horizon, financial condition and stability among other factors. Bock Evans relies heavily on written information provided by clients pertaining to their financial situation, investment objectives, time horizon, liquidity requirements, tax sensitivity and other factors. This information forms the foundation for the design and management of the Client's portfolio utilized to help meet each client's investment goals as formalized in the investment statement of the Client Information Form. Your restrictions and guidelines may affect the composition of your portfolio."

34. Bock Evans further represented in writing to all of its clients that the Firm is "guided by the Client's designated investment objective, risk tolerance and other factors and guidelines and any limitations the Client has furnished us in writing in the investment statement as agreed to by the parties."

35. Contrary to these written representations, Bock Evans failed to make personalized investment decisions on behalf of each client. Rather, Bock Evans employed a systematic "one size fits all" approach to all of its clients without regard for individual investment objectives and risk tolerance. Plaintiffs are informed and believe that Bock Evans systematically purchased high risk and highly speculative mining stocks for all of its clients without regard to each individual client's designated investment objectives and risk tolerance. As such, Bock Evans breached not only its own written representations but also failed to meet industry standards in managing the accounts of Plaintiffs and the Class.

B. Ms. Milliner's Experience

36. Ms. Milliner opened two investment accounts with Bock Evans; one was a SEP IRA Investment Account (the "Retirement Account") and the other was an investment account in the name of her Trust (the "Trust Account.") (collectively, the "Accounts.") As required by Bock Evans, both Accounts were opened as discretionary accounts.

37. At the time Ms. Milliner opened these Accounts, Bock Evans provided her with its Brochures through which Bock Evans represented its qualifications, business practices, and investment approach. Ms. Milliner read the Brochures, and relied upon the representations made therein in opening and maintaining her Accounts with Bock Evans.

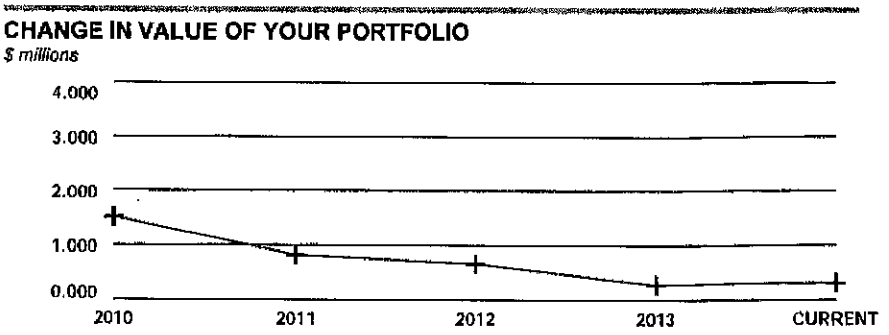
38. Thereafter, Ms. Milliner was asked to fill out a client information form through which Ms. Milliner answered questions relating to her financial situation, investment objectives and risk tolerances, under the belief, based on the representations in the Brochures, that Bock Evans would rely on this information in managing her Accounts. Rather, Bock Evans implemented a systematic "one size fits all" investment strategy which consisted of uniformly investing clients' assets in undiversified, high risk, and highly speculative foreign mining stocks.

39. Contrary to its written representations and its duties of care, Bock Evans did not employ a diversified strategy to her portfolios, but rather placed 100%, or nearly 100%, of Ms. Milliner's investment assets from *both* Accounts in foreign *mining* companies.

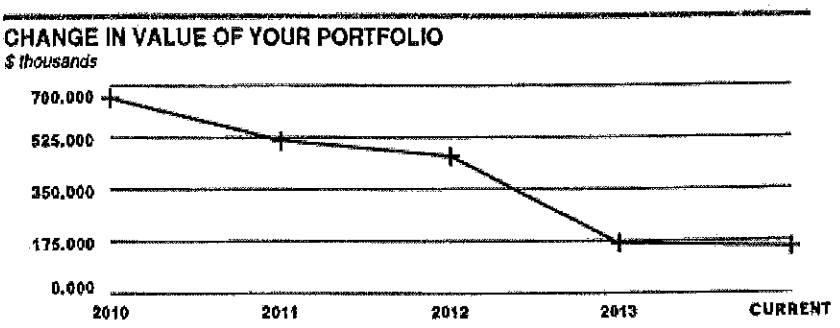
40. Also contrary to its written representations and its duties of care, Bock Evans did not avoid trading on foreign markets and did not limit its trading on OTC markets only from "time to time." Rather, the majority of the securities traded by Bock Evans on behalf of Ms. Milliner were OTC stocks, and many were even Penny Stocks.

41. Despite investing Ms. Milliner's Accounts in penny stocks, Bock Evans failed to ensure that Ms. Milliner received the benefits of the penny stock rules, including the required disclosures, prior to the purchase of penny stocks in her Accounts. Bock Evans also failed to provide other material information relevant to the risks inherent in investing in OTC stocks.

42. As a direct and proximate result of Bock Evans' breach of its fiduciary duties, Ms. Milliner's retirement assets have been decimated. As reflected in the chart below, Ms. Milliner's Retirement Account dropped by more than $1,200,000.00:



Given the "one size fits all" investment strategy employed by Bock Evans, the value of Ms. Milliner's Trust Account suffered a similar fate, having dropped by more than $500,000.00:



By comparison, from January 3, 2011 to December 31, 2014, the Dow Jones Industrial Average *increased* in value by 53%, the S&P 500 by 62%, and the NASDAQ Composite by 76%.

43. As demonstrated through the change in value of her portfolios, the securities selected by Bock Evans had a continuous downward trend for years. At no time did Bock Evans make any significant adjustment to Ms. Milliner's portfolios to reflect current economic and market conditions. Contrary to its written representations and its duties of care, Bock Evans failed to continuously monitor changes in economic and market conditions and failed to make any significant adjustments to her Accounts consistent with such changes.

C. Ms. Brem's Experience

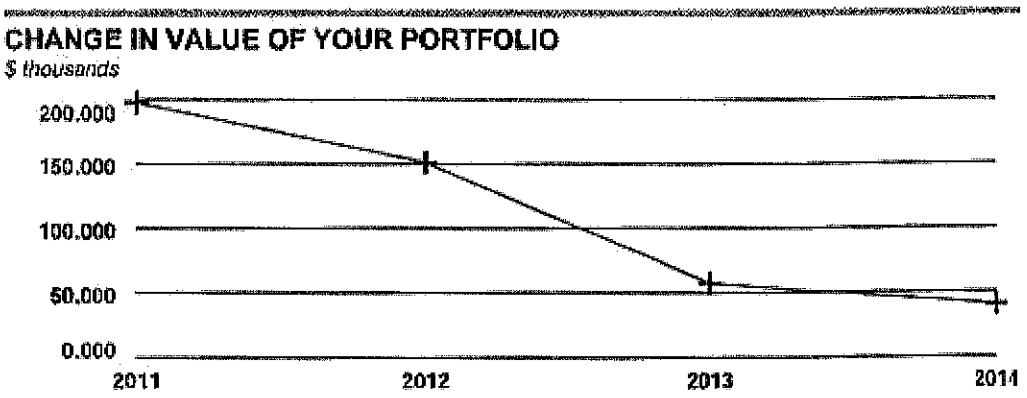
44. Ms. Brem opened one investment account with Bock Evans. As required by Bock Evans, the account was opened as a discretionary account.

45. At the time Ms. Brem opened her account, Bock Evans provided her with its Brochure through which Bock Evans represented its qualifications, business practices, and investment approach. Ms. Brem read the Brochures, and relied upon the representations made therein in opening and maintaining her account with Bock Evans.

46. Thereafter, Ms. Brem was asked to fill out a client information form through which Ms. Brem answered questions relating to her financial situation, investment objectives and risk tolerances, under the belief, based on the representations in the Brochure, that Bock Evans would rely on this information in managing her account. Rather, Bock Evans implemented a systematic "one size fits all" investment strategy which consisted of uniformly investing clients' assets in undiversified, high risk, and highly speculative foreign *mining* stocks.

47. Contrary to its written representations, and its duties of care, Bock Evans did not employ a diversified strategy to her portfolio, but rather placed 100%, or nearly 100%, of Ms. Brem's investment assets in foreign *mining* companies.

48. Ms. Brem opened her account with Bock Evans with an initial contribution of $200,000.00. By the time she transferred her portfolio to a different advisor in March 2015, the value of her portfolio had dropped to $34,784.15, a decline of over $165,000.00:



49. Also contrary to its written representations and its duties of care, Bock Evans did not avoid trading on foreign markets and did not limit its trading on OTC markets only from "time to time." Rather, the majority of the securities traded by Bock Evans on behalf of Ms. Brem were OTC stocks, and many were even Penny Stocks.

50. Despite investing Ms. Brem's Accounts in Penny Stocks, Bock Evans failed to ensure that Ms. Brem received the benefits of the penny stock rules, including the required disclosures, prior to the purchase of penny stocks in her Accounts. Bock Evans also failed to provide other material information relevant to the risks inherent in investing in OTC stocks.

51. As demonstrated through the change in value of her portfolio, the securities selected by Bock Evans had a continuous downward trend for years. At no time did Bock Evans make any significant adjustment to Ms. Brem's portfolio to reflect current economic and market conditions. Contrary to its written representations and its duties of care, Bock Evans failed to continuously monitor changes in economic and market conditions and failed to make any significant adjustments to her account consistent with such changes.

52. Plaintiffs are informed and believe that their experience with Bock Evans as described herein is typical of the experience of the Class. Plaintiffs further plead that Bock Evans misrepresented its investment approach, as reflected in the standard form written materials, in a similar manner to all Class members, and that Plaintiffs and Class members, were similarly exposed to Bock Evans' breach of its fiduciary duties.

V. CLASS ACTION ALLEGATIONS

53. Plaintiffs bring this action under Rule 23 of the Federal Rules of Civil Procedure on behalf of themselves and all persons or entities others who are similarly situated.

54. Plaintiffs seek to represent the following proposed class under Rule 23(b)(3):

> All persons and entities who were or currently are clients of Defendant Bock Evans Financial Counsel, Ltd. with discretionary investment portfolios.

55. Subject to additional information obtained through further investigation and discovery, the foregoing definitions of the Class may be expanded or narrowed by amendment or amended complaint. Specifically excluded from the Class is Defendant, its officers, directors, agents, trustees, parents, children, corporations, trusts, representatives, employees, principals, servants, partners, joint venturers, or entities controlled by Defendant, and its heirs, successors, assigns, or other persons or entities related to or affiliated with Defendant and/or its officers and/or directors, or any of them; the Judge assigned to this action; and any member of the Judge's immediate family.

56. Plaintiffs' action meets the prerequisites of Rule 23(a) because:

a. **Numerosity:** The class as defined above consists of dozens of individuals and is so numerous that joinder of all members as individual plaintiffs is impracticable. Though the exact number and identity of class members is not presently known, they can be identified through Defendant's records.

b. **Commonality:** There are questions of law and fact common to the Class. Such common questions include, but are not limited to:

i. What was the scope of the duty owed by Bock Evans to the Class;

ii. Whether Bock Evans provided uniform, written representations of its investment strategy to the Class;

iii. Whether Bock Evans failed to diversify the holdings of the Class;

iv. Whether Bock Evans purchased OTC stocks for the Class;

v. Whether Bock Evan purchased penny stock for the Class;

vi. Whether Bock Evans failed to ensure that the Class received the benefit of penny stock rules;

vii. Whether Bock Evans adopted a one-size-fits all investment strategy for the Class;

viii. Whether Bock Evans monitored Class portfolios and made adjustments to reflect current economic and market conditions;

ix. Whether Bock Evans is liable for damages and the amount of such damages;

x. Whether Bock Evans' conduct warrants an award of punitive damages.

c. **Typicality:** Plaintiffs' claims are typical of the Class in that they received the Brochures, maintained discretionary accounts at Bock Evans, their portfolios were not diversified by Bock Evans, their portfolios held OTC stock and penny stock, and their portfolios were not adjusted by Bock Evans to reflect current economic and market conditions.

d. **Adequacy:** Plaintiffs will fairly and adequately protect the interests of the Class. Plaintiffs have no interests that are antagonistic to or in conflict with the interests of the Class, and Plaintiffs engaged competent counsel experienced in complex litigation and class actions.

57. This elements of Rule 23(b) are also met in that:

a. Questions of law or fact common to members of the class each predominate over any questions affecting only individual members (Rule 23(b)(3)(A));

b. The class action is superior to other available methods for the fair and efficient adjudication of the controversy (Rule 23(b)(3)(B));

c. Whatever difficulties may exist in the management of the class action will be greatly outweighed by the benefits of the class action procedure for fair and efficient adjudication of the controversy. (Rule 23(b)(3)(C)).

FIRST CLAIM FOR RELIEF
BREACH OF FIDUCIARY DUTY

58. Plaintiffs hereby incorporate each of the paragraphs of this Complaint as though fully set forth herein.

59. By virtue of the relationship between Plaintiffs and Bock Evans, a relationship was created whereby Plaintiffs and the Class placed their trust, confidence, and reliance on Bock Evans' expertise in making investments decisions in accordance with its written representations and applicable duty of care. Bock Evans' duties included, but were not limited to, the duty of loyalty, the duty to deal fairly and honestly with Plaintiffs, the duty of full disclosure, the duty to act in the utmost good faith and in the best interest of Plaintiffs and the Class.

60. As their investment advisor, Bock Evans also owed Plaintiffs and the Class specific duties, including the duty to employ a diversified investment strategy; the duty to limit high risk and highly speculative OTC securities and penny stocks; the duty to ensure that

Plaintiffs and the Class received the benefits of the penny stock rules, including the required disclosures prior to the purchase of Penny Stocks; the duty to provide all information that was material to the interests of Plaintiffs and the Class; and the duty to continuously monitor customers' portfolios against changing financial and market conditions, and make adjustments to those portfolios consistent with current economic and market conditions.

61. Bock Evans breached its duty of care by failing to employ a diversified investment strategy for Plaintiffs and the Class.

62. Bock Evans breached its duty of care by implementing a uniform investment strategy consisting primarily of high risk and highly speculative investments for Plaintiffs and the Class, including OTCs and penny stock.

63. Bock Evans breached its duty of care by failing to ensure that Plaintiffs and the Class received the benefit of the penny stock rules, including the required disclosures prior to the purchase of penny stocks in the accounts of Plaintiffs and the Class.

64. Bock Evans breached its duty of care by failing to provide Plaintiffs and Class material information about the risks attendant to OTC and penny stock transactions.

65. Bock Evans breached its duty of care by failing to continuously monitor Clients' portfolios against changes in economic and market conditions, and failing to make adjustments to its clients' portfolios consistent with such changes.

66. Bock Evans breached its duty of care by employing a systematic "one size fits all" approach to all of its clients without regard for each client's individual investment objectives and risk tolerance.

67. As direct and proximate result of Bock Evans' breach of its fiduciary duties, Plaintiffs and the Class have been damaged in an amount according to proof. Plaintiffs and the Class are also entitled to seek rescission for each unlawful transaction Bock Evans made on behalf of Plaintiffs and the Class.

68. In committing the acts described herein, Bock Evans acted maliciously, fraudulently, and oppressively, thereby entitling Plaintiffs and the Class to recover punitive damages in an amount according to proof.

SECOND CLAIM FOR RELIEF
GROSS /WILLFUL/WANTON NEGLIGENCE

69. Plaintiffs hereby incorporate each of the paragraphs of this Complaint as though fully set forth herein.

70. The fiduciary duties owed by registered investment advisors set forth a duty of care owed by Bock Evans to Plaintiffs and the Class. Pursuant to this standard of care, Bock Evans owed a multitude of duties to Plaintiffs and the Class, including but not limited to the duty of loyalty, the duty to deal fairly and honestly with Plaintiffs, the duty of full disclosure, the duty to act in the utmost good faith and in the best interest of Plaintiffs and the Class.

71. As their investment advisor, Bock Evans also owed Plaintiffs and the Class the ongoing duty to employ a diversified investment strategy; the duty to limit investments in high risk and highly speculative OTC securities and penny stock; the ongoing duty to continuously monitor customers' accounts and make adjustments consistent with changing economic and market conditions; the duty to ensure that Plaintiffs and the Class received the benefits of the penny stock rules, including the required disclosures prior to the purchase of penny stocks; and the duty to provide all information that was material to the interests of Plaintiffs and the Class. This duty of care is especially significant, where, as here, Bock Evans provided continuous and regular supervisory and portfolio management services on a discretionary basis.

72. Bock Evans breached its duty of care to Plaintiffs and the Class, and was grossly negligent in managing the portfolios of Plaintiffs and the Class, in that its conduct, both actions and failure to act, reflects a lack of any care and an extreme departure from the ordinary standard of care. Bock Evans' gross negligence, willful misconduct, recklessness, and utter lack of care is reflected in the fact that it failed, among other things, to employ a diversified investment strategy for Plaintiffs and the Class; failed to ensure that Plaintiffs and the Class received the benefit of the

penny stock rules, including the required disclosures prior to the purchase of penny stocks in the accounts of Plaintiffs and the Class; failed to provide Plaintiffs and Class members with information about the risks attendant to OTC stock transactions; employed a systematic "one size fits all" approach to all of its clients; and failed to continuously monitor clients' accounts against changing economic and market conditions and make adjustments to those portfolios in light of current conditions.

73. As a direct and proximate result of Bock Evans' gross negligence, Plaintiffs and the Class have been damaged in an amount according to proof.

THIRD CLAIM FOR RELIEF
FRAUD BY MISREPRESENTATION AND OMISSION

74. Plaintiffs hereby incorporate each of the paragraphs of this Complaint as though fully set forth herein.

75. Through its Brochures, Bock Evans uniformly and expressly represented that it would:

a. employ a diversified strategy for most portfolios under most market conditions;

b. not trade in foreign OTCs;

c. trade in domestic OTCs only "on occasion" and "from time to time"

d. continuously monitor economic and market conditions and continuously make adjustments to clients' portfolios in light of these changing conditions.

e. make investments based on the individual investment needs of each particular client.

76. These representations were material in inducing Plaintiffs and the Class into hiring and retaining Block Evans as their investment advisor.

77. At the time Bock Evans made the above-referenced promises and representations to Plaintiffs and the Class, Bock Evans knew them to be false as it had no intention of performing them. The true facts were that Bock Evans:

a. Never intended to employ, and never did employ, a diversified investment strategy for the portfolios of Plaintiffs and the Class;

b. intended to engage in an investment strategy primarily consisting of trades in OTCs;

c. Never intended to continuously monitor the changing economic and market conditions and adjust client portfolios in light of current conditions;

d. Never intended to disclose to Plaintiffs and the Class that it would not provide Plaintiffs or the Class with the benefits of the penny stock rules, including the required special disclosures;

e. Never intended to make personalized investment decisions on behalf of each client. Rather, Bock Evans intended to employ and did employ a systematic "one size fits all" investment approach to all of its clients.

78. Bock Evans also omitted disclosing that many of the stocks it purchased were penny stocks subject to the penny stock disclosure rules, which information was material, as reflected by the SEC's special disclosure requirements.

79. Bock Evans made these representations with the intention of inducing Plaintiffs and Class members into opening and maintaining accounts with Bock Evans. In addition, when Bock Evans failed to disclose and concealed material information regarding its true investment intentions, including with respect to the purchase of OTCs and penny stock, Bock Evans did so with the intent to deceive and defraud Plaintiffs and the Class and to induce them to act in the manner herein alleged.

80. Plaintiffs and Class members justifiably relied on Bock Evans' false representations and omissions. At the time the promises and omissions occurred, and at the time Plaintiffs took the actions herein alleged, they were ignorant of Bock Evans' secret intention not

to perform and Plaintiffs could not, in the exercise of reasonable diligence, have discovered Bock Evans' secret intentions. Plaintiffs reasonably relied on these representations in opening and maintaining accounts with Bock Evans. Plaintiffs were ignorant of Bock Evans' omissions of material fact. Had Plaintiffs known the actual facts, they would not have opened nor maintained accounts with Bock Evans.

81. As a direct and proximate result of Bock Evans' fraud, Plaintiffs and the Class have suffered damages in an amount according to proof.

82. Plaintiffs and Class members are also entitled to seek rescission for each unlawful transaction Bock Evans made on behalf of Plaintiffs and the Class.

83. In committing the acts described herein, Bock Evans acted maliciously, fraudulently, and oppressively, thereby entitling Plaintiffs and the Class to recover punitive damages in an amount according to proof.

FOURTH CLAIM FOR RELIEF
CONSTRUCTIVE FRAUD

84. Plaintiffs hereby incorporate each of the paragraphs of this Complaint as though fully set forth herein.

85. By virtue of the relationship between Bock Evans and its clients, a relationship was created whereby Plaintiffs and the Class placed their trust, confidence, and reliance on Bock Evans' expertise in making investments decisions in accordance with its written representations and applicable duty of care. Bock Evans' duties included, but were not limited to, the duty of loyalty, the duty to deal fairly and honestly, the duty of full disclosure, the duty to act in the utmost good faith and in the best interest of Plaintiffs and the Class.

86. As their investment advisor, Bock Evans also owed Plaintiffs and the Class specific duties, including the duty to employ a diversified investment strategy; the duty to limit high risk and highly speculative OTC securities and penny stocks; the duty to ensure that Plaintiffs and the Class received the benefits of the penny stock rules, including the required disclosures prior to the purchase of penny stocks; the duty to provide all information that was

material to the interests of Plaintiffs and the Class; and the duty to continuously monitor customers' portfolios against the changing economic and market conditions, and make adjustments to those portfolios consistent with current economic and market conditions.

87. Despite having voluntarily accepted the trust and confidence of Plaintiffs and the Class, and in violation of this relationship of trust and confidence, Bock Evans abused this trust and confidence by, among other ways, (a) failing to employ a diversified investment strategy, (b) failing to limit high risk and highly speculative OTC securities and penny stocks; (c) failing to ensure that Plaintiffs and the Class received the benefits of the penny stock rules, including the required disclosures prior to the purchase of penny stocks; (d) failing to provide all information that was material to the interests of Plaintiffs and the Class; and (e) failing to continuously monitor customers' portfolios against the changing economic and market conditions, and make adjustments to those portfolios consistent with current economic and market conditions.

88. Plaintiffs and Class members justifiably relied on the trust and continued fidelity of Bock Evans to their detriment. As a result of Bock Evans' aforementioned breach of fiduciary duties to Plaintiffs, Bock Evans gained an advantage in that Plaintiffs and the Class opened and maintained investment accounts with Bock Evans.

89. As a direct and proximate result of Bock Evans's constructive fraud, Plaintiffs and the Class suffered damage in an amount according to proof.

90. Plaintiffs and Class members are also entitled to seek rescission for each unlawful transaction Bock Evans made on behalf of Plaintiffs and the Class.

91. In committing the acts described herein, Bock Evans acted maliciously, fraudulently, and oppressively, thereby entitling Plaintiffs and the Class to recover punitive damages in an amount according to proof.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs pray for judgment as follows and as permitted as to each cause of action:

A. For compensatory damages in an amount according to proof;

B. For rescission;

C. For lost opportunity costs;

D. For attorneys' fees and costs;

E. For costs of suit and all other recoverable costs and expenses to the fullest extent allowed by law;

F. For interest at the maximum legal rate from the earliest possible date on all sums awarded;

G. For punitive damages in an amount according to proof, and

H. Such other and further relief as may be just and proper.

Dated: April 20, 2015

THE LAW OFFICES OF DAVID STURGEON-GARCIA

By: *David Sturgeon-Garcia*
David Sturgeon-Garcia, Esq.

Attorneys for Plaintiffs Charlotte B. Milliner, Joanne Brem, and the putative class

DEMAND FOR JURY TRIAL

Pursuant to Fed. R. Civ. P. 38(b), Plaintiffs and the Class hereby demand a trial by jury for all causes of action, claims or issues in this action which are triable as a matter of right to a jury.

Dated: April 20, 2015

THE LAW OFFICES OF DAVID STURGEON-GARCIA

By: *David Sturgeon-Garcia*
David Sturgeon-Garcia, Esq.

Attorneys for Plaintiffs Charlotte B. Milliner, Joanne Brem, and the putative class

EXHIBIT B

FILED
11/8/2018 3:59 PM
DOROTHY BROWN
CIRCUIT CLERK
COOK COUNTY, IL
2018CH13978

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

EUGENE SIMMONS, ALEXANDRA EIVA, CAROL HARMS, ROSEMARY MAZIARZ IRA, and RANDALL M. THOMPSON, IRA, individually and on behalf of all others similarly situated, Plaintiffs, v. GOLDSTONE FINANCIAL GROUP, L.L.C., ANTHONY PELLEGRINO, and MICHAEL PELLEGRINO, Defendants.	CASE NO. 2018CH13978 **PLAINTIFFS' CLASS ACTION COMPLAINT AND JURY DEMAND**

Plaintiffs Dr. Eugene Simmons, Alexandra Eiva, Carol Harms, Rosemary Maziarz IRA, and Randall M. Thompson, IRA, individually, and on behalf of all others similarly situated (the "Class"), by and through their attorneys, file this class action complaint against Defendants Goldstone Financial Group, L.L.C., Anthony Pellegrino, and Michael Pellegrino (collectively "Goldstone" or "Defendants"). Plaintiffs' allegations are based on information and belief, except as to those allegations concerning Plaintiffs, which are alleged upon personal knowledge. Plaintiffs' information and belief are based upon, among other things, their counsel's investigation which includes a review and analysis of the proceedings in *In re: 1 West Capital LLC, Case No. 18-19122-RBR (S.D. Fla. Bankr.); In re: 1 Global Capital LLC, Case No. 18-19121-RBR (S.D. Fla. Bankr.);* and *Securities and Exchange Commission v. 1 Global Capital, LLC, et al., Case No. 18-cv-61991-BB (S.D. Fla.)* (the "SEC Case"), and a review of other publicly available information concerning 1 Global Capital, LLC and the Defendants.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

1. Defendants actively promoted, marketed, and sold unlawful and unregistered securities offered by 1 Global Capital LLC ("1 Global") in breach of their fiduciary duties to their clients – Plaintiffs and members of the proposed Class – without first conducting adequate due diligence and through untrue statements and omissions of material fact as to the true risks and nature of an investment in 1 Global.

2. According to the SEC Case, 1 Global fraudulently raised more than $287 million from more than 3,400 investors in at least twenty-five states, including Plaintiffs and members of the proposed Class, through the offer and sale of those unregistered securities, purportedly to fund its business of offering short-term financing to small and medium sized businesses.

3. 1 Global used a network of brokers, registered and unregistered investment advisers, and other sales agents, including Defendants, to offer and sell those unregistered securities, and 1 Global paid its sales agents millions of dollars in referral fees or commissions in return. 1 Global, through the use of uniform marketing materials distributed to sales agents, and marketing materials prepared by the sales agents based on information 1 Global provided them, promised investors a safe, low-risk investment paying an attractive return, in which 1 Global would use investor money to make short-term cash advances called Merchant Cash Advances ("MCAs") to businesses that could not obtain more traditional financing such as bank loans. 1 Global touted a rigorous underwriting process through which it purportedly approved only one in ten merchants who applied for a loan, and an electronic collection process that would allow investors to make a profit.

4. In reality, according to the SEC Case, 1 Global used a substantial amount of investor money for purposes other than MCAs, including paying operating expenses and

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

purchasing already distressed, long-term credit card debt. In addition, the SEC alleged that 1 Global misappropriated at least $35 million of investor money, at least $28 million of which was paid: (a) directly to 1 Global's founder, Chairman, and CEO Carl Ruderman ("Ruderman"), the Ruderman Family Trust, and other entities he owned or controlled; (b) to companies owned or operated by Ruderman's relatives and acquaintances that had nothing to do with 1 Global's cash advance business; and (c) to fund Ruderman's lavish expenses such as a luxury vacation to Greece and monthly payments for his Mercedes-Benz.

5. According to the SEC Case, 1 Global and its sales representatives made numerous material misrepresentations and omissions to investors, including: (a) that investments in 1 Global were not "securities"; (b) that the company would only use investor money to fund MCAs; (c) falsely representing the amount of investor money the company would take for its own use; (d) sending monthly account statements to investors that falsely represented their portfolio balances, rates of return, and the amount of their cash 1 Global had in the bank to fund merchant loans; and (e) falsely representing the company had an independent auditor that verified the numbers set forth in each investor's monthly statement.

6. The SEC alleged that largely as a result of 1 Global's misappropriation and improper use of investor funds, by no later than October 2017, 1 Global experienced a shortage of investor funds approximating $23 million that should have been in the company's bank accounts and available for merchant loans. This shortfall continued and increased with time, so that by June 30, 2018, 1 Global's financial records showed approximately $50 million in missing investor funds.

7. Less than a month later, 1 Global and a sister company, 1 West Capital LLC (which 1 Global used to make merchant loans in California), filed for Chapter 11 bankruptcy

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

protection, placing investors at risk of losing significant funds. An independent management team is now operating 1 Global and 1 West Capital LLC.

8. Defendants aggressively marked and promoted 1 Global securities to their customers, hundreds of whom purchased 1 Global securities through Goldstone.

9. Among other things, Goldstone hosted seminars in the Chicago area during which it adopted and repeated 1 Global's false and misleading statements, and promoted 1 Global as a safe investment suitable for retirees and IRA investors. Goldstone also distributed a brochure, which displayed Goldstone's name and address, and while it did not mention 1 Global by name, it described an investment in 1 Global repeating the false and misleading statements approved by 1 Global, and also including a range of expected returns that Defendant Michael Pellegrino determined based on allegedly fake documents shown to him by a friend who also sold and promoted 1 Global securities. Goldstone's materials also repeated 1 Global's false statement that 1 Global notes sold to investors were not securities.

10. Plaintiffs and the members of the proposed Class invested in 1 Global securities directly through Goldstone, and have lost most or all of the value of their investments.

PARTIES

11. Plaintiff Dr. Eugene Simmons is an individual residing in Chicago, Illinois. He invested a portion of his retirement savings in 1 Global on or about December of 2017 through Defendant Goldstone.

12. Plaintiff Alexandra Eiva is an individual residing in Wheaton, Illinois. She invested a portion of her retirement savings in 1 Global on or about March 8, 2018 through Defendant Goldstone.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

13. Plaintiff Carol Harms is an individual residing in DuPage County, Illinois. She invested a portion of her retirement savings in 1 Global on or about May of 2018 through Defendant Goldstone.

14. Plaintiff Rosemary Maziarz IRA is a self-directed IRA that established by and is controlled, managed, and directed by Rosemary Maziarz. Plaintiff Maziarz is an individual residing in St. Charles, Illinois. She invested in 1 Global for her IRA account on or about November 13, 2017 through defendant Goldstone.

15. Plaintiff Randall M. Thompson, IRA, is a self-directed IRA that established by and is controlled, managed, and directed by Randall Thompson. Plaintiff Thompson is an individual residing in Lake Zurich, Illinois. He invested a portion of his retirement savings in 1 Global on or about February 2018 through Defendant Goldstone.

16. Defendant Goldstone Financial Group, L.L.C. is an Illinois limited liability company with its principal place of business in Oakbrook Terrace, Illinois. Goldstone is an SEC Registered Investment Advisor ("RIA") with more than $100 million in assets under management and approximately 600 clients. Defendants Anthony and Michael Pellegrino are Goldstone's managers.

17. Defendant Anthony Pellegrino is an individual residing in Elmhurst, Illinois, and is a principal and manager of Goldstone.

18. Defendant Michael Pellegrino is an individual residing in Villa Park, Illinois, and is a principal and manager of Goldstone.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

FACTUAL ALLEGATIONS

1 Global's Merchant Cash Advance Business

19. Carl Ruderman founded 1 Global in 2013, purportedly seeking "a better growth opportunity for his family's funds." By 2018, the company had grown to more than 100 employees in sales, underwriting, collections, finance, technology and lawyers.

20. According to the SEC Case, Ruderman was a hands-on Chairman and CEO, personally overseeing all aspects of the company's operations. There was no board of directors or any other high-level executive with decision-making authority. Rudernan signed 1 Global's agreements with third-party sales agents, including Goldstone, to allow it to offer and sell 1 Global's unregistered securities. Those agreements specified the sales agents' compensation and required 1 Global to approve all marketing materials and sales brochures the agents used.

21. Until it ceased operations on July 27, 2018, 1 Global claimed to be in the business of funding MCAs – short-term loans to small and medium-sized businesses. According to its marketing materials and website, 1 Global provided these businesses with an alternative source of funding to traditional bank loans and other financing methods, which it touted as insufficient to meet the short-term needs of smaller businesses.

22. 1 Global claimed that it contracted with 100 to 200 third-party vendors to find merchants interested in applying for cash advances. 1 Global paid those companies a finder's fee for each merchant who received a cash advance. The amount of each finder's fee varied, depending on the loan amount, the third party's track record with 1 Global, and other factors. 1 Global determined the amount of the finder's fee in each instance. According to the SEC Case, through April 2018, 1 Global paid third parties who solicited merchants approximately $15 million in finder's fees for their efforts.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

23. Once a finder located an interested merchant, the merchant would apply directly to 1 Global for a cash advance. In marketing materials 1 Global sent to sales agents to use in soliciting investors, 1 Global touted a comprehensive underwriting process and stressed that it only approved loans to one out of every ten merchants who applied.

24. The company indicated in its marketing materials that it used a variety of methods to weed out risky loan candidates, including internet research, credit checks, specific programs for background checks and business analysis, a review of bank records and other documents, and, most importantly, personal contact with every merchant before the company made an advance.

25. The company's materials also reported that 1 Global's MCAs were typically small, averaging $68,000. The typical repayment term was anywhere from four months to one year. The MCAs were purportedly made against a business' future cash receivables, and merchants agreed to make daily payments via electronic (ACH) debiting from their business operating bank accounts as they received payments from their customers or vendors.

26. 1 Global's materials also touted a consistently low default rate, specifically stating that its average annual loan write-off rate was only 4%. In addition, the company told investors and others that approximately 30% of the merchants it loaned money to refinanced their loans.

27. In reality, according to the SEC Case, the company's MCA process was not nearly so rigorous and its cash advance business functioned much differently. In contrast to its claim that its average loan amount was $68,000, 1 Global often made loans of hundreds of thousands or even millions of dollars. In one instance, 1 Global made an MCA of approximately $40 million to a single California automobile dealership.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

28. The company also had far more difficulty collecting from merchants than it publicly disclosed. For example, according to the SEC Case, in 2016, 210 of the approximately 1,166 MCAs 1 Global funded – a total of 18% – were the subject of collection lawsuits. In 2017, 328 of 1 Global's 2,092 MCAs – a total of 15% – were the subject of collection lawsuits.

29. Additionally, the company's website – possibly because it was directed towards prospective borrowers – revealed a different story than the thorough underwriting process 1 Global touted to investors and elsewhere. For example, the company's website stressed how simple and quick it was for merchants to obtain loans, noting that the MCAs were unsecured business cash advances. The website consistently promised merchants they could execute an MCA and "have your money in as little as 24 hours."

30. The website also promised merchants that "If you own a business and need cash fast, we're the company to call," going on to promise "We can provide the money you need without the hassles and hoops other financial institutions put you through . . .You do not have to come to us hat in hand with scads of paperwork proving your credit worthiness only to have your application denied. We fund 90% of the businesses that apply without basing it on their credit scores . . .We have the resources and the commitment to get you that unsecured advancement you need immediately."

31. According to the SEC Case, through April 2018, 1 Global and 1 West made about $348 million in merchant cash advances involving approximately 4,000 MCAs. As of that same month, merchants had repaid approximately $241 million of that amount. As of April 2018, due to collectability issues and the misappropriation of investor funds, 1 Global owed investors at least $272 million but only had $27.5 million in its bank accounts. 1 Global does not currently have enough funds to repay investors and filed for bankruptcy in July 2018.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

1 Global's Solicitation Of Investor Funds

The Network Of Sales Agents

32. 1 Global funded its MCA business and its operations almost entirely with money from investors, whom the company referred to alternately as "Lenders" or "Syndicate Partners." According to the SEC Case, the only non-investor source of revenue for 1 Global came from a $10 million line of credit the company obtained from a hedge fund in 2016, from which it drew down $9.5 million over several months in 2016 and 2017 to make MCAs at the direction of the hedge fund. The remainder of 1 Global's MCA revenue derived entirely from investor money.

33. According to the SEC Case, 1 Global found its investors through a network of sales agents consisting in large part of registered and unregistered investment advisers and former (and in some cases barred) brokers.

34. For example, many sales agents, including Goldstone, received 3%[1] of every new investment amount they brought in to the company. If the investment rolled over into another term, most sales agents received an additional 1.68%. In addition, some sales agents who brought other sales agents into the company received an additional 1% of every amount their recruited sales agents sold. Through April 2018, 1 Global paid sales agents nearly $9 million in commissions for getting investors to put money into 1 Global. Goldstone was one of the sales agents 1 Global used to promote its securities.

35. Sales agents signed an Affiliate Agreement with 1 Global outlining their rights and responsibilities in, and compensation for, selling the 1 Global investment. The Agreements specified that 1 Global had to provide or approve all marketing materials the sales agents

[1] The agreements 1 Global entered into with its sales agents specified that agents would receive 4% per annum, or 2.25% for rollovers, which worked out to 3% and 1.68% respectively for a 9-month note.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

provided to prospective investors. In the Agreements and in meetings and telephone calls, 1 Global stressed that its minimum investment amount was $25,000, and that the investment opportunity was for a limited number of sophisticated investors.

36. In practice, however, as the SEC Case alleged, 1 Global placed no restrictions on who sales agents could solicit to invest in the company, and frequently waived the $25,000 minimum investment requirement. Sales agents, including Goldstone, regularly solicited large numbers of their existing clients to invest. In short, the company accepted money from any and all investors the sales agents could find.

37. According to the SEC Case, from February 2014 through April 2018, 1 Global received at least $287 million from 3,400 investors located in at least 25 states, with at least 100 investors each located in California, Florida, Illinois, Ohio, and Tennessee. More than one-third of the money came from those who invested through their IRAs. In the months after April 2018, 1 Global continued to receive millions of dollars from investors. The funds 1 Global raised were commingled or pooled together into one or more of 1 Global's bank accounts.

The Memorandum Of Indebtedness

38. 1 Global offered and sold its investments through an instrument entitled a Memorandum of Indebtedness ("MOI") as the note or contract between the company and investors.

39. The MOI termed the investor a "Lender," and identified the company as the "Borrower." The MOI specifically stated that an investor was providing money to 1 Global so the company could expand its business activities, which it termed the "Covered Activities." The only specific Covered Activity identified in the MOI was the MCAs. And the only use of investor money the company identified in its marketing materials was the MCAs. After 1 Global

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

received investor funds, it pooled and commingled them together in non-segregated 1 Global bank accounts.

40. While the MOI stated that it was a nine-month note, for most of the time 1 Global raised money from investors, the MOI also stated the note would automatically roll over into a new nine-month term unless the investor expressly informed the company in at least 30 days before the end of the nine months that he or she did not want the note to roll over.

41. According to the SEC Case, the overwhelming majority of investors allowed their investments to automatically roll over. One sales agent estimated only six to eight of the hundreds of investors he solicited redeemed their investments after nine months. Company bank records show that as of April 30, 2018, investors had sent more than $287 million to 1 Global, but 1 Global had returned only about $16 million of those funds through redemptions or other payments.

42. Even if an investor redeemed his or her investment after nine months, the note extended beyond nine months because it took 1 Global several months to fully pay out an investor's principal and interest. 1 Global called this period "the unwinding" and "the grace period" in the MOIs.

43. The unwinding period was caused by the way 1 Global used investor money to fund MCAs. Rather than use investor funds on a single MCA or a small number of MCAs, the company gave each investor a small, fractionalized interest in up to hundreds of MCAs. A company computer system would assign the investor's funds automatically, based on the amount of MCAs that came in daily in the weeks following an investment. Under this system, one MCA would be funded with dozens or even hundreds of investors' funds pooled together.

44. Using this process often resulted in the company taking months to place all of an

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

investor's funds into MCAs. Thus, according to the SEC Case, if an investor elected to redeem his or her investment after nine months, it could take months after that for the merchants who received the investor's money to fully repay the MCAs. Often the company would not generate enough money from the MCAs to fully pay redeeming investors, forcing the company to use new investor funds to pay off redeeming investors.

45. 1 Global did not pay investors the interest or the increase in valuation of their portfolio the company told them they were earning until the investor cashed out some or all of their investment. Although 1 Global sent investors monthly account statements purporting to show each investor's account credited with the interest the investor had earned on MCA repayments, investors did not receive those payments right away. Rather, according to the SEC Case, 1 Global simply commingled all those investor funds into its various bank accounts and frequently reinvested the investor money into new MCAs. This also allowed 1 Global to misappropriate investor funds.

46. 1 Global eventually memorialized the unwinding period into specific timetables at the beginning of 2018. It informed investors through marketing materials sent to sales agents that if an investor who redeemed had placed less than $250,000 with 1 Global, he or she would be fully repaid in 12 months, three months after the end of the nine-month term. For investments of greater than $250,000, the repayment would take six additional months, making the MOI a 15-month note. Goldstone changed the description of the notes in its marketing materials to reflect this change.

47. Another key provision of the MOI provided that it was within 1 Global's sole discretion how to use investor money to make MCA loans. In fact, investors had no say in how 1 Global used their money. Investors could not and did not manage their MCA loan portfolios; it

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

was solely up to 1 Global whether and when to use an investor's money to fund MCAs and which MCAs to fund. The success of the investment and whether an investor earned profits was solely dependent on 1 Global's decisions on MCA funding and other uses of funds, as well as repayment and collection efforts.

48. The MOI contained a paragraph stating the investor was sophisticated and was "qualified," meaning he or she had a certain income level or net worth. However, according to the SEC Case, 1 Global never enforced this provision, did not restrict who sales agents could offer the investments to, and accepted investments from anyone who wanted to invest, regardless of their net worth, income, or sophistication.

49. Finally, the MOIs set forth the two specific charges that were permitted to be deducted from investor money. The first was a 13% management fee that 1 Global would take from the amount collected from MCA repayments. The second was to reimburse the company for the finders' fees it paid to third parties for finding merchants to take MCAs. According to the MOIs, those were the only two charges permitted. However, according to the SEC Case, in truth 1 Global took far greater amounts than permitted from investor funds to pay its operating expenses, and diverted substantial portions of those funds to Ruderman and his related businesses.

Goldstone's Promotion of the 1 Global Investment Scheme

50. Defendants Michael and Anthony Pellegrino started Goldstone in 2008, having had no prior experience in the investment business.

51. Goldstone initially focused on selling annuities and insurance. In approximately 2011, Defendant Michael Pellegrino obtained his Series 65 license to act as an Investment Advisor Representative. Goldstone became an RIA in 2015. From 2011 to 2015, Defendant

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

Michael Pellegrino was variously associated with FINRA registered broker/dealers Brookstone Capital Management, and Center Street Securities. He was also associated with Taylor Capital Management from approximately 2012 to 2018. His brother, Defendant Anthony Pellegrino, obtained his Series 65 license sometime after 2011.

52. Approximately 60 to 70 percent of Goldstone's current clients are advisory clients, and the rest are annuity or insurance clients.

53. Goldstone is part of the network of sales agents 1 Global used to sell its securities. Over 140 Goldstone clients invested in 1 Global totaling millions of dollars.

54. Defendant Michael Pellegrino first heard of 1 Global in early 2017 from a phone call with a friend he identified as Trae Wienewitz, whom Pellegrino claims to have known from an insurance Field Marketing Organization they previously both belonged to. Pellegrino testified that Wienewitz brought up 1 Global on the call, explaining that Wienewitz recently started selling 1 Global investments to his clients, and he was very happy with the investment. According to Pellegrino, Wienewitz told him that 1 Global was in the business of making short-term advances to small businesses and then offered to introduce Pellegrino to Dale Leddbeder, whom Wienewitz represented to be 1 Global's outside legal counsel, to learn more. What Pellegrino did not ask and Wienewitz did not say, was that Wienewitz was getting paid to recruit brokers to sell 1 Global securities.

55. Wienewitz then forwarded Pellegrino several "account statements" that had purportedly been provided to Wienewitz by 1 Global. Those statements, represented to be examples of actual 1 Global client monthly account statements, showed the investor's name, the amount invested, and then listed each specific merchant "borrower" to which the investor's money was allocated. The statements also showed rates of return between being paid to

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

investors of between 12 and 17 percent. After receiving the account statements, Pellegrino called Wienewitz and asked to be introduced to Leddbedder. Pellegrino did not conduct any independent research on 1 Global prior to speaking to Leddbedder.

56. Leddbedder then called Pellegrino to discuss 1 Global. Their interaction consisted of two phone calls within a week's time during which Leddbedder purportedly explained 1 Global to Pellegrino. According to Pellegrino, Leddbedder cited his own accolades as a securities lawyer, and explained how he became 1 Global's outside lawyer, having first been an investor, and then became 1 Global's outside counsel. Leddbedder sang the praises of 1 Global's founder Carl Ruderman, describing him as a very wealthy man who sold his company after having been in the travel industry for many years. Leddbedder claimed that Ruderman needed a place to invest his money so he started 1 Global. What Leddbedder did not say, and what Pellegrino did not ask, was that Leddbedder was not actually 1 Global's outside counsel, and instead was being paid as a promoter to both recruit brokers to sell 1 Global securities, and to recruit borrowers for 1 Global.

57. During the call, Leddbedder explained to Pellegrino that 1 Global had been in business for four years, and was in the business of making Merchant Cash Advances to small businesses in the "Fintech space" in amounts of $50,000 to $60,000. According to Pellegrino, Leddbedder represented that 1 Global's underwriters looked for companies that had been in business for a while, and who were looking for capital for growth and expansion, and not to pay debts or make payroll. 1 Global conducted background checks on the business owners, and made secured loans backed by personal guarantees, collateral, and a UCC filing.

58. Leddbedder told Pellegrino that 1 Global investors were experiencing high single digit to low double digit returns. He further told Pellegrino that 1 Global employed

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

outside firms to drum up loan candidates, and that 1 Global's strict underwriting resulted in 9 out of 10 prospective borrowers being rejected. Leddbedder explained that an investment in 1 Global was considered an alternative asset class and any allocation should be limited to maximum 10% to 20% of an investor's net worth. Leddbedder never provided Pellegrino with financial statements from 1 Global, and Pellegrino understood that 1 Global did not have audited financial statements.

59. According to Pellegrino, Leddbedder told him that client account statements were verified by 1 Global's outside accounting firm, Daszkal Bolton. However, Pellegrino never spoke to Dazkal Bolton or took any steps to independently verify that Daszkal Bolton was 1 Global's accountant, or that the client account statements were verified.

60. According to Pellegrino, Leddbedder also told him that investments in 1 Global were exempt from registration under the federal securities laws due to their nine month duration. Pellegrino's only attempts to verify that conclusion consisted of some searches he conducted on the internet that turned up a research paper by the University of Indiana on exemptions from registration under the securities laws. Pellegrino did not seek further legal advice regarding or otherwise further investigate whether 1 Global's securities were in fact exempt from registration.

61. Leddbedder also told Pellegrino that the 1 Global notes had an automatic renewal feature, such that the investment would automatically renew or rollover unless the investor elected to redeem their investment. Leddbedder further told Pellegrino about the "unwinding" period whereby, even if an investor elected to redeem, it would take several months for the investor to get repaid as the "loans" had to be unwound. Thus, even if the notes themselves stated a duration of nine months, it was plainly obvious, based on the rollover

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

provision and unwinding period, that the investments were much longer than nine months in duration.

62. Pellegrino took Leddbedder and Wienewitz's statements at face value and did not take any independent steps to corroborate them. Based on what Pellegrino was told by Wienewitz in their initial phone conversations, and his subsequent two phone conversations with Leddbedder, Goldstone decided to begin recommending the 1 Global securities to its clients. Before it did that, Pellegrino informed his broker/dealer Taylor Capital Management ("TCM") that Goldstone intended to offer nine-month notes to its clients. Pellegrino answered TCM's questions about the investment based on what Leddbedder told him, and Pellegrino did not provide TCM more information than that. Based on what Pellegrino told Taylor, he received TCM approval to sell the 1 Global notes.

63. Goldstone then entered into an agreement with 1 Global signed by Michael Pellegrino and Ruderman that provided, among other things, that 1 Global would receive a referral fee of 4 percent per annum of each client's initial investment, plus an additional 2.25 percent of any renewal investments in 1 Global, which amounted to a prorated payout of 3% and 1.68% respectively to Goldstone for investments that matured in nine months. The agreement further provided that all marketing materials had to be approved in advance by 1 Global.

Pellegrino Ignored Contradictory Information Before and After He Started to Sell 1 Global Securities to Goldstone's Clients

64. Pellegrino admitted in his testimony that it was his practice to review, and he in fact did review and was familiar with 1 Global's website and Memorandum of Understanding, prior to when Goldstone began to sell 1 Global securities to its clients. As such, he admitted he

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

knew or was aware of the following.

65. 1 Global's website described the 1 Global MCA's as "unsecured cash advances." This directly contradicted what Pellegrino claims he was told by Leddbedder that 1 Global made secured loans backed by personal guarantees, collateral, and UCC filings.

66. 1 Global's website represented that "we provide businesses with unsecured funding they can use to get their business on solvent footing." This directly contradicted what Pellegrino claims he was told by Leddbedder that 1 Global's underwriters looked for companies that had been in business for a while, and who were looking for capital for growth and expansion, and not to pay debts or make payroll.

67. 1 Global's Memorandum of Indebtedness ("MOI") entered into with each investor stated that investor money was to be used to enable the borrower to "expand its current business activities" which it defined as "Covered Activities." It further stated that "Covered Activities shall include, ***but shall not be limited to*** providing innovative funding known as Merchant Cash Advance Transaction. . ." (Bold and italics added). Thus, while Goldstone told its clients that their money could only be used by 1 Global for MCAs, 1 Global's MOI revealed otherwise – that 1 Global had discretion to use investor money for whatever purpose it wanted. Pellegrino saw the language but admitted he didn't ask questions.

68. Pellegrino was also told by Leddbedder, as was repeated in 1 Global's MOI, that an investment in 1 Global would automatically renew unless redeemed, and even if redeemed, the investment had a "grace period" of several months required to "unwind" each client's investment. Thus, it was clear to Pellegrino from the start that the notes were of more than nine months duration.

69. Once Goldstone began selling 1 Global investments, its clients started to receive

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

monthly account statements. Those Goldstone client account statements did not list specific merchants to whom the MCA's were made unlike the exemplar statements provided to him by Wienewitz, which did list the specific merchants. Pellegrino inquired as to why his client's statements did not list the specific merchants and was told due to privacy concerns. Pellegrino accepted that answer.

70. Pellegrino was also aware that it often took months for client money to be fully deployed. When asked what the money was doing in the interim, Pellegrino responded "sitting in cash." When asked where that cash was held, Pellegrino responded "I have no idea." Thus, Pellegrino took no independent steps to insure that his client's money was being safeguarded and not looted while it was waiting to purportedly be deployed.

Goldstone Created Its Own MOI to "Clarify" Information for Investors

71. Pellegrino testified that Goldstone created its own MOI on Goldstone letterhead which he described as a document Goldstone used to clarify the terms of the investment for its own clients. Goldstone maintains signed copies of the Goldstone MOI for each client.

72. According to Pellegrino, Wienewitz drafted the wording of the MOI, and forwarded a copy to Pellegrino in or about June 2017. Wienewitz told Pellegrino that Wienewitz sent his document to Leddbedder, who didn't think it was a good idea to use with his clients because "it could be construed by regulators possibly down the road as a security disclosure." Pellegrino and his brother disagreed and used it with Goldstone's clients anyway. Pellegrino put Wienewitz's document on Goldstone's letterhead and possibly added "risk of loss" language. He revised the Goldstone MOI at the beginning of 2018 to clarify what was always understood about the grace period.

73. Goldstone, however, adopted much of Wienewitz's language, including that an

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

MOI was a private commercial loan, and that the MOIs were not regulated by state or federal securities, insurance or banking agencies. He also borrowed Wienewitz's statement that the MOIs were not securities transactions under the Securities Acts of 1933 and 1934. Goldstone, on the other hand, added its own language that an investor understands that the notes were for 9 months with an automatic renewal.

Goldstone Marketed and Sold 1 Global Securities Based on Information Provided by 1 Global

74. Goldstone received periodic communications from 1 Global, which it used to formulate its marketing pitch to its prospective and existing clients. Goldstone distributed one brochure to its clients that it based on a brochure Wienewitz sent to Pellegrino in July 2017. Goldstone's brochure represented that the MCA's were "backed by collateral." Goldstone's brochure told clients that the investment was 9 to 12 months. Goldstone came up with that language itself to include the unwinding period based on what Leddbedder told Pellegrino.

75. Among other things, it told its clients that the 1 Global investment was a high-return, low-risk investment that was not subject to stock market or interest rate risk. In its brochure, Goldstone represented that the 1 Global MCAs were carefully made in reliance on credit scores, 36 months of bank statements, personal guarantees, and lienable assets, and that no business received more than 1 percent of 1 Global lending. Goldstone claimed that 1 Global used a rigorous underwriting process for making the MCAs that approved only one in ten merchants and that an electronic collection process ensured that the advances were repaid in a timely fashion.

76. Goldstone's brochure further advertised 6 to 10% consistent predictable returns. The 6 to 10% numbers were determined by Pellegrino himself based on the purported client

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

statements Wienewitz showed him and the statements made to him by Leddbedder.

77. Approximately sixty to seventy percent of Goldstone's clients invested in 1 Global. Almost all of them rolled their investments over with less than ten of these investors redeemed their investments after nine months. Some of Goldstone's clients invested all their money, including retirement funds, in 1 Global notwithstanding Leddbedder's statement to Pellegrino that the maximum allocation should be 10% to 20% of a client's net worth.

78. In 2017, 1 Global paid commissions to Defendant Anthony Pellegrino in the total amount of $387,081.96 and to Defendant Michael Pellegrino in the total amount of $380,086.56.

79. According to 1 Global's Statement of Financial Affairs filed in connection with its bankruptcy schedules, 1 Global made payments it characterized as "Finders Fee[s]" to Defendant Anthony Pellegrino in the total amount of $312,504.96 and to Defendant Michael Pellegrino in the total amount of $316,079.01 within 90 days of its bankruptcy filing on July 27, 2018.

80. In other words, it appears Goldstone's clients—on Goldstone's recommendation—invested nearly the same amount of money in 1 Global in the three-month period immediately preceding 1 Global's bankruptcy filing than they did in all of 2017.

81. Goldstone's willingness to take the word of Wienewitz, Leddbedder, and others at 1 Global at face value without any independent verification or corroboration, in the face of contradictory and inconsistent information known to Goldstone, resulted in its failure to detect the following.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

Misrepresentations And Omissions To Investors

False Claims About Use Of Investor Funds as Alleged by the SEC

82. The SEC Case alleges the following. 1 Global falsely represented to investors on its website, in its marketing materials, and in the MOIs that it would use all of their money to fund MCAs but for a 13% management fee and any amounts due to third parties for finding merchants to take MCAs. In reality, 1 Global used far more investor money than it told investors for purposes other than making MCAs. First, 1 Global used a significant amount of investor money on the company's operations. 1 Global spent approximately $53 million in operating expenses through April 2018.

83. However, the total amount of investor money 1 Global was permitted to use for operating expenses was only about $46.6 million. Thus, 1 Global spent about $6.4 million more in investor funds on operating expenses than it told investors it would.

84. 1 Global also used substantial amounts of investor money for purposes other than MCAs. For example, Ruderman authorized 1 Global to use $50 million of investor money to purchase $60 million of bad credit card debt from an entity called Travis Portfolio. 1 Global began making the payments for this purchase on September 28, 2017. The $50 million represented about of all investor funds 1 Global raised through April 2018.

85. Buying the credit card debt was not an MCA, and thus not an allowed use of investor funds. Travis Portfolio was not using the money to fund specific business operations as 1 Global's marketing materials and website indicated MCAs were for. Furthermore, because the credit card debt was already considered bad debt, this was a very risky investment and the repayment time was far longer than the 4-to-12 months for MCAs that 1 Global advertised. In fact, Travis Portfolio collected the credit card debt so slowly that it could have taken that entity

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

four years to repay 1 Global the entire amount. This slow repayment impacted investors' ability to make a profit and 1 Global's ability to fund its MCA business and repay investors.

86. Last, the SEC Case further alleged that 1 Global misappropriated at least $28 million in investor funds to pay Ruderman personally as well as several companies in which he or his family members had a direct interest. This included, as described more fully below, money to help fund a family vacation to Greece, monthly payments for a Mercedes Benz Ruderman leased, his monthly American Express credit card bill, payments for Ruderman's chef and housekeeper, and $4 million to his family trust.

87. It also included more than $20 million payments over several years to Bright Smile Financing and Ganador, companies that funded consumer and individual loans that had nothing to do with MCAs, and which Ruderman either owned outright or partially owned through trusts he controlled. The first payment by 1 Global to Bright Smile Financing occurred on May 6, 2017, while 1 Global made its first payment to Ganador on April 28, 2016.

88. The SEC Case alleged that the misappropriation also included a $1 million payment on January 16, 2018 from 1 Global to BRR Block, a company owned by one of Ruderman's sons that also had nothing to do with MCAs. None of the payments was disclosed in 1 Global's marketing materials or the MOIs, and these payments led directly to the shortage of investor funds.

False Monthly Account Statements as Alleged by the SEC

89. 1 Global provided every investor with a monthly account statement that showed all of the individual MCAs in which an investor's money was spent — frequently numbering into the hundreds of contracts. The monthly statements at first showed the individual merchants who received each MCA, then were changed to show only contract numbers, then changed again

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

to show only the type of business that had received each MCA.

90. Early versions of the account statements added up the dollar amount in each MCA to reflect "total net current account receivables" – i.e., how much each investor could expect to receive in repayment from the outstanding MCAs. Below that figure, the account statement contained a total alternatively called "cash not yet deployed," "cash to be deployed," or "cash for future receivables." Regardless of the terminology used, the figure represented the amount of the investment that 1 Global had not yet put into MCAs and was purportedly sitting in 1 Global's bank accounts available for MCA funding.

91. The early versions of the account statement added up the two totals to represent what the investor's portfolio was then purportedly worth. Investors could plainly see on these monthly statements how much their investment had allegedly increased in value, which directly correlated to the rate of return each investor was allegedly earning. In addition, on the first page of each monthly statement, 1 Global expressly told investors the value of their portfolio, the increase in the valuation of their portfolio since they invested, and what rate of return their investment had earned to date.

92. According to the SEC Case, starting no later than October 2017, the monthly account statements misrepresented the amount of "cash not yet deployed" available in 1 Global's bank accounts on every investor's account statement. That month, due in large part to the Ruderman-authorized misappropriation and misuse of investor funds, the company's financial analysts discovered that the total of "cash not yet deployed" on all the account statements was approximately $23 million higher than the actual cash in I Global's bank accounts.

93. As of October 31, 2017, investor account statements in the aggregate showed approximately $89 million in "cash not yet deployed." Yet, 1 Global's bank accounts held only

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

approximately $65.7 million in cash, a difference of $23.3 million. Thus, according to the SEC Case, every account statement showed a false amount of "cash not yet deployed." Because that amount was false, the total value of each investor's portfolio, the increase in the valuation since they had invested, and the rate of return each account statement showed for each investor were all overstated.

94. The SEC Case further alleged that the cash shortfall not only continued, but increased over time. As of November 30, 2017, the combination of all investors' account statements showed 1 Global should have had approximately $100.3 million in its bank accounts as "cash not yet deployed." Yet the bank accounts held only approximately $75.5 million, a difference of $24.8 million. Thus the rates of return, the value of the portfolio, and the increase in valuation of the portfolio since inception for each investor on each monthly account statement were overstated.

95. For December 2017, when according to the total of all monthly statements 1 Global should have had approximately $97.7 million in "cash not yet deployed" in its bank accounts, the company had only approximately $72.4 million in its accounts, a difference of $25.3 million. So again the rates of return and other financial metrics described above were false for each investor.

96. This pattern continued through at least June 2018, when at month's end the combination of all investor account statements showed the company should have had approximately $70 million in its bank accounts, while the accounts held only about $20 million, a difference of $50 million. As a result, the rates of return and other financial metrics described above were false on each investor's account statement.

97. Investors receiving these account statements often based their decision to allow

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

their investment to automatically roll over on the profits and rates of return 1 Global represented they were making. Investors said they would not have invested with 1 Global if they had known 1 Global was misrepresenting the amount of investor cash it had on hand and the rates of return investors were earning.

False Claims About Daszkal Bolton's Work as Alleged by the SEC

98. According to the SEC Case, each investor's monthly account statement falsely claimed that "Our independent audit firm, Daszkal Bolton L.L.P., has endorsed and agrees with the rate of return formula." However, Daszkal Bolton never audited 1 Global's financial statements and never endorsed nor agreed with 1 Global's rate-of-return formula.

99. The SEC Case alleged that while 1 Global did hire Daszkal Bolton, the firm's work was limited to drafting a set of agreed-upon procedures for evaluating investors' accounts. Furthermore, the audit firm stopped doing work for 1 Global after 2016. Thus, every account statement containing the representation about Daszkal Bolton was false. Investors said they would not have invested in 1 Global if they had known 1 Global was misrepresenting the work Daszkal Bolton performed for 1 Global.

100. The SEC Case alleged that in addition to misrepresenting Daszkal Bolton's status on the monthly account statements, numerous versions of 1 Global's Frequently Asked Questions provided to sales agents and in some cases to investors stated that "An external accounting firm validates [investor] loan balances quarterly."

101. This statement was also false, according to the SEC Case, because neither Daszkal Bolton nor any other external accounting firm ever validated the amounts listed on investor account statements or any other document showing the amounts in an investor portfolio.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

Misappropriation Of Investor Funds as Alleged by the SEC Case

102. According to the SEC Case, beginning no later than 2016, Ruderman regularly instructed 1 Global accountants and other employees to transfer investor funds to benefit himself, his family, and other close acquaintances, either directly or through entities they owned. When one accountant repeatedly questioned these transfers as improper, Ruderman told the accountant 1 Global was his company and he could do what he wanted with its money.

103. The SEC Case further alleged that as of June 30, 2018, 1 Global at Ruderman's direction had transferred about $15.3 million to Bright Smile Financing, a company that loaned individuals money for cosmetic dental procedures. There was no agreement between 1 Global investors and Bright Smile Financing for 1 Global to provide that funding, and 1 Global investors do not have a documented ownership interest in Bright Smile Financing. Bright Smile Financing provided no consideration or services in exchange for the money. Corporate records show Bright Smile Financing is 100% owned by Ruderman through the Bright Smile Trust.

104. According to the SEC Case, also as of June 30, 2018, 1 Global had sent approximately $5.6 million to Ganador, a consumer/payday loan service, at Ruderman's direction. 1 Global investors do not have a documented ownership interest in Ganador, but the Ruderman Family Trust owns 50% of the firm. Ganador provided no consideration or services for the $5.6 million.

105. The SEC Case alleged that Ruderman authorized or ordered 1 Global to send investor funds to family members as well. For example, on January 10, 2018, one of Ruderman's sons incorporated BRR Block. Six days later, 1 Global funded BRR Block with $1 million of investor funds for no consideration or services.

106. Further, according to the SEC Case, Ruderman also had more than $4 million of

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

1 Global investor money sent to the Ruderman Family Trust, of which his wife and children are beneficiaries. Ruderman had the company pay the trust approximately $81,283 a month (slightly less than $1 million a year) in investor funds, purportedly to compensate Ruderman for his interest in entities that had almost nothing to do with 1 Global's business. The last of these payments occurred on July 26, 2018, one day before 1 Global filed for bankruptcy. The trust provided no services or consideration for the money.

107. According to the SEC Case, 1 Global paid Ruderman's current wife an annual salary of $116,000 although she had no listed job with the company and no office or desk there. 1 Global employees never saw her do any work for the company. In addition, Ruderman received a $240,000 annual salary.

108. According to the SEC Case, Ruderman's pilfering of investor funds did not stop there. He used significant amounts to fund a lavish lifestyle that included:

a. Monthly lease payments for a Mercedes-Benz;

b. Payment for a luxury family vacation to Greece;

c. Payments to a housekeeper and a chef;

d. Monthly payments on a personal American Express credit card and a Bank of America credit card;

e. Payment for his son's auto insurance;

f. Payment to a company where his wife's sister was listed as the manager; and

g. Payments to his ex-wife.

109. None of these payments to Ruderman and related entities was disclosed to investors, and the fleecing of investor funds by Ruderman from 1 Global directly inhibited 1

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

Global's ability to make MCA loans and placed investor funds at risk.

Plaintiffs' Investments in 1 Global Through Goldstone

110. Plaintiff Dr. Eugene Simmons is a retired math teacher who resides in Chicago, Cook County, Illinois. He invested a portion of his retirement savings in 1 Global on or about December of 2017. While Plaintiff has a Ph.D. in mathematics, he does not possess formal education in finance or investing and, therefore, trusted Defendant Goldstone's purported expertise.

111. Plaintiff Dr. Simmons learned about 1 Global through a television advertisement. In response to the advertisement, Plaintiff contacted Defendant Goldstone. Goldstone prepared a financial plan proposing that Plaintiff invest $30,000 in 1 Global, recommending that Plaintiff "Protect the money you need to live on," and representing that Defendant Goldstone "...will provide you prospectuses on all funds recommended," when, in reality, 1 Global was not a fund, but a fraud.

112. Plaintiff Alexandra Eiva is a retired art instructor who lives in Wheaton, Illinois. She invested a portion of her retirement savings in 1 Global on or about March 8, 2018 through Goldstone.

113. Plaintiff Alexandra Eiva learned of the 1 Global investment opportunity through Goldstone's promotional mailings and emails. Goldstone told her the 1 Global investments were low risk, secure, short-term investments for retirees looking to earn a higher rate of return than on a savings account. Goldstone told her that other clients who had invested in Goldstone had received a good return on their investment and that many were already renewing their investments.

114. Plaintiff Alexandra Eiva invested in 1 Global, upon Goldstone's

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

recommendation, and lost most if not all of her investment.

115. Plaintiff Carol Harms is a nurse practitioner who lives in DuPage County, Illinois. She invested a portion of her retirement savings in 1 Global on or about May of 2018 through Goldstone.

116. Plaintiff Carol Harms learned of the 1 Global investment opportunity through a dinner Goldstone hosted. Goldstone told her the 1 Global investment would be low risk, safer than the stock market, and that she could anticipate returns ranging from 7% to 10%.

117. Plaintiff Rosemary Maziarz IRA, is an Individual Retirement Account owned by Roesmary Maziarz. Plaintiff Maziarz first learned of Goldstone in or about 2007/2008 when she received a mailing from Goldstone inviting her to an informational dinner on retirement strategies. Plaintiff Maziarz attended the dinner, and Michael Pellegrino conducted the presentation, much of which was focused on "safe" investing strategies that protect investors' initial investment from any risk of loss. Plaintiff Maziarz met with Michael Pellegrino several years later in 2011, at which time she became a Goldstone client and purchased an annuity. The annuity matured, and in 2017, Defendant Michael Pellegrino called Plaintiff Maziarz and recommended she purchase 1 Global in her IRA as a good and safe investment. Plaintiff Maziarz followed Pellegrino's advice and agreed to purchase 1 Global in her IRA.

118. Plaintiff Randall M. Thompson IRA, is an Individual Retirement Account owned by Randall Thompson. Plaintiff Thompson first learned of Goldstone in or about November 2017 when he received a mailing from Goldstone inviting him to an informational dinner on retirement strategies. Plaintiff Thompson attended the dinner, and much of the presentation was focused on "safe" investing strategies that protect your initial investment from any risk of loss. Plaintiff Thompson met with Michael Pellegrino at which time Pellegrino recommended he

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

purchase 1 Global in his IRA as a good and safe investment. Plaintiff Thompson became a Goldstone client and followed Pellegrino's advice and agreed to purchase 1 Global in his IRA.

CLASS ACTION ALLEGATIONS

119. This action is brought by Plaintiffs, for themselves and on behalf of all others similarly situated, as a class action pursuant to Fed. R. Civ. P. 23(a) and (b)(3).

Class Definition

120. The proposed Class (the "Class") is defined as follows:

> All persons and entities that invested in 1 Global Capital LLC through Defendants.

121. Excluded from the class are: (1) any judge or judicial officer who may hear any aspect of this case and his or her law clerks; and (2) Defendants, and any person, firm, trust, corporation, or other entity related to or affiliated with Defendants.

Numerosity

122. The members of the Class are so numerous and geographically dispersed that joinder of all members is impracticable. While the exact number of Class members remains unknown at this time, Plaintiffs believe there are hundreds of members of the proposed class. The exact number of class members is within Defendants' knowledge.

Commonality

123. There are common questions of law and fact in this class action that relate to and affect the rights of each member of the Class including, *inter alia*:

a. Whether Defendants intentionally and/or negligently misrepresented and omitted risks associated with the investments to Plaintiffs and each proposed Class member;

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

b. Whether Defendants had a duty to Plaintiffs and the proposed Class members;

c. Whether Defendants breached duties owed to Plaintiffs and the proposed Class members by failing to conform their conduct to the requirements of the law and applicable regulations;

d. Whether 1 Global's statements or omissions misrepresented material facts about the 1 Global investment scheme;

e. Whether Defendants' statements or omissions misrepresented material facts about the 1 Global investment scheme;

f. Whether Defendants violated federal and state securities laws;

g. Whether Defendants' misconduct entitles Plaintiffs and proposed Class members to rescission and/or damages for the loss of the amounts invested by Plaintiffs and proposed Class members;

h. What remedies are appropriate compensation for the damages caused to Plaintiffs and each of the proposed Class members; and

i. Whether Plaintiffs and proposed Class members are entitled to a reasonable award of attorneys' fees, interest and costs of suit.

Typicality

124. Plaintiffs' claims are typical of the claims of all proposed Class members. Plaintiffs are situated identically to all members of the proposed Class with respect to the issues presented in this case, as Plaintiffs and all proposed Class members invested in the 1 Global investment scheme through Defendants and suffered the exact same loss (in proportion to the amount of their investment). Plaintiffs' claims are based on the same fundamental factual allegations and legal theories as the claims of all other proposed Class members.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

125. All investors who invested in the 1 Global investments scheme through Defendants have been adversely affected by the wrongdoing of Defendants as described herein.

Adequacy of Representation

126. Plaintiffs will adequately represent and protect the interests of the Class and have no interests that conflict with or are antagonistic to the interests of the Class.

127. Plaintiffs have retained attorneys who are experienced and capable of prosecuting complex litigation such as this case. The attorneys for Plaintiffs and the Class will actively conduct and be responsible for the prosecution of this litigation and the expenses thereof. The attorneys for Plaintiffs have adequate resources, experience and commitment to litigate this matter.

Predominance and Superiority

128. A class action is superior to any other method available for the fair and efficient adjudication of this controversy because it would be impractical and undesirable for each of the individual Class members who have suffered damages to bring separate actions. Some investors invested amounts in the 1 Global investment scheme that would make it impracticable for them to litigate individualized securities fraud cases concerning this matter. Moreover, the common issues identified above predominate over individual issues, if any, particular to each class member. Defendants made uniform misrepresentations and were responsible for uniform omissions with respect to each member of the Class and each member of the Class was injured in exact proportion to the amount of their investment in the 1 Global investment scheme.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

COUNT ONE: VIOLATIONS OF ILLINOIS SECURITIES LAW OF 1953 (815 ILL. COMP. STAT. ANN. 5/1 ET SEQ.)

129. Plaintiffs repeat and re-allege each of the allegations set forth above.

130. This Count alleges that Defendants violated § 815 ILCS 5/12 by selling unregistered securities to Plaintiff and the Class.

131. The 1 Global investments were "securities" within the meaning of 815 Ill. Comp. Stat. Ann. 5/2.1.

132. 815 Ill. Comp. Stat. Ann. 5/5 requires that all non-exempt securities be registered prior to their offer or sale in Illinois. The 1 Global securities were neither registered nor exempt from registration under § 815 ILCS 5/3 or § 815 ILCS 5/4.

133. 815 Ill. Comp. Stat. Ann. 5/12 provides in relevant part that:

> It shall be a violation of the provisions of this Act for any person:
>
> A. To offer or sell any security except in accordance with the provisions of this Act.
>
> B. To deliver to a purchaser any security required to be registered under Section 5, Section 6 or Section 7 hereof unless accompanied or preceded by a prospectus that meets the requirements of the pertinent subsection of Section 5 or of Section 6 or of Section 7.
>
> * * *
>
> G. To obtain money or property through the sale of securities by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

134. As set forth above, Defendants offered and sold the unregistered, non-exempt 1 Global investments to Plaintiffs and the members of the Class without a prospectus, and through numerous untrue statements of material facts as well as omissions of material facts regarding, among other things, the use of investment proceeds and 1 Global's financial

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

condition.

135. Such misrepresented and omitted facts are "material" because they were facts a reasonable investor would consider in deciding whether to invest.

136. Defendants either knew or in the exercise of reasonable care should have known that the misrepresentations and omissions made by 1 Global in connection with the 1 Global investment scheme were misleading.

137. Defendants are liable for participating in the sale of unregistered securities to Plaintiffs and the proposed Class members without a prospectus, and for the misrepresentations and omissions made in connection with those securities pursuant to 815 Ill. Comp. Stat. Ann. 5/13.

138. Pursuant to 815 Ill. Comp. Stat. Ann. 5/13, Plaintiffs and the members of the Class are entitled to rescission of their purchase of their 1 Global investments and recovery of the full amount of consideration paid for such investments as well as interest at the applicable legal rate (10 percent per annum), costs, and reasonable attorney fees. Alternatively, Plaintiffs and members of the Class are entitled to damages, measured as the difference between the price at which the 1 Global investments were purchased and the value of such notes at the time such notes were disposed of.

COUNT TWO: NEGLIGENCE

139. Plaintiffs repeat and re-allege each of the allegations set forth above.

140. Defendants had a duty to conduct adequate due diligence as to the 1 Global investment scheme before undertaking to promote it.

141. To establish the applicable standard of care under the circumstances, the Court may examine professional standards of conduct in the industry.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

142. Defendants owed Plaintiffs and the proposed Class members the duty to act as a reasonable financial advisor would do under the same or similar circumstances. The duties set forth herein arise from the regulations, customs, and usage of the brokerage trade, including rules promulgated by the Securities and Exchange Commission.

143. Defendants negligently breached its duties to Plaintiffs and the Class by:

a. Failing to perform adequate due diligence regarding the 1 Global investment scheme securities and failing to obtain reliable information as to the 1 Global investment scheme and Ruderman before promoting the 1 Global investment scheme offering; and

b. Failing to warn Plaintiffs and the proposed Class members that Defendants did not have a reasonable basis to promote and had not adequately vetted the 1 Global investments.

144. Plaintiffs and the proposed Class members invested in the 1 Global investment scheme in reliance upon Defendants' misleading representations discussed above.

145. As a direct and proximate result of Defendants' negligent due diligence as to the 1 Global investment scheme, Plaintiffs and the proposed Class members have suffered damages.

COUNT THREE: NEGLIGENT MISREPRESENTATION

146. Plaintiffs repeat and re-allege each of the allegations set forth above.

147. Defendants made false statements to Plaintiffs and the proposed Class members regarding the 1 Global investments. Among other things, they promised investors that (a) the 1 Global MCAs were rigorously underwritten and diversified and that therefore the 1 Global investment was a high-return, low-risk investment and (b) the 1 Global MCAs were secured and

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

back by collateral. These statements, and other statements Defendants made regarding the 1 Global securities detailed above, were false.

148. Defendants failed to perform adequate due diligence regarding the 1 Global securities before recommending them to Plaintiffs and the proposed Class members, and thus Defendants were careless and/or negligent in ascertaining the truth of their statements regarding the 1 Global investments.

149. As Plaintiffs' and the proposed Class members' investment advisors, Defendants were under a duty to communicate accurate information to Plaintiffs and the proposed Class members.

150. Defendants' statements were made for the purpose of inducing Plaintiffs and the proposed Class members to invest in the 1 Global securities. Defendants sought to induce Plaintiffs and the proposed Class members to invest in 1 Global because they received significant compensation from 1 Global for such investments.

151. Plaintiffs and the proposed Class members relied on Defendants' statements regarding the 1 Global securities in deciding whether to invest, and ultimately suffered significant investment losses as a result.

COUNT FOUR: BREACH OF FIDUCIARY DUTY

152. Plaintiffs repeat and re-allege each of the allegations set forth above.

153. In their capacity as investment advisors to Plaintiffs and the members of the Class, Defendants owed to Plaintiffs and other Class members a fiduciary duties with respect to each of the investments Defendants recommended for their clients.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

154. Such fiduciary duty included, among others, the duty to conduct adequate due diligence and to make truthful statements and not omit material information as to the nature and risks of each investment.

155. Defendants breached their fiduciary duties to Plaintiffs and other members of the proposed class by, among other things:

a. Failing to perform adequate due diligence regarding the 1 Global investment scheme securities and failing to obtain reliable information as to the 1 Global investment scheme and Ruderman before promoting the 1 Global investment scheme offering;

b. Failing to warn Plaintiffs and the proposed Class members that Defendants did not have a reasonable basis to promote and had not adequately vetted the 1 Global investments; and

c. Failing to notify Plaintiffs and the proposed Class members of the conflict of interest that arose by virtue of the fact that Defendants earned significant compensation for selling the 1 Global investments.

156. As a direct and proximate consequence of Defendants' conduct as described in the foregoing and throughout this complaint, Plaintiffs and other investors have lost a significant portion of money they invested in the 1 Global scheme. As a result of Defendants' breach of fiduciary duty, the Class has suffered damages in an amount to be determined at trial.

COUNT FIVE: AIDING AND ABETTING BREACH OF FIDUCIARY DUTY

137. Plaintiffs repeat and re-allege each of the allegations set forth above.

138. As set forth herein, the 1 Global scheme perpetrators owed fiduciary duties to the 1 Global investors because they acted as managers of the 1 Global securities offering who

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

promised investors to carefully and diligently invest their money and because the 1 Global investors were to entirely rely on the skill and diligence of the 1 Global scheme perpetrators to manage their investments.

139. The 1 Global scheme perpetrators breached their fiduciary duties to the 1 Global investors by, among others, defrauding them and by misusing and converting their money, as more fully detailed above.

140. Defendants knowingly provided substantial assistance to the 1 Global scheme perpetrators' breach of fiduciary duty to the 1 Global investors by among other things:

A. Selling and marketing the securities by means of their own brochure, and MOI;

B. Repeating the false statements provided to them by 1 Global, Leddbedder, and Wienewitz.

141. Defendants received substantial compensation for such transactions in the form of outsized commissions and other incentive payments, and such compensation gave it the incentive to turn a blind eye and continue to assist the 1 Global scheme perpetrators' breach of fiduciary duty.

142. As more fully described above, Defendants acquired actual knowledge of the widespread breach of fiduciary duty by the 1 Global scheme's perpetrators. For example:

A. While Pellegrino claims he was told by Leddbedder that 1 Global made secured loans backed by personal guarantees, collateral, and UCC filings, 1 Global's website – which Pellegrino admits to having read and been familiar therewith – described the 1 Global MCA's as "unsecured cash advances."

B. While Pellegrino claims he was told by Leddbedder that 1 Global's

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

underwriters looked for companies that had been in business for a while, and who were looking for capital for growth and expansion, and not to pay debts or make payroll, 1 Global's website – which Pellegrino admits to having read and been familiar therewith – represented that "we provide businesses with unsecured funding they can use to get their business on solvent footing."

C. While Goldstone told its clients that their money could only be used by 1 Global for MCAs, 1 Global's MOI revealed otherwise – that 1 Global had discretion to use investor money for whatever purpose it wanted. Pellegrino saw the language, but admitted he did not ask questions.

D. While Goldstone told its clients that the 1 Global notes were not securities because of their nine-month duration, Pellegrino knew and was told by Leddbedder, as was repeated in 1 Global's MOI, that an investment in 1 Global would automatically renew unless redeemed, and even if redeemed, the investment had a "grace period" of several months required to "unwind" each client's investment. Thus, it was clear to Pellegrino from the start that the notes were of more than nine months duration.

E. While the exemplar statements provided to Pellegrino by Wienewitz listed the specific merchants that purportedly received MCAs, Goldstone clients' account statements did not list specific merchants to whom the MCA's were made. While Pellegrino inquired as to why his clients' statements did not list the specific merchants, he was told it was due to privacy concerns and he accepted that answer.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

JURY DEMAND

Plaintiffs demand a trial by jury for all issues triable thereby.

FILED DATE: 11/8/2018 3:59 PM 2018CH13978

Date: November 8, 2018

Respectfully submitted,

/s/ James B. Zouras

James B. Zouras
STEPHAN ZOURAS, LLP
100 N Riverside Plaza, Suite 2150
Chicago, IL 60606
Telephone: 312-233-1550
Email: jzouras@stephanzouras.com

Alan L. Rosca (pro hac vice forthcoming)
Paul Scarlato (pro hac vice forthcoming)
GOLDMAN SCARLATO & PENNY PC
Eight Tower Bridge, 161 Washington St
Conshohocken, PA 19428
Telephone: (484) 342-0700
Email: rosca@lawgsp.com
Email: scarlato@lawgsp.com

J. Barton Goplerud (pro hac vice forthcoming
Brian O. Marty (pro hac vice forthcoming)
SHINDLER ANDERSON GOPLERUD & WEESE PC
5015 Grand Ridge Dr, Ste 100
West Des Moines, IA 50265
Telephone: (515) 223-4567
Facsimile: (515) 223-8887
Email: goplerud@sagwlaw.com
Email: marty@sagwlaw.com

Interim Class Counsel for Plaintiff

EXHIBIT C

KeyCite Yellow Flag - Negative Treatment
Distinguished by Mosher v. DeWaay Financial Network, LLC, Iowa App., March 25, 2015

277 F.R.D. 316
United States District Court,
N.D. Texas,
Dallas Division.

Donald STOTT, Plaintiff,
v.
CAPITAL FINANCIAL SERVICES, INC., Defendant.

No. 3:11–cv–2073–F.
|
Sept. 12, 2011.

Synopsis

Background: Investor who had purchased stock and partnership interests in a series of shale gas ventures that were ultimately determined to be part of a Ponzi scheme filed putative class action against brokerage firm and dealers alleging violations of federal and state **securities** laws, negligence, and breach of fiduciary duty. Investors moved for final approval of class action settlement.

Holdings: The District Court, Royal Furgeson, Senior District Judge, held that:

group of 650 investors met class action numerosity requirement;

there were common questions of law that all class members would have to prove in pursuing their claims;

class met typicality requirement;

class counsel and class representative were adequate;

the whole of the inadequate settlement fund would be devoted to paying claims, as factor in determining whether limited fund class action settlement should be approved;

claimants would be treated equitably among themselves, if limited fund class action settlement was approved;

totals of aggregated liquidated claims and the fund available for satisfying them, set definitely at their maximums, demonstrated inadequacy of fund to pay all claims;

court would enjoin arbitration of pending claims against the firm, pursuant to All Writs Act; and

proposed settlement was fundamentally fair, adequate, and reasonable under class certification rule.

Motion granted.

Attorneys and Law Firms

***320** Jonathan K. Levine, Christina HC Sharp, Girard Gibbs LLP, San Francisco, CA, Daniel C. Girard, Girard Gibbs LLP, San Francisco, CA, Lewis T. Leclair, Mckool Smith, Dallas, TX, Richard A. Speirs, Susan Salvetti, Zwerling Schachter & Zwerling LLP, New York, NY, for Plaintiff.

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Barry G. Flynn, Gordon & Rees LLP, Houston, TX, for Defendant.

MEMORANDUM OPINION AND ORDER GRANTING PLAINTIFFS' MOTION FOR FINAL APPROVAL OF CLASS ACTION SETTLEMENT WITH CAPITAL FINANCIAL SERVICES, INC.

ROYAL FURGESON, Senior District Judge.

BEFORE THE COURT is Representative Plaintiff Donald Stott's Motion for Final Approval of Class Action Settlement with Capital Financial Services, Inc., filed on February 18, 2011 (*Stott* Docket No. 2).[1] The Court held two separate fairness hearings regarding this Motion on April 8, 2011 and August 10, 2011. Certain individual class members previously filed objections to the proposed settlement; however, several of these objections were withdrawn shortly before the August 10, 2011 hearing.

In addition to the issues surrounding approval of the proposed settlement under the relevant provisions of Federal Rule of Civil Procedure 23, this proposed settlement raises two particularly novel and important issues: (1) whether the Court may approve the settlement under a "limited fund" theory, which is a rare settlement device that does not permit class members to opt out and must satisfy the requirements of Rule 23(b)(1)(B); and (2) whether, in the course of approving this settlement, the Court has the authority to enjoin arbitrations brought by class members against the settling defendant under the All Writs Act. The Court believes that these two issues are of paramount importance and require the significant analysis contained in this Order.

After considering the Motion, the briefs and submissions to the Court, and the objections of class members, it is ORDERED that the Representative Plaintiff's Motion for Final Approval of Class Action Settlement with Capital Financial Services, Inc. is GRANTED.[2]

I. Factual Background and Terms of the Proposed Settlement

This class action arose out of an alleged Ponzi scheme related to an entity known as Provident Royalties, LLC ("Provident"). Provident's purported business was the development of oil and gas properties, and the Provident **securities** were sold as preferred stock and partnership interests in a series of shale gas ventures. Provident **securities** issued ***321** by affiliates of Provident were sold by a number of broker-dealers, including Capital Financial Services, Inc. ("Capital Financial"). In total, Provident raised over $400 million from investors, and Capital Financial sold approximately $65 million of Provident **securities** to over 650 investors. Capital Financial sold Provident **securities** by the use of Private Placement Memoranda ("PPMs"), which the Representative Plaintiff contends contained untrue statements of material

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

fact and omitted material facts about the Provident entities.

In 2009, an SEC investigation revealed that Provident was in fact a Ponzi scheme, and upon Provident's entrance into bankruptcy, many investors lost the bulk of their investments. The Representative Plaintiff in this case, Donald Stott, as part of a suit with several other representative plaintiffs who had invested in Provident through other broker-dealers, filed suit against Capital Financial in an attempt to recover the investments of those who had purchased Provident **securities** through Capital Financial, alleging violations of federal and state **securities** laws, negligence, and breach of fiduciary duty. The Representative Plaintiff asserted that Capital Financial had failed to perform proper due diligence on the Provident **securities**, sold the **securities** that contained material misrepresentations, breached its duties to investors in selling the **securities** to them, and sought restitution of the lost funds on behalf of a class of investors who bought Provident **Securities** through Capital Financial. The Representative Plaintiff also asserted claims against Capital Financial Holdings, Inc. ("Capital Holdings"), Capital Financial's parent company. The original case, ***Billitteri*** *v.* ***Securities America***, *Inc.*, 3:09–cv–1568–F, was filed in the Northern District of Texas on August 24, 2009. Members of the proposed class are investors who purchased Provident **securities** through a Capital Financial broker-dealer between 2006 and January 2009, when Provident suspended dividend payments.

While this class action has proceeded, a number of investors who purchased Provident **securities** from Capital Financial, who are members of the proposed class, pursued arbitrations against Capital Financial, and in some cases certain registered representatives affiliated with Capital Financial, under the auspices of the Financial Industry Regulatory Authority ("FINRA"). Such arbitrations were provided for in the investors' contracts with Capital Financial. The arbitration claimants sought a total of $11,830,000 in damages. In the months following this case's filing, the class action and the individual arbitrations moved forward on parallel tracks. Additionally, the Liquidating Trustee of the Provident Royalties Liquidating Trust created by the Bankruptcy Court, Milo Segner, pursued claims against Capital Financial assigned by class members to the Trust in a related case brought in Bankruptcy Court. That case eventually came before this Court after the reference to the Bankruptcy Court was withdrawn on November 23, 2010, and is currently captioned *Segner v.* ***Securities America***, *Inc.*, 3:10–cv–1884–F. Capital Financial is a defendant in the *Segner* case.

On December 21, 2010, the Representative Plaintiff and Capital Financial filed a Motion for Preliminary Approval of Class Action Settlement (***Billitteri*** Docket No. 151), seeking the Court's approval of a proposed settlement under Federal Rule of Civil Procedure 23(b)(1)(B). The proposed settlement would release claims against Capital Financial, its insurer, Arch Specialty

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Insurance Company ("Arch"), and a number of individuals, including Capital Financial's current and prior officers and directors and registered representatives. In the later stages of the settlement approval process, the settling parties decided that the settlement would only release those individuals who provided their financial information to the Court so it could more accurately assess whether a true "limited fund" existed. Notably, the proposed settlement does not release claims against Capital Holdings, and Capital Holdings remains a defendant in the original ***Billitteri*** action. [3]

322** The proposed settlement fund consists of approximately $1,520,000. The settlement fund was compiled from two sources. The first source consists of approximately $1,400,000 that remains of Capital Financial's $2,000,000 applicable insurance sub-policy with Arch that covers all claims related to Capital Financial's sale of Provident **securities**. Capital Financial's insurance policy with Arch can be found at ***Billitteri Docket No. 170–14. [4] The policy is a "wasting policy" in which all defense costs are deducted from the available coverage. Approximately $550,000 of this policy has been expended in attorneys' fees in defense of claims against Capital Financial. The remainder of the policy was preserved by the Court's enjoining of individual claims against Capital Financial, which shall be discussed further in this Order. The entirety of the remainder of the policy shall be contributed to the settlement.

The second source of the settlement fund consists of a $120,000 payment from Capital Financial's net surplus regulatory capital. FINRA determined that Capital Financial could afford to pay $200,000 from its surplus net capital without putting itself in imminent jeopardy of violating the SEC's net capital rule, which requires a broker-dealer to maintain a certain amount of liquid assets. *See* 17 C.F.R. § 240.15c3–1. FINRA has made an independent determination that $120,000 of that $200,000 should go to the payment of claims arising from the sale of Provident **securities**, and $80,000 for the payment of claims should go to the payment of claims arising from the sale of **securities** for Medical Capital Holdings, a related entity that was also revealed to be a Ponzi scheme in 2009. As established at a hearing held in January 2011, the total amount of net capital available at the time that FINRA made the determination that $200,000 was all that Capital Financial could afford to contribute to a settlement without running afoul of SEC regulations, Capital Financial's total net capital was approximately $266,000. *See* Stott App., *Stott* Docket No. 22, at 16–17. According to FINRA, compelling a direct contribution of any more than $200,000 would bring Capital Financial perilously close to regulatory violations and potential insolvency. FINRA has advised the parties that this $120,000 Provident contribution is to be distributed in accordance with the order of this Court, and FINRA's representative, Marshall Gandy, made similar representations at a hearing held by this Court in January. *See* Stott App., *Stott* Docket No. 22, at 5–7. These

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

two concrete sources constitute the total settlement fund.

Among the provisions of the proposed settlement is the Court's ordering a stay and eventual injunction on all litigation and arbitrations brought by individual members of the class against Capital Financial. When the original Motion for Preliminary Approval of this settlement was filed on December 21, 2010 (***Billitteri*** Docket No. 151), the Settling Parties contended that the Court had the authority to take such an action under the All Writs Act. On December 23, 2010, the Representative Plaintiff filed a Motion for Temporary Restraining Order (***Billitteri*** Docket No. 156), which asked the Court to exercise its authority under the All Writs Act to enjoin an arbitration scheduled to begin on January 3, 2011 in North Dakota brought by two individual investors, a Mr. and Mrs. Benson, who would be members of the proposed settlement class against Capital Financial and affiliated individuals. The Court granted the Motion for Temporary Restraining Order on December 28, 2010 (***Billitteri*** Docket No. 159). Objections to preliminary approval of the proposed settlement were filed by several groups of intervenors known as the Campen Intervenors and the Erickson Intervenors (***Billitteri*** Docket Nos. 166 & 182), two objectors to the proposed settlement, Donald and Marva Latimer (***Billitteri*** Docket No. 185), and Milo Segner, the liquidating trustee for the Provident Royalties Liquidating Trust that was created by the Bankruptcy Court (***Billitteri*** Docket No. 160).

The Court held a preliminary approval hearing on January 3, 2011 and a teleconference ***323** with counsel for various interested parties on January 11, 2011. On January 11, 2011, the Court issued an Order exercising its authority under the All Writs Act preliminarily enjoining arbitration procedures brought by members of the proposed settlement class against Capital Financial (***Billitteri*** Docket No. 188) pending the Court's decision on final approval of the proposed class action settlement. On January 25, 2011, the Court issued an Order (***Billitteri*** Docket No. 192) preliminarily approving of the settlement and approving class notice. After the Court granted preliminary approval of the settlement, three members of the class, Terry and Carolyn Stanfield and Christine Meengs, filed virtually identical objections to the settlement (***Billitteri*** Docket Nos. 255 and 262), which, unlike the objections of the Campen and Erickson Intervenors, have not been withdrawn. Jac and Judith Slominski sent a letter to the Court dated February 24, 2011 objecting to the settlement, and the aforementioned Mr. and Mrs. Benson also maintain an undocketed objection dated March 2, 2011.

The Court held a fairness hearing on April 8, 2011, at which the Court heard the testimony of John Carlson, the president and chief compliance officer of Capital Financial, as to the financial condition of Capital Financial. As part of this testimony, the Representative Plaintiff submitted quarterly financial reports and other financial documents relating to Capital Financial that confirmed the small

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

amount of capital available from Capital Financial's net surplus capital for purposes of this proposed settlement. The Court also heard arguments regarding approval of the settlement and the objections of various intervenors and class members, including groups identified as the Campen Intervenors and the Erickson Intervenors. Each of these groups consisted of individuals who had brought their claims against Capital Financial to arbitration, and, at the time, objected to several provisions of the settlement. After hearing their arguments, the Court determined that their concerns deserved further consideration and asked the parties to submit more up-to-date information regarding Capital Financial's financial position and the financial information of individual Capital Financial broker-dealers, who would be released from liability were the settlement to be approved. This information was submitted prior to the Court's second fairness hearing. The information provided to the Court, including updated FOCUS reports for the first part of 2011, confirmed that net capital remained close to the levels determined by FINRA, and supported FINRA's continuing assertion that a $120,000 contribution to the proposed settlement fund was all that could be afforded without provoking a regulatory violation. *See* Stott App., *Stott* Docket No. 25, at 5–39.

The Court held a second fairness hearing on August 10, 2011. One day before the fairness hearing, the Campen Intervenors and the Erickson Intervenors withdrew their objections to the proposed settlement, leaving several individual objections to the settlement remaining, including the docketed objections of Christine Meengs and Terry and Carolyn Stanfield. At the second fairness hearing, the Court considered the arguments of class counsel, counsel for Capital Financial, and the testimony of Mitchell Willis Carter, an expert witness who opined that the settlement "provides for the ... maximum material amount that Capital Financial Services could provide and still have an opportunity to continue in operations." Transcript of August 10, 2011 Hearing, ***Billitteri*** Docket No. 487, at 24. The Court also considered the additional financial information submitted by the parties and the financial information submitted by certain Capital Financial individual broker-dealers.[5] At the hearing, class counsel reiterated its contentions that the proposed settlement fund encompassed all of the funds that could possibly be obtained from Capital Financial without forcing the company to become insolvent, and that there were no appreciable assets that could plausibly be obtained from individual broker-dealers without cost that would outweigh any benefit to the class. ***324** Shortly after the August 10, 2011 hearing, the Court granted a joint motion to sever Stott's claims against Capital Financial into the above-captioned action. *See* Order, *Stott* Docket No. 1.

Although a number of the objections to the settlement have been withdrawn, the Court is still faced with several important issues that must be addressed if the Court is to approve this proposed settlement. First, the Court must assess whether the traditional

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

requirements of Rule 23(a) for the approval of a class action settlement are met. Second, the Court must address whether a "limited fund" exists under Rule 23(b)(1)(B). Third, the Court must determine whether this Court has the authority to enjoin arbitrations brought by individual class members as a part of the settlement agreement. Fourth, the Court must determine whether there has been proper notice in this case and whether Girard Gibbs LLP and Zwerling, Schachter & Zwerling, LLP should be appointed as class counsel for purposes of the settlement. Finally, the Court must address whether the requirements of Rule 23(e) for approval of class action settlements are met. The Court shall address each of these issues in turn.

II. Requirements of Rule 23(a)

A district court has wide discretion in deciding whether or not to certify a proposed class. *Jenkins v. Raymark Indus., Inc.*, 782 F.2d 468, 471–72 (5th Cir.1986). However, that discretion is not unlimited; the Court must undertake a "rigorous analysis" to ensure that the requirements of Rule 23(a) are met. *General Tel. Co. of Southwest v. Falcon*, 457 U.S. 147, 161, 102 S.Ct. 2364, 72 L.Ed.2d 740 (1982). "Rule 23(a) requires that the proposed class representatives demonstrate numerosity, commonality, typicality, and adequacy of representation." *Maldonado v. Ochsner Clinic Found.*, 493 F.3d 521, 523 (5th Cir.2007). The Court shall address each of these Rule 23(a) factors in turn.

1. Numerosity

Numerosity is satisfied when the proposed class is "so large that joinder of all members is impracticable." Fed.R.Civ.P. 23(a)(1); *Mullen v. Treasure Chest Casino, LLC*, 186 F.3d 620, 623 (5th Cir.1999) (citing *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 613, 117 S.Ct. 2231, 138 L.Ed.2d 689 (1997)). The proposed settlement class includes at least 650 investors. A class of such a size is comparable or in excess of the sizes of other classes certified within this Circuit. *See, e.g., Mullen*, 186 F.3d at 624 (noting that a class of 100 to 150 members satisfies the numerosity requirement). Furthermore, members of the settlement class are geographically dispersed, decreasing the practicability of joinder into one action. *See Zeidman v. J. Ray McDermott & Co.*, 651 F.2d 1030, 1038 (5th Cir.1981) (noting the relevance to the numerosity requirement of "geographic dispersion" of the class). It is therefore clear that the settlement class created by the proposed settlement sufficiently satisfies the numerosity requirement.

2. Commonality

Commonality is met when "there are questions of law or fact common to the class." Fed.R.Civ.P. 23(a)(2). The test of commonality is "not demanding"; all that is required is that "there is one common question of law or fact." *James v. City of Dallas*, 254 F.3d 551, 570 (5th Cir.2001). "The interests and claims of the various plaintiffs need not be identical. Rather, the commonality test is met when there is 'at least one issue whose resolution will affect

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

all or a significant number of the putative class members.' " *Forbush v. J.C. Penney Co.*, 994 F.2d 1101, 1106 (5th Cir.1993) (quoting *Stewart v. Winter*, 669 F.2d 328, 335 (5th Cir.1982)). Here, all of the class members invested in Provident through Capital Financial, creating at least one major issue of fact in common with all class members. Furthermore, the claims of the class members are replete with common questions of law that class members would have to prove in pursuing their claims, including whether Capital Financial as a broker-dealer can be held liable for the misrepresentations in the PPMs issued by Provident, whether the PPMs contained misrepresentations or omissions of material facts, and whether Capital Financial owed a fiduciary duty to class members. Accordingly, the Court is convinced ***325** that the commonality requirement is met in this case.

3. Typicality

Typicality is satisfied when "the claims or defenses of the representative parties are typical of the claims or defenses of the class." Fed.R.Civ.P. 23(a)(3). The test for typicality is "not demanding," and "focuses on the similarity between the named plaintiffs' legal and remedial theories and the theories of those whom they purport to represent." *Mullen*, 186 F.3d at 625; *Lightbourn v. Cnty. of El Paso, Tex.*, 118 F.3d 421, 426 (5th Cir.1997). "Typicality does not require a complete identity of claims. Rather, the critical inquiry is whether the class representative's claims have the same essential characteristics as those of the putative class. If the claims arise from a similar course of conduct and share the same legal theory, factual differences will not defeat typicality." *James*, 254 F.3d at 571 (quoting 5 JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE ¶ 23.24[4] (3d ed.2000)). "The prerequisite in the settlement context requires 'proof that the interests of the class representatives and the class are commonly held for purposes of receiving similar or overlapping benefits from a settlement.' " *DeHoyos v. Allstate Corp.*, 240 F.R.D. 269, 281 (W.D.Tex.2007) (Biery, J.) (citation omitted).

The Representative Plaintiff asserts claims that arise out of Capital Financial's sale of Provident **securities**, and each class member's claims would involve proving similar facts about Capital Financial's actions in selling those **securities** and making statements or omissions concerning those **securities**. *See Longden v. Sunderman*, 123 F.R.D. 547, 557 (N.D.Tex.1988) (Sanders, J.) ("The individual factual differences between the class representatives will not defeat class certification in this case where Plaintiffs have alleged a continuous course of conduct by defendants which is uniformly fraudulent and that they, as well as each member of the class, suffered a financial loss as a result of the ... scheme."). Although certain of the class members may have dealt with different individuals associated with Capital Financial, these factual differences are not sufficient to overcome the similarity of the nature of the Representative Plaintiff's claims. The Representative Plaintiff has brought claims that are typical of the members of the Settlement Classes. Accordingly, the

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Representative Plaintiff's claims satisfy the typicality requirement.

4. Adequacy of Representation

"Rule 23(a)(4) is satisfied where: (1) the named plaintiffs' counsel will prosecute the action zealously and competently; (2) the named plaintiffs possess a sufficient level of knowledge about the litigation to be capable of taking an active role in and exerting control over the prosecution of the litigation; and (3) there are no conflicts of interest between the named plaintiffs and the absent class members," *Hamilton v. First Am. Title Ins. Co.*, 266 F.R.D. 153, 163–64 (N.D.Tex.2010) (Fish, J.) (citing *Feder v. Elec. Data Sys. Corp.*, 429 F.3d 125, 129 (5th Cir.2005)).

Based on the information provided to the Court and the Court's involvement with counsel in this case, the adequacy of representation requirement is satisfied as to this proposed settlement. First, class counsel in this case and other counsel involved in the representation of class members in this matter, all of whom possess substantial experience in class action litigation, have zealously pursued the interests of class members as a whole. Second, the Representative Plaintiff, through a submitted statement and declaration, has provided to the Court sufficient indications that he will continue to take an active role in the prosecution of this class action and administration of this proposed settlement to its conclusion. The Court's observations throughout this litigation have also established that the Representative Plaintiff has and will exert control over the prosecution of the remainder of this litigation, should the settlement be approved, which would largely constitute administration of the settlement. Finally, the Court is satisfied that no conflict of interest exists between the Representative Plaintiff and absent class members, or involving class counsel, which represents plaintiffs in several cases related to Provident before this Court. Here, considering the effort expended to achieve the ***326** contemplated recovery, the Court is convinced that "all class members are asserting [the] common right [of] achieving a maximum potential recovery for the class"; accordingly, "the class interests are not antagonistic for representation purposes." *In re Corrugated Container Antitrust Litig.*, 643 F.2d 195, 208 (5th Cir.1981); *see also McNamara v. Bre–X Minerals Ltd.*, 214 F.R.D. 424, 428–29 (E.D.Tex.2002) (Folsom, J.) (finding that the adequacy of representation requirement was met when the named plaintiffs and class members all sought maximum recovery and where class counsel was skilled and experienced); *White v. Nat'l Football League*, 822 F.Supp. 1389, 1405 (D.Minn.1993) (finding that class counsel's representation of various plaintiffs in related class action and individual lawsuits resulted in no conflict of interest and supported approval of class action settlement, citing class counsel's experience, the interrelationship of claims, and class counsel's role in facilitating the settlement).

* * *

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Accordingly, the four requirements of Rule 23(a) are met for purposes of approval of this class action settlement.

III. The Existence of a "Limited Fund" Under Rule 23(b)(1)(B)

Having determined that the proposed class action settlement satisfies the conditions of Rule 23(a), the Court now addresses whether a "limited fund" exists under Rule 23(b)(1)(B). The Court shall first discuss the concept of a "limited fund," and shall then assess whether the circumstances of this case allow for the approval of a "limited fund" settlement.

A. The "Limited Fund" Concept

The concept of a "limited fund" settlement long predates the Federal Rule of Civil Procedure by which it is governed, Rule 23(b)(1)(B). This Rule provides, in relevant part, "A class action may be maintained if Rule 23(a) is satisfied and if ... adjudications with respect to individual class members that, as a practical matter, would be dispositive of the interests of the other members not parties to the individual adjudications or would substantially impair or impede their ability to protect their interests." "Among the varieties of suit traditionally encompassed by Rule 23(b)(1)(B) are those involving a 'limited fund,' in which numerous individual claims against an insufficient fond would impair the ability of all members of the class to protect their interests." *Williams v. Nat'l Sec. Ins. Co.*, 237 F.R.D. 685, 692 (M.D.Ala.2006) (citing *Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 834, 119 S.Ct. 2295, 144 L.Ed.2d 715(1999)).

The basic concept of a "limited fund" settlement is that there is a definite, limited amount of capital that is available to class members, and that such a fond is insufficient to cover all claims. The traditional "limited fond" situation typically involved multiple claims to a single, tangible fond, such as a bank account, trust, insurance policy, or proceeds from a sale of an asset. *See Ortiz*, 527 U.S. at 835–36, 119 S.Ct. 2295; *see also* Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 Duke L.J. 1251, 1306 (2002); Arthur R. Miller, *An Overview of Federal Class Actions: Past, Present, and Future*, 4 JUST. SYS.. J. 197, 211 (1978). In a traditional "limited fond" situation, the aggregation of the claims would be greater than the amount made available in this tangible fond. A court would subsequently have the ability to enforce a settlement that provided for a pro rata distribution of the fund to all claimants, to ensure each claimant was treated fairly and equitably under the circumstances. *See Ortiz*, 527 U.S. at 834–36, 119 S.Ct. 2295 (discussing *Dickinson v. Burnham*, 197 F.2d 973 (2d Cir.1952)). As noted by the Supreme Court in *Ortiz*, the Advisory Committee involved in drafting the Federal Rules of Civil Procedure was aware of the precedent involving "limited fund" settlements, and accounted for previous use of the "limited fund" device by courts in providing commentary on Rule 23(b). *See id.* at 833–36, 841–42, 119 S.Ct. 2295 ("The Advisory Committee, and presumably the Congress in approving subdivision (b)(1)

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

(B), must have assumed that an action with these characteristics would satisfy the limited fund rationale cognizable under that subdivision."). This kind of class action necessarily provides for mandatory *327 participation by class members because allowing class members to opt out of the class and pursue individual claims would deplete the fund to the detriment of other class members. *See* MARCY HOGAN GREER, A PRACTITIONER'S GUIDE TO CLASS ACTIONS 77 (American Bar Association Publication 2010) ("[Rule 23(b)(1)(B)] is typically used when, in the absence of a classwide remedy, claimants suing individually would be prejudiced by exhaustion of the limited fund."). Common features of a "limited fund" settlement thus include no opportunity for class members to opt out, and for the approving court to enjoin claims brought in other forums by individual class members that would deplete the fund if the individual class members managed to obtain an award from the defendant.

The Supreme Court's decision in *Ortiz* established the requirements for a "limited fund" under Rule 23(b)(1)(B).[6] The Supreme Court adopted the following three elements as presumptively necessary requirements to establishing a "limited fund" for a mandatory no opt-out class: (1) the totals of the aggregated liquidated claims and the fund available for satisfying them, set definitely at their maximums, demonstrate the inadequacy of the fund to pay all claims; (2) the whole of the inadequate fund is to be devoted to the overwhelming claims; and (3) the claimants identified by a common theory of recovery are treated equitably among themselves. *Ortiz*, 527 U.S. at 838–39, 119 S.Ct. 2295; *see also In re Katrina Canal Breaches Litig.*, 628 F.3d 185, 193 (5th Cir.2010). *Ortiz* thus held that "mandatory class treatment through representative actions on a limited fund theory was justified with reference to a 'fund' with a definitely ascertained limit, all of which would be distributed to satisfy all those with liquidated claims based on a common theory of liability, by an equitable, pro rata distribution." *Ortiz*, 527 U.S. at 841, 119 S.Ct. 2295. The Supreme Court emphasized that it would be "essential" for the parties seeking the approval of a "limited fund" settlement to show that the fund is "limited independently of the agreement of the parties to the action." *Id.* at 864, 119 S.Ct. 2295. The Supreme Court further noted that the purpose of the "limited fund" device is to ensure that the class's recovery is the "best possible arrangement" or the "best that can be provided for class members." *Id.* at 852, 860, 119 S.Ct. 2295.

B. Whether a "Limited Fund" Exists in this Case

The Court begins its analysis with the three "presumptively necessary" elements to satisfy approving a settlement through the "limited fund" rationale: (1) the totals of the aggregated liquidated claims and the fund available for satisfying them, set definitely at their maximums, demonstrate the inadequacy of the fund to pay all claims; (2) the whole of the inadequate fund is to be devoted to the overwhelming claims; and (3) the claimants identified by a common theory of recovery are treated equitably among

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

themselves. *Ortiz*, 527 U.S. at 838–39, 842, 119 S.Ct. 2295; *Klein v. O'Neal, Inc.*, 2006 WL 325766, at *3.

There is little controversy concerning the second and third *Ortiz* factors, and the evidence before the Court indicates that these two factors have been satisfied. Regarding the second *Ortiz* factor, it is clear that the whole of the settlement fund will be devoted to paying claimants. Should the Court approve the settlement, the $1.52 million fund, minus costs and attorneys' fees, ***328** will be distributed to all class members who have claims against Capital Financial regarding its sale of Provident **securities**.

The third *Ortiz* requirement of whether the claimants are treated equitably among themselves is also satisfied in this case because the settlement fund will be distributed to class members on a *pro rata* basis. The Court finds this third factor to be particularly important to its decision in this case. Were the Court not to approve this settlement, it is extremely likely that a very small fraction of class members would have their arbitration claims heard before the fund is depleted. It may even be that none of the claimants receive any award at all due to losing at arbitration, but the fund would be expended anyway because of Capital Financial's attorneys' fees. If any were to recover at all, the fund would be depleted long before every arbitration claimant, not to mention other class members, were to receive an opportunity for compensation. A key feature of the "limited fund" device is the "equitable principles underlying the *pro rata* distribution," *In re The Reserve Fund Secs. & Derivative Litig.*, 673 F.Supp.2d 182, 204 (S.D.N.Y.2009), and this case demonstrates a situation where consideration of those equitable principles is particularly appropriate. In this situation, an arbitrator "could grant relief to an individual claimant and siphon assets away from the res without regard to any equitable concerns, thereby undermining the *pro rata* distribution this Court has deemed necessary to treat all claimants fairly and equitably." *Reserve Fund*, 673 F.Supp.2d at 204. The terms of this proposed settlement, including the enjoining of arbitrations that could result in individual rewards disproportionate to other class members, reflect the Court's equitable concern for ensuring a fair recovery for all class members. *See S.E.C. v. Forex Asset Mgmt. LLC*, 242 F.3d 325, 331 (5th Cir.2001) (holding that district court acted within its discretion when it equitably distributed remaining assets of an entity on a *pro rata* basis). While the Court must still assess the propriety of approving the settlement in light of the crucial first *Ortiz* factor, the principles of equity that are embodied in the "limited fund" doctrine are particularly pertinent to the Court's ultimate decision.

The Court thus focuses its attention on the first *Ortiz* factor of whether the totals of the aggregated liquidated claims and the fund available for satisfying them, set definitely at their maximums, demonstrate the inadequacy of the fund to pay all claims. The Court must first consider whether the Representative Plaintiff has demonstrated the total liquidated amount of the claims and the total amount of the purported "limited

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

fund." Many courts have been reluctant to utilize the "limited fund" device when the claimants have claims for unknown and unliquidated amounts of damages. *See Ortiz*, 527 U.S. at 850, 119 S.Ct. 2295; *Katrina*, 628 F.3d at 193–94 (rejecting a proposed "limited fund" settlement when "[t]he class members in this case suffered a wide variety of injuries, ranging from property damage to personal injury and death, and no method is specified for how these different claimants will be treated vis-a-vis each other"); *Klein*, 2006 WL 325766, at *4–*5 (holding that first *Ortiz* requirement not met in products liability claim relating to intravenous pharmaceutical product when the figures related to damages were estimated).

However, unlike what has been seen in mass tort cases such as *Katrina* or *Klein*, the amount of losses in this case is known and ascertainable, as each class member can easily determine the amount of his or her investment that was lost as a result of the collapse of Provident. *See Klein*, 2006 WL 325766, at *4 (in proposed "limited fund" settlement of mass tort claims, rejecting first element because "plaintiffs' estimate of potential claim liability does not provide the court with any comfortable certainty of the total value of the claims"). The evidence presented to the Court demonstrates that the total amount of losses that class members seek to recover this case adds up to over $65 million, and because of the nature of the losses in this case, the Court can rest assured that the amount contemplated is a "sufficiently reliable conclusion regarding the probable total of the aggregated liquid damages." *Id.* at *5. Unlike in mass tort cases, the damages here are known to each class member based on the losses they suffered ***329** through their investments in Provident **securities**. Indeed, the damages in this case, which can be clearly calculated because each claimant has a concrete amount of losses arising from the purchase of Provident **securities** through Capital Financial, are amenable to determining the total liquidated amount of the claims for purposes of a "limited fund" settlement. Accordingly, this feature of a proper "limited fund" is satisfied in this case.

The Court next considers whether the "amount of funds available to satisfy the claims" is set definitively at its maximum. *Ortiz*, 527 U.S. at 838–39, 119 S.Ct. 2295. The proposed settlement fund itself consists of $1,520,000, consisting of $1,400,000 remaining in insurance coverage and a $120,000 contribution directly from Capital Financial, which is the absolute maximum amount that FINRA has determined Capital Financial can contribute while maintaining the amount of assets necessary to maintain operations. It is clear that this sum is inadequate to pay all claims, and the Court is convinced that the fund is not "postulated" or "not easily susceptible to proof, definition, or ... estimation." *In re Simon II Litig.*, 407 F.3d 125, 138 (2d Cir.2005). Instead, there is a clear amount that has been designated by the remaining amount within the insurance fund and amount that FINRA has determined that Capital Financial can contribute to the settlement without violating SEC regulations. Accordingly, it is clear that

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

the total settlement fund, like the total amount of damages, is clearly ascertained, and, if approved, is an appropriate concrete number for purposes of a "limited fund" settlement.

However, the Court must still determine whether this proposed settlement meets the requirement of *Ortiz* that the "limited fund" be "set definitively at [its] maximum[ ]." *Ortiz*, 527 U.S. at 838, 119 S.Ct. 2295. Indeed, one of the most pressing issues before the Court is whether this sum, consisting of the insurance proceeds and the amount provided to FINRA, can be considered a "limited fund," when Capital Financial will remain in business and functioning if this settlement is approved, and will therefore maintain certain assets required for its continued operation that will not go to class members. In attempting to gain approval for a "limited fund" settlement, "the settling parties must present not only their agreement, but evidence on which the district court may ascertain the limit and the insufficiency of the fund." *Ortiz*, 527 U.S. at 849, 119 S.Ct. 2295. The parties have submitted clear evidence as to the two sources of the fund: the remaining insurance benefits, which have been preserved through the Court's temporarily enjoining arbitration claims against Capital Financial, or $1.4 million, and the $120,000 approved for inclusion in the settlement fund by FINRA.

The Court first addresses whether the $1.4 million amount is the maximum amount of insurance benefits available to satisfy claims against Capital Financial related to the sale of Provident **securities** for the purposes of the first *Ortiz* factor. Certain objectors, including Jac and Judith Slominski, argue that a larger $5 million aggregate policy, rather than a $2 million sublimit, applies to the Provident claims against Capital Financial. Arch has taken the position that the claims asserted by class members are "related," and refers to the relevant provision of its policy, which states:

> Related Claims means all Claims, whether made against more than one Insured or by more than one claimant, arising out of a single Wrongful Act or a series of Wrongful Acts that have as a common nexus any fact, circumstance, situation, event, transaction, cause or series of causally connected facts, circumstances, situations, events, transactions or causes.

Supp.App., ***Billitteri*** Docket No. 170–14, at 137 (emphasis omitted). The policy further provides that "All Related Claims shall be deemed a single Claim...." *Id.* at 141 (emphasis omitted). Arch thus asserts that the $2 million sublimit concerning "Related Claims" applies to claims against Capital Financial arising out of its sale of Provident **securities** to class members, rather than the $5 million aggregate limit.

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

The Court does not presume to rule, absent full litigation of this issue, that the Arch is correct in this assertion. However, the Court is of the opinion that the "limited *330 fund" in this case can properly be based upon the $2 million sublimit. First, other portions of the $5 million aggregate insurance policy are being considered in regard to Capital Financial's sale of Medical Capital and other securities that were related to the Provident Ponzi scheme. Much of the litigation involving these other claims that are the subject of the policy has been consolidated before this Court, and the Court is well aware of the need for other portions of the policy to be devoted to claims arising from the sale of Medical Capital and other related securities, much as FINRA was aware of the need to devote $120,000 of Capital Financial's $200,000 contribution to this proposed settlement and reserve the other $80,000 to addressing claims arising from Capital Financial's sale of Medical Capital.

Second, the Court is convinced that the settling parties' reliance upon the $2 million sublimit was appropriate for purposes of this proposed settlement. In *Ortiz,* the Supreme Court noted that "value discounted by risk" could possibly be taken into account in assessing whether a "limited fund" based upon applicable insurance coverage existed. *Ortiz,* 527 U.S. at 851, 119 S.Ct. 2295. In this case, based on its assessment of the insurance policy, the Court's own experience in this litigation, and the interests of the class members in getting at least some recovery in a short amount of time, the Court is of the opinion that the circumstances allow for such an approach. Having reviewed the insurance policy, the Court is of the opinion that Arch would have a substantial chance of success in confirming its position through litigation, and the Court does not believe that the settling parties' reliance upon the sublimit in submitting this "limited fund" settlement to the Court for consideration was inconsistent with the "limited fund" doctrine. The Court's experience in this litigation has made it well aware of the time and expense it would take to litigate this issue, and how rejection of this proposed settlement on this ground could significantly delay recovery by class members. For example, litigation on a similar insurance coverage issue in relation to Arch's coverage of another defendant in the ***Billitteri*** case, NEXT Financial Group, Inc., entitled *NEXT Financial Group Inc. v. Arch Specialty Insurance Company,* 3:10–cv–2206–F, took ten months to reach a resolution and underwent substantial motion practice. Furthermore, as noted above, the insurance policy at issue is a "wasting" policy, and the cost of additional litigation regarding this question would be deducted from the fund itself. Thus, in addition to the delay, class members' recovery would very likely be reduced even further by the cost of litigating the issue, while a successful outcome in such litigation that has the possibility of making up for such losses is far from certain.

For these reasons, taking into account the facts surrounding the Arch policy and the best interests of the class, as the Court is required to do under *Ortiz,* this objection by the Slominskis is overruled. Accordingly, the

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

$1.4 million remaining of the assets within the $2 million Arch insurance subpolicy is a proper amount set at its maximum for purposes of the first *Ortiz* factor.

The Court now focuses on the evidence of whether the latter portion of the fund, namely the direct contribution from Capital Financial, is set definitively at its maximum. As with all decisions regarding class certification, the Court takes a " 'close look' at the parties' claims and evidence in making its Rule 23 decision." *Unger v. Amedisys Inc.*, 401 F.3d 316, 321 (5th Cir.2005) (citing *Amchem*, 521 U.S. at 615, 117 S.Ct. 2231).

At the initial fairness hearing and in subsequent filings, the Court was presented with evidence of Capital Financial's financial condition and available assets, including quarterly FOCUS reports mandated by FINRA dating back several years that detail Capital Financial's assets, surplus, and other financial features. As demonstrated at the Court's hearing on January 11, 2011, the evidence and testimony presented to the Court shows that Capital Financial's net capital requirements are barely met after the FINRA-mandated amount is deducted from Capital Financial's net capital. The $200,000 contribution, when the excess net capital was at around $266,000, would indeed leave Capital Financial barely able to meet regulatory requirements. Based on the Court's assessment of the evidence, the Court is convinced ***331** that FINRA's assessment should not be doubted, and that $120,000 is all that can be contributed to this settlement without putting Capital Financial in imminent danger of potential regulatory violations and insolvency.

The remaining objections to the settlement by Christine Meengs and Terry and Carolyn Stanfield argue that the use of the excess net capital figure in determining the "limited fund" is inappropriate, and argues that any "limited fund" settlement should include the overall net worth of Capital Financial. *See* Stanfield Objection, ***Billitteri*** Docket No. 255, at 1–2; Meengs Objection, ***Billitteri*** Docket No. 262, at 1–2 ("Without considering all of Capital Financial's assets, the Class Plaintiffs have failed to show that this is an adequate settlement."). In support of this argument, the Stanfields and Meengs note that *Ortiz* rejected a "limited fund" settlement that did not include all of a defendant's assets and where the district court had not made a finding of the defendant's net worth, noting that such an arrangement was not the best that could be obtained for class members. *Id.* (citing *Ortiz*, 527 U.S. at 850, 860, 119 S.Ct. 2295). The Stanfields and Meengs ask that the Court reject this proposed settlement, citing one district court's conclusion the "[n]et capital does not equate to net worth" for the purpose of a "limited fund" settlement. *Cooper v. Miller Johnson Steichen Kinnard, Inc.*, No. 02–1236 (RHK/AJB), 2003 WL 1955169, at *4 (D.Minn. Apr. 21, 2003).

While the Court takes the Stanfields' and Meengs's argument into account, the Court is convinced that the circumstances in this case and Fifth Circuit precedent permit the finding of a proper "limited fund" under Rule 23(b)(1)(B). The source

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

of the $120,000 amount contributed by Capital Financial comes from FINRA's determination that such an amount was the maximum that could be contributed to a settlement of Provident claims without forcing Capital Financial into a violation of SEC regulations and potentially shutting down its operations. Throughout the settlement approval process, certain objectors have argued that this amount cannot support a "limited fund" settlement because Capital Financial remains in possession of certain assets to continue operations, and that Capital Financial must contribute all of its assets to the settlement fund. However, the Court is of the opinion that the fact that Capital Financial will maintain limited assets to continue operations does not preclude the Court from approving this settlement. Indeed, courts have approved "limited fund" settlements that do not encompass a company's entire net worth. For example, in *Williams v. National Security Insurance Co.*, 237 F.R.D. 685 (M.D.Ala.2006), two plaintiffs sued National Security Insurance Company ("NSIC"), alleging that NSIC had discriminated against African–American policy-holders by charging higher premiums to them than the premiums charged to white policy-holders. *Id.* at 687. The plaintiffs represented a class of over 1,000 members, with 174 of them pursuing individual claims against NSIC through individual lawsuits. *Id.* at 692. The parties to the *Williams* case sought the court's approval of a "limited fund" settlement that would enjoin all claims by class members that would increase class members' benefits, and decrease NSIC's surplus capital by approximately 35%. *Id.* This "limited fund" settlement would thus allow NSIC to continue operations and maintain some of its assets while releasing it from liability.

In approving the settlement under Rule 23(b)(1)(B), the Court cited the statements of the deputy commissioner of the Alabama Department of Insurance ("ALDOI"), which regulated NSIC's solvency:

> One of the obvious signs which concern regulators from the standpoint of solvency is a large reduction in surplus. The subject proposed settlement involves as cost to NSIC of in excess of 30% of its surplus. In the context of solvency regulation, this cost is very large in relation to the surplus of NSIC and is a matter for concern. The cost of this settlement is definitely material to the solvency of NSIC but does not require that it be placed under supervision. A further material negative development could well affect its surplus, its financial viability and its ability to continue in business, not to mention the performance of its obligations under the subject proposed settlement ***332** ... ALDOI

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

> considers the non opt-out feature of this settlement to be essential because the cost of defense of numerous individual cases or the imposition of a large verdict, could require that ALDOI place this company under supervision or in receivership.

Id. at 693. ALDOI did not assess additional sanctions against NSIC "precisely because of concerns over the company's continuing solvency":

> Both the direct and indirect costs to [NSIC] of the implementation of the measures called for by the Stipulation will be substantial. Any additional sanctions imposed by the Department against NSIC would not be in the best interests of NSIC, its current or former policyholders, the consumers of this state, or the state of Alabama.

Id. The district court approved the settlement, citing the risk of the prosecution and adjudication of individual claims as threatening the interests of the class and taking ALDOI's concerns and recommendations into account. *Id.*

The Court is faced with a similar situation in this case. The $120,000 amount that Capital Financial is directly contributing to the settlement is not some arbitrary number that was randomly chosen, but was determined by FINRA as the maximum that Capital Financial could contribute without violating the requirements for capital on hand established by the SEC, which regulates Capital Financial. Here, similar to *Williams,* the Court is faced with a situation where the input of a regulating body has established the source and the appropriateness of the creation of the "limited fund." The Court is thus satisfied that the $120,000 portion was "limited independently of the agreement of the parties to the action." *Ortiz,* 527 U.S. at 864, 119 S.Ct. 2295. While the situation is not exactly like *Williams,* this case presents similar concerns: FINRA, whose representative, Marshall Gandy, was present at one of the January hearings and supported the Court's procedures in dealing with this settlement, has not only determined that a settlement of this type would allow Capital Financial to remain in regulatory compliance, but has actually determined the maximum amount that it could contribute to such a settlement without being forced into regulatory violations.[7] Furthermore, the Court takes into account the fact that the *Williams* decision considered regulatory interests, preserved the rights of the settling defendant to continue operations in light of the Rule 23(b)(1)(B) settlement, and approved of the settlement without including

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

every asset that the settling defendant possessed, instead relying on regulatory requirements. As in *Williams,* approving this settlement, in addition to satisfying equitable concerns, favors the interests of the class members and the entity performing regulatory oversight. *Williams,* 237 F.R.D. at 693. *Williams* thus supports approval of this proposed "limited fund" settlement.

In support of its conclusion that the Court may certify a Rule 23(b)(1)(B) settlement class without including all of Capital Financial's assets, the Court also notes the Fifth Circuit's decision in *Baker v. Washington Mutual Finance Group, LLC,* 193 Fed.Appx. 294 (5th Cir.2006).[8] In *Baker,* a class plaintiff ***333** attempted to certify a settlement class in which punitive damages claims would be resolved in a no-opt-out "limited fund" format under Rule 23(b)(1)(B). *Id.* at 296–97. This "limited fund" was established at $3.5 million. *Id.* at 296. The district court approved the settlement, and certain objectors appealed, arguing that Washington Mutual's worth was actually between $50 and $70 million, and that the upper limit of the fund was inadequate in light of this assertion. *Id.* at 297.

The Fifth Circuit held that the district court did not abuse its discretion in approving the "limited fund" settlement. The Fifth Circuit noted that the district court had taken into consideration the fact that Washington Mutual had ceased operations in Mississippi and, if an award were finally approved by the Mississippi Supreme Court in a different case against Washington Mutual, "Washington Mutual's net worth will be greatly diminished and perhaps completely eradicated." *Id.* at 298. The Fifth Circuit noted that the district court "went on to explain that the $3.5 million figure was not simply 'plucked out of thin air,' " as the objectors contended. *Id.* The Fifth Circuit further wrote:

> In addition, the district court found that if the class is not certified it is likely that tends of thousands of individual lawsuits will ensure. After considering the breathtaking cost of defendant against so many individual lawsuits, the district court determined that $3.5 million was the most that Washington Mutual would be able to pay as punitive damages.

Id. The Fifth Circuit thus held that it "[could not] deem the district court's factual determination that $3.5 million was the upper limit an abuse of discretion." *Id.*

The Court finds *Baker* instructive in this case. In *Baker,* the district court took all of the circumstances surrounding the settling defendant's financial condition into account in determining that approving a $3.5 million settlement fund would be a proper exercise of the "limited fund" device, and the Fifth Circuit approved this action as within the district court's discretion. In

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

this case, the Court similarly finds, after an intensive inquiry of the financial condition of Capital Financial and its registered representatives, which has included going through two fairness hearings, hearing substantial testimony, and reviewing dozens of financial reports, that approval of a "limited fund" of containing a $120,000 direct contribution from Capital Financial in addition to the $1.4 million remaining of the insurance policy is appropriate. As in *Baker,* Capital Financial will be forced with defending arbitrations and other proceedings by individual claimants at "breathtaking cost," *id.,* and the Court is convinced that this situation compels a similar result. Furthermore, it is clear that the $120,000 figure was not "plucked out of thin air." While the figure in *Baker* was approved in consideration of the defendant's circumstances, the $120,000 figure is based specifically on a determination by a regulating body of the amount that could be contributed without causing the collapse of Capital Financial. The figure in this case thus does not even contain the hint of arbitrariness of the figure that was ultimately approved in *Baker. See also In re Telectronics Pacing Systems, Inc.,* 221 F.3d 870, 880 (6th Cir.2000) (reversing the district court's approval of a "limited fund" settlement in which a defendant contributed $10 million because the district court "did not undertake an independent risk analysis, but instead accepted the $10 million settlement figure as representing the maximum amount the Australian defendants could be required to pay claimants," and calling such an action "plainly improper").

It is true that the district court in *Cooper* did not approve a "limited fund" settlement based upon a company's net capital rather than its net worth. *See Cooper,* 2003 WL 1955169, at *4. However, in addition to the fact that *Cooper* is not binding upon this Court, the Court is of the opinion that *Baker* and *Williams* are more applicable to this situation, and permit approval of a settlement that does not include the company's entire net worth or require the finding of the company's net worth. Instead, the district courts in *Baker* and *Williams* took into account the reality of the situation with the defendant companies at issue in those cases, and approved "limited fund" settlements that ***334** did not include a finding of the company's net worth or a settlement fund that included the company's entire net worth. In *Baker,* the Fifth Circuit affirmed the district court's approval of a "limited fund" settlement that included far less than the defendant's apparent net worth when a vast majority of the defendant's assets were on the verge of being depleted by the imminent approval of a judgment by another court and the specter of individual actions in light of these circumstances threatened to leave all class members with no recovery. *Baker,* 193 Fed.Appx. at 298. In *Williams,* the district court approved a "limited fund" settlement when many individual actions would have disposed of the interests of members of the class as a whole, and when the relevant regulatory agency endorsed the settlement as in the public interest. *Williams,* 237 F.R.D. at 692–93. Both of these cases allowed for a "limited fund" settlement

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

that preserved some of the assets and the operational capacity of the defendant, but where a searching court inquiry and the interests of the class as a whole would be served by approval of the settlement. *Baker* and *Williams* support approving a "limited fund" settlement that does not cause the settling defendant's insolvency by carefully considering all of the facts surrounding a company's financial condition and considering the Court's goal of ensuring "the fair and equitable treatment of all claimants." *Reserve Fund,* 673 F.Supp.2d at 204. This case compels a similar result.

Accordingly, the Court does not consider a total deprivation of Capital Financial's assets a requirement to approving this "limited fund" settlement. *See Williams,* 237 F.R.D. at 692–93 (approving a "limited fund" settlement that, in the opinion of state regulators, reflected "both fairness to the class and [the settling defendant's] continuing solvency").[9] The Court is convinced that, when taking the equitable interests of class members into account, the composition of the settlement fund in this case is a proper use of the "limited fund" doctrine. This is not to say that approval of a "limited fund" settlement without including all of a defendant's assets is appropriate in every situation; instead, the Court comes to this conclusion in this particular case, taking the best interests of the class members into account, as instructed by *Ortiz,* and approving of a settlement that realistically provides the best possible result for the class as a whole. In this case, as in *Baker* and *Williams,* after a full assessment of the facts and the potential recovery for class members, the Court is of the opinion that approving the "limited fund" settlement truly is "the best that can be provided for class members" under these circumstances, and should be approved. *Ortiz,* 527 U.S. at 860, 119 S.Ct. 2295.[10]

A second issue that the Court must address is the fact that the assets of Capital Financial's individual registered representatives against whom claims are asserted by individual class members, are not included in the settlement, and yet claims against them will be released. Certain individual class members have included these individuals as defendants in their arbitration claims against Capital Financial, asserting that they were ***335** themselves liable for their role in the sale of Provident **securities**. Certain objectors, particularly the Campen Intervenors, strongly argued that a "limited fund" settlement could not be approved if these individuals would be released from liability and the assets of these individuals would not be included within the "limited fund." Although the Campen Intervenors have since withdrawn their objection to the settlement, the Stanfields and Meengs also briefly mention this argument without elaboration in their objections to the settlement, which remain pending. Jac and Judith Slominski also raise this argument in their letter of February 24, 2011.

Class counsel contends that pursuing these individual registered representatives would be a more costly endeavor than the amount of assets that they could recover from them. However, class counsel took into account the Court's concerns about this element at

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

the first fairness hearing, and undertook an effort to provide the Court with the financial information of these individuals to support their assertion. *See Stott* Docket No. 23. After the fairness hearing, the terms of the proposed settlement were altered so that registered representatives who provided their financial information to the Court for review could be included in the release from liability. Many directors, officers, and registered representatives of Capital Financial, who are listed in Appendix A to this Order, submitted their financial information as part of this arrangement. *See id.*

Although the assets of the released individuals will not be included in the settlement, the Court is of the opinion that approval of the settlement is still a proper application of the "limited fund" doctrine. The Court has extensively reviewed the financial information of the individual registered representatives that have submitted such information to the Court, and the Court is inclined to agree with class counsel that pursuing claims against these individuals would incur substantial expense for very little in terms of assets that could be recovered, and that pursuing the claims against indemnification defenses by the registered representatives would be exceedingly difficult and costly. *See* *Newby v. Enron Corp.*, 394 F.3d 296, 309 (5th Cir.2004) (holding that a district court was justified in strongly weighing the opinion of class counsel against that of objecting class members "in light of their superior sophistication"); *Cotton v. Hinton*, 559 F.2d 1326, 1330 (5th Cir.1977) (in evaluating a class action settlement, "the trial court is entitled to rely upon the judgment of experienced counsel for the parties"). Notably, at least one court has not let the release of claims against individuals prevent approval of a "limited fund" settlement against their employer. *See* *Reserve Fund*, 673 F.Supp.2d at 202–03 (approving a "limited fund" settlement that enjoined claims against the settling defendant's "officers, directors, trustees, representatives, against or employees to the extent that such claims are subject to indemnification"). In light of the Court's assessment of the evidence submitted to the Court, which included a searching review of the information painstakingly collected by class counsel and submitted to the Court, the Court is of the opinion that the release of the individual registered representatives who have submitted financial information for the Court's review without contributing to the "limited fund" should not prevent approval. *See* *Ortiz*, 527 U.S. at 851, 119 S.Ct. 2295 (while noting that application of such an analysis was "a step removed from the historical model," leaving open the possibility that taking into account "limit as a value discounted by risk" of continuing litigation could be considered by courts in assessing a proposed "limited fund"). While these individuals have not contributed to the settlement, the Court is of the opinion that the procedures and requirements undertaken by the Court have provided sufficient protection to class members and justification for releasing claims against individual registered representatives, directors, and officers. [11]

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

*336 Accordingly, the Court concludes that the "limited fund" model applies to this situation, and that the Court may approve this settlement under Rule 23(b)(1)(B). Although this "limited fund" settlement involves a number of elements that require intensive analysis of the facts surrounding the case, the Court is of the opinion that prior case law, including *Baker* and *Williams,* support approval of this settlement, which in the opinion of the Court is in "the best that can be provided for class members." *Ortiz,* 527 U.S. at 860, 119 S.Ct. 2295. Approval is especially appropriate in light of the aforementioned equitable considerations related to the class members themselves, who, without this proposed settlement, would very likely be subject to an unfair distribution of the remaining funds or no recovery at all. *See* GREER at 77 (noting that the use of the "limited fund" device is appropriately used when "claimants suing individually would be prejudiced by exhaustion of the limited fund"). The objections to the fund based on the applicability of Rule 23(b)(1)(B), including those of the Bensons, the Slominskis, Meengs, and the Stanfields are accordingly overruled. However, while the characteristics of the "limited fund" are appropriate for approval in this case, the Court must still address whether it has the authority to enjoin arbitrations brought by individual class members, which it shall do in the next section of this Order.

IV. The Court's Authority to Enjoin Arbitrations

Having determined that a "limited fund" exists in this case, the Court must now assess whether it has the authority to permanently enjoin arbitrations brought by individual class members against Capital Financial and its officers, directors, and brokers. As noted in the previous section, the nature of a Rule 23(b)(1)(B) "limited fund" class action settlement inherently limits other actions by class members because the purpose of the device is to preserve the "limited fund" for equitable distribution to members of the class. Accordingly, as part of approving this settlement, the Court would have to permanently enjoin all claims brought by individual class members against the settling defendant.

Unlike other more common types of settlements under Rule 23(b)(3), a "limited fund" settlement does not permit class members to opt out. *See* *Ortiz,* 527 U.S. at 838, 119 S.Ct. 2295 (noting that a settlement meeting the conditions of a "limited fund" is one from which "no one has the right to secede"). To do so could jeopardize the "limited fund" because separate adjudications pertaining to individual class members could deplete the fund, disrupt the terms of the settlement, and cause an inequitable recovery. *See* *In re Joint Eastern & Southern Dist. Asbestos Litig. (JESDAL),* 134 F.R.D. 32, 36–38 (E.D.N.Y.1990) (citing depletion of the funds available to pay into a "limited fund" settlement as a justification for enjoining pending litigation around the country); *accord* *Wilson v. Airborne, Inc.,* No. EDCV 07–770–VAP (OPx), 2007 WL 5010298, at *3 (C.D.Cal. Nov. 28, 2007). Accordingly,

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

"limited fund" settlements often involve enjoining other legal proceedings to preserve the limited assets that would available to all class members. *See, e.g.,* *Lloyd v. Cabell Huntington Hosp., Inc.*, 58 F.Supp.2d 694, 696 (S.D.W.Va.1999); *Holmes v. Trustmark Nat'l Bank*, No. CIV.A. 195–CV–323 GR, 1996 WL 904513, at *2 (S.D.Miss. Jan. 11, 1996) (holding that "in class-action cases involving a limited fund and multiple litigants, the Court is clearly empowered to stay pending state proceedings for purposes of exercising jurisdiction over the class action"); *see also* *Fecht v. Makowski*, 406 F.2d 721, 723 (5th Cir.1969) (in the context of a "limited fund" situation in maritime actions, noting that "[t]he reason ***337** for enjoining state court suits is to distribute effectively a limited fund in a single proceeding").

This particular "limited fund" settlement has a unique aspect that requires the Court's careful consideration. Rather than enjoining litigation brought by individual class members, the claims raised by individual class members have been brought in arbitration under the auspices of FINRA, as provided by their contracts with Capital Financial. As part of its approval of this proposed settlement, the Court would have to enjoin these arbitrations. Such an action would require the Court to utilize its authority under the All Writs Act, and would implicate rights guaranteed by contract, statute, and the Constitution. The class members who have pursued arbitration clearly have a substantive contractual right to arbitration, which is protected by the statutory provisions of the Federal Arbitration Act[12] and the strong federal policy within the court system in favor of arbitration. *E.g.,* *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24, 103 S.Ct. 927, 74 L.Ed.2d 765 (1983); *Jones v. Halliburton Co.*, 583 F.3d 228, 235 (5th Cir.2009). Additionally, this proposed settlement would abridge the due process rights of individual class members because they will be unable to either opt out of the settlement or further pursue their claims through arbitration. The Rules Enabling Act provides that the Federal Rules of Civil Procedure "shall not abridge, enlarge, or modify any substantive right." *Ortiz*, 527 U.S. at 845, 119 S.Ct. 2295 (quoting 28 U.S.C. § 2072(b)); *see also* *Amchem*, 521 U.S. at 613, 117 S.Ct. 2231. Because this proposed settlement abridges the individual investors' contractual and due process right to pursue their claims through arbitration, there is a question as to whether the Court should utilize Rule 23(b)(1)(B) to approve a "limited fund" settlement that abridges this substantive right.

The Court's authority to enjoin competing litigation stems from the All Writs Act. The All Writs Act provides, "The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law." 28 U.S.C. § 1651(a). The Fifth Circuit has instructed that the All Writs Act should be construed narrowly and applied "only under 'such extraordinary circumstances ... that indisputably *demand* such a course of action as absolutely necessary to vouchsafe the central integrity of the federal court

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

judgment.' " *Singh v. Duane Morris LLP*, 538 F.3d 334, 341 (5th Cir.2008) (quoting *Texas v. Real Parties in Interest*, 259 F.3d 387, 395 (5th Cir.2001)).

In approving a "limited fund" settlement, courts are frequently forced to enjoin competing litigation in order to preserve the "limited fund" utilizing their authority under the All Writs Act. *See Holmes*, 1996 WL 904513, at *2; *JESDAL*, 134 F.R.D. at 37 ("The All–Writs Act furnishes additional authority to certify a class action and to stay all pending proceedings."); *Mycka v. Celotex Corp.*, Civ. A. No. 87–2633, 1988 WL 80042, at *4 (D.D.C. July 18, 1988) (in approving "limited fund" class action settlement, "exercis [ing] its jurisdiction under the All Writs Act ... and expressly prohibit[ing] any person from prosecuting any presently pending individual actions or from commencing any new actions against [the settling defendant] seeking recovery for personal injuries," applying such an action to "proceedings pending in both the federal and state courts"). Because use of the "limited fund" device is appropriate when a recovery by one class member "cannot be made without affecting ***338** the proportionate interests of other class members similarly situated," GREER at 77 (citation omitted), a court's enjoining of competing procedures is generally necessary to ensure that the "limited fund" is not depleted and that all class members are treated fairly. *Reserve Fund*, 673 F.Supp.2d at 204.

It is thus clear that federal courts have the power under the All Writs Act to enjoin competing litigation to preserve its jurisdiction over a class action settlement before it, particularly when faced with a "limited fund" situation. *See Liles v. Del Campo*, 350 F.3d 742, 746 (8th Cir.2003) ("Injunctions of related proceedings in other federal courts are appropriate when necessary for adjudication or settlement of a case."); *In re Baldwin–United Corp.*, 770 F.2d 328, 335 (2d Cir.1985) ("Even before a federal judgment is reached, ... the preservation of the federal court's jurisdiction or authority over an ongoing matter may justify an injunction against actions in state court."); *Reserve Fund*, 673 F.Supp.2d at 204 (issuing an injunction of individual class members' litigation under the All Writs Act when "dealing with a limited res that is likely to be dissipated absent an injunction"); *Lucas v. Kmart Corp.*, 234 F.R.D. 688, 697 (D.Colo.2006) ("The Court ... finds it appropriate to preliminarily enjoin members of the [settlement classes] from asserting or pursuing any of the claims to be released pursuant to this settlement in either state or federal court, as numerous other courts have done in connection with preliminary approval of proposed class action settlement.").[13] In *Liles*, the Eighth Circuit explained the benefits of enjoining other proceedings when a "limited fund" exists:

> The district court enjoined proceedings in related litigation to preserve the settlement fund, to eliminate the risk of inconsistent or varying adjudications that would deplete the fund, to avoid

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

> confusion among the class members, and to save scarce judicial resources. The court acted within its discretion in issuing the injunction because enjoining related litigation was necessary to ensure the enforceability of the order approving the preliminary settlement and to prevent further draining of the limited settlement fund. As the district court found, neither settlement nor notification of class members could be achieved if the settlement fund were eaten up by litigation in other courts. Without enjoining related litigation, the court ran the risk of undermining the settlement that had been negotiated and preliminarily approved and of exhausting the only asset available for class recovery. We conclude that the court did not abuse its discretion in enjoining related litigation.
>
> *Liles*, 350 F.3d at 746–47.

All of the interests noted in *Liles* are present in this case, with the sole difference being that the Court here is being asked to enjoin arbitration rather than litigation. The question before the Court, therefore, is whether the Court's authority to enjoin pending proceedings under the All Writs Act in aid of approving a "limited fund" settlement extends to arbitration proceedings. For the reasons stated below, the Court believes that its authority does extend to enjoining arbitrations under these circumstances.

There is no dispute that the individual class members have a substantive contractual right to arbitrate that is supported by provisions of the Federal Arbitration Act. *See* ***339** *In re Piper Funds, Inc.*, 71 F.3d 298, 303 (8th Cir.1995). However, the Court is of the opinion that the guidance provided by *Ortiz* permits the approval of a "limited fund" settlement that would enjoin individual arbitration claims under these circumstances. In *Ortiz*, the Supreme Court noted that a "limited fund" class action settlement under Rule 23(b)(1)(B) created several concerns in light of the Rules Enabling Act and the Constitution, including, as noted above, individual class members' rights to due process and to a jury trial. *Ortiz*, 527 U.S. at 845–47, 119 S.Ct. 2295. Nonetheless, the Supreme Court held that approval of a limited fund settlement was acceptable despite these implications. It is for this very reason that the Supreme Court adopted a narrow interpretation of the "limited fund" device that remained close to the historical model that existed prior to the passage of Rule 23(b)(1)(B). *See* *Ortiz*, 527 U.S. at 845, 119 S.Ct. 2295 ("Even if we assume that some such tension is acceptable under the Rules Enabling Act, it is best kept within tolerable limits by keeping limited fund practice under Rule 23(b)(1)(B) close to the practice preceding its adoption."); *see also* *id.* at 842, 119 S.Ct. 2295 (adopting a "limiting construction [of Rule 23(b)(1)(B) that] finds support in the Advisory Committee's expressions of understanding, minimizes potential conflict with the Rules Enabling Act, and avoids serious constitutional concerns raised by the mandatory class resolution of individual legal claims").[14] *Ortiz* thus acknowledged that a "limited fund" class action settlement provided for by Rule 23(b)(1)(B), which by its nature would abridge the constitutional rights of class members by preventing them

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

from pursuing litigation, *id.* at 845–47, 119 S.Ct. 2295, was permissible in appropriate situations, despite the provision of the Rules Enabling Act that a federal rule shall not abridge any substantive right.

The Court is aware that, despite these authorities, enjoining arbitration presents a different situation than enjoining litigation. Indeed, throughout this litigation, the Court has been urged to follow the Eighth Circuit's decision not to enjoin arbitration proceedings in *In re Piper Funds,* 71 F.3d 298 (8th Cir.1995). In *Piper Funds,* a nonprofit medical corporation, Park Nicollet, hired Piper, a capital management company, to manage its endowment fund. *Id.* at 299. The agreement between Park Nicollet and Piper contained a contractually-agreed arbitration clause, ensuring that all controversies between them should be determined by arbitration in accordance with the rules of the National Association of **Securities** Dealers ("NASD"). *Id.* Piper invested much of Park Nicollet's funds in its own mutual fund, whose shares subsequently lost 20% of their value due to investments in derivatives hit hard by rising interest rates. *Id.* A number of subsequent class actions by investors against Piper were consolidated in the District of Minnesota, raising numerous claims under federal and state **securities** laws and common law claims for misrepresentation and breach of fiduciary duty. *Id.*

In January 1995, Park Nicollet filed a Statement of Claim with the NASD, requesting an arbitration award of $4.5 million. Park Nicollet informed the NASD that it would elect not to participate in the class action, which was at that time uncertified. *Id.* at 300. In February 1995, Piper and the attorneys for the plaintiff class in the case before the District of Minnesota tentatively settled the class action for approximately $70 million. *Id.* On March 2, 1995, Park Nicollet advised the district court that it had chosen to resolve its dispute with Piper by arbitration, and that it had decided to opt out of the class action. *Id.* On March 3, 1995, however, the district court conditionally certified the proposed class, and issued an order under the All Writs Act enjoining all pending proceedings by absent class members, including Park Nicollet's arbitration claim, despite the fact that Park Nicollet had informed the district court that it was opting out of any class action.

***340** On appeal, the Eighth Circuit vacated the district court's order and held that the district court had abused its discretion. The Eighth Circuit noted that a court's exercise of its authority under the All Writs Act must be " 'agreeable to the usages and principles of law,' [28 U.S.C.] § 1651(a), which in this case include the [Federal Arbitration Act] as well as Rule 23." *Piper Funds,* 71 F.3d at 300 n. 2. The Eighth Circuit held that the district court's reason for granting the injunction, preserving a carefully negotiated class settlement agreement, was not a sufficient basis to limit Park Nicollet's contractual right to arbitrate under the FAA. The court determined that "Park Nicollet's contractual and statutory right to arbitrate may not be sacrificed on the altar

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

of efficient class action management." *Id.* at 303.

Some objectors in this case have argued that *Piper Funds* dictates that the Court cannot stay arbitration proceedings under the All Writs Act. However, the Court is convinced that *Piper Funds* does not govern this situation. The proposed settlement in *Piper Funds* did not invoke the "limited fund" mandatory class action settlement device, and allowed class members the opportunity to opt out. Park Nicollet had notified the Court of its desire to opt out of the settlement before the Court had issued its order, and the Eighth Circuit ruled that the district court abused its discretion in preventing Park Nicollet from doing so. *Id.* at 303–04. If the proposed settlement in this case were not a "limited fund" settlement under Rule 23(b)(1)(B) that did not provide for an opportunity to opt out, *Piper Funds* would likely provide the Court with proper guidance. Indeed, when additional funds are available beyond the settlement fund established by a proposed settlement, a court would have no basis to enjoin other proceedings that could access other sources of funds.

In this case, however, the Court has determined that a "limited fund" is present, and class members have no opportunity to opt out of such a settlement under Rule 23(b)(1)(B), in order to ensure that the funds remaining for all claimants were preserved and distributed in a fair and equitable manner. The circumstances in this case are fundamentally different from those faced in *Piper Funds,* and the Court is convinced that they require a different approach. The Eighth Circuit reversed the district court in *Piper Funds* because it determined that the district court's basis for enjoining the arbitration was insufficient. The district court's reasoning for its order enjoining the arbitration was "because an arbitrator's 'ruling on whether or not Piper made fraudulent representations could jeopardize' the 'carefully negotiated' class action settlement." *Id.* at 303. In this case, however, the Court's reasoning and justification for enjoining the arbitrations of class members is very different from the district court's reasoning in *Piper Funds.* Most importantly, the Court's concern here is not to efficiently manage and preserve the class action settlement, but to preserve and ensure the fair distribution of the limited amount of capital available for settlement, which would be depleted regardless of the conclusions of individual arbitrators because of the cost of defending those arbitrations. Indeed, even if Capital Financial emerged victorious from the arbitrations going forward, the "limited fund" would be swiftly depleted by the vast attorneys' fees needed for its defenses in numerous arbitrations. *See Reserve Fund,* 673 F.Supp.2d at 204 (issuing an injunction of individual class members' litigation under the All Writs Act when "dealing with a limited res that is likely to be dissipated absent an injunction"). Therefore, the situation in this case is distinguishable from *Piper Funds.* As the Court has determined that a "limited fund" does exist in this case, there is justification for enjoining arbitration claims brought by other class members.

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

It is true that other cases involving enjoining claims under the "All Writs Act" have largely involved enjoining litigation, not arbitration. *E.g.*, *Liles*, 350 F.3d at 746–47; *Baldwin–United*, 770 F.2d at 337–38; *Reserve Fund*, 673 F.Supp.2d at 204; *Williams*, 237 F.R.D. at 699–700. However, the reasoning behind enjoining other proceedings in a "limited fund" situation is the same regardless of whether those proceedings are litigations or arbitrations. As in *Williams*, "[t]he prosecution of separate actions," regardless of their nature, against Capital Financial ***341** "unquestionably creates a risk of adjudications that, as a practical matter, would be dispositive of the interests of class members not parties to the adjudications or would substantially impair or impede their ability to protect their interests." *Williams*, 237 F.R.D. at 693. The necessary circumstances for a "limited fund" settlement that protects the interests of class members are present, despite the fact that the individual claims are brought in arbitration rather than litigation.

The Court is well aware of oft-noted "federal policy favoring arbitration," *e.g.*, *Moses H. Cone*, 460 U.S. at 24, 103 S.Ct. 927, which provokes serious caution whenever a district court considers enjoining arbitration. Nonetheless, the Court would feel very uncomfortable endorsing a legal structure that allows a court to approve a "limited fund" class action that abridges one's constitutional right to a jury trial, but renders a court powerless to abridge one's contractual right to arbitration under the exact same circumstances. *See In re Painewebber Ltd. P'ships Litig.*, No. 94 CIV. 8547 SHS, 1996 WL 374162, at *4 (S.D.N.Y. July 1, 1996) (holding that "it would be incongruous if the Court had the authority to stay pending litigation, but not to enjoin arbitration, 'in aid of its jurisdiction' even before judgment is entered."). Such a result may imply that a contractually-provided right is more protected than rights provided by the Fifth or Seventh Amendments to the Constitution. As the Supreme Court acknowledged in *Ortiz* that "limited fund" settlements are permissible despite their abridgement of constitutional rights to a jury trial and due process, the Court is of the opinion that the Rules Enabling Act does not foreclose the Court from abridging contractual rights to arbitration.

It is important to note, however, that an exercise of a district court's authority to enjoin arbitration must be limited to situations where it is necessary to do so. The Court would be reluctant to expand its holding to situations beyond the extraordinary circumstances of a "limited fund" settlement where it is necessary to exercise its power under the All Writs Act to ensure a fair and just result for class members, particularly in situations where such an exercise of authority would run counter to the federal policy favoring arbitration. If the Court were considering a non-"limited fund" settlement that provided class members the ability to opt out, the Court would not be willing to "sacrifice" individual class members' contractual right to arbitrate "upon the altar of efficient class action management." *Piper Funds*, 71 F.3d at 303. However, the circumstances faced by the Court in this situation go beyond the

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

desire to promote "efficiency"; instead, the Court is faced with a situation of necessity. Had the Court not enjoined the arbitrations at first, and declined to exercise its authority to permanently enjoin the arbitrations by way of approving this proposed settlement, the proposed "limited fund" would have been depleted, undermining the Court's ability to approve the proposed settlement and ensuring that the vast majority of class members, if not all class members, received nothing. Allowing any competing proceedings to go forward, regardless of their nature, would have interfered with the Court's jurisdiction to consider the settlement before it. Therefore, the Court holds that a federal court's power under the All Writs Act to enjoin competing proceedings by individual class members to protect its jurisdiction over a class action settlement can be exercised over arbitration proceedings when a mandatory "limited fund" situation exists. Such a result is appropriate under the All Writs Act, and is not prevented by the Federal Arbitration Act or the Rules Enabling Act.[15] The objections to the settlement concerning the Court's power under the All Writs Act to enjoin arbitrations, including those of the Bensons and the Slominskis, are accordingly overruled.[16]

*342 V. Appointment of Settlement Class Counsel

Rule 23(g) provides, in relevant part, "(1) Unless a statute provides otherwise, a court that certifies a class must appoint class counsel. In appointing class counsel, the court: (A) must consider: (i) the work counsel has done in identifying or investigating potential claims in the action; (ii) counsel's experience in handling class actions, other complex litigation, and the types of claims asserted in the action; (iii) counsel's knowledge of the applicable law; and (iv) the resources that counsel will commit to representing the class." The Court may also "consider any other matter pertinent to counsel's ability to fairly and adequately represent the interests of the class." Fed.R.Civ.P. 23(g)(1)(B).

Here, all of the aforementioned factors provided by Rule 23(g)(1) support appointing Girard Gibbs LLP and Zwerling, Schachter & Zwerling, LLP as settlement class counsel in this case. Both of these firms have performed substantial work on this action and have substantial experience in class action litigation work. Both firms, through their submissions to the Court, have demonstrated that they have knowledge of the relevant applicable law and that they have and will contribute substantial resources to implementing the proposed settlement. Accordingly, the Court hereby appoints Girard Gibbs LLP and Zwerling Schachter, & Zwerling, LLP as class counsel for purposes of approval of this class action settlement.

Additionally, the parties seek appointment of Sommerman & Quesada, L.L.P., Passman & Jones, P.C., Rochelle McCullough, LLP and Fleming & Associates, L.L.P. as subclass counsel for an "Assigned Claims Subclass" consisting of the claims of those who have assigned their claims to Milo

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Segner, the Liquidating Trustee of the Provident Royalties Liquidating Trust. The Court has reviewed this request, and, being satisfied that the requirements of Rule 23(g) are met, hereby appoint those firms as counsel for Milo Segner, who shall be the representative of this Assigned Claims Subclass.

VI. Notice to Class Members

Rule 23(c)(2)(A) provides, "For any class certified under Rule 23(b)(1) or (b)(2), the court may direct appropriate notice to the class." Rule 23(e)(2) requires the Court "to direct notice in a reasonable manner to all class members who would be bound by the proposal." In this case, notice was provided of this proposed settlement to all class members by first class mail sent out on February 2, 2011. The Court has reviewed the notice and finds it to be in compliance with the relevant provisions of Rule 23(c) and Rule 23(e). The notice clearly provided the nature of the action, the definition of the Settlement Class, the terms of the settlement, the class members' options, including the fact that they could not exclude themselves, the claims, defenses, and issues, and the procedures surrounding the settlement. Class members were further provided with the date of the fairness hearing and were given the opportunity to object to the settlement, which was described in clear terms. *See* Pl.'s Appx., *Stott* Docket No. 4, at 86. The scope of the class and effect of the Court's potential approval of the settlement were clearly explained to the recipients of the notice. Such notice successfully "fairly apprised the prospective members of the class of the terms of the settlement and the options that are open to them," and provided them with "sufficient information for them to make a 'rational decision whether they should intervene in the settlement approval procedure.' " *Maher v. Zapata Corp.*, 714 F.2d 436, 451 (5th Cir.1983) (citation omitted). Accordingly, the requirements of Rule 23(c) and Rule 23(e) as to notice are satisfied, and the Court finds that class members have been given reasonable notice. *In re Dell Inc.*, No. A–06–CA–726–SS, 2010 WL 2371834, at *5 (W.D.Tex. June 11, 2010) (Sparks, J.); *Schwartz v. TXU Corp.*, No. 3:02–CV–2243–K (lead case), 2005 WL 3148350, at *11 (N.D.Tex. Nov. 8, 2005) (Kinkeade, J.).

*343 VII. Whether the Proposed Settlement Satisfies Rule 23(e)

Having determined that the class may be certified under Rule 23(a) and Rule 23(b)(1)(B), the Court now addresses whether the settlement may be approved under Rule 23(e), In regard to a proposed class action settlement, Rule 23(e)(2) provides, "If the proposal would bind class members, the court may approve it only after a hearing and on finding that it is fair, reasonable, and adequate," The Fifth Circuit has provided six factors for district courts to consider in determining if a settlement satisfies the "fair, reasonable, and adequate" standard:

> (1) evidence that the settlement was obtained

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

> by fraud or collusion; (2) the complexity, expense, and likely duration of the litigation; (3) the stage of the litigation and available discovery; (4) the probability of plaintiffs' prevailing on the merits; (5) the range of possible recovery and certainty of damages; and (6) the opinions of class counsel, class representatives, and absent class members.

Newby, 394 F.3d at 301; *Reed v. Gen. Motors Corp.*, 703 F.2d 170, 172 (5th Cir.1983). These factors are commonly referred to as the *Reed* factors, and the Court will address each of them in turn. The Court will also address any objections to the settlement in regard to the *Reed* factor that they relate to for the Court's consideration.

1. Evidence that the Settlement was Obtained by Fraud or Collusion

As to the first factor, there is no evidence that the settlement was obtained by fraud or collusion. This settlement came about when the parties agreed to present it to the Court for certification before no funds whatsoever were available to the class as a whole. It was not a negotiated amount, but the amount remaining from Capital Financial's insurance policy and an amount mandated by FINRA. The proposed settlement also does not favor any class member or group of class members, which also weighs against any evidence of fraud or collusion and in favor of approval. *Vaughn v. Am., Honda Motor Co.*, 627 F.Supp.2d 738, 748 (E.D.Tex.2007) (Ward, J.). The Court thus finds that this factor weighs in favor of approval.

2. Complexity, Expense, and Likely Duration of the Litigation

The second factor addresses the complexity, expense, and likely duration of the litigation. The Court is of the opinion that this factor weighs in favor of approval of the settlement. There is no doubt that this litigation is particularly complex, especially as it implicates not only litigation under **securities** law, which "on the whole is 'notoriously difficult and unpredictable,' " *Dell*, 2010 WL 2371834, at *7 (quoting *Maher*, 714 F.2d at 455), but the intersection of a class action settlement and individual class members' rights to arbitration. Were this litigation to continue, which would almost certainly take a substantial amount of time and effort, the expense of litigating the claims would likely exceed the amount even available for recovery,[17] and the attorneys' fees expended by Capital Financial in defending this suit, as well as numerous arbitration proceedings brought by individual class members, would swiftly deplete any funds available. *See* *Williams*, 237 F.R.D. at 695 (holding this factor to support settlement in a similar situation where pursuit of hundreds of individual claims would result in the defendant's insolvency).

Furthermore, as Judge Sparks remarked in *Dell*, "[**s**]**ecurities** claims are difficult to prove, and without agreeing to a settlement,

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Plaintiffs no doubt face unpredictable and significant delays and expense in prosecuting this case." *Dell,* 2010 WL 2371834, at *7. In the event of a trial, "they would face tall *344 hurdles in establishing the elements of their claims in the district court and convincing the jury of liability and the amount of damages." *Id.* Plaintiffs in this case would have the further unenviable task of surviving a motion for summary judgment, class certification, and an almost-certain appeal. *See DeHoyos,* 240 F.R.D. at 291–92 (holding that the complexity, expense, and likely duration factor to favor approval of the settlement when further proceedings would include class certification, dispositive motions, Rule 23(f) appeal, trial, and further appeals). The Court has little doubt that the amount of time it would take to recover on behalf of class members, many of whom invested substantial portions of their retirement investments in this alleged Ponzi scheme, would measure in years rather than the months contemplated by the parties at this stage were the Court not to approve this settlement. *See Schwartz,* 2005 WL 3148350, at *19 (weighing a potential "delay in the receipt of any relief" in favor of approving a proposed settlement). There is the further possibility that failure to approve the settlement could result in Capital Financial's insolvency and potentially no recovery whatsoever for class members. *See Williams,* 237 F.R.D. at 695 (holding this factor to favor approval of "limited fund" settlement when allowing continued litigation of the class action and competing individual actions would result in no benefits or the loss of benefits to the class because of the defendant's likely resulting insolvency). Considering the potential road ahead for the litigants, and that failure to approve the settlement could result in no recover for any class member at all, the second factor weighs strongly in favor of approving this settlement.

3. Stage of Litigation and Availability of Discovery

The third consideration is the stage of litigation and availability of discovery. This litigation has been ongoing for over two years. This process of approving the proposed settlement has been ongoing since December, and the parties and the Court are very aware of the magnitude of the case and the positions of the parties. Although there has not been a full range of discovery in this case, sufficient information has been disseminated to give the Court and the parties an effective view of the important issues. Additionally, the Court did issue an Order compelling at least some discovery as to individuals' financial information in regard to this proposed settlement. *See* Order, ***Billitteri*** Docket No. 386, at 5–6. In any case, "the lack of [formal discovery] does not compel the conclusion that insufficient discovery was conducted" for the purposes of settlement approval. *Cotton,* 559 F.2d at 1332. At this stage, the Court and the parties "possess ample information with which to evaluate the merits of the competing positions." *Ayers v. Thompson,* 358 F.3d 356, 369 (5th Cir.2004). Accordingly, this factor favors approval of the settlement.

4. Probability of Success on the Merits

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

The Court now addresses the fourth factor of the probability of success on the merits, which the Fifth Circuit has identified as the "most important factor." *Parker v. Anderson*, 667 F.2d 1204, 1209 (5th Cir.1982). "A district court faced with a proposed settlement must compare its terms with the likely rewards the class would have received following a successful trial of this case." *Reed*, 703 F.2d at 172. Here, the Court is of the opinion that the potential result strongly favors approval of the settlement. If the class action had proceeded to trial and the class was to prevail, recovery from Capital Financial, which, as noted at a previous hearing, is perilously undercapitalized, would be extremely difficult. Class members would have to prove not only that the statements contained within the Private Placement Memoranda ("PPM") issued by Provident entities were false, but that Capital Financial knew or should have known of the untruths or omissions within the PPMs. Even if the class were victorious, however, the "likely rewards" to the class would likely be even smaller than what is currently contemplated because Capital Financial would have few assets to fund any award they receive. Furthermore, the costs of litigating this dispute with Capital Financial and the burdens that the class would have to overcome further include surviving renewed motions to dismiss and motions for summary judgment, obtaining ***345** class certification, convincing a jury at trial, and very likely overcoming an eventual appeal. *DeHoyos*, 240 F.R.D. at 291–92. The settlement contemplated here would avoid those costs and difficulties.

This litigation has already seen several broker-dealers, including defendants in the ***Billitteri*** case, cease operations or file for bankruptcy due to the expense of litigating claims. Such experience demonstrates that declining to approve this settlement would severely delay or prevent entirely any recovery on behalf of the class. Instead, approving the settlement at this stage would provide an "immediate and automatic benefit to the class." *Vaughn*, 627 F.Supp.2d at 747. Accordingly, taking these considerations into account, the Court is of the opinion that this factor weighs in favor of approving the settlement.

5. Range of Possible Recovery by the Class

The fifth factor is the range of possible recovery by the class. This factor includes an inquiry into whether the terms of the settlement "fall within *a reasonable range of recovery,* given the likelihood of the plaintiffs' success on the merits." *Klein v. O'Neal, Inc.*, 705 F.Supp.2d 632, 656 (N.D.Tex.2010) (emphasis in original) (quoting *Turner v. Murphy Oil USA, Inc.*, 472 F.Supp.2d 830, 849–50 (E.D.La.2007)). "Under [the range of possible recovery] factor, a court should consider the views of objecting class members when their 'objections to the settlement agreement center on their view that the relief it provides is inadequate.' " *Klein*, 705 F.Supp.2d at 656 (quoting *Ayers*, 358 F.3d at 370).[18] In assessing the potential range of recovery, the Court takes into account the risks involved in the litigation and the potential costs

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

involved, and ultimately considers whether the settlement amount is fair and reasonable and falls within a reasonable range of recovery. *See id.* (citations omitted).

Most of the objections to the settlement are relevant to this factor. Namely, class members largely object to the amount of the recovery, which admittedly amounts to a mere fraction of the losses.[19] The size of the recovery compared to the amount of claims asserted by the class is of deep concern to the Court. However, the Court must take into account the fact that, if this litigation were to continue and the class was to emerge victorious, they would possess a judgment worth millions with no one to collect it from. Furthermore, as the Court has previously noted, continued pursuit of these claims, either by individual class members or class counsel, will ensure the accrual of massive costs and likely deplete any amount available for recovery, with no guarantee that they will be able to succeed in this litigation. *See Williams,* 237 F.R.D. at 695 (approving "limited fund" settlement when "there is a substantial and documented risk that continued litigation of this case and various individual cases would result in [the settling defendant's] insolvency, thus denying class members any increase in policy benefits pursuant to the settlement and a probable loss of existing benefits as they now exist"). This settlement at least provides class members with some measure of recovery, and the Court is of the opinion that the settlement should be approved when the alternative is no recovery at all.

It is worth noting that this settlement does not resolve claims against all of registered representatives; it only releases claims against those who have submitted financial information to the Court. Furthermore, this settlement would not release claims against Capital Financial's parent company, Capital Holdings, against whom claims remain pending in the ***Billitteri*** case. Although this particular settlement only provides class members ***346** with a small percentage of their losses, it is important to note that recovery from individuals not covered by this settlement is still possible, and that class members may be able to obtain an additional recovery from Capital Holdings or individuals not released by this settlement.

Accordingly, there are competing considerations as to the fifth *Reed* factor. The fact that the recovery is only a small percentage of the class members' losses weighs against approval, but the risks involved in the litigation, the class's likelihood of success, the potential for Capital Financial to incur large litigation costs, and the likelihood that not approving the settlement will result in either an unfair recovery or no recovery at all weigh in favor of approval. In light of these considerations, the fifth factor weighs only slightly in favor of approving the settlement.

6. Opinions of Class Counsel, Class Representatives, and Absent Class Members

The final factor is the opinions of class counsel, class representatives, and absent class members. As class counsel tends to be the most familiar with the intricacies of a

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

class action lawsuit and settlement, "the trial court is entitled to rely upon the judgment of experienced counsel for the parties." *Cotton*, 559 F.2d at 1330; *see also Reed*, 703 F.2d at 175. In this case, class counsel has informed the Court that the amount contemplated by this settlement was simply the most that counsel could gather for the class from Capital Financial, and any additional assets were either unavailable or, in the cases of individual officers, directors, and registered representatives, not worth the expense of obtaining. After viewing the information provided to the Court, including financial information about Capital Financial and the relevant individuals who will be released from liability, the Court agrees with this assessment. The amount contemplated appears to have been all that class counsel could obtain for the class, and is an acceptable result particularly when the alternative is nothing at all. In regard to the assets of individual officers, directors, and registered representatives, the Court agrees with class counsel that obtaining their assets, which in many cases are negligible, would cost more than the amount that could possibly be obtained, and releasing those who have provided financial information to the Court from liability should not be an impediment to this "limited fund" settlement. Furthermore, the class representative in this case, Donald Stott, has indicated to the Court his approval of this proposed settlement.

The Court also takes the opinions of the two organized groups of objectors seriously into account. The Campen Intervenors and the Erickson Interveners both sent representatives to the Court's first fairness hearing, and their cogent arguments about whether a "limited fund" exists in this case are what prompted the Court to request further information from the parties to conduct additional analysis of whether a "limited fund" existed in this case. However, one day before the second fairness hearing, both the Campen Intervenors and the Erickson Intervenors withdrew their objections to the proposed settlement. See Notices of Withdrawal, ***Billitteri*** Docket Nos. 484 & 485. The Campen Intervenors later notified the Court of their intention to participate in the settlement, contrary to their previous assertions to the Court. *See* Advisory, *Stott* Docket No. 31. Additionally, counsel for the Provident Royalties Liquidating Trustee, Milo Segner, who also previously objected to the settlement, did not raise his objections at the second fairness hearing, indicating that Segner would support the Court's ultimate decision. The fact that these objectors, despite their previous opposition to the settlement, have withdrawn their objections and indicated their desire to participate in the settlement supports approval of the proposed settlement.

Certain class members, including the Bensons, the Slominskis, the Stanfields, and Meengs, have objected to certain terms of the proposed settlement, including the Court's enjoining of individual arbitrations, the applicability of the "limited fund" doctrine, and the small recovery, which would amount to about 2% to 3% of their investment losses. The "limited fund" arguments were addressed and rejected earlier in this ***347**

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Order. Regarding the contentions that the settlement is inadequate, although the Court is sympathetic to these objectors' circumstances, the Court is convinced that approval of this class action settlement is necessary to ensure a fair and just recovery for the entire class as a whole. Accordingly, the objections that remain in this case are overruled, and the Court finds the sixth factor to weigh in favor of approving the settlement.

* * *

Having assessed the *Reed* factors, the Court finds that the first, second, third, fourth, and sixth factors favor approval. While some of the considerations involved in the fifth factor weigh against the settlement, other considerations in regard to that factor weigh in favor of the settlement. Overall, the fifth factor slightly supports approval. Accordingly, the Court is convinced that the settlement agreement is fair, reasonable, and adequate, and should be approved.

Conclusion

For the reasons outlined above, the Court is of the opinion that this proposed settlement should be granted final approval. The Court is satisfied that it has the authority to enjoin the arbitrations at issue, that a "limited fund" exists in this case, and that the settlement meets all of the requirements of Rule 23. Accordingly, it is ORDERED that the Representative Plaintiff's Motion for Final Approval of Class Action Settlement with Capital Financial Services, Inc. is GRANTED.

The Court hereby ORDERS that all pending and future claims in arbitration and litigation against Capital Financial by members of the class certified in this Order, including but not limited to all pending arbitrations and the Provident Royalties' Liquidating Trustee's claims that were assigned by class members against Capital Financial in the case of *Segner v. Securities America, Inc.*, 3:10–cv–1884–F, are ENJOINED.

The Court shall separately issue an Order detailing the specific terms of the settlement and an Order on the pending motion concerning attorneys' fees. The Court shall also separately issue an Order of Final Judgment pursuant to Rule 58(a).

IT IS SO ORDERED.

APPENDIX A

List of Settling Defendant's Current and Prior Officers, Directors and Registered Representatives Released by the Settlement

Dayton Ault

Larry Bakken

James Batten

Randall Benhke

David Bjork

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

Brian Boppre

James Brinkman

Harry Brown Jr.

John Carlson

Patrick Carney

Jacqueline Case

Carl Davis Jr.

Kala Duncan

Michael Eathorne

Larry Feldkamp

Daniel Flees

Kevin Fox

Robert Galloway

Gary Gent

Kyle Hoffman

Robert Jackson

John Jay John

David Johnson

Lloyd Johnson

Tom Kunkel

Robert Labonte

Jeff Lindsey

Drew MacEwan

Pam McClenney

Kevin Mickan

George Pitra

Theresa O'Clair

*348 John Rose

Joseph Roubik

Anthony Savarese

Robert Scullen

Peter Shurow, Jr.

Peter Shurow, Sr.

Mark Sitter

Bradley Wells

Mark Witt

All Citations

277 F.R.D. 316

Footnotes

1 This Motion was originally pending as Docket No. 213 in *Joseph **Billitteri** v. **Securities America**, Inc.*, 3:09–cv–1568–F. On August 19, 2011, by an Order issued in the ***Billitteri*** case (***Billitteri*** Docket No. 488), pursuant to Federal Rule of Civil Procedure 21, the Court severed all claims by Representative Plaintiff Donald Stott against Capital Financial Services, Inc., creating the above-captioned new cause of action of *Donald Stott v. Capital Financial Services, Inc.*, No. 3:11–cv–

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

2073–F, in the interest of allowing for a more efficient disposition of this matter and entrance of final judgment in regard to the claims contemplated by this Motion.

2 This resolves *Stott* Docket No. 2.

3 On August 8, 2011, class counsel filed a supplemented memorandum in the *Stott* case (*Stott* Docket No. 27) and informed the Court that a mediation had taken place on May 20, 2011, in which a number of parties attempted to reach a settlement with Capital Holdings. That mediation was unsuccessful, but settlement efforts with Capital Holdings appear to be ongoing.

4 The applicability of the $2 million sublimit, as opposed to the $5 million aggregate limit, is discussed later in this Order.

5 The Court also heard arguments about the pending Motion for Attorneys Fees and Reimbursement of Expenses in connection with this proposed settlement (Docket No. 5). The Court shall address this Motion in a separate Order.

6 Drawing upon cases that preceded the adoption of Rule 23(b)(1)(B), the Supreme Court described the traditional bounds of a mandatory "limited fund" settlement, and explained that its opinion sought to "keep[ ] limited fund practice under Rule 23(b)(1)(B) close to the practice preceding its adoption." *Ortiz*, 527 U.S. at 845, 119 S.Ct. 2295. The Supreme Court therefore adopted a narrow interpretation of Rule 23(b)(1)(B). *Id.* at 838–41, 119 S.Ct. 2295; *see also In re Simon II Litig.*, 407 F.3d 125, 137 (2d Cir.2005) ("While neither the Rule itself, nor the Advisory Notes accompanying it, purports to delineate the outer limits of the Rule's application in the particular subset of 'limited fund' cases, the Supreme Court in *Ortiz* has read the 'limited fund' case as being moored to the Rule's historical antecedents...."); *In re Telectronics Pacing Sys., Inc.*, 221 F.3d 870, 877 (6th Cir.2000) ("*Ortiz* confirmed that a literal reading of the Rule is inappropriate and that mandatory class treatment is to be confined to a narrow category of cases.").

7 While not raised by the parties, the Court does note that failure to approve this settlement would almost certainly result in Capital Financial's bankruptcy or intervention of FINRA regulators. This action would certainly force FINRA, a bankruptcy court, and others to invest substantial time and public resources in liquidating or overseeing Capital Financial, and would certainly delay any recovery by class members. While this is not directly relevant to the issues raised under Rule 23(b)(1)(B), the costs to the public that would result from not approving this settlement which would be substantial. *See Williams*, 237 F.R.D. at 693 (noting ALDOI's contention that failing to approve the "limited fund" settlement before the district court "could require that ALDOI place [the defendant] under supervision or in receivership"). This does not, of course, weigh in favor of or against approval of the settlement, but the Court is well aware of the implications of this settlement beyond the members of the class.

8 While *Baker* is an unpublished decision, and is therefore not binding upon this Court, *see* 5th Cir. R. 47.5, the Court nonetheless finds it persuasive and applicable to this situation. *See Rivera v. PNS Stores, Inc.*, 647 F.3d 188, 197 n. 33 (5th Cir.2011) (noting an unpublished decision's nonbinding nature but "find[ing] its reasoning persuasive").

9 The Court notes that, in support of applying a "limited fund" theory, the district court in *Holmes v. Trustmark Nat'l Bank*, No. CIV.A. 195–CV–323 GR, 1996 WL 904513, at *2 (S.D.Miss. Jan. 11, 1996), cited *Allen v. R & H Oil & Gas Co.*, 63 F.3d 1326, 1334 (5th Cir.1995), for the proposition that "multiple awards of exemplary damages in class action suits ... should not be so oppressive that they amount to destruction of the wrongdoers." *Holmes*, 1996 WL 904513, at *2. While the Court acknowledges that *Allen* was discussing punitive damages, which are not at issue here, the Court reads and applies *Allen* as *Holmes* did, supporting a "limited fund" theory when, as here, individual adjudications would entirely deplete the fund, leave Capital Financial out of business, and provide many class members with no ability to recover whatsoever.

10 The Court further notes that this settlement does not necessarily mean that class members have no other sources of recovery. Although Capital Financial will remain in operation, this settlement does not release the parent company, Capital Holdings, from liability. Indeed, Capital Holdings remains a defendant in the original ***Billitteri*** action, and recent filings indicate that settlement discussions regarding Capital Holdings took place in May of 2011 and are continuing as this litigation proceeds. Furthermore, this settlement does not release from liability those individual registered representatives who have not submitted their financial information to the Court for review. *See* Appendix A to this Order.

11 The Court also notes that, although the Campen Intervenors have since withdrawn their objection to approval of this settlement, this argument about releasing claims against individual registered representatives was the basis of Donald and Marva Latimer's objection to preliminary approval the settlement, filed on January 11, 2011. Opposition, ***Billitteri*** Docket No. 185, at 1. The Latimers did not object to settling with Capital Financial, but wished to pursue their claims against the two individual registered representatives who sold Provident **securities** to them, John Harper and Michael Boyer. Harper and Boyer did not submit their financial information to the Court, and thus are not released by the settlement. Accordingly, because the Latimers may still pursue claims against Harper and Boyer, their objection does not apply to the terms of this settlement, and it does not stand in the way of the Court's approval of the settlement. Notably, however, Jac and Judith Slominski's letter of February 24, 2011 objects to the enjoining of their claims against Larry Bakken, a former Capital Financial registered representative who is released by the terms of this settlement. However, as

WESTLAW © 2019 Thomson Reuters. No claim to original U.S. Government Works.

noted above, the Court is of the opinion that this objection should not prevent approval of the settlement, and is therefore overruled.

* * *

12 The arbitrations initiated by individual class members against Capital Financial and certain of its registered representatives were provided for in the individual class members' contracts. The Federal Arbitration Act provides in relevant part,

> If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement.

9 U.S.C. § 3. This case does not involve referring any issues before the Court to arbitration, but staying arbitrations that have already commenced.

13 This authority allows the Court to enjoin competing litigation brought by the Provident Royalties Liquidating Trustee, Milo Segner, against Capital Financial in a related case before this Court, *Segner v.* ***Securities America****, Inc.*, 3:10–cv–1884–F, which was originally brought in Bankruptcy Court before the reference was withdrawn on November 23, 2010. Although the Liquidating Trustee is not a party to this action, he is asserting claims that were assigned by members of the settlement class, and the Court has the authority under the All Writs Act to "enjoin and bind non-parties to an action when needed to preserve the Court's ability to reach or enforce its decision in a case over which it has proper jurisdiction." *United States v. Int'l Bhd. of Teamsters*, 266 F.3d 45, 50 (2d Cir.2001); *see also In re Lease Oil Antitrust Litig. No. II*, 48 F.Supp.2d 699, 707 n. 8 (S.D.Tex.1998) (Jack, J.) (noting that "a federal court even has the power to enjoin non-parties under the All Writs Act in certain circumstances"). The scope of the Court's Order shall thus include enjoining claims against Capital Financial by the Liquidating Trustee that were assigned by class members in the *Segner* action.

14 The Court further notes that *Ortiz* made clear that the idea of a "limited fund" settlement was not created by Rule 23(b)(1)(B); the Rule merely "intended ... to capture the 'standard' class actions recognized in pre-Rule practice." *Ortiz*, 527 U.S. at 843, 119 S.Ct. 2295 (quoting Benjamin Kaplan, *Continuing Work of the Civil Committee: 1966 Amendments to the Federal Rules of Civil Procedure (I)*, 81 HARV. L.REV. . 356, 394 (1967)).

15 The Court notes that it need not address the Rule 23(b)(3) requirements of predominance and superiority in its consideration of this proposed settlement, which was brought under Rule 23(b)(1)(B) rather than Rule 23(b)(3). *See In re Schering Plough Corp. ERISA Litig.*, 589 F.3d 585, 604 (3d Cir.2009) (holding that "there is no predominance or superiority requirement" when a district court is considering a Rule 23(b)(1)(B) class certification).

16 In their objection, the Slominskis note that they have raised claims against several other entities unrelated to Capital Financial in their arbitration proceeding regarding non-Provident-related **securities**. This Order shall not affect their right to pursue claims against entities other than Capital Financial.

17 As an example, the Court recently approved a proposed class action settlement with three other defendants in this litigation, which required a similar amount of work by class counsel. In that instance, the amount of attorneys' fees based on the hourly rate, or the lodestar calculation, amounted to over $9 million, and the total amount of attorneys' fees after applying the *Johnson* factors and other relevant standards was over $18 million. *See* Order Granting Class Counsel's Motion for Attorneys' Fees and Reimbursement of Expenses, ***Billitteri*** (3:09–cv–1568–F) Docket No. 473, at 18–19. Either amount would obviously dwarf the entire amount of the settlement contemplated here.

18 Three class members, Terry and Carolyn Stanfield and Christine Meengs, had two different objections to the settlement: (1) the applicability of the "limited fund" doctrine, and (2) the amount of attorneys' fees. Stanfield Objection, ***Billitteri*** Docket No. 255, at 1–2; Meengs Objection, ***Billitteri*** Docket No. 262, at 1–2. The first of these objections was addressed in the substantive section of this Order addressing Rule 23(b)(1)(B). The second objection shall be addressed in a separate order regarding class counsel's motion for attorneys' fees.

19 The amount of the recovery for class members has been estimated at about 2 to 3 percent of the each individual class member's total losses.

End of Document

© 2019 Thomson Reuters. No claim to original U.S. Government Works.

EXHIBIT D

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

JEROME TREADWELL, individually, and on behalf of all others similarly situated,	)	
Plaintiff,	)	**Case No. 2018-CH-13574**
v.	)	
POWER SOLUTIONS INTERNATIONAL, INC., and NOVATIME TECHNOLOGY, INC.,	)	
Defendants.	)	

PLAINTIFF'S MOTION FOR CLASS CERTIFICATION AND REQUEST FOR DISCOVERY ON CERTIFICATION ISSUES

Plaintiff Jerome Treadwell ("Plaintiff") alleges that Defendants Power Solutions International, Inc. ("Power Solutions") and NOVAtime Technology, Inc. ("NOVAtime") (collectively, "Defendants"), systematically violated the Biometric Information Privacy Act ("BIPA") 740 ILCS 14/1, *et seq.* This case is well suited for class certification pursuant to 735 ILCS 5/2-801. Specifically, Plaintiff seeks to certify a class consisting of hundreds of former and current similarly-situated employees who worked for Power Solutions in the State of Illinois who had their fingerprints unlawfully collected, captured, received, otherwise obtained, or disclosed by Defendants during the applicable statutory period in violation of BIPA. The question of liability is a legal question that can be answered in one fell swoop. As Plaintiff's claims and the claims of similarly-situated individuals all arise from Defendants' uniform policies and practices, they satisfy the requirement of 735 ILCS 5/2-801 and should be certified.

Plaintiff moves for class certification to protect members of the proposed class, individuals whose proprietary and legally protected personal and private biometric data was

invaded by Defendants. Plaintiff believes that the evidence and argumentation submitted within this motion are sufficient to allow the class to be certified now. However, in the event the Court (or Defendants) wishes for the parties to undertake formal discovery prior to the Court's consideration of this motion, Plaintiff requests that the Court allow him to supplement his briefing and defer the response and reply deadlines.

I. RELEVANT BACKGROUND

A. The Biometric Information Privacy Act

Major national corporations started using Chicago and other locations in Illinois in the early 2000s to test "new [consumer] applications of biometric-facilitated financial transactions, including finger-scan technologies at grocery stores, gas stations, and school cafeterias." 740 ILCS 14/5(c). Given its relative infancy, an overwhelming portion of the public became wary of this then-growing, yet unregulated, technology. *See* 740 ILCS 14/5.

The Biometric Information Privacy Act, 740 ILCS 14/1, *et seq.* was enacted in 2008, arising from concerns that these experimental uses of finger-scan technologies created a "very serious need of protections for the citizens of Illinois when it comes to biometric information." Illinois House Transcript, 2008 Reg. Sess. No. 276. Under the Act, it is unlawful for a private entity to, among other things, "collect, capture, purchase, receive through trade, or otherwise obtain a person's or a customer's biometric identifiers or biometric information unless it first:

> (1) Informs the subject . . . in writing that a biometric identifier or biometric information is being collected or stored;
>
> (2) Informs the subject . . . in writing of the specific purpose and length of term for which a biometric identifier or biometric information is being collected, stored, and used; and
>
> (3) Receives a written release executed by the subject of the biometric identifier or biometric information."

740 ILCS 14/15(b).

Although there may be benefits with using biometrics in the workplace, there are also serious risks. Unlike ID badges or time cards – which can be changed or replaced if stolen or compromised – fingerprints are a unique, permanent biometric identifier associated with each individual. These biometrics are biologically unique to the individual; once compromised, the individual has ***no*** means by which to prevent identity theft, unauthorized tracking, or other unlawful or improper use of this information. This exposes individuals to serious and irreversible privacy risks. For example, if a biometric database is hacked, breached, or otherwise exposed – as in the recent Yahoo, eBay, Equifax, Uber, Home Depot, MyFitnessPal, Panera, Whole Foods, Chipotle, Omni Hotels & Resorts, Trump Hotels, and Facebook/Cambridge Analytica data breaches, to name a few – individuals have no means to prevent the misappropriation and theft of their proprietary biometric makeup. Thus, recognizing the need to protect its citizens from harms like these, Illinois enacted BIPA specifically to regulate the collection, use, safeguarding, handling, storage, retention, and destruction of biometric identifiers and information.

A. Factual Allegations

Plaintiff Jerome Treadwell filed this class action against Defendants on October 30, 2018, to redress Defendants' unlawful collection, use, storage, and disclosure of biometric information of Power Solutions employees under BIPA. In his Class Action Complaint, Treadwell provided detailed allegations that Power Solutions employees were and continue to be universally required to scan their fingerprints for enrollment in an employee database(s) as a condition of their employment, but are not: (1) informed in writing of the purpose(s) and length of time for which fingerprint data is being collected, stored, used, and disseminated by Defendants; (2) provided a publicly available retention schedule or guidelines for permanent destruction of the biometric

data by Defendants; and (3) provided (nor did they execute) a written release for Defendants, as required by BIPA. *See* Compl. ¶¶ 11-12.

Treadwell has been working as a production assembler for Power Solutions since April 2018. *Id.* ¶ 53. As a condition of employment, Treadwell was required to scan his fingerprint so Power Solutions could use it as an authentication method to track his time worked. *Id.* ¶ 54. Power Solutions subsequently stored Treadwell's fingerprint data in its NOVAtime employee database. *Id.* ¶ 55. Treadwell was required to scan his fingerprint each time he began and ended his workday. *Id.* ¶ 56. However, Defendants failed and continue to fail to inform Power Solutions employees, including Treadwell, of the extent of the purposes for which they collect individuals' sensitive biometric data or to whom the data is disclosed. *Id.* ¶¶ 11, 12, 44, 45, 50, 57. Defendants similarly failed to provide Power Solutions employees, including Treadwell, with a written, publicly available policy identifying their retention schedule and guidelines for permanently destroying individuals' fingerprint data when the initial purpose for collecting or obtaining their fingerprint is no longer relevant, as required by BIPA. *Id.* ¶¶ 11-12, 15, 46, 48, 50, 58, 63, 95, 97, 105. Employees, including Treadwell, have no knowledge when they leave the company of when – if ever – their biometric identifiers will be removed from Defendants' database(s). *Id.* ¶ 48-49. Power Solutions employees are not told what might happen to their biometric data if and when Defendants merge with another company or, worse, if and when Defendants' entire businesses fold. *Id.* Because Defendants neither publish a BIPA-mandated data retention policy nor disclose the purposes for their collection of biometric data, employees, including Treadwell, have no idea whether any Defendant sells, discloses, re-discloses, or otherwise disseminates their biometric data. *Id.* Nor are employees told to whom any Defendant currently discloses their biometric data or what might happen to their biometric data in the event

of a merger or a bankruptcy. *Id.* Finally, Defendants never secured a written release executed by any of Power Solutions' employees, including Treadwell, permitting them to collect, store, use, and disseminate employees' biometric data, as required by BIPA. *Id.* ¶¶ 11-12, 15, 46, 48, 50, 58, 63, 95, 97, 105.

Accordingly, Defendants' practices violated BIPA. As a result of Defendants' violations, Plaintiff and similarly-situated individuals were subject to Defendants' common and uniform policies and practices and were victims of their schemes to unlawfully collect, store, use, and disseminate Power Solutions employees' biometric data in direct violation of BIPA. As a result of Defendants' violations of BIPA, Plaintiff and all other similarly-situated individuals suffered an invasion of privacy and other damages.[1]

Plaintiff now seeks class certification for the following similarly-situated individuals, defined as:

> All individuals working for Power Solutions in the State of Illinois who had their fingerprints collected, captured, received, or otherwise obtained or disclosed by any Defendant during the applicable statutory period.

Given Defendants' standard practices defined above and the straightforward and common legal questions presented in this case, Plaintiff now moves for class certification. Notably, this motion is being filed shortly after the Complaint was filed and before any Defendant has responded. The parties have not discussed settlement, neither settlement offers nor demands have

---

[1] BIPA does not require Plaintiff and the putative class to have suffered actual damages. Nonetheless, Plaintiff and the putative class have suffered an invasion of a legally protected interest when Defendants secured their personal and private biometric data at a time when they had no right to do so, an invasion of Plaintiff's and the putative Class's right to privacy; an informational injury because Defendants did not provide them with information to which they were entitled by statute; and mental anguish when contemplating what would happen to their biometric data if and when Defendants go out of business, whether Defendants will ever delete their biometric information, and whether (and to whom) Defendants share their biometric information.

been made, and a scheduling order has not been issued. For the reasons discussed herein, Plaintiff's request should be granted.

II. STANDARD FOR CLASS CERTIFICATION

"The basic purpose of a class action is the efficiency and economy of litigation." *CE Design Ltd. v. C & T Pizza, Inc.*, 2015 IL App. (1st) 131465, ¶ 9 (Ill. App. Ct. May 8, 2015) (citing *Miner v. Gillette Co.*, 87 Ill. 2d 7, 14 (1981)). "In determining whether to certify a proposed class, the trial court accepts the allegations of the complaint as true and should err in favor of maintaining class certification." *CE Design Ltd.*, 2015 IL App. (1st) 131465, ¶ 9 (citing *Ramirez v. Midway Moving & Storage, Inc.*, 378 Ill. App. 3d 51, 53 (2007)). Under Section 2-801 of the Code of Civil Procedure, a class may be certified if the following four requirements are met:

> (1) the class is so numerous that a joinder of all members is impracticable;
>
> (2) there are questions of fact or law common to the class that predominate over any questions affecting only individual members;
>
> (3) the representative parties will fairly and adequately protect the interest of the class; and
>
> (4) the class action is an appropriate method for the fair and efficient adjudication of the controversy.

See Smith v. Illinois Cent. R.R. Co., 223 Ill. 2d 441, 447 (2006) (citing 735 ILCS 5/2-801). Notably, "[a] trial court has broad discretion in determining whether a proposed class meets the requirements for class certification." *CE Design Ltd.*, 2015 IL App. (1st) 131465, ¶ 9 (citing *Ramirez*, 378 Ill. App. 3d at 53). Here, the allegations and facts in this case amply demonstrate that the four certification factors are met.

III. ARGUMENT

Plaintiff's claims here are especially suited for class certification because Defendants treated all Power Solutions employees identically for the purposes of applying BIPA. All of the putative class members in this case were uniformly subjected to the same illegal and unlawful collection, storage, use, and dissemination of their biometric data that was required as a condition of employment throughout the class period. Plaintiff meets each of the statutory requirements for maintenance of this suit as a class action. Thus, the class action device is ideally suited and is far superior to burdening the Court with many individual lawsuits to address the same issues, undertake the same discovery, and rely on the same testimony.

A. The Class Is So Numerous That Joinder of All Members Is Impracticable.

Numerosity is not dependent on a plaintiff setting forth a precise number of class members or a listing of their names. *See Cruz v. Unilock Chicago*, 383 Ill. App. 3d 752, 771 (2d Dist. 2008) ("Of course, plaintiffs need not demonstrate a precise figure for the class size, because a good-faith, non-speculative estimate will suffice; rather, plaintiffs need demonstrate only that the class is sufficiently numerous to make joinder of all of the members impracticable.") (internal citations omitted); *Hayna v. Arby's, Inc.*, 99 Ill. App. 3d 700, 710-11 (1st Dist. 1981) ("It is not necessary that the class representative name the specific individuals who are possibly members of the class."). Courts in Illinois generally find numerosity when the class is comprised of at least 40 members. *See Wood River Area Dev. Corp. v. Germania Fed. Sav. Loan Ass'n*, 198 Ill. App. 3d 445, 450 (5th Dist. 1990).

In the present case, there can be no serious dispute that Plaintiff meets the numerosity requirement. The class of potential plaintiffs is sufficiently large to make joinder impracticable.[2] As a result of Defendants' violations of BIPA, Plaintiff and all similarly-situated individuals

[2] Upon information and belief, Power Solutions employs hundreds of workers, many of whom are members of the class.

were subjected to Defendants' common and uniform policies and practices and were victims of Defendants' schemes to unlawfully collect, store, use, and disseminate their extremely personal and private biometric data in direct violation of BIPA. As a result of Defendants' violations of the Act, Plaintiff and all other similarly-situated individuals suffered an invasion of privacy as well as informational and personal injury. The precise number in the class cannot be determined until discovery records are obtained from Defendants. Nevertheless, class membership can be easily determined by reviewing Defendants' records. A review of Defendants' files regarding the collection, storage, use, and dissemination of Power Solutions employees' biometric data performed during the class period is all that is needed to determine membership in Plaintiff's proposed class. *See e.g., Chultem v. Ticor Title Ins. Co.*, 401 Ill. App. 3d 226, 233 (1st Dist. 2010) (reversing Circuit Court's denial of class certification and holding that class was certifiable over defendant's objection that "the proposed class was not ascertainable, because the process of reviewing defendant's transaction files to determine class membership would be burdensome"); *Young v. Nationwide Mut. Ins. Co.*, 693 F.3d 532, 539-40 (6th Cir. 2012)[3] (rejecting the argument that manual review of files should defeat certification, agreeing with district court's reasoning that, if manual review was a bar, "defendants against whom claims of wrongful conduct have been made could escape class-wide review due solely to the size of their businesses or the manner in which their business records were maintained," and citing numerous courts that are in agreement, including *Perez v. First Am. Title Ins. Co.*, 2009 WL 2486003, at *7 (D. Ariz. Aug. 12, 2009) ("Even if it takes a substantial amount of time to review files and determine who is eligible for the [denied] discount, that work can be done through discovery")).

---

[3] "Section 2-801 is patterned after Rule 23 of the Federal Rules of Civil Procedure and, because of this close relationship between the state and federal provision, 'federal decisions interpreting Rule 23 are persuasive authority with regard to questions of class certification in Illinois.'" *Cruz*, 383 Ill. App. 3d at 761 (quoting *Avery v. State Farm Mutual Automobile Insurance Co.*, 216 Ill.2d 100, 125 (2005)).

Once Defendants' records are obtained, the Court will know the precise number of persons affected.

Absent certification of this class action, Power Solutions employees may never know that their legal rights have been violated, and as a result, may never obtain the redress to which they are entitled under BIPA. Illinois courts have noted that denial of class certification where members of the putative class have no knowledge of the lawsuit may be the "equivalent of closing the door of justice" on the victims. *Wood River Area Dev. Corp. v. Germania Fed. Sav. & Loan Assn.*, 198 Ill.App.3d 445, 452 (5th Dist. 1990). Further, recognizing the need to protect its citizens from harms such as identity theft, Illinois enacted BIPA specifically to regulate the collection, use, safeguarding, handling, storage, retention, and destruction of biometric identifiers and information. A class action would help ensure that Plaintiff and all other similarly-situated individuals have a means of redress against Defendants for their widespread violations of BIPA.

B. Common Questions Of Law And Fact Exist That Predominate Over Any Questions Solely Affecting Individual Members Of The Class.

Courts analyze commonality and predominance under Section 2-801 by identifying the substantive issues that will control the outcome of the case. *See Bemis v. Safeco Ins. Co. of Am.*, 407 Ill. App. 3d 1164, 1167 (5th Dist. 2011); *Cruz*, 383 Ill. App. 3d at 773. The question then becomes whether those issues will predominate and whether they are common to the class, meaning that "favorable adjudication of the claims of the named plaintiffs will establish a right of recovery in other class members." *Cruz*, 383 Ill. App. 3d at 773. As stated by the Court of Appeals, the question is will "common . . . issues be the subject of the majority of the efforts of the litigants and the court[?]" *Bemis*, 407 Ill. App. 3d at 1168. The answer here is "yes."

At the heart of this litigation is Defendants' culpable conduct under BIPA. The issues are simple and straightforward legal questions that plainly lend themselves to class-wide resolution.

Notwithstanding the clear and unequivocal requirements of the law, Defendants disregarded Plaintiff's and other similarly-situated individuals' statutorily-protected privacy rights and unlawfully collected, stored, used, and disseminated their biometric data in direct violation of BIPA. Specifically, Defendants have violated and continues to violate BIPA because they failed and continue to fail to: (1) inform Plaintiff or the putative class in writing of the specific purpose(s) and length of time for which their fingerprints were being collected, stored, used, and disseminated as required by BIPA; (2) provide a publicly available retention schedule and guidelines for permanently destroying Plaintiff's and the putative class's fingerprints, as required by BIPA; and (3) receive a written release from Plaintiff or the putative class to collect, capture, use or otherwise obtain their fingerprints, as required by BIPA. Defendants treated the entire proposed class in precisely the same manner, resulting in identical violations of BIPA. These common practices create common issues of law and fact. In fact, the legality of Defendants' collection, storage, use, and dissemination of Power Solutions employees' biometric data is the focus of this litigation.

Indeed, once this Court determines whether Defendants' practices of collecting, storing, and using individuals' biometric data without adhering to the specific requirements of BIPA constitutes violations thereof, liability for the claims of class members will be determined in one stroke. The material facts and issues of law are substantially the same for the members of the class, and therefore these common issues could be tried such that proof as to one claimant would be proof as to all members of the class. This alone establishes predominance. The only remaining questions will be whether Defendants' violations caused members of the class to suffer damages and the proper measure of damages and injunctive relief, which in and of themselves are questions common to the class. Accordingly, a favorable adjudication of the Plaintiff's claims in

this case will establish a right of recovery to all other class members, and thus the commonality and predominance requirements weigh in favor of certification of the class.

C. The Named Plaintiff And Class Counsel Are Adequate Representatives Of The Class.

When evaluating adequacy, courts look to whether the named plaintiff has the same interests as those of the class and whether he or she will fairly represent them. *See CE Design Ltd.*, 2015 IL App. (1st) 131465, ¶ 16. In this case, Plaintiff's interest arises from statute. The class representative, Jerome Treadwell, is a member of the proposed class and will fairly and adequately protect the class's interests. Plaintiff, as a condition of employment, was required to have his fingerprints scanned for both accountability and time tracking purposes. Defendants subsequently stored Plaintiff's fingerprints in their database(s). Plaintiff has never been informed of the specific limited purposes (if any) or length of time for which any Defendant collected, stored, used, or disseminated his biometric data. Plaintiff has never been informed of any biometric data retention policy developed by any Defendant, nor has he ever been informed whether any Defendant will ever permanently delete his fingerprints. Finally, Plaintiff has never been provided, nor did he ever sign, a written release allowing any Defendant to collect, store, use, or disseminate his fingerprints. Thus, Plaintiff was a victim of the same uniform policies and practices of Defendants as the individuals he seeks to represent and is not seeking any relief that is potentially antagonistic to other members of the class. What is more, Plaintiff has the interests of those class members in mind, as demonstrated by his willingness to sue on a class-wide basis and step forward as the class representative, which subjects him to discovery. (*See* Exhibit A – Affidavit of Jerome Treadwell). This qualifies him as a conscientious representative plaintiff and satisfies the adequacy of representation requirement.

Proposed Class Counsel, Stephan Zouras, LLP, will also fairly and adequately represent the class. Proposed Class Counsel are highly qualified and experienced attorneys. (*See* Exhibit B – Affidavit of Andrew C. Ficzko and the Firm Resume attached thereto as Exhibit 1). Stephan Zouras, LLP, are recognized attorneys in class action lawsuits and have been designated as class counsel in numerous class actions in state and federal courts. (*See* Exhibit B, Exhibit B-1). Thus, proposed Class Counsel, too, are adequate and have the ability and resources to manage this lawsuit.

D. A Class Action Is The Appropriate Method For Fair And Efficient Adjudication Of This Controversy.

Finally, a class action is the most appropriate method for the fair and efficient adjudication of this controversy, rather than bringing individual suits which could result in inconsistent determinations and unjust results. "It is proper to allow a class action where a defendant is alleged to have acted wrongfully in the same basic manner toward an entire class." *P.J.'s Concrete Pumping Service, Inc. v. Nextel West Corporation*, 345 Ill. App. 3d 992, 1003 (2d Dist. 2004). "The purported class representative must establish that a successful adjudication of its individual claims will establish a right of recovery or resolve a central issue on behalf of the class members." *Id.*

Here, Plaintiff's claim stems from Defendants' common and uniform policies and practices, resulting in common violations of BIPA for all members of the class. Thus, class certification will obviate the need for unduly duplicative litigation that might result in inconsistent judgments concerning Defendants' practices. *Wenthold v. AT&T Technologies, Inc.*, 142 Ill. App. 3d 612 (1st Dist. 1986). Without a class, the Court would have to hear dozens, if not hundreds, of additional individual cases raising identical questions of liability. Moreover, class members are better served by pooling resources rather than attempting to litigate

individually. *CE Design Ltd.*, 2015 IL App. (1st) 131465, ¶¶ 28-30 (certifying TCPA class where statutory damages were alleged and rejecting arguments that individual lawsuits would be superior). In the interests of justice and judicial efficiency, it is desirable to concentrate the litigation of all class members' claims in a single forum. For all of these reasons, the class action is the most appropriate mechanism to adjudicate the claims in this case.

E. In The Event The Court Or Defendants Seeks More Factual Information Regarding This Motion, The Court Should Allow Supplemental And Deferred Briefing Following Discovery.

There is no meaningful need for discovery for the Court to certify a class in this matter; Defendants' practices and policies are uniform. If, however, the Court wishes for the Parties to engage in discovery, the Court should keep the instant motion pending during the discovery period, allow Plaintiff a supplemental brief, and defer Defendants' response and Plaintiff's reply. Plaintiff is moving as early as possible for class certification in part to avoid the "buy-off problem," which occurs when a defendant seeks to settle with a class representative on individual terms in an effort to moot the class claims asserted by the class representative. Plaintiff is also moving for class certification now because the class should be certified, and because no meaningful discovery is necessary to establish that fact. The instant motion is far more than a placeholder or barebones memorandum. Rather, Plaintiff's full arguments are set forth based on the facts known at this extremely early stage of litigation. Should the Court wish for more detailed factual information, the briefing schedule should be extended.

IV. Conclusion

For the reasons stated above, Plaintiff respectfully requests that the Court enter an Order: (1) certifying Plaintiff's claims as a class action; (2) appointing Plaintiff Jerome Treadwell as Class Representative; (3) appointing Stephan Zouras, LLP as Class Counsel; and (4) authorizing

court-facilitated notice of this class action to the class. In the alternative, this Court should allow discovery, allow Plaintiff to supplement this briefing, and defer response and reply briefs.

Date: 2/18/2019

Respectfully Submitted,

/s/ Andrew C. Ficzko

Ryan F. Stephan
James B. Zouras
Andrew C. Ficzko
STEPHAN ZOURAS, LLP
100 North Riverside Plaza
Suite 2150
Chicago, Illinois 60606
312.233.1550
312.233.1560 *f*
Firm ID: 43734
aficzko@stephanzouras.com

ATTORNEYS FOR PLAINTIFF

EXHIBIT E

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF IOWA
CEDAR RAPIDS DIVISION

JON HANSON, Individually and On Behalf of All Others Similarly Situated, Plaintiff, v. BERTHEL FISHER & COMPANY FINACIAL SERVICES, INC. and THOMAS JOSEPH BERTHEL Defendant.	No. 1:13-CV-67 **LRR** **JSS**

PLAINTIFF'S MOTION FOR CLASS CERTIFICATION AND TO STAY RESOLUTION PENDING CLASS DISCOVERY

Consistent with F.R.C.P. 23(a) and 23(b)(3), Plaintiff moves to certify the following class pending class discovery:

> **Primary Rule 23(b)(3) Class:**
> All persons and entities that purchased, subscribed and paid for, or otherwise acquired securities in the TNP 2008 Scheme pursuant to the TNP 2008 Scheme offering between December 2008 and March 2010.

Excluded from the class are: (1) any individuals who signed an agreement with Berthel Fisher pursuant to which they must arbitrate claims against Berthel Fisher, arising out of the sales of TNP 2008 Scheme notes, in FINRA arbitration; (2) Defendants; any judge or judicial officer who may hear any aspect of this case and his or her law clerks; and (3) any person, firm, trust, corporation, or other entity related to or affiliated with Defendants.

For the reasons more fully described in Plaintiff's accompanying Memorandum in Support of its Motion for Class Certification and to Stay Resolution Pending Class Discovery,

Plaintiff is filing its Motion for Class Certification to protect its rights and the rights of putative class members in light of the Seventh Circuit's ruling in *Damasco v. Clearwire Corp.*[1]

Plaintiff respectfully requests that this Honorable Court enter an order certifying the class described, appointing Plaintiff as class representative and its counsel as class counsel, and ordering all further relief as the Court deems appropriate but only *after* Plaintiff has completed the discovery necessary for drafting a more expressive class-certification motion and supporting memorandum for the Court's consideration.

Dated: May 30, 2014

Respectfully submitted,

/s/ J. Barton Goplerud

J. Barton Goplerud (AT0002983)
HUDSON, MALLANEY, SHINDLER & ANDERSON, PC
5015 Grand Ridge Drive, Suite 100
West Des Moines, Iowa 50265-5749
Telephone: (515) 223-4567
Facsimile: (515) 223-8887
E-mail: jbgoplerud@hudsonlaw.net

Alan L. Rosca (*pro hac vice*)
PEIFFER, ROSCA, ABDULLAH, CARR & KANE, LLC
526 Superior Avenue, Suite 1255
Cleveland, Ohio 44114
Telephone: (216) 570-0097
Facsimile: (888) 411-0038
E-mail: arosca@praclawfirm.com

Joseph C. Peiffer (*pro hac vice*)
Daniel J. Carr (*pro hac vice*)
PEIFFER, ROSCA, ABDULLAH, CARR & KANE, LLC
201 St. Charles Avenue, Suite 4610
New Orleans, Louisiana 70170
Telephone: (504) 523-2434
Facsimile: (504) 523-2464
E-mail: jpeiffer@praclawfirm.com
E-mail: dcarr@praclawfirm.com

[1] 662 F.3d 891 (7th Cir. 2011).

Attorneys for Plaintiff and the Proposed Class

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF IOWA
CEDAR RAPIDS DIVISION

JON HANSON, Individually and On Behalf of All Others Similarly Situated, Plaintiff, v. BERTHEL FISHER & COMPANY FINACIAL SERVICES, INC., and THOMAS JOSEPH BERTHEL Defendant.	No. 1:13-CV-67 **LRR** **JSS**

PLAINTIFF'S MEMORANDUM IN SUPPORT OF HIS MOTION FOR CLASS CERTIFICATION

Pursuant to F.R.C.P. 23(a) and 23(b)(3), Plaintiff moves to certify the following class pending class discovery:

> All persons and entities that purchased, subscribed and paid for, or otherwise acquired securities in the TNP 2008 Scheme pursuant to the TNP 2008 Scheme offering between December 2008 and March 2010.

Excluded from the class are: (1) any individuals who signed an agreement with Berthel Fisher pursuant to which they must arbitrate claims against Berthel Fisher, arising out of the sales of TNP 2008 Scheme notes, in FINRA arbitration; (2) Defendants; any judge or judicial officer who may hear any aspect of this case and his or her law clerks; and (3) any person, firm, trust, corporation, or other entity related to or affiliated with Defendants.

Plaintiff is filing his Motion for Class Certification to protect his rights and the rights of putative class members in light of the Seventh Circuit's ruling in *Damasco v. Clearwire Corp.*[1] where plaintiff's failure to file a class-certification motion along with his complaint allowed defendant to moot his—*and the class's*—claims for lack of Article III standing. In particular, while Damasco eventually moved for class certification, he did not do so until after Clearwire had offered him his full request for relief.

[1] 662 F.3d 891 (7th Cir. 2011).

Clearwire then removed Damasco's case to federal court where Clearwire moved to dismiss it, arguing that its offer had mooted Damasco's claim.[2] The district court agreed, dismissing Damasco's complaint and later denying his motion to reconsider.[3]

Emphasizing Article III's mootness doctrine, which demands that the parties to a federal case maintain a personal stake in the outcome at all stages of the litigation,[4] the Seventh Circuit pronounced that—despite Damasco's case having been a class action—Clearwire's individual settlement offer nevertheless stripped Damasco of his personal stake in the case's outcome and rendered his claim moot—this, despite the court's acknowledged concerns about "buy-offs"[5] and multiple courts' agreement that individual offers of judgment do *not* moot class claims.[6] Indeed, even the U.S. Supreme Court, in *Roper v. Deposit Guar. National Bank v. Roper*,[7] expressed disfavor with the notion that individual settlement offers moot a class:

> [T]he defendant has made an *unaccepted* offer of tender in settlement of the individual putative representative's claim. The action is moot in the Art. III sense only if this Court adopts a rule that an individual seeking to proceed as a class representative is required to accept a tender of only his individual claims. So long as the court does not require such acceptance, the individual is required to prove his case and the requisite Art. III adversity continues. Acceptance need not be mandated under our precedents since the defendant has not offered all that has been requested in the complaint (i.e., relief for the class) and

---

[2] *Id.* at 893.
[3] *Id.*
[4] *Id.* at 895.
[5] *Id.*
[6] *Id. See also, Pitts v. Terrible Herbst, Inc.*, 653 F.3d 1081, 1091-92 (9th Cir. 2011) ("[W]e hold that an unaccepted Rule 68 offer of judgment—for the full amount of the named plaintiff's individual claim and made before the named plaintiff files a motion for class certification—does not moot a class action."); *Lucero v. Bureau of Collection Recovery, Inc.*, 639 F.3d 1239, 1249 (10th Cir. 2011) ("[W]e conclude that the federal court's Article III jurisdiction to hear the motion for class certification is not extinguished by the Rule 68 offer of judgment to an individual plaintiff."); *Sandoz v. Cingular Wireless LLC*, 553 F.3d 913, 920-21 (5th Cir. 2008) ("If the court ultimately grants the motion to certify, then the Rule 68 offer to the individual plaintiff would not fully satisfy the claims of everyone in the collective action; if the court denies the motion to certify, then the Rule 68 offer of judgment renders the individual plaintiff's claims moot."); *Weiss v. Regal Collections*, 385 F.3d 337, 348 (3d Cir. 2004) ("[W]here a defendant makes a Rule 68 offer to an individual claim that has the effect of mooting possible class relief asserted in the complaint, the appropriate course is to relate the certification motion back to the filing of the class complaint.").
[7] 445 U.S. 326 (1980).

> any other rule would give the defendant the practical power to make the denial of class certification questions unreviewable.[8]

Acknowledging the harshness behind what it believed was a proper textual analysis, the Seventh Circuit also instructed that to avoid an unfair dismissal arising from defendant's buy-off, "[c]lass-action plaintiffs [need merely] move to certify the class at the same time that they file their complaint. The pendency of that motion protects a putative class from attempts to buy off the named plaintiffs."[9] And to the extent that this solution would provoke plaintiffs to move for certification prematurely, meaning before they have fully developed or discovered the facts necessary to obtain certification, the court instructed that "if the parties have yet to fully develop the facts needed for certification, then they can also ask the district court to delay its ruling to provide time for additional discovery or investigation."[10] After all, despite the court's ruling, courts "must [still] engage in a 'rigorous analysis'—sometimes probing behind the pleadings before ruling on certification,"[11] which analysis necessarily cannot happen until sufficient discovery occurs.[12]

To be sure—and despite the foregoing—this is most assuredly *not* the law in the Eighth Circuit. But Plaintiff is mindful that this was not the law in the Seventh Circuit either until the *Damasco* court's ruling. So to guard against the possibility that *Damasco's* consequence might somehow become applicable here (through this or another court's eventual ruling), Plaintiff, in an abundance of caution, is taking the steps that *Damasco* prescribed to prevent the possibility (albeit remote) that Defendant might successfully move to dismiss its case on *Damasco's* same basis. So consistent with *Damacso's* pronouncement, Plaintiff asks this Court "to delay its [class-certification] ruling to provide time for additional discovery or investigation"[13] so that Plaintiff can present its best case for class certification to this Court. To this end, Plaintiff intends to agree with defense counsel on a suitable discovery and

---

[8] *Id.* at 341 (Rehnquist, J., concurring) (emphasis in original).
[9] *Id.* at 896.
[10] *Id.*
[11] *Id.*
[12] *Wal-Mart Stores, Inc. v. Dukes,* 131 S. Ct. 2541, 2551 (2011).
[13] *Damasco,* 662 F.3d at 896.

briefing schedule, subject to the Court's approval.

Similarly consistent with *Damasco,* Plaintiff seeks certification of the above-described class for the following reasons:

1. The class satisfies all of the statutory prerequisites for class certification.

2. The members of the Class are so numerous and geographically dispersed that joinder of all members is impracticable. While the exact number of Class members remains unknown at this time, reports filed by the TNP 2008 Scheme with the Securities and Exchange Commission indicate there are in excess of two hundred members of the proposed class. The exact number of the TNP 2008 Scheme investors is within the knowledge of Defendants.[14] In discovery, Plaintiff will determine the precise scope of the class.

3. There are common questions of law and fact in this class action that relate to and affect the rights of each member of the Class,[15] including, *inter alia*:

(a) Whether Berthel Fisher, acting in its capacity of underwriter of the TNP 2008 Scheme, intentionally and/or negligently misrepresented and omitted risks associated with the securities issued by the TNP 2008 Scheme in the TNP 2008 PPM, which was provided to each Class member;

(b) Whether Berthel Fisher, in its capacity of underwriter of the TNP 2008 Scheme, had a duty to the members of the Class;

(c) Whether Berthel Fisher, in its capacity of underwriter of the TNP 2008 Scheme, breached duties owed to Plaintiff and the Class by failing to conform its conduct to the requirements of the law and applicable regulations;

(d) Whether statements or omissions in the TNP 2008 PPM misrepresented material facts about the TNP 2008 Scheme and/or TNP;

(e) Whether Berthel was Berthel Fisher's control person at all relevant times;

(f) Whether Berthel, in its capacity of control person of Berthel Fisher, is liable to the members of the Class for Berthel Fisher's misconduct;

[14] *See* F.R.C.P. 23(a)(1).
[15] *See* F.R.C.P. 23(a)(2), (b)(3).

(g) Whether Defendants' misconduct entitles Plaintiffs and members of the Class to rescission and/or damages for the loss of the amounts invested by Plaintiffs and members of the Class;

(h) What remedies are appropriate compensation for the damages caused to Plaintiffs and each member of the Class; and

(i) Whether the Plaintiffs and members of the Class are entitled to a reasonable award of attorneys' fees, interest and costs of suit.

4. Plaintiff will adequately represent and protect the interests of the Class and has no interests that conflict with or are antagonistic to the interests of the Class. Plaintiff has retained attorneys who are experienced and capable of prosecuting complex litigation such as this case. The attorneys for Plaintiff and the Class will actively conduct and be responsible for the prosecution of this litigation and the expenses thereof. The attorneys for Plaintiff have adequate resources, experience and commitment to litigate this matter[16]

5. The claims of Plaintiff are typical of the claims of all Class members. Plaintiff is situated identically to all members of the Class with respect to the issues presented in this case, as Plaintiff and all members of the Class were investors in the TNP 2008 Scheme and suffered the exact same loss (in proportion to the amount of their investment). The claims of Plaintiff are based on the same fundamental factual allegations and legal theories as the claims of all other members of the Class. All investors in the TNP 2008 Scheme have been adversely affected by the wrongdoing of Defendants as described in Plaintiff's First Amended Complaint.[17]

6. A class action is superior to any other method available for the fair and efficient adjudication of this controversy because it would be impractical and undesirable for each of the individual Class members who have suffered damages to bring separate actions. Some investors invested amounts in the TNP 2008 Scheme that would make it impracticable for them to litigate individualized securities fraud cases concerning this matter. Moreover, the common issues identified in Plaintiff's First Amended Complaint predominate over individual issues, if any, particular to each class

[16] F.R.C.P. 23(a)(4).

member. Defendants made uniform misrepresentations and were responsible for uniform omissions with respect to each member of the Class and each member of the Class was injured in exact proportion to the amount of their investment in the TNP 2008 Scheme.

On account of the foregoing, Plaintiff respectfully requests that this Honorable Court enter an order certifying the class described, appointing Plaintiff as class representative and its counsel as class counsel, and ordering all further relief as the Court deems appropriate but only *after* Plaintiff has completed the discovery necessary for drafting a more expressive class-certification motion and supporting memorandum for the Court's consideration.

Dated: May 30, 2014

Respectfully submitted,

/s/ J. Barton Goplerud

J. Barton Goplerud (AT0002983)
HUDSON, MALLANEY, SHINDLER & ANDERSON, PC
5015 Grand Ridge Drive, Suite 100
West Des Moines, Iowa 50265-5749
Telephone: (515) 223-4567
Facsimile: (515) 223-8887
E-mail: jbgoplerud@hudsonlaw.net

Alan L. Rosca (*pro hac vice*)
PEIFFER, ROSCA, ABDULLAH, CARR & KANE, LLC
526 Superior Avenue, Suite 1255
Cleveland, Ohio 44114
Telephone: (216) 570-0097
Facsimile: (888) 411-0038
E-mail: arosca@praclawfirm.com

Joseph C. Peiffer (*pro hac vice*)
Daniel J. Carr (*pro hac vice*)
PEIFFER, ROSCA, ABDULLAH, CARR & KANE, LLC
201 St. Charles Avenue, Suite 4610
New Orleans, Louisiana 70170
Telephone: (504) 523-2434
Facsimile: (504) 523-2464
E-mail: jpeiffer@praclawfirm.com
E-mail: dcarr@praclawfirm.com

Attorneys for Plaintiff and the Proposed

Class

EXHIBIT F

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

CONTINENTAL CASUALTY COMPANY,

Plaintiff,

v.

GOLDSTONE FINANCIAL GROUP, MICHAEL PELLEGRINO, ANTHONY PELLEGRINO, MARK R. HARRAH and MARK R. HARRAH ROTH IRA, individually and on behalf of all other persons similarly situated, LAURA SENESE, STEPHEN CRONE, ELEANOR CRONE, PADMA BHOSLEY, MARY GERACI, ERIC KELLEY, FRANK IACOVELLA, JOHN GURA, SHEILA GURA, KIRK COLEMAN, MICHELE TOMEO, SRINDHAR KOMANDUR, CLAUDE AVVISATI, JACK ZANDER, LINDA ZANDER, CHRISTINE BONDIE, CAROLE OLSON, WALTER OLSON, WESLEY RANDALL, KARLEN UDARBE, KRIS HAJEK, MARY REICHEL, MARY JO CERNOK, PATRICIA LEWIS, RON KRUSINOWSKI, JOANNE BIGA, RICHARD DEITZ, SUSAN ROTT, MICHAEL ROTT, LARRY LOBER, ROBERT RHEINHEIMER, SUSAN RHEINHEIMER, TED HOKINSON, JACQUELINE HOKINSON, JEFF RUTTER, CAROLE WOLF, MARIA GATLIN, RICHARD RUTKOWSKI, PHYLLIS RUTKOWSKI, DONNA BAUDRY, JANICE CIERNIAK, JOANNE DETRANA, JUDITH DUGAN, MARIE UDARBE, ROY MARCUS, ANN CALABRESE, RICHARD GIACALONE, RICHARD DEITCHE, ROBERT LITZ, MAUREEN MCLAUGHLIN, CAROL CRAMER, MARK LISZEO, VIRGINIA PETERSEN, DAVID HOYNE, MATTHEW MCGUIRE, DAVID DWYER, JEFFREY

Case No. 2018CH13639

COMPLAINT FOR DECLARATORY JUDGMENT

FILED
10/31/2018 1:20 PM
DOROTHY BROWN
CIRCUIT CLERK
COOK COUNTY, IL
2018CH13639

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

SCHROEN, LINDA GULOTTA, ROBERT)
OGLE, JOAN WERNER, BARBARA)
ANDLER, KATHRYN ANDLER,)
SPENCER GERKE, SALVACION)
VALERIO, ROBERT RIESER, DAWN)
TRECARTIN, ANGELA RICE, JANIS)
HAVRANEK, BERNADETTE COOK,)
LOUISA JENNRICH, SUSAN BROUCEK,)
ROMAN PLICHTA, JOSEPH KIRBY,)
THERESE STANCIK, GERALD GROSS,)
LEONARD WEBER, EDWARD SMITH,)
NATALIE SMITH, SCOTT METCALFE,)
JOHN LAMMLE, KARL LECHOWICZ,)
CYNTHIA LECHOWICZ, NOEL)
MORGRIDGE, LINDA MORGRIDGE,)
NANCY PAULOS, RITA O'CONNOR,)
RUTH FITZPATRICK, RUSSELL)
RASNER, KIM RASNER, DEAN VANCE,)
KATHLEEN BIGA, CARL WIGGINTON,)
STEVE DURAY, UMESH SHARMA,)
CHRIS ANN KOMOSA, RICHARD)
MILMONT, JANICE MAREK, CAROL)
VITTORINI, EMMA UDARBE,)
KANNACHAN PARAMPIL, DONNA)
LASOTA, EDWIN MANTEL, GARY)
STEPHENS, DENISE PRICE, WILLIAM)
PRICE, WARREN COPLER, DEBORAH)
CRYER, ROBERT SAJDAK, WALTER)
NEUHENGEN, MIKHAIL SOROKIN,)
VERONIKA NEFEDOVA, DENISE)
PAPENDIK, CHARLES PAPENDIK,)
LORNA LYDICK, MARILYN BROCK,)
JAMES BROCK, ROBERT POSS,)
PATRICIA DAVIS, GARY DAVIS,)
ANTOINETTE TOMCZAK, KAREN A.)
CLARK, CHARLOTTE HUNTER)
BROWN, DEBRA RICKERT, BERNARD)
FERRERI, MARY FERRERI, NICHOLAS)
FERRERI, DONALD BERG, AGNES)
BERG, PATRICIA ELLIOTT, GLORIA)
HOLLAND, RITA COX, THOMAS)
STRUKL, BARBARA CARDELLI,)
LAURA PLASKETES, DAWN ZULAS,)
ROSELY ALEXANDER, EILEEN)
MINOW, VLADIMIR TSIMBERG,)
JOSEPH SANTELLA, JAMES)

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

SANTELLA, JANET MURRELL, ROBERT)
MEYERS, PATRICK JOHNSTON,)
ELAINE KOSIEK, PATRICIA GENARDO,)
NANCY GENARDO, PETER LISKA,)
MARK RIORDAN SAUNDERS,)
PASQUALE PERRONE, RALPH)
INFUSINO, ROSEMARY ARNOLD,)
WILLIAM ARNOLD, ZACHARY ZARR,)
LORA SAUNDERS, WILLIAM HOLUM,)
CHRISTOPHER SCHILLER, DAVID)
BRIGGS, JOHN HORVATH, DEAN)
BONAVOLANTE, CATHERINE)
WIESNER, DIANE ZWICKER, GERHARD)
BECKER, RICHARD PONDEL, DENISE)
PONDEL, STEPHEN LOY, DOROTHY)
LOY, JOHN RITTENHOUSE, STEVEN)
ZIOLKOWSKI, CATHERINE MORASK,)
KEVIN VENECHUK, PHIROZ)
DARUKHANAVALA, NILUFER)
DARUKHANAVALA, CHRISTOPHER)
SHEALY, THOMAS HARRISON,)
BENJAMIN ROUDEBUSH, MINOO)
SUMARIWALLA, AMY)
SUMARIWALLA, VITO LETTERI, TED)
SEREDYNSKI, KENNETH GERTH,)
ANNE GERTH, DIANE COLLINS,)
GLENN MESSMER, JOANNE MESSMER,)
JOSEPH AMSTADT, DONNAJEAN)
AMSTADT, BONNIE GREET, ROBERT)
HORVATH, RYAN GOLDEN, LILLIAN)
POWERS, NANCY GOLDEN, SAMUEL)
THOMAS, ANN THOMAS, LEE)
WILLIAMS, SCOTT LYON, JOHN)
DAMAS, KATHERINE BRODY, YEAT)
YANG NACHOWICZ, JAYANT PATEL,)
KALPANA PATEL, STEVEN JOHNSON,)
KENNETH ZIOBRO, RAMESH PATEL,)
KUMUD PATEL, GARY KARAS, JOHN)
BOCHANTINE, MICHAEL MCHALE,)
GREGORY JOHNSON, DENISE REBOT,)
DIANE BASCHETTI, KENNETH GRIESE,)
JASPER TAVOLACCI, DANIEL)
VACLAV, PAMELA VACLAV, MICHAEL)
KEYES, ROBERT CARLSON,)
KATHLEEN CARLSON, CLAUDIA)
PRYOR, BERT GARNSEY, CYNTHIA)

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

GARNSEY, LINDA GABRIEL, JAMES SPACHMAN, JOYCE SPACHMAN, WALTER KROPE, KIM FOSSE, KENNETH MACHALA, DENISE D'ANDREA, JOHN NOWAK, LAURA DENOVO, ERNESTO TORRES, LARRY PRZEBIEDA, BARBARA BISHOP, ORLEY BETCHER, RICHARD MARTINAITIS, MARSHA MARTINAITIS, JOSEPH TIDABACK, RORI TIDABACK, EMIL KOSCHNITZKI, ROBERT WEBB, ANNA LIETZOW, JAMES MOELLENDORF, CHRISTINE NAYBAR, BONNIE FISHER, PHILIP GLAVAN, DENISE HOGER, DIANE SUTOR, BERNARD EGAN, PATRICIA O'RYAN, DOUGLAS DAHL and LORI DAHL,	)
Defendants.	)

Plaintiff Continental Casualty Company ("Continental"), for its Complaint for Declaratory Judgment against defendants Goldstone Financial Group ("Goldstone"), Michael Pellegrino, Anthony Pellegrino, Mark R. Harrah and Mark R. Harrah Roth IRA, individually and on behalf of all other persons similarly situated, Laura Senese, Stephen Crone, Eleanor Crone, Padma Bhosley, Mary Geraci, Eric Kelley, Frank Iacovella, John Gura, Sheila Gura, Kirk Coleman, Michele Tomeo, Srindhar Komandur, Claude Avvisati, Jack Zander, Linda Zander, Christine Bondie, Carole Olson, Walter Olson, Wesley Randall, Karlen Udarbe, Kris Hajek, Mary Reichel, Mary Jo Cernok, Patricia Lewis, Ron Krusinowski, Joanne Biga, Richard Deitz, Susan Rott, Michael Rott, Larry Lober, Robert Rheinheimer, Susan Rheinheimer, Ted Hokinson, Jacqueline Hokinson, Jeff Rutter, Carole Wolf, Maria Gatlin, Richard Rutkowski, Phyllis Rutkowski, Donna Baudry, Janice Cierniak, Joanne DeTrana, Judith Dugan, Marie Udarbe, Roy Marcus, Ann Calabrese, Richard Giacalone, Richard Deitche, Robert Litz, Maureen McLaughlin, Carol Cramer, Mark Liszeo, Virginia Petersen, David Hoyne, Matthew McGuire, David Dwyer,

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

Jeffrey Schroen, Linda Gulotta, Robert Ogle, Joan Werner, Barbara Andler, Kathryn Andler, Spencer Gerke, Salvacion Valerio, Robert Rieser, Dawn Trecartin, Angela Rice, Janis Havranek, Bernadette Cook, Louisa Jennrich, Susan Broucek, Roman Plichta, Joseph Kirby, Therese Stancik, Gerald Gross, Leonard Weber, Edward Smith, Natalie Smith, Scott Metcalfe, John Lammle, Karl Lechowicz, Cynthia Lechowicz, Noel Morgridge, Linda Morgridge, Nancy Paulos, Rita O'Connor, Ruth Fitzpatrick, Russell Rasner, Kim Rasner, Dean Vance, Kathleen Biga, Carl Wigginton, Steve Duray, Umesh Sharma, Chris Ann Komosa, Richard Milmont, Janice Marek, Carol Vittorini, Emma Udarbe, Kannachan Parampil, Donna LaSota, Edwin Mantel, Gary Stephens, Denise Price, William Price, Warren Copler, Deborah Cryer, Robert Sajdak, Walter Neuhengen, Mikhail Sorokin, Veronika Nefedova, Denise Papendik, Charles Papendik, Lorna Lydick, Marilyn Brock, James Brock, Robert Poss, Patricia Davis, Gary Davis, Antoinette Tomczak, Karen A. Clark, Charlotte Hunter Brown, Debra Rickert, Bernard Ferreri, Mary Ferreri, Nicholas Ferreri, Donald Berg, Agnes Berg, Patricia Elliott, Gloria Holland, Rita Cox, Thomas Strukl, Barbara Cardelli, Laura Plasketes, Dawn Zulas, Rosely Alexander, Eileen Minow, Vladimir Tsimberg, Joseph Santella, James Santella, Janet Murrell, Robert Meyers, Patrick Johnston, Elaine Kosiek, Patricia Genardo, Nancy Genardo, Peter Liska, Mark Riordan Saunders, Pasquale Perrone, Ralph Infusino, Rosemary Arnold, William Arnold, Zachary Zarr, Lora Saunders, William Holum, Christopher Schiller, David Briggs, John Horvath, Dean Bonavolante, Catherine Wiesner, Diane Zwicker, Gerhard Becker, Richard Pondel, Denise Pondel, Stephen Loy, Dorothy Loy, John Rittenhouse, Steven Ziolkowski, Catherine Morask, Kevin Venechuk, Phiroz Darukhanavala, Nilufer Darukhanavala, Christopher Shealy, Thomas Harrison, Benjamin Roudebush, Minoo Sumariwalla, Amy Sumariwalla, Vito Letteri, Ted Seredynski, Kenneth Gerth, Anne Gerth, Diane Collins, Glenn Messmer, JoAnne Messmer,

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

Joseph Amstadt, DonnaJean Amstadt, Bonnie Greet, Robert Horvath, Ryan Golden, Lillian Powers, Nancy Golden, Samuel Thomas, Ann Thomas, Lee Williams, Scott Lyon, John Damas, Katherine Brody, Yeat Yang Nachowicz, Jayant Patel, Kalpana Patel, Steven Johnson, Kenneth Ziobro, Ramesh Patel, Kumud Patel, Gary Karas, John Bochantine, Michael McHale, Gregory Johnson, Denise Rebot, Diane Baschetti, Kenneth Griese, Jasper Tavolacci, Daniel Vaclav, Pamela Vaclav, Michael Keyes, Robert Carlson, Kathleen Carlson, Claudia Pryor, Bert Garnsey, Cynthia Garnsey, Linda Gabriel, James Spachman, Joyce Spachman, Walter Krope, Kim Fosse, Kenneth Machala, Denise D'Andrea, John Nowak, Laura DeNovo, Ernesto Torres, Larry Przebieda, Barbara Bishop, Orley Betcher (Trustee), Richard Martinaitis, Marsha Martinaitis, Joseph Tidaback, Rori Tidaback, Emil Koschnitzki, Robert Webb, Anna Lietzow, James Moellendorf, Christine Naybar, Bonnie Fisher, Philip Glavan, Denise Hoger, Diane Sutor, Bernard Egan, Patricia O'Ryan, Douglas Dahl andLori Dahl (collectively, "Defendants"), hereby alleges, based upon its knowledge, information, and belief, as follows:

NATURE OF THIS ACTION

1. Continental brings this action to obtain a judicial determination and declaration with respect to the rights and obligations of the parties under Master Policy Life Agent Professional Liability Policy No. 596737388 (the "Master Policy"), in which Defendants Goldstone, Michael Pellegrino and Anthony Pellegrino participate through a **Certificate of Insurance** (the "Certificate") issued to Goldstone for the **Certificate Period** of June 1, 2018 to June 1, 2019.[1] A true and correct copy of the Master Policy (except for the application for the Master Policy) is attached as Exhibit 1. A true and correct copy of the Certificate (except for the application for the Certificate) is attached as Exhibit 2.

[1] Words in bold are bolded and defined in the Master Policy.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

2. An actual, ripe, and justiciable controversy has arisen between the parties in regard to their respective rights and obligations under the Certificate and, as such, the Master Policy.

3. In particular, Continental seeks a determination and declaration by this Court that: (i) the Certificate is void and Continental is entitled to rescind the Certificate as to all **Insureds** who participate in the Master Policy through the Certificate, on the basis of material misrepresentations made during the application process to procure the Certificate; and (ii) because the Certificate is rescinded and void *ab initio*, Continental has no obligation to provide defense or indemnity coverage to any **Insured** in connection with any **Claim** asserted by third parties against any **Insured**, including but not limited to the Senese Demand, the Stoltmann Demand, the Class Action and the Crone Demand (as hereinafter defined, and as collectively referred to herein as the "1 Global Matters").

4. Continental also seeks a determination that, even if the Certificate were not rescinded and void *ab initio*, Continental would have no obligation to provide defense or indemnity coverage to any **Insured** in connection with any portion of any of the 1 Global Matters based on the "Application Exclusion."

5. Continental also seeks a determination that, even if the Certificate were not rescinded and void *ab initio*, Continental would have no obligation to provide defense or indemnity coverage to any **Insured** in connection with any portion of any of the 1 Global Matters based on the Master Policy's "Bankruptcy Exclusion" (Section XVI.I).

6. Continental also seeks a determination that, even if the Certificate were not rescinded and void *ab initio*, Continental would have no obligation to provide defense or indemnity coverage to any **Insured** in connection with the lawsuit styled *Mark R. Harrah Roth*

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

IRA v. Goldstone Financial Group, et al., Case No. 18-6643 (N.D. Ill.) (the "Class Action") based on the Master Policy's "**Class Action** Exclusion" (Section XVI.X).

7. Continental further seeks a determination that, even if the Certificate were not rescinded and void *ab initio*, Continental would have no obligation to provide indemnity coverage to any **Insured** in connection with any portion of any **Claim**, including any of the 1 Global Matters, involving any **Wrongful Act** committed prior to June 1, 2018, based on the Master Policy's "**Prior Acts** Condition" (Section I).

PARTIES

8. Plaintiff Continental is a corporation organized and existing under the laws of the State of Illinois and maintains its principal place of business in Chicago, Illinois. Continental legally transacts insurance business in the State of Illinois and within the geographical jurisdiction of this Court.

9. Defendant Goldstone is an Illinois limited liability company with its principal office located in Villa Park, Illinois. Goldstone is the **Named Insured** on the Certificate. At all times relevant to the subject matter of this action, Goldstone was an **Insured** under the Master Policy.

10. Defendant Michael Pellegrino is a resident and citizen of Illinois. Michael Pellegrino is a Co-Owner and Managing Member of Goldstone. At all times relevant to the subject matter of this action, Michael Pellegrino was an **Insured** under the Master Policy.

11. Defendant Anthony Pellegrino is a resident and citizen of Illinois. Anthony Pellegrino is a Co-Owner and Managing Member of Goldstone. At all times relevant to the subject matter of this action, Anthony Pellegrino was an **Insured** under the Master Policy.

12. Defendant Mark R. Harrah Roth IRA is a self-directed IRA that was established by and is controlled, managed and directed by Defendant Mark R. Harrah, who is a resident and

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

citizen of Illinois. Mark R. Harrah Roth IRA is the named plaintiff in the Class Action and may claim an interest in the Certificate to the extent that he is awarded a judgment or settlement in the Class Action. Mark R. Harrah Roth IRA is named as a Defendant in this action in its individual capacity and also in its capacity as a representative of the class on which it purports to sue in the Class Action.

13. Defendant Laura Senese is a resident and citizen of Illinois. Ms. Senese is named as a defendant in this action because she is a claimant in the Senese Demand and may claim an interest in the Certificate to the extent that she is awarded a judgment or settlement in connection with the Senese Demand.

14. Defendant Stephen Crone's state of residence is unknown to Continental. Continental alleges that Mr. Crone has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Mr. Crone is named as a defendant in this action because he is a claimant in the Crone Demand and may claim an interest in the Certificate to the extent that he is awarded a judgment or settlement in connection with the Crone Demand.

15. Defendant Eleanor Crone's state of residence is unknown to Continental. Continental alleges that Ms. Crone has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Crone is named as a defendant in this action because she is a claimant in the Crone Demand and may claim an interest in the Certificate to the extent that she is awarded a judgment or settlement in connection with the Crone Demand.

16. Defendant Padma Bhosley is a resident and citizen of Illinois. Ms. Bhosley is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

17. Defendant Mary Geraci is a resident and citizen of Illinois. Ms. Geraci is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

18. Defendant Eric Kelley is a resident and citizen of Illinois. Mr. Kelley is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

19. Defendant Frank Iacovella is a resident and citizen of Illinois. Mr. Iacovella is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

20. Defendant John Gura is a resident and citizen of Illinois. Mr. Gura is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

21. Defendant Sheila Gura is a resident and citizen of Illinois. Ms. Gura is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

22. Defendant Kirk Coleman is a resident and citizen of Illinois. Mr. Coleman is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

23. Defendant Michele Tomeo is a resident and citizen of Illinois. Ms. Tomeo is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

24. Defendant Srindhar Komandur is a resident and citizen of Illinois. Mr. Komandur is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

25. Defendant Claude Avvisati is a resident and citizen of Illinois. Mr. Avvisati is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

26. Defendant Jack Zander is a resident and citizen of Illinois. Mr. Zander is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

27. Defendant Linda Zander is a resident and citizen of Illinois. Ms. Zander is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

28. Defendant Christine Bondie is a resident and citizen of Illinois. Ms. Bondie is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

29. Defendant Carole Olson is a resident and citizen of Illinois. Ms. Olson is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

30. Defendant Walter Olson is a resident and citizen of Illinois. Mr. Olson is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

31. Defendant Wesley Randall is a resident and citizen of Illinois. Mr. Randall is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

32. Defendant Karlen Udarbe is a resident and citizen of Illinois. Mr. Udarbe is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

33. Defendant Kris Hajek is a resident and citizen of Illinois. Kris Hajek is named as a defendant in this action because s/he is a claimant in the Stoltmann Demand and may claim an

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

interest in the Certificate to the extent s/he is awarded a judgment or settlement in connection with the Stoltmann Demand.

34. Defendant Mary Reichel is a resident and citizen of Arizona. Continental alleges that Ms. Reichel has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Reichel is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

35. Defendant Mary Jo Cernok is a resident and citizen of Illinois. Ms. Cernok is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

36. Defendant Patricia Lewis is a resident and citizen of Illinois. Ms. Lewis is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

37. Defendant Ron Krusinowski is a resident and citizen of Illinois. Mr. Krusinowski is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

38. Defendant Joanne Biga is a resident and citizen of Illinois. Ms. Biga is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

39. Defendant Richard Deitz is a resident and citizen of Illinois. Mr. Deitz is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

40. Defendant Susan Rott is a resident and citizen of Illinois. Ms. Rott is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

41. Defendant Michael Rott is a resident and citizen of Illinois. Mr. Rott is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

42. Defendant Larry Lober is a resident and citizen of Illinois. Mr. Lober is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

43. Defendant Robert Rheinheimer is a resident and citizen of Illinois. Mr. Robert Rheinheimer is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

44. Defendant Susan Rheinheimer is a resident and citizen of Illinois. Ms. Rheinheimer is named as a defendant in this action because she is a claimant in the Stoltmann

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

45. Defendant Ted Hokinson is a resident and citizen of Illinois. Mr. Hokinson is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

46. Defendant Jacqueline Hokinson is a resident and citizen of Illinois. Ms. Hokinson is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

47. Defendant Jeff Rutter is a resident and citizen of Illinois. Mr. Rutter is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

48. Defendant Carole Wolf is a resident and citizen of Illinois. Ms. Wolf is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

49. Defendant Maria Gatlin is a resident and citizen of Illinois. Ms. Gatlin is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

50. Defendant Richard Rutkowski is a resident and citizen of Illinois. Mr. Rutkowski is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

51. Defendant Phyllis Rutkowski is a resident and citizen of Illinois. Ms. Rutkowski is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

52. Defendant Donna Baudry is a resident and citizen of Illinois. Ms. Baudry is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

53. Defendant Janice Cierniak is a resident and citizen of Illinois. Ms. Cierniak is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

54. Defendant Joanne DeTrana is a resident and citizen of Illinois. Ms. DeTrana is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

55. Defendant Judith Dugan is a resident and citizen of Illinois. Ms. Dugan is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

56. Defendant Marie Udarbe is a resident and citizen of Illinois. Ms. Udarbe is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

57. Defendant Roy Marcus is a resident and citizen of Illinois. Mr. Marcus is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

58. Defendant Ann Calabrese is a resident and citizen of Florida. Continental alleges that Ms. Calabrese has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Calabrese is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

59. Defendant Richard Giacalone is a resident and citizen of Illinois. Mr. Giacalone is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

60. Defendant Richard Deitche is a resident and citizen of Illinois. Mr. Deitche is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

61. Defendant Robert Litz is a resident and citizen of Illinois. Mr. Litz is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

62. Defendant Maureen McLaughlin is a resident and citizen of Illinois. Ms. McLaughlin is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

63. Defendant Carol Cramer is a resident and citizen of Illinois. Ms. Cramer is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

64. Defendant Mark Liszeo is a resident and citizen of Illinois. Mr. Liszeo is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

65. Defendant Virginia Petersen is a resident and citizen of Illinois. Ms. Petersen is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

66. Defendant David Hoyne is a resident and citizen of Illinois. Mr. Hoyne is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

67. Defendant Matthew McGuire is a resident and citizen of New Hampshire. Continental alleges that Mr. McGuire has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Mr. McGuire is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

68. Defendant David Dwyer is a resident and citizen of Florida. Continental alleges that Mr. Dwyer has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Mr. Dwyer is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

69. Defendant Jeffrey Schroen is a resident and citizen of Illinois. Mr. Schroen is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

70. Defendant Linda Gulotta is a resident and citizen of Wisconsin. Continental alleges that Ms. Gulotta has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Gulotta is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

71. Defendant Robert Ogle is a resident and citizen of Illinois. Mr. Ogle is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

72. Defendant Joan Werner is a resident and citizen of Illinois. Ms. Werner is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

73. Defendant Barbara Andler is a resident and citizen of Illinois. Ms. Andler is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

74. Defendant Kathryn Andler is a resident and citizen of Illinois. Ms. Andler is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

75. Defendant Spencer Gerke is a resident and citizen of Illinois. Mr. Gerke is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

76. Defendant Salvacion Valerio is a resident and citizen of Illinois. Mr. Valerio is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

77. Defendant Robert Rieser is a resident and citizen of Illinois. Mr. Rieser is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

78. Defendant Dawn Trecartin is a resident and citizen of Illinois. Ms. Trecartin is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

79. Defendant Angela Rice is a resident and citizen of Illinois. Ms. Rice is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

80. Defendant Janis Havranek is a resident and citizen of Illinois. Ms. Havranek is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

81. Defendant Bernadette Cook is a resident and citizen of Illinois. Ms. Cook is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

82. Defendant Louisa Jennrich is a resident and citizen of Illinois. Ms. Jennrich is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

83. Defendant Susan Broucek is a resident and citizen of Illinois. Ms. Broucek is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

84. Defendant Roman Plichta is a resident and citizen of Illinois. Mr. Plichta is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

85. Defendant Joseph Kirby is a resident and citizen of Illinois. Mr. Kirby is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

86. Defendant Therese Stancik is a resident and citizen of Illinois. Ms. Stancik is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

87. Defendant Gerald Gross is a resident and citizen of Illinois. Mr. Gross is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

88. Defendant Leonard Weber is a resident and citizen of Illinois. Mr. Weber is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

89. Defendant Edward Smith is a resident and citizen of Illinois. Mr. Smith is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

90. Defendant Natalie Smith is a resident and citizen of Illinois. Ms. Smith is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

91. Defendant Scott Metcalfe is a resident and citizen of Illinois. Mr. Metcalfe is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

92. Defendant John Lammle is a resident and citizen of Illinois. Mr. Lammle is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

93. Defendant Karl Lechowicz is a resident and citizen of Illinois. Mr. Lechowicz is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

94. Defendant Cynthia Lechowicz is a resident and citizen of Illinois. Ms. Lechowicz is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

95. Defendant Noel Morgridge is a resident and citizen of Illinois. Mr. Morgridge is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

96. Defendant Linda Morgridge is a resident and citizen of Illinois. Ms. Morgridge is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

97. Defendant Nancy Paulos is a resident and citizen of Kentucky. Continental alleges that Ms. Paulos has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Paulos is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

98. Defendant Rita O'Connor is a resident and citizen of Illinois. Ms. O'Connor is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

99. Defendant Ruth Fitzpatrick is a resident and citizen of Illinois. Ms. Fitzpatrick is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

100. Defendant Russell Rasner is a resident and citizen of Illinois. Mr. Rasner is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

101. Defendant Kim Rasner is a resident and citizen of Illinois. Ms. Rasner is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

102. Defendant Dean Vance is a resident and citizen of Illinois. Mr. Vance is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

103. Defendant Kathleen Biga is a resident and citizen of Illinois. Ms. Biga is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

104. Defendant Carl Wigginton is a resident and citizen of Illinois. Mr. Wigginton is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

105. Defendant Steve Duray is a resident and citizen of Illinois. Mr. Duray is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

106. Defendant Umesh Sharma is a resident and citizen of Illinois. Mr. Sharma is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

107. Defendant Chris Ann Komosa is a resident and citizen of Illinois. Ms. Komosa is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

108. Defendant Richard Milmont is a resident and citizen of Illinois. Mr. Milmont is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

109. Defendant Janice Marek is a resident and citizen of Illinois. Ms. Marek is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

110. Defendant Carol Vittorini is a resident and citizen of Illinois. Ms. Vittorini is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

111. Defendant Emma Udarbe is a resident and citizen of Illinois. Ms. Udarbe is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

112. Defendant Kannachan Parampil is a resident and citizen of Florida. Continental alleges that Mr. Parampil has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Mr. Parampil is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

113. Defendant Donna LaSota is a resident and citizen of Illinois. Ms. LaSota is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

114. Defendant Edwin Mantel is a resident and citizen of Illinois. Mr. Mantel is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

115. Defendant Gary Stephens is a resident and citizen of Illinois. Mr. Stephens is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

116. Defendant Denise Price is a resident and citizen of Illinois. Ms. Price is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

117. Defendant William Price is a resident and citizen of Illinois. Mr. Price is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

118. Defendant Warren Copler is a resident and citizen of Illinois. Mr. Copler is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

119. Defendant Deborah Cryer is a resident and citizen of Illinois. Ms. Cryer is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

120. Defendant Robert Sajdak is a resident and citizen of Illinois. Mr. Sajdak is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

121. Defendant Walter Neuhengen is a resident and citizen of Illinois. Mr. Neuhengen is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

122. Defendant Mikhail Sorokin is a resident and citizen of Illinois. Mr. Sorokin is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

123. Defendant Veronika Nefedova is a resident and citizen of Illinois. Ms. Nefedova is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

124. Defendant Denise Papendik is a resident and citizen of Illinois. Ms. Papendik is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

125. Defendant Charles Papendik is a resident and citizen of Illinois. Mr. Papendik is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

126. Defendant Lorna Lydick is a resident and citizen of Indiana. Continental alleges that Ms. Lydick has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Lydick is named as a defendant in this action because she is a

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

127. Defendant Marilyn Brock is a resident and citizen of Illinois. Ms. Brock is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

128. Defendant James Brock is a resident and citizen of Illinois. Mr. Brock is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

129. Defendant Robert Poss is a resident and citizen of Illinois. Mr. Poss is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

130. Defendant Patricia Davis is a resident and citizen of Illinois. Ms. Davis is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

131. Defendant Gary Davis is a resident and citizen of Illinois. Mr. Davis is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

132. Defendant Antoinette Tomczak is a resident and citizen of Illinois. Ms. Tomczak is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

133. Defendant Karen A. Clark is a resident and citizen of Illinois. Ms. Clark is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

134. Defendant Charlotte Hunter Brown is a resident and citizen of Illinois. Ms. Brown is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

135. Defendant Debra Rickert is a resident and citizen of Illinois. Ms. Rickert is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

136. Defendant Bernard Ferreri is a resident and citizen of Illinois. Mr. Ferreri is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

137. Defendant Mary Ferreri is a resident and citizen of Illinois. Ms. Ferreri is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

138. Defendant Nicholas Ferreri is a resident and citizen of Illinois. Mr. Ferreri is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

139. Defendant Donald Berg is a resident and citizen of Illinois. Mr. Berg is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

140. Defendant Agnes Berg is a resident and citizen of Illinois. Ms. Berg is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

141. Defendant Patricia Elliott is a resident and citizen of Illinois. Ms. Elliott is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

142. Defendant Gloria Holland is a resident and citizen of Illinois. Ms. Holland is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

143. Defendant Rita Cox is a resident and citizen of Illinois. Ms. Cox is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

144. Defendant Thomas Strukl is a resident and citizen of Illinois. Mr. Strukl is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

145. Defendant Barbara Cardelli is a resident and citizen of Illinois. Ms. Cardelli is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

146. Defendant Laura Plasketes is a resident and citizen of Illinois. Ms. Plasketes is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

147. Defendant Dawn Zulas is a resident and citizen of Illinois. Ms. Zulas is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

148. Defendant Rosely Alexander is a resident and citizen of Florida. Continental alleges that Ms. Alexander has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Alexander is named as a defendant in this action

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

149. Defendant Eileen Minow is a resident and citizen of Illinois. Ms. Minow is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

150. Defendant Vladimir Tsimberg is a resident and citizen of Illinois. Mr. Tsimberg is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

151. Defendant Joseph Santella is a resident and citizen of Illinois. Mr. Santella is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

152. Defendant James Santella is a resident and citizen of Illinois. Mr. Santella is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

153. Defendant Janet Murrell is a resident and citizen of Florida. Continental alleges that Ms. Murrell has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Murrell is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

154. Defendant Robert Meyers is a resident and citizen of Illinois. Mr. Meyers is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

155. Defendant Patrick Johnston is a resident and citizen of Indiana. Continental alleges that Mr. Johnston has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Mr. Johnston is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

156. Defendant Elaine Kosiek is a resident and citizen of Illinois. Ms. Kosiek is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

157. Defendant Patricia Genardo is a resident and citizen of Illinois. Ms. Gernardo is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

158. Defendant Nancy Genardo is a resident and citizen of Illinois. Ms. Gernardo is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

159. Defendant Peter Liska is a resident and citizen of Illinois. Mr. Liska is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

160. Defendant Mark Riordan Saunders is a resident and citizen of Illinois. Mr. Saunders is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

161. Defendant Pasquale Perrone is a resident and citizen of Illinois. Mr. Perrone is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

162. Defendant Ralph Infusino is a resident and citizen of Illinois. Mr. Infusino is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

163. Defendant Rosemary Arnold is a resident and citizen of Illinois. Ms. Arnold is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

164. Defendant William Arnold is a resident and citizen of Illinois. Mr. Arnold is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

165. Defendant Zachary Zarr is a resident and citizen of Illinois. Mr. Zarr is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

166. Defendant Lora Saunders is a resident and citizen of Illinois. Ms. Saunders is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

167. Defendant William Holum is a resident and citizen of Illinois. Mr. Holum is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

168. Defendant Christopher Schiller is a resident and citizen of Illinois. Mr. Schiller is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

169. Defendant David Briggs is a resident and citizen of Illinois. Mr. Briggs is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

170. Defendant John Horvath is a resident and citizen of Illinois. Mr. Horvath is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

171. Defendant Dean Bonavolante is a resident and citizen of Illinois. Mr. Bonavolante is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

172. Defendant Catherine Wiesner is a resident and citizen of Illinois. Ms. Wiesner is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

173. Defendant Diane Zwicker is a resident and citizen of Illinois. Ms. Zwicker is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

174. Defendant Gerhard Becker is a resident and citizen of Illinois. Mr. Becker is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

175. Defendant Richard Pondel is a resident and citizen of Illinois. Mr. Pondel is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

176. Defendant Denise Pondel is a resident and citizen of Illinois. Ms. Pondel is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

177. Defendant Stephen Loy is a resident and citizen of Illinois. Mr. Loy is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

178. Defendant Dorothy Loy is a resident and citizen of Illinois. Ms. Loy is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

179. Defendant John Rittenhouse is a resident and citizen of South Carolina. Continental alleges that Mr. Rittenhouse has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Mr. Rittenhouse is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

180. Defendant Steven Ziolkowski is a resident and citizen of Illinois. Mr. Ziolkowski is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

181. Defendant Catherine Morask is a resident and citizen of Illinois. Ms. Morask is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

182. Defendant Kevin Venechuk is a resident and citizen of Illinois. Mr. Venechuk is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

183. Defendant Phiroz Darukhanavala is a resident and citizen of Illinois. Mr. Darukhanavala is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

184. Defendant Nilufer Darukhanavala is a resident and citizen of Illinois. Ms. Darukhanavala is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

185. Defendant Christopher Shealy is a resident and citizen of Illinois. Mr. Shealy is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

186. Defendant Thomas Harrison is a resident and citizen of Illinois. Mr. Harrison is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

187. Defendant Benjamin Roudebush is a resident and citizen of California. Continental alleges that Mr. Roudebush has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Mr. Roudebush is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

188. Defendant Minoo Sumariwalla's state of residence is unknown to Continental. Continental alleges that Ms. Sumariwalla has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Sumariwalla is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

189. Defendant Amy Sumariwalla's state of residence is unknown to Continental. Continental alleges that Ms. Sumariwalla has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Sumariwalla is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

190. Defendant Vito Letteri is a resident and citizen of Illinois. Mr. Letteri is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

191. Defendant Ted Seredynski is a resident and citizen of Illinois. Mr. Seredynski is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

192. Defendant Kenneth Gerth is a resident and citizen of South Carolina. Continental alleges that Mr. Gerth has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Mr. Gerth is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

193. Defendant Anne Gerth is a resident and citizen of South Carolina. Continental alleges that Ms. Gerth has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Gerth is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

194. Defendant Diane Collins is a resident and citizen of Illinois. Ms. Collins is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

195. Defendant Glenn Messmer is a resident and citizen of Illinois. Mr. Messmer is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

196. Defendant JoAnne Messmer is a resident and citizen of Illinois. Ms. Messmer is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

197. Defendant Joseph Amstadt is a resident and citizen of Illinois. Mr. Amstadt is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

198. Defendant DonnaJean Amstadt is a resident and citizen of Illinois. Ms. Amstadt is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

199. Defendant Bonnie Greet is a resident and citizen of Illinois. Ms. Greet is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

200. Defendant Robert Horvath is a resident and citizen of Illinois. Mr. Horvath is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

201. Defendant Ryan Golden is a resident and citizen of California. Continental alleges that Mr. Golden has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Mr. Golden is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

202. Defendant Lillian Powers is a resident and citizen of Illinois. Ms. Powers is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

203. Defendant Nancy Golden is a resident and citizen of Illinois. Ms. Golden is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

204. Defendant Samuel Thomas is a resident and citizen of Illinois. Mr. Thomas is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

205. Defendant Ann Thomas is a resident and citizen of Illinois. Ms. Thomas is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

206. Defendant Lee Williams is a resident and citizen of Illinois. Mr. Williams is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

207. Defendant Scott Lyon is a resident and citizen of Illinois. Mr. Lyon is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

208. Defendant John Damas is a resident and citizen of Illinois. Mr. Damas is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

209. Defendant Katherine Brody is a resident and citizen of Illinois. Ms. Brody is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

210. Defendant Yeat Yang Nachowicz is a resident and citizen of Illinois. Mr. Nachowicz is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

211. Defendant Jayant Patel is a resident and citizen of Illinois. Mr. Patel is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

212. Defendant Kalpana Patel is a resident and citizen of Illinois. Ms. Patel is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

213. Defendant Steven Johnson is a resident and citizen of Illinois. Mr. Johnson is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

214. Defendant Kenneth Ziobro is a resident and citizen of Illinois. Mr. Ziobro is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

215. Defendant Ramesh Patel is a resident and citizen of Illinois. Mr. Patel is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

216. Defendant Kumud Patel is a resident and citizen of Illinois. Mr. Patel is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

217. Defendant Gary Karas is a resident and citizen of Illinois. Mr. Karas is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

218. Defendant John Bochantine is a resident and citizen of Illinois. Mr. Bochantine is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

219. Defendant Michael McHale is a resident and citizen of Illinois. Mr. McHale is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

220. Defendant Gregory Johnson is a resident and citizen of Wisconsin. Continental alleges that Mr. Johnson has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Mr. Johnson is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

221. Defendant Denise Rebot is a resident and citizen of Illinois. Ms. Rebot is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

222. Defendant Diane Baschetti is a resident and citizen of Illinois. Ms. Baschetti is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

223. Defendant Kenneth Griese is a resident and citizen of Illinois. Mr. Griese Messmer is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

224. Defendant Jasper Tavolacci is a resident and citizen of Illinois. Mr. Tavolacci is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

225. Defendant Daniel Vaclav is a resident and citizen of Illinois. Mr. Vaclav is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

226. Defendant Pamela Vaclav is a resident and citizen of Illinois. Ms. Vaclav is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

227. Defendant Michael Keyes is a resident and citizen of Illinois. Mr. Keyes is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

228. Defendant Robert Carlson is a resident and citizen of Illinois. Mr. Carlson is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

229. Defendant Kathleen Carlson is a resident and citizen of Illinois. Ms. Carlson is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

230. Defendant Claudia Pryor is a resident and citizen of Illinois. Ms. Pryor is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

231. Defendant Bert Garnsey is a resident and citizen of Illinois. Mr. Garnsey is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

232. Defendant Cynthia Garnsey is a resident and citizen of Illinois. Ms. Garnsey is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

233. Defendant Linda Gabriel is a resident and citizen of Illinois. Ms. Gabriel is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

234. Defendant James Spachman is a resident and citizen of Illinois. Mr. Spachman is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

235. Defendant Joyce Spachman is a resident and citizen of Illinois. Ms. Spachman is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

236. Defendant Walter Krope is a resident and citizen of Illinois. Mr. Krope is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

237. Defendant Kim Fosse is a resident and citizen of Illinois. Mr. Fosse is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

238. Defendant Kenneth Machala is a resident and citizen of Illinois. Mr. Machala is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

239. Defendant Denise D'Andrea is a resident and citizen of Illinois. Ms. D'Andrea is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

240. Defendant John Nowak is a resident and citizen of Illinois. Mr. Nowak is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

241. Defendant Laura DeNovo is a resident and citizen of Illinois. Ms. DeNovo is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

242. Defendant Ernesto Torres is a resident and citizen of Illinois. Mr. Torres is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

243. Defendant Larry Przebieda is a resident and citizen of Illinois. Mr. Przebieda is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

244. Defendant Barbara Bishop is a resident and citizen of Illinois. Ms. Bishop is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

245. Defendant Orley Betcher is a resident and citizen of Illinois. Mr. Betcher is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

246. Defendant Richard Martinaitis is a resident and citizen of Illinois. Mr. Martinaitis is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

247. Defendant Marsha Martinaitis is a resident and citizen of Illinois. Ms. Martinaitis is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

248. Defendant Joseph Tidaback is a resident and citizen of Illinois. Mr. Tidaback is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

249. Defendant Rori Tidaback is a resident and citizen of Illinois. Ms. Tidaback is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

250. Defendant Emil Koschnitzki is a resident and citizen of Illinois. Mr. Koschnitzki is named as a defendant in this action because he is a claimant in the Stoltmann Demand and

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

251. Defendant Robert Webb is a resident and citizen of Illinois. Mr. Webb is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

252. Defendant Anna Lietzow is a resident and citizen of Illinois. Ms. Lietzow is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

253. Defendant James Moellendorf is a resident and citizen of Illinois. Mr. Moellendorf is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

254. Defendant Christine Naybar is a resident and citizen of Illinois. Ms. Naybar is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

255. Defendant Bonnie Fisher is a resident and citizen of Illinois. Ms. Fisher is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

256. Defendant Philip Glavan is a resident and citizen of Illinois. Mr. Glavan is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

257. Defendant Denise Hoger is a resident and citizen of Illinois. Ms. Hoger is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

258. Defendant Diane Sutor is a resident and citizen of Indiana. Continental alleges that Ms. Sutor has sufficient contact with the State of Illinois to be subject to personal jurisdiction in this matter. Ms. Sutor is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

259. Defendant Bernard Egan is a resident and citizen of Illinois. Mr. Egan is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

260. Defendant Patricia O'Ryan is a resident and citizen of Illinois. Ms. O'Ryan is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

261. Defendant Douglas Dahl is a resident and citizen of Illinois. Mr. Dahl is named as a defendant in this action because he is a claimant in the Stoltmann Demand and may claim an

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

interest in the Certificate to the extent he is awarded a judgment or settlement in connection with the Stoltmann Demand.

262. Defendant Lori Dahl is a resident and citizen of Illinois. Ms. Dahl is named as a defendant in this action because she is a claimant in the Stoltmann Demand and may claim an interest in the Certificate to the extent she is awarded a judgment or settlement in connection with the Stoltmann Demand.

JURISDICTION AND VENUE

263. Pursuant to 735 I.L.C.S. § 5/2-701, an actual controversy exists because the dispute between the parties is a concrete dispute that admits of an immediate and definitive determination of the parties' rights.

264. Continental has a tangible, legal interest in the controversy.

265. Venue is proper in this Court pursuant to 735 I.L.C.S. § 5/2-101 because numerous defendants joined in good faith reside in Cook County, Illinois.

FACTUAL BACKGROUND

A. The Procurement of the Certificate

266. Before procuring the Certificate at issue in this matter, Goldstone previously participated in the Master Policy through a prior Certificate of Insurance issued to it for the **Certificate Period** December 1, 2016 to December 1, 2017. Goldstone experienced a lapse in coverage beginning on December 1, 2017.

267. In August 2018, Goldstone sought to procure a Certificate with a retroactive **Certificate Period** beginning on December 1, 2017, the date on which the prior Certificate had expired.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

268. Ultimately, in reliance on the accuracy of the representations made by the **Insureds** in the application materials, the Certificate was issued to Goldstone with a **Certificate Period** retroactively incepting on June 1, 2018.

269. In order to procure the Certificate, through which the **Insureds** participate in the Master Policy, on August 6, 2018, Michael Pellegrino signed and submitted on behalf of Goldstone an E&O Claims Free Form (the "Claims Free Form"). Also on August 6, 2018, Goldstone electronically submitted an MGA Customer Application (the "Application"). A true and correct copy of the Claims Free Form is attached as Exhibit 3. A redacted copy of the Application is attached as Exhibit 4. Continental has redacted the Application to avoid disclosing publicly portions of the Application that Goldstone may consider to be confidential, but Continental has no objection to Goldstone submitting the entire, unredacted Application for the Court's consideration.

270. Through the Claims Free Form, which was submitted on August 6, 2018, Goldstone requested to participate in the Master Policy retroactively, effective June 2018. Ex. 3, Claims Free Form, at p. 1.

271. On the Claims Free Form, Goldstone represented that it "is not aware of any suits, threatened suits, claims, demands or of any wrongful acts which may reasonably be expected to result in a claim being made against an insured." *Id.*, at 2.

272. The Claims Free Form, which identified Goldstone as the Certificate Holder, provided: "The Certificate Holder understands that this letter will be relied upon in making underwriting decisions. The Certificate Holder also warrants and represents that the statements made above are true and that the Certificate Holder has not omitted or misrepresented any information." *Id.*

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

273. The Application defined "Applicant" to mean the "Individual or Firm applying for coverage, its directors, officers, partners, members, employees, independent contractors and any other person for whom coverage is requested." Ex. 4, Application, at p. 2.

274. In one of its threshold Eligibility Questions, the Application asked Applicant to acknowledge that, in order to qualify for insurance coverage under the program, it must truthfully answer "no" to all of the Application's questions posed in the Claims, Complaints and Disciplinary Actions section. Applicant acknowledged that, if it answered "yes" to any such questions, it "will not qualify for coverage under this program without additional underwriting review and approval." *Id.*

275. The Application also provided: "If Applicant fails to truthfully answer any of the below questions, Applicant will not be insured under the program, and any Certificate of Insurance issued as a result of any such inaccuracy will be void from inception." *Id.*

276. The Application then asked:

> After review of Applicant's records, does Applicant have any knowledge or information of any fact, situation, allegation or incident which may result in a complaint, claim, suit or arbitration against Applicant?

Id. Applicant answered "No" to this question. *See id.*

The Application Exclusion

277. The Acknowledgement section of the Application included the following statement and exclusion:

> I have no knowledge, as of the date of this enrollment application, of any wrongful act or any fact, circumstance, or situation which I have reason to suppose might result in a claim being made against me. I understand, and agree, that if I am aware of any wrongful act, or any fact, circumstance, or situation which I have any reason to suppose might result in a claim being made against me, such claim will not be covered under this policy.

See id., at p. 5 (the "Application Exclusion"). Applicant answered with an affirmative "yes."

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

B. The Certificate

278. In reliance upon Goldstone's submission of the Claims Free Form and Application, and subject to the foregoing admonitions and representations as to the accuracy of the matters set forth therein, the claims-made and reported Certificate was issued to Goldstone. As specifically requested by Goldstone, the Certificate was issued with a retroactive **Certificate Period** of June 1, 2018 to June 1, 2019. *See* Ex. 2, Certificate.

279. The Certificate provides, in two places: "No coverage exists if the representations made on the **Named Insured's** Application for Insurance are discovered to be false." *Id.*

280. The Certificate also provides: "Coverage is provided based on representations made on the **Named Insured's** Application for Insurance....Failure to provide true and accurate responses to any of the questions on the Application for Insurance will result in the immediate voiding of the insurance coverage issued and/or the denial of claims asserted against the **Named Insured**." *Id.*

281. The Certificate has a $2,000,000 per **Claim** limit of liability and a $2,000,000 aggregate limit of liability, subject to a per **Claim** deductible of $5,000. *See id.*

282. The Certificate provides that covered **Claims** are paid in accordance with the terms of the Master Policy. *See id.*

C. The Master Policy

283. Continental issued the Master Policy to Members of the NAPA Risk Purchasing Group, Inc. on a claims-made and reported basis. Ex. 1, Master Policy, Declarations, Item 1.(a).

284. The Master Policy provides a $10,000,000 **Policy Year** aggregate limit of liability. *See id.*, Endorsement No. 1.

The Prior Acts Condition

285. The Master Policy's Insuring Agreement provides, in relevant part:

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

> The Insurer shall pay on behalf of the **Insureds**, excess of the applicable Retention and within the Limits of Liability as stated in the applicable **Certificate of Insurance**, that **Loss** which the **Insureds** become legally obligated to pay resulting from a **Claim** for a **Wrongful Act** solely in the rendering or failing to render **Professional Services** provided that:
>
> 1. the **Wrongful Act** giving rise to such **Claim** occurred on or after the **Prior Acts Date**.

Id., Section I (the "**Prior Acts** Condition").

286. The Master Policy defines **Prior Acts Date** to mean:

> the date the **Named Insured** became continuously insured without interruption under any claims made professional liability policy (subject to written proof of such coverage at the time the **Named Insured** gives written notice to the Insurer of a **Claim** under this Policy). The **Named Insured** and any natural person who is a former or current secretarial, clerical or administrative employee of such **Named Insured** shall share the same **Prior Acts Date**.

Id., Section III.

287. **Named Insured** means the **Registered Investment Adviser** named in the **Certificate of Insurance**. *See id.*

288. Goldstone is the **Named Insured**, as the Master Policy defines that term. *See* Ex. 2, Certificate.

289. The date by which Goldstone, the **Named Insured**, became continuously insured without interruption under any claims made professional liability policy is June 1, 2018.

290. Accordingly, June 1, 2018 is the **Prior Acts Date**, as the Master Policy defines that term.

The Bankruptcy Exclusion

291. According to the Master Policy, Continental is not liable to pay any **Loss** in connection with any **Claim**:

> based upon, directly or indirectly arising out of, or in any way involving the insolvency, receivership, conservatorship, liquidation, bankruptcy or inability to

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

> pay of a natural person, entity, benefit plan, insurance company, managed health care organization, reinsurer, risk retention group or captive (or any self insurance plan or trust by whatsoever name), or limited partnership in which the **Insured** has placed business or obtained insurance coverage, or placed or recommended placement of the funds of a **Client**.

Ex. 1, Section XVI.I (the "Bankruptcy Exclusion").

292. The Master Policy defines **Client** to include "a natural person to whom, or entity to which, **Professional Services** are rendered by an **Insured**." *Id.*, Section III.

The Class Action Exclusion

293. The Master Policy provides that Continental is not liable to pay any **Loss** in connection with any **Claim** "that is a **Class Action Claim**." *Id.*, Section XVI.X (the "**Class Action** Exclusion").

294. The Master Policy defines **Class Action Claim** to mean "a **Claim** under which one party, or a group of parties, sue as representatives of a larger class. **Claims** brought in federal court are governed by Federal Rule of Civil Procedure 23." *Id.*, Section III.

C. Undisclosed Knowledge of Facts and Circumstances

295. Unbeknownst to Continental, Goldstone made material misrepresentations and omissions during the application process for the Certificate.

The 1 Global SEC Investigation and Bankruptcy Filing

296. On July 5, 2018, the United States Securities and Exchange Commission (the "SEC") issued a letter by overnight mail to Michael Pellegrino of Goldstone, in connection with the SEC's ongoing investigation of 1 Global Capital LLC ("1 Global"), in the matter identified as *In the Matter of 1 Global Capital, LLC (FL-4148)* (the "1 Global Investigation"). The SEC's July 5, 2018 letter to Mr. Pellegrino included a Subpoena, which required him to testify under oath before the SEC, on July 23, 2018, in connection with the 1 Global Investigation.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

297. On July 27, 2018, 1 Global filed a Voluntary Petition for Non-Individuals Filing for Bankruptcy under Chapter 11 of the Bankruptcy Code (the "Bankruptcy Petition"), in the bankruptcy proceeding styled *In re: 1 Global Capital LLC*, Case No. 18-19121 (Bankr. S.D. Fla.) (the "1 Global Bankruptcy").

298. According to the Bankruptcy Petition, 1 Global estimates that it has between 1,000 and 5,000 creditors.

299. Also on July 27, 2018, 1 Global filed in the 1 Global Bankruptcy a List of Creditors Who Have the 20 Largest Unsecured Claims and Are Not Insiders (the "1 Global Largest Creditors List"). A copy of the 1 Global Largest Creditors List is attached as Exhibit 5. Included on the 1 Global Largest Creditors List, and identified as the third largest unsecured creditor of 1 Global, is the Russell Rasner and Kimberly Ann Rasner Joint Living Trust, with an unsecured claim valued at $1,065,240.08. *See* Ex. 5, 1 Global Largest Creditors List, at p.1.

300. The SEC ultimately instituted a lawsuit against 1 Global (as well as Carl Ruderman, its founder, chairman and CEO) on August 23, 2018, as a result of an alleged "four-year-long unregistered securities offering fraud" conducted by 1 Global to the detriment of more than 3,400 investors.

301. The SEC alleges that, from no later than February 2014 until July 27, 2018, 1 Global fraudulently raised more than $287 million from more than 3,400 investors, using a network of barred brokers, registered and unregistered investment advisers and other sales agents to offer and sell unregistered securities to investors.

D. <u>The 1 Global Matters</u>

302. Goldstone placed business, or placed or recommended placement of the funds of certain of its clients, with 1 Global.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

303. Since the 1 Global Bankruptcy, more than two hundred of Goldstone's clients have asserted claims against the **Insureds** concerning the placement or recommended placement of their business or funds with 1 Global.

The Laura Senese Demand

304. By letter to Goldstone dated August 13, 2018 (the "Senese Demand"), Laura Senese demanded "full restitution" of her $25,000 "investment in 1st Global Capital loan portfolio," which Goldstone allegedly had recommended to her in April 2018.

305. According to the Senese Demand, Goldstone advised Ms. Senese of the 1 Global Bankruptcy by email on August 7, 2018 – one day after Goldstone had submitted the Claims Free Form and Application to Continental.

The Stoltmann Demand

306. By letter to Goldstone's representative dated September 17, 2018, Stoltmann Law Offices, P.C. (the "Stoltmann Firm") represented that it had been retained by 112 clients of Goldstone, "in the aggregate amount of damages of approximately $11,000,000." The letter asked that Goldstone provide the Stoltmann Firm with a copy of any potentially applicable insurance policy(ies) "which may cover some or all of the claims my clients intend to make."

307. In a later letter, addressed directly to Continental and dated October 1, 2018 (the "Stoltmann Demand"), the Stoltmann Firm demanded that Continental pay the entire $2 million limit of liability under the Certificate, in settlement of the claims of its purported 211 clients "with nearly identical claims against [Continental's] insureds, Goldstone…and its principals Anthony Pellegrino and Michael Pellegrino."

308. According to the Stoltmann Demand, the claims arise from "the negligent facilitation and promotion of loans approved by [the] insureds' broker dealer to 1 Global."

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

309. The Stoltmann Demand attaches as an Exhibit a list of the Stoltmann Firm's purported clients and the alleged amounts of their respective investments in 1 Global. The identified investment amounts total $22,581,479.27, with the vast majority of the identified investment dates pre-dating June 1, 2018 (the **Prior Acts** Date).

310. The Exhibit to the Stoltmann Demand includes Russell and Kim Rasner among the clients that the Stoltmann Firm purports to represent. As indicated above, in the 1 Global Largest Creditors List filed in the 1 Global Bankruptcy, the Rasners are identified as 1 Global's third largest unsecured creditor, with an unsecured claim valued at over $1 million.

The Class Action

311. By letter to Goldstone dated August 24, 2018, a representative of Mark Harrah asked to be provided with copies of Mr. Harrah's Customer Agreement with Goldstone, his account statements, and "all other documentation relating to his investment in 1 Global Capital LLC." According to the letter, Goldstone had promoted the investment in 1 Global during a seminar that Mr. Harrah had attended.

312. On September 29, 2018, Mr. Harrah, on behalf of the Mark R. Harrah Roth IRA, individually, "and on behalf of all other persons similarly situated," instituted the Class Action against Goldstone, Anthony Pellegrino and Michael Pellegrino, as well as a non-**Insured** defendant. A copy of the Class Action Complaint, with exhibits, filed in the Class Action is attached as Exhibit 6.[2]

[2] Continental has redacted Exhibit 7 of the Class Action Complaint to avoid disclosing publicly in this matter beneficiary information associated with the Mark R. Harrah Roth IRA.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

313. According to the Class Action Complaint, the Class Action is a "class action" brought "on behalf of the customers of Defendants who were sold securities in 1 Global." Ex. 6, Class Action Complaint, ¶ 1. *See also id.*, ¶¶ 34-43 (Class Action Allegations).

314. The Class Action Complaint complains:

> 1 Global was a fraudulent scheme in which more than 3,400 retail investors invested more than $287 million. More than one third of the investors were investing retirement funds. The money was not used by 1 Global for its stated purpose. Millions of dollars were misappropriated by insiders. 1 Global has filed for bankruptcy and is being sued for fraud by the U.S. Securities and Exchange Commission (SEC).

Id. ¶ 2.

315. According to the Class Action Complaint, the Class Action defendants "raised millions of dollars from hundreds of investors who purchased the unregistered securities of 1 Global. Defendants aggressively marketed and promoted 1 Global securities in a variety of venues to many people. Hundreds of their customers ended up purchasing the securities." *Id.* ¶ 3.

316. The Class Action Complaint asserts causes of action for violation of the Illinois Securities Act and Sections 5(a), 5(c) and 15 of the Securities Act of 1933.

317. The Class Action Complaint seeks relief in the form of rescission and the full return of all consideration paid for 1 Global securities, plus interest; compensatory damages to persons who no longer own the securities; fees; and costs. *See id.*, Prayer for Relief.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

The Crone Demand

318. By letter to Goldstone dated September 7, 2018 (the "Crone Demand"), Stephen and Eleanor Crone demanded the return of their $101,000 investment in 1 Global "that was recommended by Goldstone Financial Group."

319. According to the Crone Demand, the Crones "are investors that were directed to 1st Global Capital based upon the recommendation of Goldstone Financial Group."

320. The Crone Demand states: "In the wake of the bankruptcy filing by 1st Global, we have been contacted by multiple attorneys advertising representation for the purposes of recovering losses from both the bankrupt company and the financial advisors that recommended the investment."

321. The Crone Demand also states: "Prior to the filing of the bankruptcy, 1st Global Capital was under investigation by the SEC related to alleged possible security laws violations as well as investigations by the U.S. Attorney's office in southern Florida."

E. Notice of the 1 Global Matters

322. On September 6, 2018, Goldstone provided Continental with its first notice of the Subpoena that the SEC had issued to it on July 5, 2018 – more than one month before Goldstone had submitted the Claims Free Form and Application to Continental.

323. Also on September 6, 2018, Goldstone provided Continental with notice of the Senese Demand and Mr. Harrah's August 24, 2018 letter.

324. The September 6, 2018 notice also indicated that, on August 17, 2018, the Stoltmann Firm had advised Goldstone that it represented a client who had made a $100,000 investment in 1 Global on the advice of Goldstone, and the Stoltmann Firm was in the process of communicating with other potential claimants as well.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

325. The **Insureds** have sought coverage from Continental under the Certificate for the defense and indemnity of the 1 Global Matters.

326. On October 31, 2018, Continental sent a letter to Goldstone's coverage counsel stating its determination that it is entitled to rescind the Certificate based on material misrepresentations made during the application process to procure the Certificate. Continental also indicated that, even if the Certificate were not rescinded and void *ab initio*, coverage for the 1 Global Matters is otherwise precluded or limited on several bases, including without limitation the Application Exclusion, Bankruptcy Exclusion, Class Action Exclusion and **Prior Acts** Condition.

FIRST CAUSE OF ACTION
(For A Declaration That Continental Is Entitled To Rescind The Certificate And That The Certificate Is Void *Ab Initio*)

327. Continental incorporates by reference and realleges the allegations set forth in Paragraphs 1 through 326 of this Complaint as though fully restated herein.

328. On the Claims Free Form, Goldstone represented that it "is not aware of any suits, threatened suits, claims, demands or of any wrongful acts which may reasonably be expected to result in a claim being made against an insured."

329. Applicant also answered "No" to the question on the Application, which asked: "After review of Applicant's records, does Applicant have any knowledge or information of any fact, situation, allegations or incident which may result in a complaint, claim, suit or arbitration against Applicant?"

330. These responses were false because, at the time Goldstone submitted the Claims Free Form and the Application (on August 6, 2018), Goldstone was aware of (1) the SEC's 1 Global Investigation, in connection with which Michael Pellegrino already had been subpoenaed

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

to testify, and (2) the 1 Global Bankruptcy, which involved unsecured claims held by clients of Goldstone, whose monies were invested in 1 Global on the advice of or at the direction of Goldstone.

331. Continental reasonably relied upon the representations made in the Claims Free Form and the Application in issuing the Certificate.

332. The false and misleading representations and omissions made in the Claims Free Form and the Application were material to the risk assumed by Continental and increased the risk of loss in a manner of which Continental was not and could not have been aware. Had Continental known the true facts, as known to and concealed by Goldstone, it would not have issued the Certificate, or it would not have issued the Certificate on the same conditions.

333. Continental has tendered and hereby retenders to Goldstone a refund of the premium paid for the Certificate. By this means, Continental will restore the status quo ante existing between Continental and Goldstone before the misrepresentations and omissions that are at issue in this action were made.

334. As a consequence of the material misrepresentations and omissions of material fact communicated by Goldstone to Continental as described in this Complaint, Continental is entitled to a declaration that the Certificate is rescinded and void *ab initio*.

335. Continental is further entitled to a declaration that, because the Certificate is rescinded and void *ab initio*, there is no coverage for any claims made against any **Insured** under the Certificate, including but not limited to any of the 1 Global Matters.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

THIRD CAUSE OF ACTION
(For a Declaration That The Bankruptcy Exclusion Precludes Defense And Indemnity Coverage For The 1 Global Matters)

343. Continental incorporates by reference and realleges the allegations set forth in Paragraphs 1 through 342 of this Complaint as though fully restated herein.

344. Pursuant to the Bankruptcy Exclusion, coverage is not available for any **Claim** "based upon, directly or indirectly arising out of, or in any way involving the…bankruptcy or inability to pay of [an]…entity…in which the **Insured** has placed business…or placed or recommended placement of the funds of a **Client**."

345. Each of the 1 Global Matters is "based upon, directly or indirectly arising out of, or in any way involving the…bankruptcy or inability to pay of [an]…entity…in which the **Insured** has placed business…or placed or recommended placement of the funds of a **Client**."

346. Namely, each of the 1 Global Matters is "based upon, directly or indirectly arising out of, or in any way involving" the bankruptcy or inability to pay of 1 Global, which is an entity in which Goldstone placed business or placed or recommended placement of the funds of its **Clients**.

347. Continental therefore is entitled to a declaration that, even if the Certificate were not rescinded and void *ab initio*, the Bankruptcy Exclusion precludes defense and indemnity coverage for the 1 Global Matters, such that Continental has no obligation to pay **Defense Costs** or to defend the **Insureds** in connection with any of those matters, and has no obligation to indemnify the **Insureds** in any of those matters, or any part thereof.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

FOURTH CAUSE OF ACTION
(For a Declaration That The Class Action Exclusion Precludes Defense And Indemnity Coverage For The Class Action)

348. Continental incorporates by reference and realleges the allegations set forth in Paragraphs 1 through 347 of this Complaint as though fully restated herein.

349. Pursuant to the **Class Action** Exclusion, coverage is not available for any **Claim** "that is a **Class Action Claim,**" which the Master Policy defines as "a **Claim** under which one party, or a group of parties, sue as representatives of a larger class."

350. The Class Action qualifies as a **Class Action Claim,** as the Master Policy defines that term.

351. Continental therefore is entitled to a declaration that, even if the Certificate were not rescinded and void *ab initio*, the **Class Action** Exclusion precludes defense and indemnity coverage for the Class Action, such that Continental has no obligation to pay **Defense Costs** or to defend the **Insureds** in connection with the Class Action, and has no obligation to indemnify the **Insureds** in the Class Action.

FIFTH CAUSE OF ACTION
(For a Declaration That The Prior Acts Condition Precludes Coverage For Any Claim For Any Wrongful Act Prior To June 1, 2018)

352. Continental incorporates by reference and realleges the allegations set forth in Paragraphs 1 through 351 of this Complaint as though fully restated herein.

353. Subject to all of its terms, conditions and exclusions, the Master Policy provides coverage for certain **Claims**, provided that "the **Wrongful Act** giving rise to such **Claim** occurred on or after the **Prior Acts Date**."

354. The **Prior Acts Date** is June 1, 2018.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

355. Some or all of the 1 Global Matters involve **Wrongful Acts** allegedly committed by an **Insured** prior to June 1, 2018.

356. Continental therefore is entitled to a declaration that, even if the Certificate were not rescinded and void *ab initio*, Continental has no obligation to provide coverage to any **Insured** in connection with any portion of any of the 1 Global Matters involving any **Wrongful Act** committed prior to June 1, 2018, based on the Master Policy's **Prior Acts** Condition.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff Continental Casualty Company respectfully prays that this Court:

a. Enter judgment that Continental is entitled to rescind the Certificate of Insurance issued to Goldstone Financial Group for the **Certificate Period** of June 1, 2018 to June 1, 2019;

b. Declare that, because the Certificate is rescinded and void *ab initio*, Continental has no coverage obligations under the Certificate for any claims made against any **Insured**, including but not limited to the 1 Global Matters;

c. Declare that, even if the Certificate were not rescinded and void *ab initio*, the Application Exclusion precludes defense and indemnity coverage for the 1 Global Matters, such that Continental has no obligation to pay **Defense Costs** or to defend the **Insureds** in connection with any of those matters, and has no obligation to indemnify the **Insureds** in any of those matters, or any part thereof;

d. Declare that, even if the Certificate were not rescinded and void *ab initio*, the Bankruptcy Exclusion precludes defense and indemnity coverage for the 1 Global Matters, such that Continental has no obligation to pay **Defense Costs** or to defend the **Insureds** in connection with any of those matters, and has no obligation to indemnify the **Insureds** in any of those matters, or any part thereof;

e. Declare that, even if the Certificate were not rescinded and void *ab initio*, the Class Action Exclusion precludes defense and indemnity coverage for the Class Action, such that Continental has no obligation to pay **Defense Costs** or to defend the **Insureds** in connection with the Class Action, and has no obligation to indemnify the **Insureds** in the Class Action;

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

f. Declare that, even if the Certificate were not rescinded and void *ab initio*, Continental has no obligation to provide coverage to any **Insured** in connection with any portion of any of the 1 Global Matters involving any **Wrongful Act** committed prior to June 1, 2018, based on the Master Policy's **Prior Acts** Condition; and

g. Award Continental its litigation costs and all such other and further relief as the Court may deem necessary or appropriate in the interests of justice.

Respectfully submitted,

DATED: October 31, 2018

/s/ Richard A. Simpson
Richard A. Simpson
Illinois Bar No. 3122509
WILEY REIN LLP
1776 K Street N.W.
Washington, D.C. 20006
(202) 719-7000
rsimpson@wileyrein.com

Counsel for Continental Casualty Company

/s/ Greta A. Matzen
Greta A. Matzen
Illinois Bar No.: 6307545
CNA COVERAGE LITIGATION GROUP
151 North Franklin Street – 14th Floor
Chicago, IL 60606
Firm I.D. 60645
312-822-4963
greta.matzen@cna.com

CERTIFICATE OF SERVICE

The undersigned, an attorney, certify that I caused a copy of the foregoing to be electronically filed with the Circuit Court of Cook County electronic filing system on this 31st day of October, 2018.

/s/ Greta A. Matzen

FILED
10/31/2018 1:20 PM
DOROTHY BROWN
CIRCUIT CLERK
COOK COUNTY, IL
2018CH13639

CNA

MASTER POLICY
LIFE AGENT PROFESSIONAL LIABILITY

Declarations

NOTICE:

THIS IS A CLAIMS-MADE AND REPORTED POLICY AND, SUBJECT TO ITS PROVISIONS, APPLIES ONLY TO ANY CLAIM FIRST MADE AGAINST AN INSURED AND REPORTED TO THE INSURER IN ACCORDANCE WITH SECTION VII, NOTICE. NO COVERAGE EXISTS FOR CLAIMS FIRST MADE AFTER THE END OF THE POLICY PERIOD UNLESS, AND TO THE EXTENT THAT, THE EXTENDED REPORTING PERIOD APPLIES. DEFENSE COSTS REDUCE THE LIMIT OF LIABILITY AND ARE SUBJECT TO THE RETENTION. PLEASE REVIEW THE POLICY CAREFULLY AND DISCUSS THE COVERAGE WITH YOUR INSURANCE AGENT OR BROKER.

<table>
<tr><td colspan="2">CUSTOMER NUMBER: 707721</td><td rowspan="2">INSURER: Continental Casualty Company</td></tr>
<tr><td colspan="2">POLICY NUMBER: 596737388</td></tr>
<tr><td colspan="2">POLICYHOLDER AND ADDRESS</td><td rowspan="3">PRODUCER
Gallagher MGA
8430 Enterprise Circle, Suite 200
Lakewood Ranch, FL 34202</td></tr>
<tr><td>Item 1.(a)</td><td>Members of the NAPA Risk Purchasing Group, Inc.
8430 Enterprise Circle, Suite 200
Lakewood Ranch, FL 34202</td></tr>
<tr><td>Item 1.(b)

Attn: Jason Rogers</td><td>Insurance companies represented:
Not Applicable</td></tr>
<tr><td colspan="3">Item 2. Policy Period: incepts on November 1, 2016 12:01 a.m. local time at the address stated in Item 1</td></tr>
<tr><td colspan="2">Item 3. Notice to Insurer:
Claims Notices: SpecialtyProNewLoss@cna.com
or
CNA – Claims Reporting
P.O. Box 8317
Chicago IL 60680-8317
Fax: 866-773-7504</td><td>All other notices:
Life Agent Underwriting Unit
CNA Global Specialty
125 Broad Street, 8th Floor
New York, NY 10004</td></tr>
</table>

Item 4. Endorsements forming a part of this Policy at issuance:

1. CNA87112XX (9-16) Professional Liability Aggregate Endorsement
2. CNA87113XX (9-16) Cost of Corrections Endorsement
3. CNA87114XX (9-16) Firms with Multiple Advisers Endorsement
4. CNA87115XX (9-16) Privacy Protection Endorsement
5. CNA87116XX (9-16) Social Media Coverage Endorsement
6. CNA87117NY (9-16) New York Amendatory Endorsement
7. GSL7805FL (4-10) Cancellation and Non-Renewal Endorsement
8. GSL7806FL (8-10) Amendatory Endorsement – Florida
9. CNA77863FL 02-14 Policyholder Notice – Florida

These Declarations, along with the completed and signed **Application**, the Policy, and any written endorsements attached thereto shall constitute the contract between the **Insureds** and the Insurer.

Authorized Representative: _____ Date: December 7, 2016

© Copyright CNA All Rights Reserved

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

CNA

MASTER POLICY
REGISTERED INVESTMENT ADVISER PROFESSIONAL LIABILITY

NOTICE:

THIS IS A CLAIMS-MADE AND REPORTED POLICY AND, SUBJECT TO ITS PROVISIONS, APPLIES ONLY TO ANY CLAIM FIRST MADE AGAINST AN INSURED AND REPORTED TO THE INSURER IN ACCORDANCE WITH SECTION VII, NOTICE. NO COVERAGE EXISTS FOR CLAIMS FIRST MADE AFTER THE END OF THE INSURED'S CERTIFICATE PERIOD UNLESS, AND TO THE EXTENT THAT, THE EXTENDED REPORTING PERIOD APPLIES. DEFENSE COSTS REDUCE THE LIMIT OF LIABILITY AND ARE SUBJECT TO THE RETENTION. PLEASE REVIEW THE POLICY CAREFULLY AND DISCUSS THE COVERAGE WITH YOUR INSURANCE AGENT OR BROKER.

The Insurer and the **Policyholder** agree as follows, in consideration of the payment of the premium and in reliance upon all statements made in the **Application** furnished to the Insurer designated in the Declarations, a stock insurance corporation, hereafter called the "Insurer".

I. INSURING AGREEMENT

PROFESSIONAL LIABILITY

The Insurer shall pay on behalf of the **Insureds**, excess of the applicable Retention and within the Limits of Liability as stated in the applicable **Certificate of Insurance**, that **Loss** which the **Insureds** become legally obligated to pay resulting from a **Claim** for a **Wrongful Act** solely in rendering or failing to render **Professional Services** provided that:

1. the **Wrongful Act** giving rise to such **Claim** occurred on or after the **Prior Acts Date**; and,
2. the **Claim** is first made against any **Insured** during the **Certificate Period**, or any Extended Reporting Period, if applicable, and reported to the Insurer in accordance with Section VII, NOTICE; and
3. prior to the date of the **Insured's** initial enrollment under this Policy, or under any other policy issued by the Insurer (or its affiliated insurers) of which this Policy is a renewal (whether successive or not) or replacement, whichever is earlier, no **Insured** knew of, or could have reasonably foreseen that any such **Wrongful Act** could result in a **Claim**; and
4. no **Insured** gave notice under any Prior Policy of any such **Wrongful Act** or any **Interrelated Wrongful Acts**; and
5. there is no other policy issued by the Insurer, or any affiliate of such Insurer, that provides coverage for such **Claim**.

II. DEFENSE

A. Defense of **Claims**

1. If a **Claim** is made against the **Insured** within the United States of America, its territories or possessions or Canada, the Insurer shall have the right and duty to defend such **Claim**, even if any of the allegations of the **Claim** are groundless, false or fraudulent. The Insurer may make such investigation and negotiate settlement of any **Claim** it deems expedient, but the Insurer shall not be obligated to pay any **Loss** to defend or continue to defend any **Claim** after the applicable limit of the Insurer's liability has been exhausted by payment of **Loss**.
2. If a **Claim** is made against the **Insured** outside of the United States of America, its territories or possessions or Canada, the Insurer shall indemnify the **Insured** pursuant to the terms, conditions, provisions and exclusions of the Policy, but shall not have the duty to defend the **Insured**. The Insurer shall instead reimburse **Defense Costs** incurred by the **Insured** in defending such **Claims**. In connection with such **Claims**, the **Insured** shall obtain the Insurer's consent to the selection of counsel, including counsel rates, and ensure that counsel complies with CNA's *Defense Counsel Guidelines*. CNA shall have the right, but not the duty, to associate with the **Insured** in the defense of any such **Claim**.

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

B. Insurer's Consent

The **Insured** shall not admit liability, consent to any judgment, agree to any settlement, make any settlement offer, assume any obligation or incur any default judgment or award without the Insurer's prior consent, which consent shall not be unreasonably withheld. The Insurer shall not be liable for any **Loss** incurred by the **Insured** to the extent the **Loss** results from such **Insured** admitting liability, consenting to any judgment, agreeing to any settlement, making any settlement offer or incurring expenses without the Insurer's prior consent. The **Insureds** agree that they shall not knowingly take any action which increases the Insurer's exposure for **Loss** under this Policy resulting from any **Claim**.

C. Arbitration

The **Insured** shall not demand or agree to arbitration of any **Claim** made against the **Insured** without the written consent of the Insurer, except with respect to arbitration between an **Insured** and a **Client**. In the event any **Claim** is submitted to arbitration, the Insurer, as soon as practicable, shall notify the **Insured** of the date of the arbitration hearing. The Insurer shall be entitled to exercise all of the **Insureds'** rights in the choice of arbitrators and in the conduct of any arbitration proceeding involving a **Claim** covered by this Policy.

III. DEFINITIONS

Wherever appearing in bold print in this Policy:

Accredited Investor shall mean the most recent definition provided by the Securities and Exchange Commission at the time the **Wrongful Act** giving rise to a **Claim** occurred.

Administration of Employee Benefit Plans means consultation with participants in an employee benefit plan in order to explain the provisions of such plan and handling day-to-day ministerial functions required by such plan, including without limitation enrollment, record keeping and filing reports with government agencies. **Administration of Employee Benefit Plans** also includes third party claims administration. **Administration of Employee Benefit Plans** shall not include **Professional Services** performed by an **Insured Enroller**.

Agent or General Agent, whether used separately or together, means a natural person:

A. who maintains a life agent contract with a life insurance company, and;

B. who is also a **Registered Investment Adviser**.

Agent or General Agent also includes any corporation, partnership, or other business entity owned or controlled by, or on whose behalf such natural person referred to in A. or B. of this definition provides **Professional Services** for other, but solely with respect to the liability of such entity as it arises out of the rendering of or failing to render **Professional Services** by an **Insured Agent or General Agent**, as defined in A. or B. of this definition.

Application means all signed applications for this Policy and for any policy in an uninterrupted series of policies issued by the Insurer or any affiliate of the Insurer of which this Policy is a renewal or replacement. An "affiliate of the Insurer" means an insurer controlling, controlled by or under common control with the Insurer.

Broker/Dealer means any securities broker or dealer as those terms are defined in the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, or the Investment Advisers Act of 1940, as amended.

Certificate of Insurance means the document issued to the **Named Insured** evidencing the terms, limits, premium and endorsements provided to the **Insureds** thereunder.

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

Certificate Period means the period of time between the inception date shown on the **Certificate of Insurance** and the effective date of termination, expiration or cancellation of the **Certificate of Insurance** issued to the **Named Insured**.

Claim means:

A. a written demand for monetary damages; or

B. a civil adjudicatory or arbitration proceeding for monetary damages,

against an **Insured** for a **Wrongful Act**, including any appeal thereof, brought by or on behalf of or for the benefit of any **Client**.

Class Action Claim means a **Claim** under which one party, or a group of parties, sue as representatives of a larger class. **Claims** brought in federal court are governed by Federal Rule of Civil Procedure 23.

Client means a natural person to whom, or entity to which, **Professional Services** are rendered by an **Insured**. **Client** does not include any Insurance Company, Insurance Agent or **Broker/Dealer**.

Defense Costs means reasonable and necessary fees and expenses incurred by or at the direction of the Insurer in defense of any **Claim,** and costs of appeal, attachment or similar bonds. The Insurer has no obligation to provide such bonds. **Defense Costs** shall not include salaries, wages, fees, overhead or benefit expenses associated with the directors, officers and employees of the **Insured**, or fees and expenses of independent adjusters.

Domestic Partner means any person qualifying as such under any federal, state or local laws or under any **Insured** entity's employee benefit plans.

Insured means the **Named Insured** and any natural person who is a former or current secretarial, clerical or administrative employee, of such **Named Insured** but solely for services performed within his or her capacity as such and on behalf of such **Named Insured**, provided such natural person did not receive any commission income pursuant to an agent, broker or registered representative contract with any insurance company or **Broker/Dealer** as a result of providing **Professional Services** offered by the **Named Insured**.

Interrelated Wrongful Acts means any **Wrongful Acts** which are logically or causally connected by reason of any common fact, circumstance, situation, transaction or event.

Investment Advisory Services means advisory services provided by a **Registered Investment Adviser** pursuant to the Investment Advisers Act of 1940 with respect to securities approved by a **Broker/Dealer**, provided that, prior to providing such services, the **Registered Investment Adviser** gave written notice of such services to the **Broker/Dealer** and received written approval from such **Broker/Dealer** to conduct such transactions.

Investment Manager means any fiduciary as defined in Section 3(38) of the Employee Retirement Income Security Act of 1974, as amended.

Loss means monetary settlements or monetary judgments (including any award of pre-judgment and post-judgment interest) and **Defense Costs** for which the **Insured** is legally obligated to pay on account of a covered **Claim**.

However, **Loss** shall not include:

A. criminal or civil fines or penalties imposed by law or taxes. However, **Loss** shall include any taxes, fines, and penalties incurred by a third party and included in such third party's **Claims** against the **Insured**;

B. any amount for which there is no legal recourse against the **Insureds**;

C. punitive or exemplary damages or the amount of any multiplied damage award which is in excess of the damage award so multiplied;

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

D. costs incurred as a result of any injunctive relief;

E. the return of commissions, fees or charges for services rendered by an **Insured**; or

F. matters which are uninsurable under the law pursuant to which this Policy shall be construed.

Named Insured means the **Registered Investment Adviser** named in the **Certificate of Insurance**.

Outside Business means products placed by an **Insured** with any insurance company not specified in Item 1a. or 1b. of the Declarations.

Personal Injury means injury or damage sustained by any person or organization caused by or arising out of:

A. false arrest, detention or imprisonment, or malicious prosecution;

B. libel or slander or other defamatory or disparaging material, or a publication or utterance in violation of an individual's right of privacy; or

C. wrongful entry or eviction, or other invasion of the right of private occupancy.

Policy Period means the period from the effective date of this Policy as specified in the Declarations to the date the Policy is terminated as set forth in Section **VIII. TERMINATION OF MASTER POLICY.**

Policyholder means the natural person or organization specified in Item 1a. of the Declarations.

Pollutants mean any substance exhibiting hazardous characteristics as or may be defined or identified on any list of hazardous substances issued by the United States Environmental Protection Agency or any state or local or foreign counterpart. **Pollutants** also means, without limitation, any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals or waste (including materials to be recycled, reconditioned or reclaimed), as well as any air emission, odor, waste water, oil or oil products, infectious or medical waste, asbestos, or asbestos products or any noise.

Prior Acts Date means the date the **Named Insured** became continuously insured without interruption under any claims made professional liability policy (subject to written proof of such coverage at the time the **Named Insured** gives written notice to the Insurer of a **Claim** under this Policy). The **Named Insured** and any natural person who is a former or current secretarial, clerical or administrative employee of such **Named Insured** shall share the same **Prior Acts Date**.

Professional Services means:

A. with respect to an **Agent or General Agent**, to the extent they are provided in the course and scope of such **Agent or General Agent's** business as an **Agent or General Agent** and such **Agent or General Agent** has the appropriate license in both the **Client's** resident state or jurisdiction and the state or jurisdiction in which the business is conducted:

1. the sale, attempted sale or servicing of life insurance, accident and health insurance or managed health care organization contracts (that does not require a securities license);
2. the sale, attempted sale or servicing of disability income insurance;
3. the sale, attempted sale or servicing of indexed/fixed annuities;
4. **Administration of Employee Benefit Plans**;
5. financial planning activities in conjunction with services described in paragraphs 1. through 4. of this definition, whether or not a separate fee is charged;
6. the supervision, management and training of an **Agent** by a **General Agent** with respect to activities otherwise covered by this Policy; or
7. services as a notary public.

B. with respect to a **Registered Representative** or **Registered Investment Adviser**, and only to the extent **Professional Services** are provided in the course and scope of such **Registered Representative's** or **Registered Investment Adviser's** business as a **Registered Representative**

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

or **Registered Investment Adviser**, and such **Registered Representative** or **Registered Investment Adviser** has the appropriate license in both the **Client's** resident state or jurisdiction and the state or jurisdiction in which the business is conducted:

1. the sale, attempted sale or servicing of variable annuities, variable insurance (that requires a securities license) or mutual funds, that are registered with the Securities Exchange Commission, if required, through a **Broker/Dealer** that is a member of the Financial Industry Regulatory Authority;
2. **Investment Advisory Services**;
3. The sale or attempted dale or servicing of securities (other than variable annuities, variable life insurance and mutual funds) approved by and offered on the securities platform of the **Broker/Dealer** with whom the **Registered Representative** had a contract at the time of the **Wrongful Act**;
4. financial planning activities in conjunction with services described in paragraph 1. through 3. of this definition, whether or not a separate fee is charged;
5. Investment advice or other services provided as a fiduciary, as that term is defined under Section 3(21)(A) of the Employee Retirement Income Security Act of 1974, as amended, or **Investment Manager**, unless the **Registered Investment Adviser** is designated as a named fiduciary on the plan instrument;
6. Services performed as a Fiduciary Advisor as defined in the Pension Protection Act of 2006, or the Department of Labor's Conflict of Interest provisions as they relate to retirement investment advice, and any amendment thereof.

Registered Investment Adviser means:

1. a natural person, or any corporation, partnership or other business entity owned or controlled by such individual providing **Investment Advisory Services** in its capacity as an Investment Advisor registered as such under the Investment Advisors Act of 1940, as amended;
2. who maintains a contract with RIA in a Box;
3. who has elected to enroll for coverage under this Master Policy or any policy issued by the Insurer of which this Master Policy is a renewal;
4. whose enrollment is on file with the **Policyholder**;
5. solely with respect to the liability of such organization arising out of failing to render **Professional Services**, any corporation, partnership or other business entity on whose behalf an **Insured** provides **Professional Services**.

Registered Investment Adviser also includes any natural person who qualifies under paragraphs 1. through 5. of this definition and also qualifies for coverage as an **Agent or General Agent** or **Registered Representative**.

Registered Representative means a natural person **Registered Investment Adviser** who is or was registered with the Financial Industry Regulatory Authority at the time of the **Wrongful Act**.

Wrongful Act means any negligent act, error or omission of, or **Personal Injury** caused by, the **Insureds** in rendering or failing to render **Professional Services**.

IV. EXTENDED REPORTING PERIOD

A. If during the **Certificate Period** a **Named Insured** ceases their status as such with the **Policyholder**, such **Named Insured** shall have an Automatic Extended Reporting Period, beginning on his/her date of termination and terminating 30 days thereafter, during which time coverage for such **Named Insured** shall continue in accordance with the terms and conditions of this Policy, but only with respects to **Wrongful Acts** (i) committed after the **Prior Acts Date** as defined in the Policy; (ii) committed before his/her termination date; and (iii) which are **Wrongful Acts** otherwise covered under the terms and conditions of this Policy.

B. A **Named Insured** shall not be entitled to such Automatic Extended Reporting Period if he or she, at the time any **Claim** is made, is enrolled in any broker, dealer, life agent, registered representative, registered investment adviser, financial planning or professional liability policy, other than this Policy, whether or not that policy actually affords coverage for the **Claim** in question.

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

C. A **Named Insured** shall not be entitled to such Automatic Extended Reporting Period if the Insurer has cancelled such **Named Insured's Certificate of Insurance** for non payment of premium when due.

D. Optional Extended Reporting Period

Within 30 days after the termination of his/her status as such with the **Policyholder,** specified in Item 1. A. of the Declarations, a **Named Insured** shall have the right to purchase, upon payment of an additional rate determined (as a percentage of the expiring annual rate specified below), an optional extension of this Policy for the period described below ("The Optional Extended Reporting Period"). The Optional Extended Reporting Period shall begin on his/or date of termination, during which coverage for such **Named Insured** shall continue as an **Insured** under this Policy, but only with respect to **Wrongful Acts** (i) committed after the **Prior Acts Date** as defined in the Policy; (ii) committed before his/her termination date; and (iii) which are **Wrongful Acts** otherwise covered under the terms and condition of this Policy.

Optional Extended Reporting Period	Rate %
1 year	100%
2 years	160%
3 years	200%

V. ESTATES, LEGAL REPRESENTATIVES AND SPOUSES

The estates, heirs, legal representatives, assigns spouses or **Domestic Partners** of **Insureds,** shall be considered **Insureds** under this Policy; provided however, that coverage is afforded to such estates, heirs, legal representatives, assigns, spouses or **Domestic Partners** only for a **Claim** arising solely out of their status as such and, in the case of a spouse or **Domestic Partner**, where such **Claim** seeks damages from marital community property, jointly-held property or property transferred from the **Insured** to the spouse or **Domestic Partner**. No coverage is provided for any **Wrongful Act** of an estate, heir, legal representative, assign spouse or **Domestic Partner**. All terms and conditions of this Policy, including without limitation the Retention applicable to **Loss** incurred by the **Insured** shall also apply to **Loss** incurred by such estates, heirs, legal representatives, assigns, spouses or **Domestic Partners**.

VI. LIMIT OF LIABILITY, RETENTION AND ALLOCATION

A. Each **Claim** and Aggregate per **Certificate of Insurance**

The Limit of Liability set forth in each **Certificate of Insurance** shall apply as follows:

1. Each **Claim-** per **Certificate of Insurance**

Subject to paragraph 2. below, the Limit of Liability of the Insurer for **Loss** for each covered **Claim** shall not exceed the amount stated in such **Named Insured's Certificate of Insurance**.

2. Aggregate – per **Certificate of Insurance**

The Limit of Liability of the Insurer for **Loss** for all **Claims** in the aggregate shall not exceed the amount stated in such **Named Insured's Certificate of Insurance**.

B. Multiple **Insureds**

The Limits of Liability, shown in each **Certificate of Insurance**, shall be the Insurer's maximum Limit of Liability for all **Insureds** thereunder, regardless of the number of **Insureds, Claims** made or persons or entities making **Claims**.

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

C. Exhaustion of Limit of Liability

The Insurer's obligations under each **Certificate of Insurance** shall be deemed completely fulfilled and extinguished if the Limit of Liability thereunder is exhausted by payment of **Loss.**

D. Retention

Subject to the applicable Limit of Liability, the Insurer shall pay all covered **Loss** excess of all applicable Retentions, if any, set forth in each **Named Insured's Certificate of Insurance**. If more than one Retention is applicable to any single **Claim**, the maximum aggregate Retention for such **Claim** shall be the largest of such Retentions.

If the Insurer, in the exercise of its discretion and without any obligation to do so, pays any amount within the amount of the applicable Retention, the **Insured** shall be liable to the Insurer for any and all such amounts and, upon demand, shall pay such amounts to the Insurer.

E. **Interrelated Wrongful Acts**

More than one **Claim** involving the same **Wrongful Act** or **Interrelated Wrongful Acts** shall be considered as one **Claim** which shall be deemed to have been made on the earlier of:

1. the date on which the earliest such **Claim** was first made; or
2. the first date valid notice was given by an **Insured** and received by the Insurer under this Policy of any **Wrongful Act** or under any prior policy of any **Wrongful Act** or any fact, circumstance, situation, event or transaction which underlies any such **Claim**.

F. Allocation

If a **Claim** made against the **Insureds** includes both covered and uncovered matters or if a **Claim** is made against **Insureds** who are extended coverage under this Policy and others who are not extended coverage therefor under this Policy, the **Insureds** agree that there must be an allocation between insured and uninsured **Loss** (other than that part of **Loss** attributable to **Defense Costs**). The **Insureds** and the Insurer shall exert their best efforts to agree upon a fair and proper allocation between such insured and uninsured **Loss** based upon the relative legal exposures of the parties to such matters.

G. **Investment Manager**

With respect to **Claims** based on **or** arising out of investment advice or other services provided as an **Investment Manager**, the amount of $250,000 shall be the Insurer's maximum limit of liability for each **Claim** and the amount of $250,000 shall be the policy Aggregate limit of liability per **Named Insured**. These amounts are sub-limits of insurance which are included within and not in addition to the Limits of Liability set out in Item 6. of the **Certificate of Insurance**.

H. Subpoena Expenses

In the event the **Insured** receives a subpoena for documents or sworn testimony, during the applicable **Certificate Period**, arising out of **Professional Services** rendered by the **Insured**, the **Insured** may provide the Insurer with a copy of the subpoena and the Insurer, at its sole discretion, may retain an attorney to provide advice regarding the production of documents, to prepare the **Insured** for sworn testimony, and to represent the **Insured** at the **Insured's** depositions, provided that:

a. the subpoena arises out of a lawsuit to which the **Insured** is not a party; and

b. the **Insured** has not been engaged to provide advice or sworn testimony in connection with the lawsuit, nor has the **Insured** provided such advice or sworn testimony in the past.

If such criteria are met, the Insurer will pay such attorney's legal fees excluding any disbursements up to the amount of $15,000 (fifteen thousand dollars) for each **Insured**. While not **Loss**, such fees

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

incurred under this provision are part of and not in addition to the Aggregate Limit of Liability set forth in each **Insured's Certificate of Insurance**. Any notice the **Insured** gives the Insurer of such subpoena shall be deemed notification of a potential **Claim** under Section VII.B. of this Policy.

I. Pre-Claim Assistance

Until the date a **Claim** is made, the Insurer may pay, at its sole discretion, up to $10,000 (ten thousand dollars), for all reasonable and necessary fees and expenses it incurs as a result of investigating a potential **Claim** that the **Insured** reports to the Insurer in accordance with the section entitled **NOTICE,** paragraph B. Should a potential **Claim** be investigated pursuant to this paragraph, and that potential **Claim** later become a covered **Claim** under this Policy, then the Limits of Liability and the Retention applicable to such **Claim** shall apply to such **Claim**. While not **Loss**, this amount is part of and not in addition to the Aggregate Limit of Liability set forth in each **Insured's Certificate of Insurance**.

VII. NOTICE

A. If a **Claim** is made against any **Insured**, the **Insured** shall, as soon as practicable, notify the Insurer during the applicable **Certificate Period** or during a consecutive, immediately following **Certificate Period** and forward to the Insurer every demand, notice, summons, or other process received. The limits of insurance for the **Certificate Period** in effect on the date the **Claim** is reported to the Insurer shall apply.

In addition, in the event of cancellation or non-renewal of the **Certificate of Insurance**, the **Insured**, may report **Claims** made against the **Insured** during the **Certificate Period** or within 30 days immediately following the cancellation or non-renewal of such **Certificate of Insurance**.

In no event, however, shall the Insurer be responsible to pay any **Loss** in connection with any default judgment entered against an **Insured** prior to notice to the Insurer or as a result of untimely notice to the Insurer nor shall the Insurer be responsible to pay any **Loss** in connection with any **Claim** in which the Insurer's interests have been prejudiced because of the **Insured's** failure to supply timely notice to the Insurer.

B. If, during the **Certificate Period** the **Insured** first becomes aware of specific **Wrongful Acts** which may reasonably give rise to a future **Claim** and during such period give written notice to the Insurer of:

1. the names of the potential claimants and a description of the specific **Wrongful Act** which forms the basis of their potential **Claim**;
2. the identity of the specific **Insureds** allegedly responsible for such specific **Wrongful Act**;
3. the consequences which have resulted or may result from such specific **Wrongful Act**;
4. the nature of the potential monetary damages or non-monetary relief which may be sought in consequence of such specific **Wrongful Act**; and
5. the circumstances by which the **Insureds** first became aware of such specific **Wrongful Act**,

then any **Claim** otherwise covered under this Policy which is subsequently made against the **Insureds** and which arises out of such **Wrongful Act** shall be deemed to have been first made at the time such written notice was received by the Insurer. No coverage is provided for a **Claim** resulting from such **Wrongful Act** until such time as such **Claim** is reported to the Insurer in accordance with paragraph A. above.

C. Except as provided in paragraph B. above, a **Claim** shall be deemed to be made:

1. in the case of a civil proceeding or arbitration, on the earliest of the date of service upon or other receipt by any **Insured** of a complaint or similar document against the **Insured** in such proceeding or arbitration; or
2. in the case of a written demand for monetary damages, on the **Insured's** receipt of notice of such demand.

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

D. The **Insureds** shall give written notice to the Insurer at the address specified of the **Certificate of Insurance**, which shall be effective upon receipt.

E. The **Insureds** shall furnish the Insurer with copies of reports, investigations, pleadings, and all related papers and such other information, assistance and cooperation as the Insurer may reasonably request. The **Insureds** agree to cooperate with the Insurer, and provide all assistance and information reasonably requested by the Insurer. When requested by the Insurer, the **Insureds** shall submit to examination by a representative of the Insurer, under oath if required, and shall attend hearings, depositions, and trials and shall assist in the conduct of **Claims** including but not limited to effecting settlement, securing and giving evidence, obtaining the attendance of witnesses, giving written statements to the Insurer's representatives and meeting with such representatives for the purpose of investigation or defense, all of the above without charge to the Insurer.

VIII. TERMINATION OF MASTER POLICY

A. Termination of Master Policy

This Master Policy shall remain continuously in effect until canceled by the Insurer or by the **Policyholder** as follows:

1. The Insurer may cancel this Policy for any reason by providing to **Policyholder** written notice stating when, not less than 60 days thereafter, such cancellation shall be effective.

2. This Policy may be canceled by the **Policyholder** by surrender of this Policy to the Insurer or by giving written notice to the Insurer stating when thereafter such cancellation shall be effective. The making of such notice by registered, certified or other first class mail, to the Insurer at the address shown in the **Certificates of Insurance**, shall be sufficient proof of notice and this Policy shall terminate at the date and hour specified in such notice.

Certificates of Insurance in effect at the time of cancellation of the Policy shall remain in effect until the expiration date of the **Certificate of Insurance** as set forth in the **Certificate of Insurance** and **Claims** submitted under such **Certificates of Insurance** shall be otherwise governed by this Policy. In such event, each **Named Insured** will be notified of non-renewal pursuant to the requirements of the Cancellation/Nonrenewal Endorsement attached to the **Named Insured's Certificate of Insurance**.

IX. OTHER INSURANCE

If any **Loss** resulting from any **Claim** is insured under any other policies, this Policy shall apply only to the extent the **Loss** exceeds the Limit of Liability under such other insurance whether such other insurance is stated to be primary, contributory, excess, contingent or otherwise, unless such other insurance is written only as specific excess insurance over this Policy.

X. SUBROGATION AND RECOVERY

In the event of any payment under this Policy, the Insurer shall be subrogated to all the **Insured's** rights of recovery therefore against any person or organization, and the **Insured** shall execute and deliver instruments and papers and do whatever else is necessary to secure such rights. The **Insured** shall do nothing to prejudice such rights. Any amount recovered in excess of the Insurer's total payment shall be restored to the **Insured**, less the cost to the Insurer of recovery.

XI. CHANGES

Notice to any agent or knowledge possessed by an agent or by any other person shall not affect a waiver or a change in any part of this Policy, or stop the Insurer from asserting any right under the provisions of this Policy. The provisions of this Policy shall not be waived, changed or modified except by endorsement issued to form a part of this Policy.

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

XII. NO ACTION AGAINST INSURER

No action shall be taken against the Insurer unless, as a condition precedent thereto, the **Insured** shall have fully complied with all terms of this Policy, or until the amount of the **Policyholder**'s obligation to pay shall have been finally determined either by judgment against the **Insured** after actual trial or by written agreement of the **Insured**, the claimant and the Insurer. Any person or organization or the legal representative thereof who has secured such judgment or written agreement shall thereafter be entitled to recover under this Policy to the extent of the insurance afforded by this Policy. Nothing contained in this Policy shall give any person or organization any right to join the Insurer in any action against the **Insured** to determine the **Insured's** liability, nor shall the Insurer be impleaded by the **Insured** or their legal representative in any such **Claim**.

XIII. ASSIGNMENT OF INTEREST

Assignment of interest under this Policy shall not bind the Insurer unless its consent is endorsed to this Policy.

XIV. TERRITORY

Except as provided in Section II. DEFENSE, Paragraph A,2. this Policy applies to **Wrongful Acts** which happen anywhere in the world, but only with respect to **Claims** made or suits brought against the **Insured** in the United States of America, its territories or possessions, or Canada.

XV. ENTIRE AGREEMENT

The **Policyholder** agrees that this Policy, including the **Application**, any materials submitted or required to be submitted therewith, and any written endorsements attached, constitute the entire contract existing between **Insureds** and the Insurer or any of its agents relating to this insurance.

XVI. EXCLUSIONS

The Insurer shall not be liable to pay any **Loss** in connection with any **Claim**:

A. **Prior Litigation**

based upon, directly or indirectly arising out of, or in any way involving facts alleged in any litigation against the **Insured** pending on or prior to the inception date of such **Insured's Certificate of Insurance**;

B. **Claims by Specified Persons or Entities**

by or on behalf of, or for the benefit of, whether directly or indirectly,

1. any parent, spouse, **Domestic Partner**, or child of the **Insured**
2. an entity in which one or more **Insureds**, at the time of the **Wrongful Act** giving rise to a **Claim**:
   i. had a total of ten percent (10%) or more equity interest, or
   ii. operated, controlled, or managed;
3. an individual or entity which has, or did have at the time of the **Wrongful Act,** a total of ten percent (10%) or more equity interest in an entity **Insured** or operates, controls or manages an entity **Insured**;
4. any past or present **Insured**, whether it be an individual, class or derivative action, except and to the extent that such **Claim** is by an **Insured** in his or her capacity as a **Client**;
5. any governmental or quasi-governmental official or agency, including but not limited to any state or federal securities or insurance commission or agency, in any capacity; however, this exclusion shall not apply subject to the Insurer's maximum Limit of Liability of $25,000 for all **Loss** for all such **Claims** made against an **Insured**, which amount shall be part of and not in addition to the amount set forth in the **Certificate of Insurance.** Notwithstanding anything in the Policy to the contrary, the applicable retention amount for all such **Claims** shall be $5,000;
6. any self-regulatory organization including, but not limited to, the Securities and Exchange Commission, the Financial Industry Regulatory Authority, the Securities Investor Protection Corporation, in any capacity; however, this exclusion shall not apply subject to the Insurer's maximum Limit of Liability of $25,000 for all **Loss** for all such **Claims** made against an

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

Insured, which amount shall be part of and not in addition to the amount set forth in the **Certificate of Insurance**. Notwithstanding anything in the Policy to the contrary, the applicable retention amount for all such **Claims** shall be $5,000;

provided, however, that paragraphs 5. and 6. above shall not apply to any **Claim** by an official of such agency or organization if such official is bringing the **Claim** in his or her capacity as a direct **Client** of an Insured and not as an official of such agency or organization;

C. **Intentional Acts**

based upon, directly or indirectly arising out of, or in any way involving any actual or alleged dishonest, fraudulent, criminal, malicious, purposeful or intentional act, error or omission, or any actual or alleged willful violation of any statute or law as determined in fact by any trial court verdict, court ruling, regulatory ruling or legal admission;

For purposes of determining the applicability of this Exclusion:
1. the facts pertaining to and knowledge possessed by any natural person **Insured** shall not be imputed to any other natural person **Insured**; and
2. only facts pertaining to and knowledge possessed by any executive officer shall be imputed to the **Insured** entity;

D. **Bodily Injury/Property Damage**

based upon, directly or indirectly arising out of, or in any way involving any actual or alleged bodily injury, sickness, disease, emotional distress, mental anguish or death of any person, or damage to or destruction of any tangible property, including loss of use thereof;

E. **Contractual Liability/Promises/Guarantees**

based upon, directly or indirectly arising out of, or in any way involving actual or alleged
1. liability of others assumed by an **Insured** under any contract or agreement; provided, however, that this paragraph shall not apply to the extent that the liability would attach to an **Insured** in the absence of such contract or agreement; or
2. making or stating of any promises or guarantees as to interest rates or fluctuations in interest rates, the market value of any investment or insurance product, or future premium payments;

F. **Specified Services**

based upon, directly or indirectly arising out of, or in any way involving actual or alleged:
1. performance of or failure to perform services by the **Insured** as:
   a. an actuary, accountant, attorney, property or casualty agent, real estate agent, or third party administrator; or
   b. a market maker or specialist in any securities;
2. tax advice provided by the **Insured** except to the extent that such tax advice is an incidental part of the **Professional Services** being rendered; or
3. churning or excessive trading by an **Insured**.

G. **Premium/claim/tax monies**

based upon, directly or indirectly arising out of, or in any way involving:
1. the **Insured**'s inability or refusal to pay or collect premium, claim or tax monies; or
2. a dispute over fees, commissions or charges, including without limitation the structure of fees or excessive fees; however, this paragraph 2. shall not apply to surrender charges;

H. **Commingling/Illegal Profit**

based upon, directly or indirectly arising out of, or in any way involving:
1. any actual or alleged commingling or use of **Client** funds; or
2. any actual or alleged profit, remuneration or pecuniary advantage gained by any **Insured**, to which the **Insured** was not legally entitled;

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

I. **Insolvency**

based upon, directly or indirectly arising out of, or in any way involving the insolvency, receivership, conservatorship, liquidation, bankruptcy or inability to pay of a natural person, entity, benefit plan, insurance company, managed health care organization, reinsurer, risk retention group or captive (or any self insurance plan or trust by whatsoever name), or limited partnership in which the **Insured** has placed business or obtained insurance coverage, or placed or recommended placement of the funds of a **Client**;

J. **Employee Benefit Plans**

based upon, directly or indirectly arising out of, or in any way involving:

1. any actual or alleged pension, profit sharing, health and welfare or other employee benefit plan or trust sponsored by the **Insured** or any entity owned or controlled by the **Insured** or in which the **Insured** is a participant, trustee or named fiduciary, as defined under the Employee Retirement Income Security Act of 1974, as amended, or any similar common or statutory law; or
2. the actual or alleged design of any employee benefit plan;

K. **Sale or Servicing of Certain Products**

based upon, directly or indirectly arising out of, or in any way involving the actual or alleged sale, attempted sale or servicing of any

1. coverage, alleged coverage or plan placed with any form of Multiple Employer Welfare Arrangement as defined by the Employee Retirement Income Security Act of 1974, as amended, or any employee benefits plan involving self funding in whole or in part, by any employer, union, or employment related entity;
2. products or services not approved by the **Broker/Dealer** with which the **Registered Representative** was contracted at the time of the **Wrongful Act**;
3. commodities, commodities futures contracts, or any type of option contract with the exception of covered call or covered put writing;
4. promissory notes
5. ETS pay phone investments or other similar type investments;
6. viatical settlements, viatical insurance benefits, viatical investment pools or any security backed by viatical settlements;
7. Structured products, including but not limited to, structured settlements, structured notes, principal protected notes or reverse convertibles notes;
8. Life Settlements; Reverse mortgages or similar transactions in which the present value of a conditional contract is exchanged or sold;
9. issuer callable certificates of deposit and/or equipment sale-lease-buy-back transactions of any kind;
10. Leveraged or Inverse Products, including but not limited to Exchange Traded Funds or Mutual Funds, or Exchange Traded Notes;
11. Stranger Originated Life Insurance (STOLI) or Speculator Initiated Life Insurance (SPIN-LIFE) or any similar transactions;
12. any life insurance policy in which the premium was paid for, in whole or in part, by or through any premium finance mechanism or any premium finance company; or
13. plans created under sections 412 or 419 of the internal revenue code; or
14. insurance sold as part of or to be used in conjunction with or to fund any plan created under sections 412 or 419 of the internal revenue code.

L. **Discretionary Authority**

based upon, directly or indirectly arising out of, or in any way involving any actual or alleged activities in connection with the exercise of discretionary authority with regard to the management or disposition of assets (whether for individuals, groups, employee benefit plans, or other entities of whatever legal form or character); however, this exclusion shall not apply to the activities of the **Insured** when exercising discretionary authority as a **Registered Investment Adviser**;

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

M. **Nuclear/Pollution**

based upon, directly or indirectly arising out of, or in any way involving:

1. any nuclear reaction, radiation or contamination; or
2. any actual, alleged or threatened discharge, release, escape, or disposal of, or exposure to, **Pollutants**; any request, direction or order that any of the **Insureds** test for, monitor, clean up, remove, contain, treat, detoxify, neutralize or in any way respond to or assess the effect of **Pollutants** or nuclear reaction, radiation or contamination, or any voluntary decision to do so; or any actual or alleged property damage, or bodily injury, sickness, disease or death of any person, or financial loss to the **Insureds**, their security holders, or their creditors resulting from any of the aforementioned matters;

N. **Anti-trust**

based upon, directly or indirectly arising out of, or in any way involving actual or alleged price fixing, price discrimination, predatory pricing, restraint of trade, antitrust, monopolization, unfair trade, or unfair anti-competitive conduct; however, the knowledge of any such act by any **Insured** individual shall not be imputed to any other **Insured** individual; and only such knowledge of an executive officer shall be imputed to an **Insured** entity;

O. **Confidential or non-public information**

based upon, directly or indirectly arising out of or in any way involving the actual or alleged use, misuse or disclosure of:

1. confidential information, including but not limited to such use for the purpose of replacement of coverage; or
2. non-public information in a manner prohibited by the laws of the United States, including, but not limited to, the Insider Trading and Securities Fraud Enforcement Act of 1988, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, any similar laws of any other jurisdiction, or any rules or regulations promulgated under any of the foregoing, all as amended;

P. **Unlicensed entity**

based upon, directly or indirectly, arising out of or in any way involving the placement of a **Client's** coverage or funds directly or indirectly with any organization, entity or vehicle of any kind, nature or structure which is not licensed to do business in the state or jurisdiction with authority to regulate such business; however, this Exclusion shall not apply to any **Claim** arising from or contributed to by the placement of a **Client's** coverage or funds directly or indirectly with such organization, entity or vehicle which is an eligible surplus lines insurer in the state or jurisdiction with authority to regulate such business;

Q. **Investment Banking Activities**

based upon, directly or indirectly arising out of, or in any way involving any actual or alleged underwriting, syndicating, or investment banking work, or associated counseling or investment activities, including but not limited to, any aspect of any actual, attempted or threatened mergers, acquisitions, divestitures, tender offers, proxy contests, leveraged buy-outs, going private transactions, reorganizations, capital restructuring, recapitalization, spin-offs, primary or secondary offerings of securities (regardless of whether the offering is a public offering or a Private Placement), other efforts to raise or furnish capital or financing for any enterprise or entity or any disclosure requirements in connection with any of the foregoing; provided, however, that this exclusion shall not apply to **Claim**s arising from sales by an **Insured** of securities in connection with an offering thereof where such **Claim**s relate solely to conduct by the **Insured** detrimentally relied upon by particular clients of the **Insured Broker/Dealer** and do not arise from facts or circumstances affecting the offering generally such as, but not limited to, actual or alleged misrepresentations or omissions in the formal written offering materials, including registration statements, offering memoranda and circulars;

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

R. **Securities below Minimum Capitalization Levels**

based upon, directly or indirectly arising out of, or in any way involving any security issued by an entity unable to meet the minimum capitalization and other standards for listing and maintenance on the NASDAQ SmallCap Market;

S. **Owned funds or investment products**

based upon, directly or indirectly arising out of, or in any way involving any proprietary fund or investment products in which an **Agent or General Agent** or **Registered Representative** has any ownership interest;

T. **Investment in Specified Securities or Funds**

based upon, directly or indirectly arising out of, or in any way involving the use of or investment in:

1. any security that is not registered with the Securities and Exchange Commission; however, this Exclusion shall not apply to securities which are both exempt from registration with the Securities and Exchange Commission and approved by the **Broker Dealer**; or
2. any hedge fund, whether it is registered or not with the Securities and Exchange Commission.

U. **Alternative Investments**

based upon, directly or indirectly arising out of, or in any way involving the use of or investment in any **Private Placement**, Limited Partnership, Direct Participation Program, Tennant in Common Investments (pursuant to Section 1031 of the Internal Revenue Code), Real Estate Investment Trusts (REIT's), Business Development Company, issuer callable certificates of deposit, and/or equipment sale-lease-buy-back transactions of any kind; however, subject to a limit of liability of $500,000 each **Claim** and $500,000 in the aggregate per **Insured**, this exclusion shall not apply provided that the **Client's** investment portfolio did not exceed a total concentration of 5% of such products (when taken together) at the time of sale, and the **Wrongful Act** giving rise to the **Claim** was committed after January 1, 2010. Furthermore, coverage shall only apply provided that the sale attempted sale or servicing of **Private Placements**, Limited Partnerships, REIT's, Tenant in Common Interests or Direct Participation Programs were:

a. compliant with all applicable Blue Sky Laws that exist from time to time in the various states;

b. with respect to **Private Placements**, are sold only to **Accredited Investors**; and

c. with respect to publicly registered Limited Partnerships and/or REIT's, are sold only to investors who meet the various state minimum suitability standards outlined in their respective Blue Sky Laws;

Notwithstanding the foregoing, the Insurer shall not pay any **Loss** in connection with any **Claim** involving the actual or alleged sale or attempted sale of any oil & gas limited partnerships.

V. **Fiduciary Services**

based upon, directly or indirectly arising out of, or in any way involving investment advice provided by a Fiduciary Adviser if such investment advice is not provided pursuant to and in accordance with all of the requirements of the Pension Protection Act of 2006 as it may be amended; however, this exclusion shall not apply to a **Registered Investment Advisor's** services performed as defined under the definition of **Professional Services** sub-section B.5.

W. **Wrongful Employment Practices**

based upon, directly or indirectly arising out of, or in any way involving employment practices including but not limited to discrimination or termination of employment; or

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

X. **Class Action Claim**

that is a **Class Action Claim**.

Y. **Unsolicited Communications**

Based upon, directly or indirectly arising out of, or in any way involving:

1. any actual or alleged violation of any federal anti-spam statute or regulation, including the CAN-SPAM Act of 2003;

2. any actual or alleged violation of any federal statute or regulation prohibiting the dissemination of unsolicited communications, including any violation of the Telephone Consumer Protection Act of 2001; or

3. any actual or alleged violation of any federal, state or local ant-spam statute, ordinance or other regulation that addresses, prohibits, or limits the printing, dissemination, disposal, collecting, recording, sending, transmitting, communicating or distribution of material or information including any statute or regulation prohibiting the dissemination of unsolicited communications.

XVII. TRADE EMBARGOES AND SANCTIONS

This Policy does not provide coverage for **Insureds**, transactions or that part of **Loss** that is uninsurable under the laws or regulations of the United States concerning trade or economic sanctions.

XVIII. HEADINGS AND NUMBER

The descriptions in the headings of this Policy are solely for convenience, and form no part of the terms and conditions of coverage. Defined terms in the singular also include the plural and defined terms in the plural also include the singular.

IN WITNESS WHEREOF, the Insurer has caused this Policy to be executed by its Chairman and Secretary, but this Policy shall not be binding upon us unless completed by the attachment of the Declarations.

Chairman

Secretary

© Copyright CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

MASTER POLICY
PROFESSIONAL LIABILITY AGGREGATE ENDORSEMENT

It is agreed that solely with respect to those **Insureds** who are not residents of or practice in New York State, the Policy is amended as follows:

1. Aggregate Limits

   Policy Year Aggregate Limit of Liability: $10,000,000

2. The Section entitled **DEFINITIONS** is amended to add a new definition as follows:

   Policy Year means the period of one year following the effective date of the **Policy Period** or any subsequent one-year anniversary thereof.

3. New paragraphs are added to the Section entitled **LIMIT OF LIABILITY, RETENTION AND ALLOCATION** as follows:

   - Policy Aggregate:

     The amount set forth as the **Policy Year** Aggregate Limit of Liability in paragraph 1. of this Endorsement shall be the maximum Aggregate Limit of Liability of the Insurer for each **Policy Year**, regardless of the number of **Insureds**, **Claims** made, or persons or entities bringing such **Claims**. The **Policy Year** Aggregate Limit in effect at the time a **Certificate of Insurance** is issued shall be the applicable **Policy Year** Aggregate Limit for such **Certificate of Insurance** regardless of when such **Certificate of Insurance** expires.

   - Per **Claim** Aggregate:

     Each **Insured's** applicable Limit of Liability shall be the maximum Limit of Liability of the Insurer for such **Insured**, regardless of the number of **Insureds**, **Certificates of Insurance, Claims** made, or persons or entities bringing such **Claims**. The per **Claim** Aggregate Limit in effect at the time a **Certificate of Insurance** is issued shall be the applicable **Policy Year** Aggregate Limit for such **Certificate of Insurance** regardless of when such **Certificate of Insurance** expires. Further, where two or more **Insureds** are involved in a **Claim**, the maximum aggregate Limit of Liability of the Insurer for all such **Insureds** shall be the largest single Limit of Liability applicable to any one of such **Insureds**.

All other terms and conditions of the Policy remain unchanged.

This endorsement, which forms a part of and is for attachment to the Policy issued by the designated Insurers, takes effect on the effective date of said Policy at the hour stated in said Policy, unless another effective date is shown below, and expires concurrently with said Policy.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

CNA

COST OF CORRECTIONS ENDORSEMENT

In consideration of the premium charged, it is hereby understood and agreed that the Policy is amended as follows:

- The Section entitled **DEFINITIONS** is amended to add the following new definition:

  Cost of Corrections Demand means a demand by an **Named Insured** for reimbursement of the cost incurred by the **Named Insured** in indemnifying a **Client** of such **Named Insured** for **Loss** incurred as a result of a **Wrongful Act**.

- The following new Section is added

  1. Solely with respect to **Professional Services** as set forth in Item B.2., provided such **Professional Services** are provided by or through a **Named Insured**, the Insurer shall reimburse the **Named Insured** for a **Cost of Corrections Demand**, up to the Limits of Liability specified below and subject to the **Named Insured's Cost of Corrections Demand** Retention, provided that such **Cost of Corrections Demand** involves one or more of the following acts, errors or omissions:
     a. The failure of the **Insured** to follow directions from a **Client** in connection with a non-discretionary investment;
     b. Mechanical or computer error in processing transactions that were implemented to follow directions from a **Client** in connection with a non-discretionary investment;
     c. Human error related to discretionary transactions implemented by the **Insured**, to the extent such transactions are otherwise covered by this Policy;
     d. Mechanical or computer error in processing discretionary transactions implemented by the **Insured**, to the extent such transactions are otherwise covered by this Policy, including when performed by a back office employee of the **Named Insured**; However, there shall be no Supplemental Benefit for **Cost of Corrections Demands** arising from such errors unless:
        i. the **Insured** has the ability to correct the error or prevent it from increasing; and
        ii. if not immediately corrected, the error will continue to increase in monetary value or impact; and
        iii. the **Insured** incurs a measurable monetary cost in correcting the error; and
        iv. the **Insured** notifies the Insurer of the correction as soon as practicable, and provides the Insurer proper documentation of the error, the resulting damages and the correction thereof.

  2. This Supplemental Benefit is granted under the strict reservation by the Insurer to reimburse the **Named Insured** for the mutually agreed upon portion of such cost that is attributable to such acts, errors or omissions of the **Named Insured**, or any employee of the **Named Insured** as are described in 1.d.i. through iv. above. The Insurer shall not be responsible for any portion attributable to the conduct of any other party, including the claimant or the **Insured**.

  3. For the purposes of the application of the Limits of Liability and Exclusions Sections only, a **Cost of Corrections Demand** will be deemed to be a **Claim**.

- The Section entitled **LIMIT OF LIABILITY, RETENTION AND ALLOCATION** shall be amended to add the following:

  Subject to the Insurer's each **Claim** and Aggregate Limit of Liability, as shown on the **Named Insured's Certificate of Insurance**, the Limit of Liability of the Insurer for **Loss** for all covered **Cost of Corrections Demands** shall not exceed $75,000 for each **Costs of Corrections Demand** and $75,000 in the aggregate for each **Named Insured,** regardless of the number of **Costs of Corrections Demands**. These amounts shall be a sublimit, included within and not in addition to, the Limits of Liability set forth in the **Certificate of Insurance**.

All other terms and conditions of the Policy remain unchanged.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

This endorsement, which forms a part of and is for attachment to the Policy issued by the designated Insurers, takes effect on the effective date of said Policy at the hour stated in said Policy, unless another effective date is shown below, and expires concurrently with said Policy.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

CNA

FIRMS WITH MULTIPLE ADVISERS ENDORSEMENT

In consideration of the premium charged, and solely with respect to those **Insureds** who purchased coverage for Firms With Multiple Advisers and are on file with the Insurer and who are not resident of or practice in New York State, the Policy is amended as follows:

I. The section entitled **DEFINITIONS** is amended as follows:

A. The definition of **Registered Investment Adviser** is deleted in its entirety and replaced with the following:

Registered Investment Adviser means:

i. a corporation, partnership or other business entity providing **Investment Advisory Services** in its capacity as an Investment Advisor registered as such under the Investment Advisors Act of 1940, as amended;
ii. which maintains a contract with RIA in a Box;
iii. which has elected to enroll for coverage under this Master Policy or any policy issued by the Insurer of which this Master Policy is a renewal and is named on the **Certificate of Insurance**;
iv. whose enrollment is on file with the **Policyholder**;

B. The definition of **Insured** is deleted in its entirety and replaced with the following:

Insured means:

i. The **Named Insured**
ii. An Investment Adviser Representative contracted with the Named Insured for the purposes of providing Investment Advisory Services on behalf of clients of the Named Insured;
iii. Any natural person who is a former or current secretarial, clerical or administrative employee of the **Named Insured**, but solely for services preformed within his or her capacity as such and on behalf of such **Named Insured** or **Investment Adviser Representative** contracted with the **Named Insured**, provided such natural person did not receive any commission income pursuant to an agent, broker or registered representative contract with any insurance company or **Broker/Dealer** as a result of providing **Professional Services** offer by the **Named Insured;**

Notwithstanding the foregoing, **Insured** shall not include any **Registered Investment Adviser** or **Investment Adviser Representative** who fails to meet the eligibility criteria as outlined in the application for coverage.

C. The definition of **Investment Advisory Services** is deleted in its entirety and replaced with the following:

Investment Advisory Services means advisory services provided by a **Registered Investment Adviser** or **Investment Adviser Representative** pursuant to the Investment Advisers Act of 1940 with respect to securities approved by a **Broker/Dealer**, provided that, prior to providing such services, the **Registered Investment Adviser** or **Investment Adviser Representative** gave written notice of such services to the **Broker/Dealer** and received written approval from such **Broker/Dealer** to conduct such transactions.

D. The following definition of **Investment Adviser Representative** is added:

Investment Adviser Representative shall mean a natural person providing **Investment Advisory Services** in his or her capacity as an Investment Advisor registered as such under the Investment Advisors Act of 1940, as amended.

E. Solely with respect to coverage provided pursuant to this endorsement, the definition of **Professional Services** sub-section B. is deleted in its entirety and replaced with the following:

B. with respect to a Registered Investment Adviser, and only to the extent Professional Services are provided in the course and scope of such Registered Investment Adviser's business as a

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

Registered Investment Adviser, and such Registered Investment Adviser has the appropriate license in both the Client's resident state or jurisdiction and the state or jurisdiction in which the business is conducted:

1. **Investment Advisory Services**;
2. financial planning activities in conjunction with services described in paragraph 1. of this definition, whether or not a separate fee is charged;
3. Investment advice or other services provided as a fiduciary, as that term is defined under Section 3(21)(A) of the Employee Retirement Income Security Act of 1974, as amended, or **Investment Manager**, unless the **Registered Investment Adviser** is designated as a named fiduciary on the plan instrument;
4. Services performed as a Fiduciary Advisor as defined in the Pension Protection Act of 2006, and any amendment thereof.

All other terms and conditions of the Policy remain unchanged.

This endorsement, which forms a part of and is for attachment to the Policy issued by the designated Insurers, takes effect on the effective date of said Policy at the hour stated in said Policy, unless another effective date is shown below, and expires concurrently with said Policy.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

PRIVACY PROTECTION ENDORSEMENT

If this coverage is purchased, it is understood and agreed that solely with respect to those **Insureds** that purchased this coverage, the Policy is amended as follows:

I. The section entitled **INSURING AGREEMENT** is amended to add the following new Insuring Agreements:

A. PRIVACY INJURY COVERAGE AGREEMENTS

If this Insuring Agreement has been purchased, the Insurer shall pay on behalf of the **Insured**, excess of the applicable Retention and within the applicable Limits of Liability, that **Loss** which the **Insured** become legally obligated to pay:

1. Privacy Injury Liability

as **Loss** resulting from any **Claim** first made against an **Insured** during the **Policy Period**, or any extended reporting period, if applicable, alleging **Wrongful Acts** by an **Insured** or by someone (including a **Rogue Employee** or **Third-Party Custodian**) for whose **Wrongful Acts** the **Insured** is legally liable;

2. Privacy Regulation Proceeding

as **Loss** (including **Privacy Regulation Fines**) resulting from any **Claim** first made against an **Insured** during the **Policy Period**, or any extended reporting period, if applicable, alleging **Wrongful Acts** by an **Insured** or by someone (including a **Rogue Employee** or **Third-Party Custodian**) for whose **Wrongful Acts** the **Insured** is legally liable;

Provided that:

a. prior to the inception date of this Policy or the first such policy issued and continuously renewed by the Insurer, of which this Policy is a renewal, whichever is earlier;

1. the **Insured** did not know or should not have known that any such **Wrongful Act**, or **Interrelated Wrongful Act**, might result in such **Claim**;

2. such **Wrongful Act** has not been the subject of any notice given under any prior policy;

b. such **Wrongful Act** occurred on or after the applicable **Prior Acts Date** and prior to the end of the **Policy Period**; and,

c. the **Claim** is reported to the Insurer in accordance with the section entitled **Notice of Claims or Circumstances** of this endorsement;

d. such **Claim** is not covered under any other Insuring Agreement of this Policy or any other coverage issued by the Insurer, or any affiliate of the Insurer.

B. PRIVACY EVENT EXPENSE

If this Insuring Agreement has been purchased, as indicated above, the Insurer will reimburse the **Insured** for **Privacy Event Expenses**, up to the **Privacy Event Expenses** Limit of Liability provided that:

1. the **Privacy Event** is first discovered during the **Policy Period**;

2. the **Privacy Event Expenses** were incurred within twelve months after the date that the **Insured** reports the **Privacy Event**, in accordance with the section entitled **Notice of Claims or**

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

Circumstances of this endorsement and such amounts are consented to in writing by the Insurer, such consent may not to be unreasonably withheld; and,

3. there is no other coverage issued by the Insurer, or any affiliate of the Insurer, that provides coverage for such **Privacy Event**.

II. Solely with respect to the coverage provided by this endorsement, the section entitled **LIMIT OF LIABILITY, RETENTION AND ALLOCATION** is amended to add the following new paragraphs:

A. The Insurer's maximum Limit of Liability for all **Loss** under the coverage provided by this endorsement shall be:

$100,000 all **Loss** in the Aggregate per **Insured**

$100,000 each **Claim** and in the Aggregate for **Privacy Injury Liability**

$100,000 each **Claim** and in the Aggregate for **Privacy Regulation Proceeding**

$25,000 each **Privacy Event**

This amount is a sublimit which part of, and not in addition to, the each **Claim** Limit of Liability and the in the Aggregate Limit of Liability set forth on the Declarations Page.

Subject to the Privacy Protection Aggregate Limit of Liability the maximum limit of liability of the Insurer for Privacy Injury Liability, Privacy Regulation Proceeding and Privacy Event Expense shall be the amount set forth above.

B. Notwithstanding anything to the contrary set forth on the Declarations, the retention amount applicable for each **Privacy Injury Liability**, **Privacy Regulation Proceeding**, and **Privacy Event** shall be $5,000.

III. Solely with respect to the coverage provided by this endorsement, the section entitled **DEFINITIONS** is amended to add the following new terms:

Confidential Health Information means information pertaining to a **Client** that has been received or created by the **Insured** or provided by the **Insured** to another, subject to protection pursuant to "HIPAA", including an individual's health, or healthcare treatment information, including the fact that any such individual has been treated by any provider.

Network means a party's local or wide area network owned or operated by or on behalf of or for the benefit of that party; provided, however, **Network** shall not include the internet, telephone company networks, or other public infrastructure network (collectively "public infrastructure network") unless such public infrastructure network is operated and controlled exclusively by the **Policyholder**.

Privacy Event means any act, error or omission which, in the reasonable opinion of the **Insured** did cause or is reasonably likely to result in the unauthorized disclosure or the unauthorized use of **Nonpublic Personal Information**.

Privacy Event Expenses means all reasonable and necessary fees, costs and expenses incurred by the **Insured** and consented to by the Insurer:

A. to directly affect compliance with a **Security Breach Notice Law** including notification to individuals or entities who are required to be notified;

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

B. to provide voluntary notification to individuals or entities whose **Nonpublic Personal Information** may have been subject to a **Privacy Event**;

C. to hire a computer forensics firm to investigate the existence and cause of a **Privacy Event** and to determine the extent such **Nonpublic Personal Information** has been or may have been disclosed;

D. to hire an attorney or expert to determine the applicability of and the actions necessary to comply with **Security Breach Notice Laws**;

E. to minimize harm to the **Insured's** reputation from a **Privacy Event**, including but not limited to the costs to set up a call center or provide a credit monitoring service for those impacted by a **Privacy Event**.

However, **Privacy Event Expenses** do not include the costs, fees and expenses necessary to remediate any deficiencies that gave rise to the **Privacy Event**.

Privacy Injury means:

A. unauthorized collection, disclosure, use, access, destruction or modification of **Nonpublic Personal Information**;

B. failure to implement, maintain, or comply with policies and procedures stating the **Insured's** obligations with regard to **Nonpublic Personal Information**.

Privacy Regulation Fines means civil fines, sanctions or penalties insurable under applicable law and imposed under any **Privacy Regulation Proceeding** for a violation of any **Security Breach Notice Law** or any law, statute or regulation governing **Nonpublic Personal Information**.

Privacy Regulation Proceeding means a civil, administrative or regulatory proceeding by a federal, state, local or foreign governmental authority, including a complaint, investigation or hearing instituted against an **Insured** by the Department of Health and Human Services or its designee alleging a violation of responsibilities or duties imposed upon an **Insured** under the Health Insurance Portability and Accountability Act ("HIPAA") or any rules or regulations promulgated thereunder, with respect to the management of **Nonpublic Personal Information** alleging a **Wrongful Act** as defined in paragraph B. of the definition of **Wrongful Act**.

Nonpublic Personal Information means two or more elements of information not available to the general public from which an individual may be identified, including without limitation, an individual's name, address, telephone number, social security number, account relationships, account numbers, account balances, and account histories. **Nonpublic Personal Information** shall also include **Confidential Health Information**.

Related Claims mean all **Claims** based upon or arising out of a single **Wrongful Act** or any **Interrelated Wrongful Acts**.

Rogue Employee means a past, present or future employee of the **Insured** who acts outside of his or her scope of employment.

Security Breach Notice Law means any statute or regulation that requires an entity that maintains **Protected Information** to provide notice to specified individuals of any actual or potential unauthorized disclosure or potential disclosure of such **Nonpublic Personal Information**.

Third-Party Custodian means any third party to whom the **Insured** entrusts **Nonpublic Personal Information**.

IV. Solely with respect to the coverage provided by this endorsement, the following definitions are deleted in their entirety and replaced as follows:

Claim means:

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

A. a written demand for monetary damages or non-monetary relief, including a demand for injunctive or declaratory relief;

B. a civil proceeding in a court of law or equity or any alternative dispute resolution proceeding;

C. a **Privacy Regulation Proceeding**,

against an **Insured**, alleging a **Wrongful Act** including any appeal therefrom. **Claim** also means a written request received by the **Insured** to toll or waive a statute of limitations in connection with a **Claim** as defined by paragraphs **B.** and **C.** above.

However, a **Claim** does not include any criminal proceeding or criminal or civil investigation. Nor does a **Claim** include any regulatory proceeding except if the regulatory proceeding is a **Privacy Regulation Proceeding**.

Defense Costs mean:

A. fees charged by attorneys designated by the Insurer;

B. all other reasonable and necessary fees, costs and expenses resulting from the investigation, adjustment, defense and appeal of a **Claim** if incurred by the **Insured** including, but not limited to, premiums for any appeal bond, attachment bond or similar bond but without any obligation of the **Insured** to apply for or furnish any such bond.

In the event the **Insured** is entitled by law to select independent counsel to defend the **Insured** at the Insurer's expense, **Defense Costs** also include fees the Insurer must pay to such counsel provided that such fees are limited to fees charged in accordance with the rates the Insurer actually pays to counsel that it retains in the ordinary course of business in the defense of similar **Claims** in the community where the **Claim** is being defended;

However, **Defense Costs** do not include fees and expenses of independent adjusters or salaries of the Insurer's officials or employees.

Insured shall mean an **Agent or General Agent**, **Registered Representative** or **Registered Investment Adviser** whose enrolment is on file with the Policyholder and the Insurer.

Loss means settlements, judgments (including any award of pre-judgment and post-judgment interest on a covered judgment), or other amounts for which the **Insured** is legally obligated to pay on account of a covered **Claim**. However, **Loss** does not include:

1. civil or criminal fines, penalties, taxes, sanctions or forfeitures, imposed on the **Insured**, except that this does not apply to **Privacy Regulation Fines**;

2. fees, costs and expenses paid or incurred or charged by the **Insured**, no matter whether claimed as restitution of specific funds, financial loss, mitigation expenses, set-off amounts or payments in the form of service credits or coupons or other non-cash consideration;

3. liquidated damages pursuant to a written contract or agreement in excess of the **Insured's** liability caused by the **Wrongful Act**;

4. the **Insured's** production costs, or the **Insured's** cost of reprinting, recalling, recovering, shipping, mailing, correcting, reprocessing, restoring, repairing, replacing, or reproducing erroneous, damaged or lost tangible property;

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

5. any amount attributable to the cost of any non-monetary relief, including without limitation any costs associated with compliance with any injunctive relief of any kind or nature;

6. funds, monies, or securities that the **Insured** transferred or failed to transfer;

7. any loss of investment income;

8. any amounts assessed as royalty fees or payments;

9. any amount for which the **Insured** is absolved from payment by reason of any covenant, agreement or court order;

10. punitive and exemplary damages and the multiplied portion of multiplied award;

11. plaintiff's attorney fees or expenses associated with items **1.** through **10.** above.

Loss also includes **Defense Costs** and **Privacy Event Expenses**.

Prior Acts Date means the effective date of the first **Policy Period** to which this endorsement is attached and that is in a continuous series to the current policy effective date.

Wrongful Act means:

A. with respect to Insuring Agreement **A.1.** only, **Wrongful Act** means any **Privacy Injury**;

B. with respect to Insuring Agreement **A.2.** only, **Wrongful Act** means any actual or alleged act, error or omission that results in a violation of any statute or regulation governing **Nonpublic Personal Information** or any violation of a **Security Breach Notice Law**.

V. EXCLUSIONS

Solely with respect to the coverage provided by this endorsement, the section entitled **EXCLUSIONS** is amended to add the following new exclusions:

This Policy does not apply to any **Claim**:

- **BODILY INJURY/PROPERTY DAMAGE**

  based upon or arising out of any actual or alleged bodily injury (including death), sickness, disease, emotional distress, mental anguish, of any person, or property damage, provided however that this exclusion does not apply to the wrongful infliction of emotional distress or mental anguish arising out of **Privacy Injury**;

- **CLAIMS BY INSUREDS**

  by or on behalf of the **Insured** provided, however that this exclusion does not apply to:

  1. any **Claim** that is in the form of a crossclaim, third-party claim or otherwise for contribution or indemnity which is part of and results directly from a **Claim** which is not otherwise excluded under this Policy;

  2. any **Claim** brought or maintained by or on behalf of a bankruptcy or insolvency trustee, examiner, liquidator, receiver or rehabilitator for the **Insured** or any assignee of such trustee, examiner, liquidator, receiver or rehabilitator;

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

3. any **Claim** by the **Insured** (other than the **Insured**) that alleges **Privacy Injury**;

- **DISCRIMINATION**

based upon or arising out of any actual or alleged discrimination, humiliation, harassment or misconduct that relate to an individual's race, creed, color, age, sex, national origin, religion, handicap, marital status or sexual preference;

- **GOVERNMENTAL ORDERS**

based upon or arising out of any action or order by any domestic or foreign law enforcement, administrative, regulatory or judicial body or other governmental authority, to ban, limit or restrict access to, or provide access to, or intercept, confiscate, monitor or analyze, the **Network** or any data, software or other information stored or processed on, or transmitted to or from, the **Network**, whether authorized by the **Policyholder** or not, including without limitation, interception, monitoring, or analysis by the NSA, CIA or FBI, or under the Foreign Intelligence Surveillance Act, the USA Patriot Act or any other domestic or foreign law, regulation or order;

- **OWNED ENTITY**

made against the **Insured** by any entity, if at the time of the **Wrongful Act** giving rise to such **Claim**:

1. the **Insured** controlled, owned, operated or managed such entity;

2. the **Insured** was an owner, partner, director, officer or employee of such entity;

For the purpose of this exclusion, a 5% or more owner of the voting stock of a publicly held corporation or a 40% or more owner of the voting stock of a privately held corporation shall be deemed to own such entity;

- **PATENT INFRINGEMENT**

based upon or arising out of actual or alleged infringement of patent;

- **SECURITIES AND INVESTMENT CLAIMS**

based upon or arising out of any actual or alleged:

1. filing of any registration statement under the Securities Acts of 1933, or the Securities Exchange Act of 1934, any State Blue Sky Law, or any other state or local securities law;

2. violation of the Investment Advisers Act of 1940, the Securities Act of 1933, the Securities and Exchange Act of 1934, rules or regulations of the Securities Exchange Commission under either or both acts, similar securities laws or regulations of state, or any laws of any state relating to any transaction arising out of, involving, or relating to the public offering of securities;

Provided however that this exclusion does not apply to any **Claim** for **Privacy Injury**;

- **TRADE SECRETS**

based upon or arising out of any actual or alleged misappropriation of trade secrets obtained by the **Insured** prior to commencing employment with the **Insured**;

- **UNFAIR COMPETITION/ANTITRUST CLAIMS/RICO CLAIMS**

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

based upon or arising out of any actual or alleged:

1. unfair competition, dilution, deceptive trade practices, civil actions for consumer fraud or false or deceptive advertising or misrepresentation in advertising;

2. charges of price fixing, monopolization or restraint of trade;

3. violation of:

   a. the Federal Trade Commission Act;

   b. the Sherman Act, the Clayton Act, or any federal statutory provision regarding anti-trust, monopoly, price fixing, price discrimination, predatory pricing or restraint of trade;

   c. the Racketeer Influenced and Corrupt Organizations Act;

   d. any rules or regulations promulgated under or in connection with the above statutes, or any similar provision of any federal, state, foreign or other law (including common law) or statute,

except that paragraphs **1.** and **3.a.** do not apply to any **Claim** under the Insuring Agreement entitled **Privacy Regulation Proceeding**.

VI. NOTICE OF CLAIMS OR CIRCUMSTANCES

Solely with respect to the coverage provided by this endorsement, the following is added:

1. Notice of Claim

The **Insured**, as a condition precedent to the obligations of the Insurer, shall give written notice of any **Claim** or **Privacy Event** to the Insurer as soon as reasonably practicable after the **Insured** learn of such **Claim** but in no event later than ten (10) days after termination or expiration of the **Policy Period** or extended reporting period, if applicable. All **Claims** arising out of the same **Wrongful Act** will be considered as having been made at the time the first **Claim** is made.

2. Notice of Circumstances

If during the **Policy Period**, the **Insured** first become aware of any facts or circumstances which may reasonably be expected to give rise to a **Claim** and during such **Policy Period** give written notice to the Insurer of:

1. the allegations anticipated as the basis of the potential **Claim** and the names of any potential claimants;

2. the identity of the specific individual allegedly responsible for such specific facts and circumstances;

3. the consequences which have resulted or may result from such specific facts and circumstances;

4. the amount of the potential monetary damages or the nature of non-monetary relief which may be sought in consequence of such specific facts and circumstances; and

5. the circumstances by which the **Insured** first became aware of such specific facts and circumstances,

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

then any such covered **Claim** which is subsequently made and which arises out of such facts and circumstances shall be deemed to have been first made against the **Insured** and reported to the Insurer by the **Insured** at the time such written notice was received by the Insurer.

All other terms and conditions of the Policy remain unchanged.

This endorsement, which forms a part of and is for attachment to the Policy issued by the designated Insurers, takes effect on the effective date of said Policy at the hour stated in said Policy, unless another effective date is shown below, and expires concurrently with said Policy.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

CNA

SOCIAL MEDIA COVERAGE ENDORSEMENT

In consideration of the premium charged, it is hereby understood and agreed that the Policy is amended as follows:

1. The Section entitled **DEFINITIONS** is amended by adding the following new definition:

   Social Media means a form of internet marketing which seeks to achieve the marketing and communications goals of an Insured's business as an **Agent or General Agent**, **Registered Representative** or **Registered Investment Adviser** through the participation in various internet social media networks.

2. The Section entitled **DEFINITIONS**, the definition of **Professional Services** is amended as follows:

   A. Subpart A. is amended to add the following:

   - The use of **Social Media** in conjunction with services described in paragraphs 1. through 7. of this definition.

   B. Subpart B. is amended to add the following:

   - The use of **Social Media** in conjunction with services described in paragraphs 1. through 6. of this definition.

3. Solely with respect to coverage provided pursuant to this endorsement, the Section entitled **EXCLUSIONS** is amended by adding the following new exclusion:

   based upon or arising out of or in any way involving any regulatory proceeding brought by any governmental or quasi-governmental official or agency, including but not limited to any state or federal securities or insurance commission or agency or any self-regulatory agency, in any capacity based upon or arising out of the **Agent** or **General Agent** or **Registered Representative's** use of **Social Media** provided, however, that this exclusion shall not apply to any **Claim** by an official of such agency or organization if such official is bringing the **Claim** in his or her capacity as a direct **Client** of an **Insured** and not as an official of such agency or organization;

All other terms and conditions of the Policy remain unchanged.

This endorsement, which forms a part of and is for attachment to the Policy issued by the designated Insurers, takes effect on the effective date of said Policy at the hour stated in said Policy, unless another effective date is shown below, and expires concurrently with said Policy.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

NEW YORK AMENDATORY ENDORSEMENT
Applicable to Policy Form CNA-87111 XX

This endorsement forms a part of Policy Number 596737388 issued to the Policyholder by the Insurer. In consideration of the premium charged, it is hereby understood and agreed that solely with respect to those **Agents**, **General Agents**, **Registered Representatives**, **Registered Investment Adviser** and **Insureds** under this Policy, who are residents of or practice in New York State, the Policy is amended as follows:

1. The Notice and introductory paragraph on page 1 is deleted in its entirety and replaced as follows:

   NOTICE: THIS IS A CLAIMS MADE POLICY AND, SUBJECT TO ITS PROVISIONS, APPLIES ONLY TO ANY CLAIM FIRST MADE AGAINST AN INSURED/POLICYHOLDER AND REPORTED TO THE INSURER DURING THE COVERAGE RELATIONSHIP OR ANY EXTENDED REPORTING PERIOD.

   DEFENSE COSTS REDUCE THE LIMIT OF LIABILITY AND ARE SUBJECT TO THE RETENTION. THIS COULD RESULT IN THE LIMIT OF LIABILITY BECOMING COMPLETELY EXHAUSTED BY THE PAYMENT OF DEFENSE COSTS, IN WHICH CASE, NO FURTHER COVERAGE IS PROVIDED BY THIS POLICY. PLEASE REVIEW THE POLICY CAREFULLY AND DISCUSS THE COVERAGE WITH YOUR INSURANCE AGENT OR BROKER.

2. The introductory paragraph on page 1 of the Policy is deleted in its entirety and replaced as follows:

   The Insurer, the **Policyholder** and the **Insureds** agree as follows, in consideration of the payment of the premium and in reliance upon all statements made in the **Application** furnished to the Insurer designated in the **Policyholder's** Declarations and the **Insured's Certificate of Insurance**, a stock insurance corporation, hereafter called the "Insurer".

3. Section I. INSURING AGREEMENT, PROFESSIONAL LIABILITY subpart 5. is deleted in its entirety and replaced with the following:

   5. there is no other policy, whether primary contributory, excess contingent or otherwise, which provides insurance to any **Insured** for a **Claim** for a **Wrongful Act** solely in rendering or failing to render **Professional Services** by such **Insured** while affiliated with an entity other than the **Policyholder**.

4. Section II. DEFENSE, Paragraph A.1. is deleted in its entirety and replaced as follows:

   A. Defense of **Claims**

      1. If a **Claim** is made against the **Insured** within the United States of America, its territories or possessions or Canada, the Insurer shall have the right and duty to defend such **Claim**, even if any of the allegations of the **Claim** are groundless, false or fraudulent.

         The Insurer shall have the right to appoint counsel and to make such investigation and defense of a **Claim** as it deems necessary. The **Insureds** or **Policyholder**, as applicable, shall have the option to:

         a. select the defense attorney or to consent to the Insurer's choice of defense attorney, which consent shall not be unreasonably withheld;
         b. participate in, and assist in the direction of, the defense of any **Claim**; and
         c. consent to a settlement, which consent shall not be unreasonably withheld.

         Subject to paragraph 2. below, the Insurer's obligation to defend any **Claim** or pay any **Loss**, shall be completely fulfilled and extinguished if the limit of liability has been exhausted by payment of **Loss**.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

For any **Claim** made against the **Insured** outside of the United States of America, its territories or possessions or Canada, the Insurer shall have the right and duty to defend such **Claim**, even if any of the allegations of the **Claim** are groundless, false or fraudulent. Provided however, if the Insurer is prevented by law or lacks expertise in carrying out the defense and supplementary provisions, the Insurer shall instead reimburse **Defense Costs** incurred by the **Insured** in defending such **Claims**. In connection with such **Claims**, the **Insured** shall obtain the Insurer's consent to the selection of counsel, including counsel rates, and ensure that counsel complies with CNA's *Defense Counsel Guidelines*. CNA shall have the right, but not the duty, to associate with the **Insured** in the defense of any such **Claim**.

2. Limitation on the Insurer's Duty to Defend

If the Insurer concludes that the Limit of Liability applicable to a **Claim** may become exhausted prior to the conclusion of any **Claim**, the Insurer will notify the **Insureds**, in writing, to that effect.

When the Limit of Liability applicable to a **Claim** has actually been exhausted prior to the conclusion of the **Claim**, the Insurer will notify the **Insured,** in writing, as soon as practicable, that such limit has been exhausted and that the Insurer's duty to defend such **Claim** and any other **Claim** has ended.

The Insurer will initiate, and cooperate in, the transfer of control to the **Insured**, of any **Claims** which were subject to that Limit of Liability and which were reported to the Insurer prior to the exhaustion of such limit. The **Insured** must cooperate in the transfer of control of such **Claims**.

The Insurer agrees to take the necessary steps as the Insurer deems appropriate to avoid a default in, or continue the defense of, such **Claims** until such transfer has been completed, provided that the **Insureds** are cooperating in completing such transfer.

The **Insured** must reimburse the Insurer for expenses the Insurer incurs in taking those steps the Insurer deems appropriate to avoid a default in, or continuing the defense of, any **Claim**.

The Insurer will not take any action with respect to any **Claim** that would have been subject to such Limit of Liability, had it not been exhausted, if the **Claim** is reported to the Insurer after that limit has been exhausted.

The exhaustion of any limit by payment of any **Claim**, and the resulting end of the Insurer's duty to defend, will not be affected by the Insurer's failure to comply with any of the terms and conditions of this provision.

5. Section III. DEFINITIONS are amended as follows:

A. The following new definitions are added:

- **Coverage Relationship** means that period of time between the effective date of the first claims-made **Certificate of Insurance** issued by the Insurer to the **Insured** and the cancellation or nonrenewal of the last consecutive claims-made **Certificate of Insurance** issued by the Insurer to the **Insured,** where there has been no gap in coverage, but does not include any period covered by **Extended Reporting Period**.

- **Extended Reporting Period** means the period of time after the **Coverage Relationship** for reporting **Claims** due to a **Wrongful Act**. The **Wrongful Act** must happen on or after the **Prior Acts Date** and before the end of the **Coverage Relationship**.

- **Termination of Coverage** means, whether made by the Insurer or the **Insured** at any time:

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

1. Cancellation or nonrenewal of the **Named Insured's Certificate of Insurance**; or
2. Decrease in limits, reduction of coverage, increased deductible or self-insured retention, new exclusion, or any other change in coverage less favorable to the **Insured**.

B. The definitions of **Policyholder** and **Pollutants** are each deleted in its entirety and replaced as follows:

Policyholder means the person or organization named in Item 1.(a) of the **Policyholder's** Declarations.

Pollutants means, without limitation, any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste (including materials to be recycled, reconditioned or reclaimed).

C. The definition of **Insured** is amended to add the following new language at the end:

Insured shall not include the **Policyholder**.

D. The definition of **Domestic Partner** is deleted in its entirety.

E. The first paragraph of the definition of **Loss** is deleted in its entirety and replaced as follows:

Loss means monetary settlements or monetary judgments (including any award of pre-judgment interest) and **Defense Costs** for which the **Insured** is legally obligated to pay on account of a covered **Claim**.

F. The definition of **Administration of Employee Benefit Plans** is deleted in its entirety and replaced as follows:

Administration of Employee Benefit Plans means consultation, other than legal advice, with participants in an employee benefit plan in order to explain the provisions of such plan and handling day-to-day ministerial functions required by such plan, including without limitation enrollment, record keeping and filing reports with government agencies. **Administration of Employee Benefit Plans** also includes third party claims administration.

6. Section IV. EXTENDED REPORTING PERIOD is deleted in its entirety and replaced as follows:

A. The provisions of the **Extended Reporting Period** coverage will not apply, except for the one year automatic **Extended Reporting Period** if the **Coverage Relationship** has been less than one year and the **Certificate of Insurance** was terminated for nonpayment of premium or fraud.

B. In the event of **Termination of Coverage** a one year automatic **Extended Reporting Period**, extension will be granted to the **Insured**, at no additional charge, only with respect to **Claims** made against the **Insured** and reported to the Insurer during such extension by reason of any **Wrongful Act** committed before the **Termination of Coverage**. The automatic **Extended Reporting Period** does not create any separate or additional Limit of Liability.

C. Within thirty days of **Termination of Coverage**, the Insurer will notify the **Named Insured**, in writing, of the automatic one year **Extended Reporting Period**. The Insurer will also notify the **Named Insured** of the availability of, the premium for, and the importance of purchasing an additional **Extended Reporting Period**. The additional **Extended Reporting Period** described herein shall be three years, inclusive of the one year period specified in paragraph B. above and the premium shall be computed in accordance with the rates in effect when the **Certificate of Insurance** was last issued or renewed. The premium to be charged for the additional **Extended Reporting Period** coverage shall be based upon the rates for such coverage in effect on the date this **Certificate of Insurance** was issued or last renewed and shall be for three years at 175% of such premium.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

D. The **Named Insured** shall have the greater of 60 days from the effective date of **Termination of Coverage** or 30 days from the date of mailing or delivery of the advice of the availability to purchase the additional **Extended Reporting Period** coverage, to submit written acceptance of the additional **Extended Reporting Period** coverage. The premium for such additional **Extended Reporting Period** must be paid promptly when due. The premium shall be fully earned at the inception of this endorsement.

E. If the **Named Insured** has been placed in receivership, liquidation or bankruptcy or permanently ceases operations, then any one qualifying as an **Insured** has the right to an **Extended Reporting Period** issued in the name of the **Named Insured** for the benefit of all **Insureds**. The request for such **Extended Reporting Period** coverage must be made within 120 days of the **Termination of Coverage**.

F. Upon termination of this **Certificate of Insurance**:
   i. any return premium due the **Named Insured** shall be credited toward the premium for the additional **Extended Reporting Period** coverage if the **Named Insured** elects such coverage.
   ii. where premium is due to the Insurer for coverage during the **Coverage Relationship**, any monies received by the Insurer from the **Named Insured** as payment for the **Extended Reporting Period** coverage shall first be applied to such premium owing for this **Certificate of Insurance**.

G. In order to purchase the **Extended Reporting Period**, the total premium for the **Named Insured's Certificate of Insurance** must have been paid.

H. If the **Extended Reporting Period** is purchased, the entire premium shall be deemed earned at its commencement without any obligation by the Insurer to return any portion thereof.

I. Limits of Liability for such additional **Extended Reporting Period** shall be:
   i. at least equal to 100 percent of the **Certificate of Insurance**'s applicable annual aggregate limit where a **Coverage Relationship** has continued for three years or more; or
   ii. if the **Coverage Relationship** has continued for less than three years, the Limit of Liability shall be at least equal to the greater of:
      a. the amount of coverage remaining in such **Certificate of Insurance**'s applicable annual aggregate Limit of Liability, or
      b. 50 percent of such **Certificate of Insurance**'s annual aggregate Limit of Liability.

7. Section V. ESTATES, LEGAL REPRESENTATIVES AND SPOUSES is deleted in its entirety and replaced as follows:

V. ESTATES, LEGAL REPRESENTATIVES AND SPOUSES

The estates, heirs, legal representatives, assigns or spouses of **Insureds**, shall be considered **Insureds** under this Policy; provided however, that coverage is afforded to such estates, heirs, legal representatives, assigns or spouses only for a **Claim** arising solely out of their status as such and, in the case of a spouse, where such **Claim** seeks damages from marital community property, jointly-held property or property transferred from the **Insured** to the spouse. No coverage is provided for any **Wrongful Act** of an estate, heir, legal representative, assign or spouse. All terms and conditions of this Policy, including without limitation the Retention applicable to **Loss** incurred by the **Insured** shall also apply to **Loss** incurred by such estates, heirs, legal representatives, assigns or spouses.

8. Section VI. LIMIT OF LIABILITY, RETENTION AND ALLOCATION is deleted in its entirety and replaced as follows:

VI. LIMIT OF LIABILITY AND RETENTION

A. Professional Liability Insuring Agreement.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

If a Limit of Liability is set forth in the **Insured's Certificate of Insurance** for the applicable **Insured** under the Professional Liability Insuring Agreement the Limit of Liability set forth in each **Certificate of Insurance** shall apply as follows:

1. Each **Claim**

   Subject to paragraph 2. below, the Limit of Liability of the Insurer for **Loss** for each **Claim** first made against an **Insured** and reported to the Insurer during the **Certificate Period** or **Extended Reporting Period** shall not exceed the amount stated in such **Insured's Certificate of Insurance** for each **Claim**.

2. Aggregate

   The Limit of Liability of the Insurer for **Loss** for all **Claims** first made against an **Insured** and reported to the Insurer during the **Certificate Period** or any **Extended Reporting Period** shall not exceed the amount stated in the **Insured's Certificate of Insurance** for all **Claims** in the Aggregate.

If the Limits of Liability for the Professional Liability Insuring Agreement, as set forth in the **Insured's Certificate of Insurance** includes more than one option, only one Limit of Liability option shall be available to each **Insured** and such option shall be the option identified in the written records of the **Policyholder**, subject to the maximum aggregate Limit of Liability as set for in this Section VI.

B. Exhaustion of Limit of Liability

The Insurer's obligations under this Policy shall be deemed completely fulfilled and extinguished if the applicable Limit of Liability is exhausted by payment of **Loss**.

C. Retention

Subject to the applicable Limit of Liability, the Insurer shall pay all covered **Loss** excess of the applicable Retention, if any, set forth in the **Insured's Certificate of Insurance**. The Retentions shall apply separately to each **Insured** as follows:

A single and separate Retention shall apply to all **Loss** resulting from each **Claim**. If more than one Retention is applicable to a single **Claim**, the maximum aggregate Retention for such **Claim** shall be the largest of such Retentions.

If the Insurer, in the exercise of its discretion and without any obligation to do so, pays any amount within the amount of the applicable Retention, the **Insured** shall be liable to the Insurer for any and all such amounts and, upon demand, shall pay such amounts to the Insurer.

D. **Interrelated Wrongful Acts**

More than one **Claim** involving the same **Wrongful Act** or **Interrelated Wrongful Acts** shall be considered as one **Claim** which shall be deemed to have been made on the earlier of:

1. the date on which the earliest such **Claim** was first made; or

2. the first date valid notice was given by an **Insured** and received by the Insurer under this Policy of any **Wrongful Act** or under any prior policy of any **Wrongful Act** or any fact, circumstance, situation, event or transaction which underlies any such **Claim**.

9. Section VII. NOTICE is amended as follows:

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

A. Paragraph A is deleted in its entirety and replaced as follows:

If a **Claim** is made against any **Insured**, the **Insured** shall give written notice to the Insurer or any of the Insurer's licensed agents, of such a **Claim** as soon as practicable during the **Coverage Relationship** or any **Extended Reporting Period** and forward to the Insurer every demand, notice, summons or other process received. The limits of insurance for the **Certificate Period** in effect on the date the **Claim** is reported to the Insurer shall apply.

In no event, however, shall the Insurer be responsible to pay any **Loss** in connection with any default judgment entered against an **Insured** prior to notice to the Insurer or as a result of untimely notice to the Insurer nor shall the Insurer be responsible to pay any **Loss** in connection with any **Claim** in which the Insurer's interests have been prejudiced because of the **Insured's** failure to supply timely notice to the Insurer.

Failure to give any notice required to be given by this Policy within the time prescribed herein shall not invalidate coverage of any **Claim**, unless the failure to provide timely notice has prejudiced the Insurer or unless the notice is provided after the expiration of the policy period, any renewal policy period and any extended reporting period. However, failure to give any notice required to be given by this Policy within the time prescribed therein shall not invalidate any **Claim** made by the **Insured**, by an injured person or by any other claimant if it shall be shown not to have been reasonably possible to give such notice within the prescribed time and that notice was given as soon as was reasonably possible thereafter.

Notwithstanding any provision in this Policy to the contrary, with respect to any **Claim** alleging death or personal injury, if the Insurer disclaims liability or denies coverage based upon the failure to provide timely notice, then the injured person, someone acting for the injured person or other claimant may bring an action against the Insurer, provided the sole question is whether such disclaimer or denial is based on the failure to provide timely notice.

However, the injured person, someone acting for the injured person or other claimant may not bring an action if within 60 days after the Insurer denies coverage, or does not admit liability, the Insurer or any **Insured** under the policy:

(a) brings an action to declare the rights of the parties under the policy; and

(b) names the injured person, someone acting for the injured person or other claimant as a party to the action.

B. The first sentence of paragraph B up to the colon is deleted in its entirety and replaced as follows:

If, during the **Insured's Certificate Period**, or the **Extended Reporting Period**, if applicable, an **Insured** first becomes aware of any **Wrongful Act** which may reasonably give rise to a future **Claim** and during such period give written notice to the Insurer or any of the Insurer's licensed agents, of:

C. Paragraph D is deleted in its entirety and replaced as follows:

The **Insureds** shall give written notice under this Policy to the Insurer or any of the Insurer's licensed agents as specified in the **Certificate of Insurance**, which shall be effective upon receipt. Failure to give any notice required to be given by paragraphs A, B and C above, within the time prescribed therein shall not invalidate any **Claim** made by the **Insured** or by any other claimant if it shall be shown not to have been reasonably possible to give such notice within the prescribed time and that notice was given as soon as was reasonably possible.

D. Paragraph E is deleted in its entirety and replaced as follows:

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

The **Insureds** shall furnish the Insurer with copies of reports, investigations, pleadings, and all related papers and such other information, assistance and cooperation as the Insurer may reasonably request. The **Insureds** agree to cooperate with the Insurer, and provide all assistance and information reasonably requested by the Insurer. When requested by the Insurer, the **Insureds** shall submit to examination by a representative of the Insurer, under oath if required, and shall attend hearings, depositions, and trials and shall assist in the conduct of **Claims**.

10. A new section is added as follows:

CANCELLATION/NONRENEWAL/CONDITIONAL RENEWAL OF CERTIFICATE OF INSURANCE

A. Cancellation of this **Certificate of Insurance**

1. This **Certificate of Insurance** may be canceled by the **Named Insured** by surrendering it to the Insurer or any of our authorized agents. The **Named Insured** may also cancel his or her **Certificate of Insurance** by written notice to the Insurer or our licensed agent, stating at what future date cancellation is to be effective.

2. If this **Certificate of Insurance** has been in effect for sixty (60) days or less, this **Certificate of Insurance** may be canceled by the Insurer by mailing or delivering to the **Named Insured** written notice stating the reason for cancellation at the mailing address shown on this **Certificate of Insurance**, and to the **Named Insured's** authorized agent or broker and to the **Policyholder** at least:

   a. twenty (20) days before the effective date of cancellation if this **Certificate of Insurance** is canceled for any reason not included in paragraph (b) below.
   b. fifteen (15) days before the effective date of cancellation if this **Certificate of Insurance** is canceled for any of the following reasons:
      i. nonpayment of premium provided; however, a notice of cancellation on this ground shall inform the **Named Insured** of the amount due;
      ii. conviction of a crime arising out of acts increasing the hazard insured against;
      iii. discovery of fraud or material misrepresentation in the obtaining of this **Certificate of Insurance** or in the presentation of a **Claim**;
      iv. after issuance of this **Certificate of Insurance** or after the last renewal date, discovery of an act or omission, or a violation of any policy condition, that substantially and materially increases the hazard insured against, and which occurred subsequent to inception of the current **Certificate Period**;
      v. material change in the nature or extent of the risk, occurring after issuance or last annual renewal anniversary date of this **Certificate of Insurance**, which causes the risk of loss to be substantially and materially increased beyond that contemplated at the time this **Certificate of Insurance** was issued or last renewed;
      vi. a determination by the New York State Superintendent of Insurance that continuation of the Insurer's present premium volume would jeopardize the Insurer's solvency or be hazardous to the interest of the Insurer's policyholders, creditors or the public;
      vii. a determination by such Superintendent that the continuation of this **Certificate of Insurance** would violate, or would place the Insurer in violation of, any provision of the New York Insurance Code; or
      viii. revocation or suspension of the **Named Insured's** license to provide **Professional Services**.

3. If this **Certificate of Insurance** has been in effect for more than sixty (60) days, or if this **Certificate of Insurance** is a renewal or continuation of a **Certificate of Insurance** issued by the Insurer, this **Certificate of Insurance** may be canceled by the Insurer only for any of the reasons

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

listed in paragraph A.2.b. above provided a written notice stating the reason for cancellation is mailed or delivered to the **Named Insured** at the address shown in this **Certificate of Insurance**, and his or her authorized agent or broker and to the **Policyholder** at least fifteen (15) days before the effective date of cancellation.

4. Notice of cancellation will state the effective date of cancellation. The **Certificate Period** will end on this date. If notice is mailed, proof of mailing will be sufficient proof of notice.

5. If the **Named Insured** cancels, earned premium will be computed in accordance with the customary short rate table and procedure. If the Insurer cancels, earned premium shall be computed pro rata. However, when the premium is advanced under a premium finance agreement, the cancellation refund will be pro rata. Under such financed policies, the Insurer will be entitled to retain a minimum earned premium of 10% of the total policy premium or $60, whichever is greater. Premium adjustment may be made either at the time cancellation is effected or as soon as practicable after cancellation becomes effective, but payment or tender of unearned premium is not a condition of cancellation.

6. If one of the reasons for cancellation set forth in Paragraph A.2.b. exists, the Insurer may cancel this entire **Certificate of Insurance**, even if the reason for cancellation pertains only to a new coverage or endorsement initially effective subsequent to the original issuance of this **Certificate of Insurance**.

B. Nonrenewal / Conditional Renewal of this **Certificate of Insurance**

1. If the Insurer elects not to renew this **Certificate of Insurance**, the Insurer shall send notice as provided in paragraph 3. below along with the reason for nonrenewal.

2. If the Insurer conditions renewal of this **Certificate of Insurance** upon:

   a. Change of limits;
   b. Change in type of coverage;
   c. Reduction of coverage;
   d. Increased deductible;
   e. Addition of exclusion;
   f. Increased premiums in excess of 10%, exclusive of any premium increased due to and commensurate with insured value added or increased exposure units; or as a result of experience rating, loss rating, retrospective rating or audit; the Insurer shall send notice as provided in paragraph 3.b. below.

   The Insurer shall send notice as provided in paragraph 3.

3. Notice of nonrenewal and conditional renewal will be provided as follows:
   a. If the Insurer decides not to renew this **Certificate of Insurance** or to conditionally renew this **Certificate of Insurance** as provided in paragraphs 1.and 2. above, the Insurer shall mail or deliver written notice to the **Named Insured** at least sixty (60) but not more than one hundred twenty (120) days before:
      i. the expiration date; or
      ii. the anniversary date if this is a continuous **Certificate of Insurance**.

   b. Notice will be mailed or delivered to the **Named Insured** at the address shown in this **Certificate of Insurance** and his or her authorized agent or broker and to the **Policyholder**. The notice will include the specific reason or reasons for nonrenewal or conditional renewal. If notice is mailed, proof of mailing will be sufficient proof of notice.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

c. The Insurer will not send the **Named Insured** notice of non-renewal or conditional renewal if the **Named Insured** or his or her authorized agent or broker or another insurer of the **Named Insured** mails or delivers notice that this **Certificate of Insurance** has been replaced or is no longer desired.

4. If the Insurer violates any of the provisions of the paragraphs above by sending the **Named Insured** an incomplete or late notice of conditional renewal or notice of nonrenewal:

a. Coverage will remain in effect at the same terms and conditions of this **Certificate of Insurance** at the lower of the current rates or the prior **Certificate Period's** rates until sixty (60) days after such notice is mailed or delivered, unless the **Named Insured**, during this sixty (60) day period, has replaced the coverage or elects to cancel.

b. On or after the expiration date of this **Certificate of Insurance**, coverage will remain in effect at the same terms and conditions of this **Certificate of Insurance** for another **Certificate Period** at the lower of the current rates or the prior **Certificate Period's** rates, unless the **Named Insured**, during this **Certificate Period**, has replaced the coverage or elects to cancel.

11. Section IX. OTHER INSURANCE is deleted in its entirety and replaced as follows:

IX. OTHER INSURANCE

If any **Loss** resulting from any **Claim** is insured under any other policies, this Policy shall apply only to the extent the **Loss** exceeds the amount paid under such other valid and collectible insurance whether such other valid and collectible insurance is stated to be primary, contributory, excess, contingent or otherwise, unless such other valid and collectible insurance is written only as specific excess insurance over this Policy.

12. Section XVI. EXCLUSIONS is amended as follows:

A. Paragraph A. **Prior Litigation** is amended to add the words "or **Policyholder**" after the first use of the word "**Insured**."

B. Paragraph M. **Nuclear/Pollution** is amended as follows:

1. The title is changed from "**Nuclear/Pollution**" to "**Pollution**".

2. The phrase "nuclear reaction, radiation or contamination," is removed from the exclusion.

C. Exclusion I. **Insolvency**, is deleted in its entirety and replaced as follows:

I. **Insolvency**

based upon, arising out of, due to or involving directly or indirectly the insolvency, receivership, liquidation or inability to pay, of any insurance carrier, broker/dealer, trust or investment vehicle in which the **Insured** has placed or obtained coverage for a client or an account.

However, this exclusion does not apply:

a. to any **Claim** arising from the **Insured's** placement of coverage with an admitted Insurer with an A.M. Best rating of "A-" or better rating at the time the **Insured** initially placed the risk with such Insurer; or

b. to any entity described above, if the entity was authorized or operated by a government body or bodies pursuant to statute or regulation, including assigned risk plans, joint

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

underwriting associations, pools, FAIR Plans, or other residual market mechanisms, but only with respect to such entity in its capacity or operation in such programs.

D. Exclusion Q. **Investment Banking Activities**, is deleted in its entirety and replaced as follows:

Q. **Investment Banking Activities**

based upon, directly or indirectly arising out of, or in any way involving any actual or alleged underwriting; syndicating; or investment banking work; or associated counseling or investment activities which includes any aspect of any actual, attempted or threatened mergers, acquisitions, divestitures, tender offers, proxy contests, leveraged buy-outs, going private transactions, reorganizations, capital restructuring, recapitalization, spin-offs, primary or secondary offerings of securities (regardless of whether the offering is a public offering or a Private Placement); other efforts to raise or furnish capital or financing for any enterprise or entity or any disclosure requirements in connection with any of the foregoing; provided, however, that this exclusion shall not apply to **Claim**s arising from sales by an **Insured** of securities in connection with an offering thereof where such **Claim**s relate solely to conduct by the **Insured** detrimentally relied upon by particular clients of the **Insured Broker/Dealer** and do not arise from facts or circumstances affecting the offering generally such as actual or alleged misrepresentations or omissions in the formal written offering materials, including registration statements, offering memoranda and circulars;

E. Exclusion W. **Wrongful Employment Practices**, is deleted in its entirety and replaced as follows:

W. **Wrongful Employment Practices**

based upon, directly or indirectly arising out of, or in any way involving employment practices which includes discrimination or termination of employment;

13. Section XII. NO ACTION AGAINST INSURER is deleted in its entirety and replaced with the following:

No action shall be taken against the Insurer unless, as a condition precedent thereto, the **Insured** shall have fully complied with all terms of this Policy, nor until the amount of the **Insured's** obligation to pay shall have been finally determined either by judgment against the **Insured** or by written agreement of the **Insured**, the claimant and the Insurer. Any person or organization or the legal representative thereof who has secured such judgment or written agreement shall thereafter be entitled to recover under this Policy to the extent of the insurance afforded by this Policy. Nothing contained in this Policy shall give any person or organization any right to join the Insurer in any action against the **Insured** to determine the **Insured's** liability, nor shall the Insurer be impleaded by the **Insured** or their legal representative in any such **Claim**.

14. The following new section is added to the Policy:

BANKRUPTCY

Bankruptcy or insolvency of any **Insured** or of the **Insured's** estate will not relieve the Insurer of its obligations under this Policy.

This endorsement is attached to the **Named Insured's Certificate of Insurance** and amends the **Insured's** coverage under the Master Policy. It takes effect on the effective date of the **Named Insured's Certificate of Insurance**, unless another effective date is shown below. All other provisions of the **Insured's** coverage under the Policy remain unchanged.

All other terms and conditions of the Policy remain unchanged.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

This endorsement, which forms a part of and is for attachment to the Policy issued by the designated Insurers, takes effect on the effective date of said Policy at the hour stated in said Policy, unless another effective date is shown below, and expires concurrently with said Policy.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

CNA

CANCELLATION AND NON-RENEWAL ENDORSEMENT

FLORIDA

In consideration of the payment of the premium, not withstanding anything to the contrary in the Policy, the Cancellation and Non-renewal provision is as follows:

Cancellation/Nonrenewal

1. Cancellation by the **Named Insured**

   The **Named Insured** has the right to cancel his or her **Certificate of Insurance** at any time by giving notice to the Insurer stating when thereafter the cancellation shall be effective. If the **Certificate of Insurance** is so canceled, earned premium shall be computed pro rata.

2. Cancellation by the Insurer

   a. The Insurer has the right to cancel the **Name Insured's Certificate of Insurance** at any time and for any reason within the first ninety (90) days. The Insurer must mail notice of cancellation at least twenty (20) days prior to the effective date of such cancellation. If the Insurer cancels for non-payment of premium, the Insurer must mail notice of cancellation at least ten (10) days prior to the effective date of such cancellation. However, the Insurer may cancel "immediately" for material misrepresentation or failure to comply with underwriting requirements.

   b. After the **Name Insured's Certificate of Insurance** has been in effect for ninety-one (91) days or more, it may be canceled for one of the following reasons:

      (1) Nonpayment;
      (2) **Certificate of Insurance** obtained through material misrepresentation;
      (3) The **Named Insured** violated the terms and conditions of the policy;
      (4) The risk originally accepted has measurably increased;
      (5) The cancellation is for all Insured's under such coverages for a given class of Insured's.

      The Insurer must mail notice of cancellation at least forty five (45) days prior to the effective date of such cancellation. If the Insurer cancels for non-payment of premium, the Insurer must mail notice of cancellation at least ten (10) days prior to the effective date of such cancellation.

3. Non-Renewal by the Insurer

   The Insurer has the right to non-renew the **Named Insured's Certificate of Insurance** effective on any **Certificate of Insurance** anniversary date. All notices of non-renewal must be mailed to the **Named Insured** at the last mailing address known to the Insurer, at least forty five (45) days prior to the effective date of non-renewal and shall provide a specific explanation of the reason(s) for non-renewal.

This endorsement is attached to the **Named Insured's Certificate of Insurance** and amends the **Insured's** coverage under the Master Policy. It takes effect on the effective date of the **Named Insured's Certificate of Insurance**, unless another effective date is shown below. All other provisions of the **Insured's** coverage under the policy remain unchanged.

All other terms and conditions of the Policy remain unchanged.

This endorsement, which forms a part of and is for attachment to the Policy issued by the designated Insurers, takes effect on the effective date of said Policy at the hour stated in said Policy, unless another effective date is shown below, and expires concurrently with said Policy.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

CNA

LIFE AGENT PROFESSIONAL LIABILITY POLICY

MASTER POLICY - AMENDATORY ENDORSEMENT - FLORIDA

1. In consideration of the premium paid, it is agreed that the following is added to this Policy:

   If **Insured Persons** have any questions regarding this Policy please call 1-312-822-5000 for assistance.

2. In consideration of the premium paid, it is agreed that the definition of **Domestic Partner** under Section **III. DEFINITIONS** is deleted in its entirety and replaced with the following:

   Domestic Partner means any person qualifying as such under any federal, state or local laws.

3. In consideration of the premium paid, it is agreed that the definition of **Loss** of Section **III. DEFINITIONS** is deleted and replaced as follows:

   However, **Loss** shall not include:

   A. any amount for which there is no legal recourse against the **Insureds**;

   B. costs incurred as a result of any injunctive relief;

   C. the return of commissions, fees or charges for services rendered by an **Insured**; or

   D. matters which are uninsurable under the law pursuant to which this Policy shall be construed.

   E. However, **Loss** shall include any taxes incurred by a third party and included in such third party's **Claims** against the **Insured**;

4. In consideration of the premium paid, it is agreed that the definition of **Pollutants** of Section **III. DEFINITIONS** is deleted in its entirety and replaced as follows:

   Pollutants means, any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals or waste (including materials to be recycled, reconditioned or reclaimed).

5. In consideration of the premium paid, it is agreed that paragraph 1. of Section **XII. NO ACTION AGAINST INSURER** is deleted and replaced as follows:

   1. No action shall be taken against the Insurer unless, as a condition precedent, there shall have been full compliance with all the provisions of this Policy. Such action must be taken within five (5) years.

6. In consideration of the premium paid, it is agreed that Section **XVII. TRADE EMBARGOES AND SANCTIONS** is deleted in its entirety and not replaced.

All other terms and conditions of the Policy remain unchanged.

This endorsement, which forms a part of and is for attachment to the Policy issued by the designated Insurers, takes effect on the effective date of said Policy at the hour stated in said Policy, unless another effective date is shown below, and expires concurrently with said Policy.

© CNA All Rights Reserved.

FILED DATE: 10/31/2018 1:20 PM 2018CH13639

IMPORTANT INFORMATION

FOR OUR FLORIDA POLICY HOLDERS

As a result of legislation which was signed into law effective July 1, 2013, commercial insurers are permitted to deliver insurance policies electronically in Florida. Electronic transmission of a policy constitutes delivery of the policy under Florida statute 627.421 unless the insured communicates in writing or electronically to the insurer that it does not agree to electronic delivery.

The purpose of this notice is to inform you that you have the right to receive your policy via United States mail rather than via electronic transmission by notifying us that you do not agree to electronic delivery.

To request delivery of your policy by United States mail or if you have any questions, please contact your CNA independent agent or broker.

© CNA All Rights Reserved.

EXHIBIT G

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

CROWN CAPITAL SECURITIES, L.P.,

Plaintiff,

vs.

LIBERTY SURPLUS INSURANCE CORPORATION, a New Hampshire corporation; and DOES 1 to 10

Defendants.

Case No.: 1:15-cv-02878-PKC

AMENDED COMPLAINT FOR:

(1) BREACH OF CONTRACT UNDER CALIFORNIA OR, ALTERNATIVELY, NEW YORK LAW

(2) BREACH OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING UNDER CALIFORNIA LAW

(3) DECLARATORY JUDGMENT UNDER 28 U.S.C. SECTION 2201

(4) UNFAIR BUSINESS PRACTICES UNDER CALIFORNIA LAW – CAL. BUS. AND PROF. CODE SECTION 17200 ET SEQ.

THE PARTIES

1. Plaintiff Crown Capital Securities, L.P. ("Plaintiff") is, and at all relevant times was, a limited partnership, of which Darol K. Paulsen ("Paulsen"), Delta Broker Holding, LLC ("Delta") and Ret, L.P. are the sole members. Plaintiff's principal place of business is located in Orange, California.

2. Paulsen is an individual who at all relevant times was (and remains) a citizen and resident of the State of California.

3. Delta is a limited liability company of which Paulsen, fifteen individuals and Stanford Enterprises, L.P. are the sole members. Of the sixteen individual members who are not Paulsen, four individual members at all relevant times were (and remain) citizens of the State of California, six individual members at all relevant times were (and remain) citizens of the State of Oregon, two individual members at all relevant times were (and remain) citizens of the State of Arizona, one individual member at all relevant times was (and remains) a citizen of the State of Kentucky, one individual member at all relevant times was (and remains) a citizen of the State of Georgia, one individual member at all relevant times was (and remains) a citizen of the State of Michigan, one individual member at all relevant times was (and remains) a citizen of the State of Minnesota. Stanford Enterprises, L.P. is a partnership of which two individuals are the sole partners. One individual is a general partner who at all relevant times was (and remains) a citizen of the State of Tennessee. One individual is a limited partner who at all relevant times was (and remains) a citizen of the State of Tennessee.

4. Ret, L.P. is a limited partnership of which two individuals are the sole partners. One individual is a general partner of Ret, L.P. who at all relevant times was (and remains) a citizen of the State of Tennessee. One individual is a limited partner of Ret, L.P. who at all relevant times was (and remains) a citizen of the State of Alabama.

5. Therefore, based on the facts alleged above, Plaintiff at all relevant times was and remains a citizen of the States of California, Oregon, Arizona,

Alabama, Kentucky, Georgia, Minnesota, Michigan and Tennessee for the purposes of establishing diversity jurisdiction under 28 U.S.C. section 1332(c).

6. Plaintiff is informed and believes, and on that basis alleges, that Defendant Liberty Surplus Insurance Corporation ("Liberty") is, and at all relevant times was, a New Hampshire corporation with its principal place of business in Boston, Massachusetts. Liberty was at all relevant times and is an insurance company validly licensed to conduct business within the State of California.

7. Defendant Does 1 through 10, inclusive, are sued by fictitious names because their true name and capacities, whether individual, corporate, associate or otherwise, and/or their responsibility and culpability for the acts alleged herein are unknown to Plaintiff at this time. Plaintiff is informed and believes, and on that basis alleges, that each defendant sued herein as "Doe" is responsible in some manner for the acts and events referred to herein. When their true names, capacities, responsibility and culpability are ascertained, Plaintiff will seek leave of this Court to amend the complaint as appropriate.

8. Plaintiff is informed and believes, and on that basis alleges, that at all times mentioned herein, each of the fictitiously named defendants was the agent, representative, co-conspirator, successor-in-interest, assignee or employee of each remaining defendant, and in doing the things alleged herein, was acting within the course and scope of such agency, representation, conspiracy, assignment and employment.

JURISDICTION AND VENUE

9. This Court has jurisdiction pursuant to 28 U.S.C. section 1332 because Plaintiff (a citizen of California, Oregon, Arizona, Alabama, Kentucky, Georgia, Minnesota, Michigan and Tennessee) and Liberty (a citizen of Massachusetts and New Hampshire) are citizens of different states and the amount in controversy exceeds $75,000.

10. Plaintiff contends venue is proper in the Central District of California because the insurance contract at issue, and Liberty's liability to Plaintiff, arose in Orange County, California and Plaintiff's primary place of business is there. In addition, Liberty conducted extensive business in California, including Orange County, during the relevant times, and issued to Plaintiff the subject professional liability policy while it had its primary place of business in Orange County. Finally, the New York forum selection clause in the insurance policy at issue is invalid, against the public policy of the state of California and was waived and forfeited by Liberty. Nonetheless, the Central District of California ordered this matter transferred to this Court, the Southern District of New York, which Order Plaintiff has sought to overturn via a pending petition for writ of mandamus to the Ninth Circuit Court of Appeal, and so venue is proper in this Court at least until that writ petition is resolved.

GENERAL FACTS AND ALLEGATIONS

11. Plaintiff is an independent broker dealer in the business of selling and purchasing securities and other investment products (including stocks, bonds,

mutual funds, fixed and variable annuities and other specialty products) to clients and providing investment advice and services related to these products.

12. Plaintiff is, and at all relevant times was, an insured under broker-dealer and registered investment adviser professional liability policy no. E05NAADF7W002 issued by Liberty to Plaintiff with a policy period of April 1, 2012 to April 1, 2013 ("Policy"). Liberty sold the Policy to Plaintiff in California. A true and correct copy of the Policy is attached hereto as Exhibit "1."

13. The "Insuring Agreements" provision of the Policy obligates Liberty to:

> [P]ay on behalf of the Insured all sums in excess of the Deductible amount referenced in the Declarations which the Insured shall become legally obligated to pay as Damages and/or Claims Expenses resulting from Claims first made during the Policy Period or Extended Reporting Period, if applicable, as a result of a Wrongful Act by an Insured or an entity for whom the Insured is legally liable, provided that such Wrongful Act was committed on or after the Retroactive Date and before the end of the Policy Period.

14. The Policy Limits of the Policy are $2 million per Claim, a $2 million Registered Representative aggregate and $10 million maximum policy aggregate. The deductible amount for the Named Insured (*i.e.*, Plaintiff) for each Claim is $25,000 and $5,000 for each Registered Representative Claim.



15. The Policy defines "Claim" to mean "a written demand for Damages alleging a Wrongful Act, including a complaint, arbitration proceeding, or civil lawsuit." The Policy defines "Wrongful Act" to mean "any actual or alleged negligent act, error or omission solely while performing Professional Services, for others."

16. Section II. P. of the Policy defines "Professional Services" to mean:

1. the purchase, sale or servicing of Securities to a client of the Broker-Dealer, provided that these Securities are approved and authorized in writing by the Broker-Dealer and that these Securities are processed or approved for processing by the Broker-Dealer;

2. the sale or servicing of fixed annuity products, or life, health, disability, or accident insurance sold by a properly licensed Insured;

3. the sale and servicing of individual retirement accounts ("IRAs"), Keogh retirement plans, or employee benefit plans, but solely when such accounts/plans have been funded with the products identified in Sub-sections 1. and/or 2. above.

4. providing financial, investment or economic advice as a Registered Investment Adviser in connection with any of the activities or products identified in Sub-sections 1., 2. or 3. above.

5. providing financial planning services including, but not limited to, advice regarding personal risk management or planning for insurance, savings, investments, or retirement.

17. Endorsement No. 8 of the Policy defines "Professional Services" to mean "the purchase, sale or servicing of Securities to a client of the Broker-Dealer,

provided that these Securities are approved and authorized in writing by the Broker-Dealer and/or the Registered Representative's prior Broker-Dealer and that these Securities are processed or approved for processing by the Broker-Dealer."

18. "Damages" means a compensatory monetary amount for which an Insured may be held legally liable, including judgments (inclusive of pre or post judgment interest), awards or settlements negotiated with the prior approval of the Insurer and does not include disgorgement which is sought in the Statement of Claim.

19. The Policy also contains a list of Exclusions, including Exclusion X, that provides in pertinent part that the Policy does not apply to any Claim:

> [B]ased upon, arising out of, directly or indirectly, or in any way involving the financial inability to pay, insolvency, receivership, bankruptcy, or liquidation of any entity [].

20. Plaintiff procured the Policy from Liberty in order to protect itself with insurance coverage for claims of errors or omissions, negligent acts, breach of fiduciary duty and misrepresentations in connection with its primary line of business — the purchase, sale and/or servicing of securities to its clients.

21. Plaintiff was never informed prior to the purchasing the Policy, that Liberty expansively interpreted Exclusion X to preclude coverage for *any* dispute that involves in *any* manner the inability of an independent *third-party* to pay, including situations in which Plaintiff had no responsibility for the inability of an independent *third-party* to pay. The plain language of Exclusion X, and the

Policy's express coverage for alleged "negligent act, error or omission" in Plaintiff's conduct of its main line of business – the purchase, sale or servicing of securities, does not support such a broad and unreasonable interpretation.

22. In 2006, Plaintiff, through its Registered Representative, Mary T. Gibson, began providing investment/financial services and advice to Colum O'Hare ("O'Hare"). O'Hare sought advice from Ms. Gibson, who had previously worked as O'Hare's accountant, regarding investing his funds in order to provide income for his healthcare and retirement. Based on her conversations with O'Hare and an assessment of his financial situation, Ms. Gibson recommended he purchase, through a 1031 exchange, two tenant-in-common ("TIC") investments – 3050 Superior TIC and Lake Center TIC (the "Investments") – with the proceeds from the sale of his apartment.

23. The Investments are independent third party-entities with no relationship or connection to Plaintiff. Plaintiff has absolutely no control over the Investments' establishment, finances or operations.

24. As a result of the economic downturn beginning in 2008, the Investments did not perform quite as well as when they were initially purchased by O'Hare.

25. On or about May 7, 2012, O'Hare filed a Statement of Claim before the Financial Industry Regulatory Authority (FINRA) ("O'Hare Claim"). The fundamental basis and catalyst for the O'Hare's Claim against Plaintiff and the other respondents, Ms. Gibson and Gary A. Glockzin (independent contractors of Plaintiff) is that during the process of selling the Investments, Plaintiff and other

respondents were allegedly negligent in numerous respects. Specifically, O'Hare claimed that Plaintiff misrepresented and/or failed to inform him of various aspects of the investments during the sales process, including the nature of the Investments and the risks involved with them. O'Hare alleged that Plaintiff's Registered Representative and respondent Ms. Gibson knew that O'Hare was in poor health when he sought investment advice from her and knew that he was only looking for a safe investment. O'Hare alleged that the Investments involved not only large case investments, but also large assumptions of loans. O'Hare alleged that liquidity was highly important and yet the investments were illiquid. O'Hare alleged that Plaintiff and other respondents misrepresented that the investments would guarantee income and that Plaintiff was negligent when selling the Investments to him because they failed to inform him of the risks associated with investing in these TICs. O'Hare stated that he would never have agreed to purchase the TIC's had he known the true facts and risks associated with his purchase, including the alleged commission paid by the sponsors to respondents that allegedly motivated them to sell TIC products such as the Investments. A true and correct copy of O'Hare's Statement of Claim filed with FINRA is attached hereto as Exhibit "2."

26. Nearly all of the allegations in the Statement of Claim focus on alleged negligence and misconduct by Plaintiff and other respondents in initially recommending and selling the Investments to O'Hare. O'Hare asserted, in concluding and summarizing the "Statement of Facts" section of the Statement of Claim, that Plaintiff and other respondents "should never have recommended either of these TICs to Claimant due to these investments being illiquid, overpriced, over-leveraged, and their multitude of other problems, risks, and conflicts of interest." Moreover, O'Hare alleged that they failed to inform him of the "inherent

downsides and risks with investing in these TICs." O'Hare then recounted numerous alleged structural and funding problems that existed even before the Investments were recommended to him by Plaintiff. (Statement of Claim, pg. 7). O'Hare specifically alleged that Plaintiff:

- misrepresented that these investments would provide "guaranteed income;"
- failed to disclose the risks of the Investments (Statement of Claim, pg. 5);
- failed to disclose that these investments paid to brokers was "approximately triple the commissions of far safer investments" (Statement of Claim, pg. 6);
- "never calculated the potential tax savings to be realized by Claimant in connection with the 1031 exchange to determine whether the benefit would even outweigh the extraordinary commissions and fees with the investments which they sold Claimant" (*Id.*);
- failed to exercise due care by recommending these investments because they were "illiquid, overpriced, over-leveraged, and their multitude of other problems, risks, and conflicts of interest" (*Id.*);
- it failed to inform them "that the sponsor, NNN, had purchased the properties for millions less than was raised . . . and misled investors such as Claimant; (Statement of Claim, pg. 8)"

- "there were substantial fees, charges and commissions associated with each TIC sold which amounted at times to 20% or more of the capital investment." (Statement of Claim, pg. 7)

27. O'Hare further alleged that had Plaintiff and other respondents "disclosed these facts to [O'Hare], he would never have agreed to purchase these high-risk illiquid investments." (Statement of Claim, pg. 8).

28. On the basis of these and other allegations regarding alleged misconduct by Plaintiff during the sales process, the Statement of Claim asserted claims against Plaintiff and other respondents for breach of fiduciary duty of loyalty, negligence and breach of the duty of care, breach of written and oral contract, material omissions and misrepresentations in connection with the sale of securities (securities fraud), fraud based on concealment, failure to supervise and negligent supervision and violations of federal statutes and FINRA rules and regulations regarding the sale of securities. O'Hare alleged that he suffered damages in excess of $469,125 and he sought punitive and exemplary damages, pre-award and post-award interest, costs of arbitration and expenses, and fees.

29. In his Statement of Claim, O'Hare only mentions in passing that the 3050 Superior TIC had foreclosed in February 2012. Further, although the *Lake Center TIC had not yet foreclosed when the Statement of Claim was filed*, O'Hare speculated that it would "soon have the same fate as 2050 Superior TIC." According to the allegations actually made by O'Hare in his Statement of Claim, the foreclosures of the Investments, both actual and merely speculated, were simply exemplars of the wider structural problems that he believed was not fully disclosed and explained to him. Thus, the O'Hare Claim arose from the errors and



negligence allegedly committed by Plaintiff in selling the Investments and not the consequential foreclosure of the Investments years later.

30. Plaintiff timely reported the O'Hare Claim and tendered the defense and indemnity of the O'Hare Claim to Liberty on May 22, 2012. Plaintiff reasonably believed that Liberty would swiftly meet its obligation to provide a defense against the O'Hare Claim given that the allegations in the Statement of Claim of negligent misrepresentations, material omissions and other conduct by Plaintiff in recommending and selling the Investments to O'Hare fall directly within the plain coverage language in the Policy for "negligent act, error or omission solely while performing Professional Services, for others."

31. In or around June 2012, because Liberty had not yet informed Plaintiff whether it would meet its obligation to provide a defense under the Policy, Plaintiff was forced to move forward with its own defense against the O'Hare Claim and engage the law firm of Jones, Bell, Abbott, Fleming & Fitzgerald L.L.P. ("Jones Bell") to defend and represent them in the arbitration proceedings concerning the O'Hare Claim. On July 6, 2012, Jones Bell filed an Answer to the Statement of Claim on behalf of Plaintiff and other respondents.

32. On February 5, 2013, Liberty, through its representative/agent, Lourdes Baez, sent Plaintiff a letter acknowledging receipt of Plaintiff's tender of defense against O'Hare under the Policy. Liberty stated in its letter that pending further investigation it was reserving its rights to deny coverage and/or rescind under the Policy. Liberty requested additional documents from Plaintiff regarding the Investments, which Plaintiff promptly provided to Liberty.

33. Over six months after sending its initial February 5, 2013 letter requesting additional documents regarding the Investments, Liberty, through Ms. Baez, sent a second coverage letter to Plaintiff dated August 19, 2013. In the letter, Liberty stated that it had reviewed and considered the Policy in light of the additional information it had been provided. To Plaintiff's surprise, despite the fact that the allegations in the O'Hare Claim of negligence and errors by Plaintiff in recommending and selling the Investments fell directly within the ambit of coverage under the Policy, Liberty stated in the letter that "there appears to be no coverage available under the Policy." The basis for Liberty's position was that it believed that Exclusion X, discussed above, applies to preclude coverage under the Policy for the O'Hare Claim because it had allegedly received information from defense counsel on July 11, 2013 that the Investments had been foreclosed upon and are insolvent. On this incorrect basis, Liberty argued that it did not and does not have any duty to defend Plaintiff and other respondents from the O'Hare Claim and is not obligated to pay for Damages or Claim Expenses resulting from the O'Hare Claim and arbitration. Liberty did not provide any additional explanation or even attempt to address the fact that the Statement of Claim was focused nearly entirely on alleged negligence and errors in selling the Investments long before any foreclosure and the fact that the Lake Center TIC had not even been the subject of a foreclosure when the Statement of Claim was filed. Moreover, nowhere in the Statement of Claim does O'Hare even allege that either of the Investments was insolvent. A true and correct copy of Liberty's August 19, 2013 letter is attached herein as Exhibit "3."

34. Although Liberty had wrongfully and unreasonably refused to meet its obligation to provide a defense and indemnity under the Policy, Plaintiff and its counsel, Jones Bell, were forced to move forward with mediation of the O'Hare

Claim without any assistance from Liberty. In or about September 2013, Plaintiff and other respondents and O'Hare reached an agreement to settle the O'Hare Claim for $140,000. On September 25, 2013, the parties executed the settlement agreement in the O'Hare Claim providing for dismissal of the action and mutual releases. Pursuant to the settlement agreement, Plaintiff paid O'Hare $140,000 with the expectation that Liberty would reverse its erroneous decision to deny coverage based on Exclusion X and reimburse Plaintiff the full settlement amount. A true and correct copy of the settlement agreement is attached herein as Exhibit "4."

35. On February 4, 2014, Plaintiff, through its counsel, sent a comprehensive letter to Liberty demanding that it reverse its wrongful denial decision and agree to pay the full costs of the defense concerning the O'Hare Claim and that it pay the subsequent settlement of the claim. The letter examined and explained in detail the numerous glaring errors in Liberty's position that Exclusion X applied to entirely preclude coverage of the O'Hare Claim under the Policy and why it is completely unsupported by the plain language of the Policy and the relevant legal authorities. Plaintiff asserted that Liberty improperly and in bad faith rejected Plaintiff's tender of defense and indemnity of the O'Hare Claim and that Liberty must reimburse Plaintiff's attorneys' fees and costs paid to Jones Bell in defending the O'Hare Claim and the settlement amount Plaintiff paid (less the $25,000 deductible). The letter asked that Liberty respond as soon as possible, but no later than two weeks from the date of the letter in order to avoid a lawsuit for breach of contract and insurance bad faith. A true and correct copy of the February 4, 2014 letter is attached herein as Exhibit "5."

36. Because Liberty had not provided any response to the February 4, 2014 letter, on March 27, 2014, Plaintiff's counsel sent an email to Liberty's representative/agent, Lourdes Baez, inquiring as to when Liberty would provide responses to the several letters it had sent to Liberty, including the February 4, 2014 letter regarding the O'Hare Claim. The email requested that Liberty, at the very least, provide a good faith estimate of when Plaintiff could expect a response and reiterated that Liberty's continued delay is further evidence of bad faith.

37. After receiving no response whatsoever from Liberty regarding the O'Hare Claim and whether it would pay for defense and settlement costs, Plaintiff, through its counsel, sent another letter to Ms. Baez on April 14, 2014, requesting that Liberty provide a response to the February 4, 2014 letter. The letter reiterated that Plaintiff had made repeated requests that Liberty provide an estimated date by which it would reach a decision on these matters, including regarding the O'Hare Claim. The letter stated that if Liberty did not provide a response to Plaintiff's February 4, 2014 letter by May 1, 2014, Plaintiff would begin preparing its complaint and file an action for breach of contract and insurance bad faith against Liberty. A true and correct copy of the April 14, 2014 letter to Liberty is attached herein as Exhibit "6."

38. As of filing this litigation and to date, Plaintiff has received no response of any kind from Liberty to its February 4, 2014 letter regarding Liberty's obligation to pay Plaintiff for defense costs and the settlement in the O'Hare arbitration matter under the Policy. As discussed, Liberty must reimburse Plaintiff for the $140,000 paid to settle the O'Hare Claim (less the $25,000 deductible) and it must also reimburse Plaintiff the $60,036.42 in attorneys' fees, expert fees and costs it was forced to pay Jones Bell and/or others for defending it and other

respondents in the O'Hare arbitration proceedings. Liberty has not paid or reimbursed Plaintiff for any of the costs and expenses incurred in defending and settling the O'Hare Claim.

FIRST CLAIM FOR RELIEF

For Breach of Contract Under California or, Alternatively, New York Law

(Against Defendant Liberty and Does 1 to 10)

39. Plaintiff incorporates by reference each of the foregoing paragraphs of this Complaint, as though fully set forth herein.

40. Plaintiff alleges California law applies to the parties' disputes and asserts this First Claim for Relief under California law. It does not waive the right to assert California law. However, if and to the extent the Court finds New York law applies to the parties' disputes, Plaintiff alternatively asserts this First Claim for Relief under New York law.

41. Plaintiff and Liberty entered into a valid and enforceable contract, that is, the Policy.[1]

42. Plaintiff fulfilled every condition and has duly performed each and every obligation that it was required to perform under the terms of the Policy.

[1] Plaintiff asserts certain clauses in the Policy are invalid and unenforceable as against the public policy of the State of California, including the forum selection and choice-of-law provisions. The balance of the Policy is a valid and enforceable contract.

43. The O'Hare Claim constitutes a covered "Claim" within the meaning of the Policy for which Plaintiff is entitled to be reimbursed for the attorneys' fees and costs it incurred in defending the O'Hare Claim and for the monies it paid to settle the O'Hare Claim. These sums are due and owing to Plaintiff under the Policy.

44. Liberty incorrectly denied Plaintiff's claim for defense and indemnity against the O'Hare Claim owing to it under the Policy. Contrary to Liberty's incorrect position, Exclusion X of the Policy does not preclude coverage or potential coverage for the O'Hare Claim. Liberty breached its obligations to Plaintiff under the Policy by failing to fulfill its obligations under the Policy, including but not limited to, the obligation to pay the costs of defending against the O'Hare Claim, by wrongfully refusing to indemnify Plaintiff for the settlement of the O'Hare Claim and by failing to consider the clear language of the Policy and relevant legal authority supporting the fact that the O'Hare Claim is covered and potentially covered under the Policy. Liberty breached its duty to defend the O'Hare Claim under the Policy, and its Policy duty to settle and/or indemnify Plaintiff for the settlement it made of the O'Hare Claim.

45. As a direct and proximate result of Liberty's conduct and breach of the Policy as alleged herein, Plaintiff has suffered and will continue to suffer monetary and non-monetary damages in an amount subject to proof at trial including but not limited to loss of the benefits it is entitled to under to Policy, including reimbursement of defense fees and costs and indemnity for the settlement of the O'Hare Claim, and pre-judgment interest on those benefits as permitted by California or, alternatively, New York law.

SECOND CLAIM FOR RELIEF

For Breach of the Implied Covenant of Good Faith and Fair Dealing
Under California Law
(Against Defendant Liberty and Does 1 to 10)

46. Plaintiff incorporates by reference each of the foregoing paragraphs of this Complaint, as though fully set forth herein.

47. Plaintiff alleges California law applies to the parties' disputes and asserts this Claim for Relief under California law.

48. The Policy, like all insurance policies, contains an implied covenant of good faith and fair dealing. Liberty violated this covenant when it improperly and unreasonably refused and failed to accept Plaintiff's claim for indemnity for the settlement amount of the O'Hare Claim, for a defense of the O'Hare claim, and reimbursement of costs and fees incurred in defending against the O'Hare Claim. Liberty violated the covenant also by its delay in responding to communications and investigating the Claim, among other unreasonable claims handling conduct.

49. O'Hare's Statement of Claim alleged claims against Plaintiff and other respondents in connection with the recommendation and sale of the Investments, for: breach of fiduciary duty of loyalty, negligence and breach of the duty of care, breach of written and oral contract, material omissions and misrepresentations in connection with the sale of securities (securities fraud), fraud based on concealment, failure to supervise and negligent supervision and violations of federal statutes and FINRA rules and regulations regarding the sale of securities. To support these claims, O'Hare made numerous allegations regarding, among

other things, negligent misrepresentations and material omissions/concealment regarding the risks, financial structure and suitability of the Investments for O'Hare. These actual statements and allegations in the Statement of Claim substantiate that this claim arose **not** out of the subsequent insolvency or foreclosure of the Investments, but out of the alleged sales practice violations and erroneous advice that O'Hare alleged misled him into purchasing the Investments. The allegations in the Statement of Claim plainly constitute a "Claim" under the terms of the Policy because it is a written demand for damages alleging negligent acts, errors and omissions allegedly committed by Plaintiff while performing "Professional Services" for O'Hare in selling the Investments.

50. However, after Plaintiff timely reported the O'Hare Claim and tendered its defense to Liberty on May 22, 2012, Liberty wrongfully and outrageously refused to pay defense fees and costs and refused to provide indemnity for the $140,000 settlement paid by Plaintiff to O'Hare based on its groundless and incorrect assertion that Exclusion X precludes any coverage under the Policy for the O'Hare Claim. Liberty falsely and unreasonably maintains that the O'Hare Claim is based upon, arises out of and/or involves the Investments' insolvency and/or subsequent foreclosure such that the O'Hare is not covered under the Policy. Liberty is aware that the overwhelming focus and catalyst for the Statement of Claim was the alleged malpractice and misrepresentations/omissions by Plaintiff in recommending and selling the Investments to O'Hare unrelated to any foreclosures and that the Lake Center TIC had not yet foreclosed when the Statement of Claim was filed.

51. Liberty's continued wrongful refusal to provide coverage to Plaintiff under the Policy on the basis of Exclusion X is especially contemptible because

Plaintiff's February 4, 2014 letter to Liberty explained in detail why, under California law, Exclusion X does not and cannot absolve Liberty of its duty to provide defense and indemnity in relation to the O'Hare Claim. As discussed in the letter, Plaintiff is entitled to a defense of the O'Hare Claim and indemnity concerning that claim under California law, in part on the following grounds: (1) Exclusion X does not bar coverage under the concurrent causation rule because a covered risk (for instance, negligence) is alleged in the O'Hare Claim as discussed in the important and directly applicable case of *Conestoga Servs. Corp. v. Exec. Risk Indem.*, 312 F.3d 976 (9th Cir. 2002); (2) the Policy and Exclusion X are ambiguous, particularly as to whether it applies to the insolvency/foreclosure of an independent third-party entity such as the Investments when the insured did not cause or contribute to the insolvency/foreclosure of an independent third-party entity, and should be construed in favor of Plaintiff; (3) Liberty's expansive interpretation of Exclusion X improperly renders coverage under the Policy illusory because any claim alleging Plaintiff made errors or misstatements in performance of its professional services will often in some fashion relate to the financial inability to pay of some investment/security sold by Plaintiff; and (4) the allegations and claims in the O'Hare Claim on its face does not support application of Exclusion X.

52. As of the filing of this litigation and as of the date of this Amended Complaint, Liberty has failed and continues to wrongfully refuse to provide any response to the February 4, 2014 or any of the subsequent correspondence from Plaintiff requesting that it reimburse the $60,036.42 in attorneys' fees and costs Plaintiff paid in defending against the O'Hare Claim and the $140,000 paid to settle the O'Hare Claim (less the $25,000 deductible). Despite knowledge that Plaintiff has incurred these costs and that it has a duty to reimburse them under the

Policy, Liberty has failed to make *any* reimbursement/payment to Plaintiff in relation to the O'Hare Claim.

53. Liberty's wrongful refusal to provide Plaintiff with the benefits to which it is entitled and breach of the implied covenant of good faith and fair dealing has caused Plaintiff to suffer financial damages, including attorneys' fees and costs expended on lawyers to prosecute this coverage lawsuit and obtain the benefits of the Policy to which Plaintiff is entitled, in an amount subject to proof at trial, and which it continues to incur.

54. Liberty's conduct, as alleged above, was undertaken with a malicious intent of depriving Plaintiff of its right to a paid defense and its right to indemnity against the O'Hare Claim under the Policy and otherwise causing it injury. Liberty's conduct was and is despicable, malicious, oppressive and/or fraudulent and subjected Plaintiff to a cruel and unjust hardship in conscious disregard of its rights, so as to justify an award of exemplary and punitive damages in an amount to be proven at trial.

55. As a direct and proximate result of Liberty's conduct as alleged herein, Plaintiff has suffered and will continue to suffer monetary and non-monetary damages, in an amount to be determined at trial, but which exceed $75,000, including but not limited to loss of the benefits to which it is entitled under the Policy, including reimbursement of defense fees and costs and the settlement amount (less the $25,000 deductible amount) in relation to the O'Hare Claim, interest on those benefits, and attorneys' fees and expenses incurred in obtaining the benefits due to Plaintiff under the Policy.

THIRD CLAIM FOR RELIEF

For Declaratory Judgment under 28 U.S.C. Section 2201

(Against Defendant Liberty and Does 1-10)

56. Plaintiff incorporates by reference each of the foregoing paragraphs of this Complaint, as though fully set forth herein.

57. Plaintiff seeks a declaratory judgment under 28 U.S.C. section 2201, which is necessary and proper to determine a substantial, actual controversy between the parties having adverse legal interests of sufficient immediacy and reality to warrant the issuance of a declaratory judgment.

58. Plaintiff is informed and believes, and on that basis alleges, that an actual controversy has arisen, existed at the time Plaintiff commenced this action and now exists between Plaintiff and Liberty. Specifically, Plaintiff alleges that Liberty improperly and unreasonably failed to pay and refuses to reimburse the attorneys' fees and costs incurred by Plaintiff in defending the O'Hare Claim totaling $60,036.42 and the $140,000 paid by Plaintiff to settle the O'Hare Claim despite its duty to do so under the Policy, as alleged in more detail above.

59. Plaintiff is informed and believes, and on that basis alleges, that Liberty disputes Plaintiff's contentions as alleged above.

60. Plaintiff seeks a declaration that Liberty is improperly withholding reimbursement of defense and settlement costs in relation to the O'Hare Claim and that Liberty must reimburse all defense fees and costs and settlement costs paid by

Plaintiff in relation to the O'Hare Claim in excess of the $25,000 deductible amount and pay all future fees and costs incurred in relation to the O'Hare Claim.

FOURTH CLAIM FOR RELIEF

For Unfair Business Practices Under California Law –
Cal. Bus. and Prof. Code Section 17200 *et seq.*
(Against Defendant Liberty and Does 1-10)

61. Plaintiff incorporates by reference each of the foregoing paragraphs of this Complaint, as though fully set forth herein.

62. Plaintiff alleges California law applies to the parties' disputes and asserts this Fourth Claim for Relief under California law. Namely, Liberty has engaged in unlawful, unfair and/or fraudulent business acts and practices within the meaning of California Business & Professions Code section 17200, *et seq.* by the wrongful conduct alleged in this Complaint.

63. Plaintiff is informed and believes, and on that basis alleges, that Liberty has a pattern and practice of issuing professional liability policies with a duty to defend and indemnify its insureds and then refusing and failing to thereafter respond to insureds' communications, or substantially delaying, and refusing and failing to defend and indemnify these insureds when they submit a claim, or substantially delaying, thereby forcing their insureds to pay for and incur their own defense and indemnity costs in the hope that Liberty's insureds will not pursue reimbursement of the benefits due them.

64. Liberty made material misrepresentations and misled Plaintiff by issuing professional liability policies it never intended to fully honor (and presumably each of its customers it issues similar policies that make non-honored claims). This conduct is likely to deceive the public and in fact deceived Plaintiff.

65. The pattern of fraud, deception and wrongful conduct by Liberty as set forth above constitutes not only unfair, fraudulent and unlawful business practices under California Business & Professions Code section 17200, *et seq.* but also constitutes breach of the implied covenant of good faith and fair dealing and was thus committed pursuant to business activity that is forbidden by law.

66. In addition to violating the implied covenant of good faith and fair dealing, Liberty's conduct violates other laws. Its failure in good faith to effectuate prompt, fair, and equitable settlement of Plaintiff's claims even when Liberty's liability became reasonably clear constitutes a violation of California Insurance Code section 790.03(h)(5). Liberty's failure to promptly settle Plaintiff's claims, where its liability was apparent in order to influence settlements under other portions of the insurance coverage under its professional liability policies constitutes a violation of California Insurance Code section 790.03(h)(12). Liberty's conduct toward Plaintiff in connection with the O'Hare Claim and toward other insureds violated the following subsections of California Insurance Code section 790.03(h):

> (1) Misrepresenting to claimants pertinent facts or insurance policy provisions relating to any coverages at issue.

(2) Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies. . . . .

(4) Failing to affirm or deny coverage of claims within a reasonable time after proof of loss requirements have been completed and submitted by the insured.

(5) Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear.

(6) Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by the insureds, when the insureds have made claims for amounts reasonably similar to the amounts ultimately recovered. . . . .

(12) Failing to settle claims promptly, where liability has become apparent, under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.

(13) Failing to provide promptly a reasonable explanation of the basis relied on in the insurance policy, in relation to the facts or applicable law, for the denial of a claim or for the offer of a compromise settlement.

67. Liberty engaged in its outrageous, unfair, unlawful and fraudulent conduct to force Plaintiff and other insureds to accept a lower settlement or even to completely discourage them from pursuing the benefits to which they are entitled to under the professional liability policies. Plaintiff is informed and believes, and thereon alleges, that Liberty has a general business practice of engaging in the above-alleged conduct. These actions constitute unfair, unlawful and fraudulent business practices under California Bus. & Prof. Code section 17200, et seq. and are immoral, unethical, oppressive, unscrupulous or substantially injurious to consumers.

68. Liberty's unlawful conduct appears likely to continue and, to the extent it does so, the conduct will continue to harm Plaintiff and other insureds.

69. Plaintiff is therefore entitled to an injunction against Liberty to enjoin its actions as identified above and is also entitled to restitutionary relief and its attorneys' fees in this coverage action under California Code of Civil Procedure section 1021.5.

PRAYER

WHEREFORE, Plaintiff prays for judgment as follows:

1. For all benefits due under the Policy, including defense attorneys' fees and costs and indemnity/settlement costs Plaintiff has incurred as alleged above;
2. For consequential damages;
3. As to the Second Claim for Relief, for punitive damages in an amount

sufficient to punish Liberty for its despicable conduct, as permitted by California law;

4. As to the Second Claim for Relief, for attorneys' fees incurred by Plaintiff in obtaining the Policy's benefits, as permitted by California law;
5. As to the Third Claim for Relief, for a declaratory judgment;
6. As to the Fourth Claim for Relief, for injunctive and restitutionary relief as permitted by California law and Plaintiff's attorneys' fees in this action under California Code of Civil Procedure section 1021.5;
7. For pre-judgment interest as allowed by California or, alternatively, New York law;
8. For the costs of suit; and
9. For such other and further relief as the Court deems just and proper.

Dated: July 24, 2015 Respectfully submitted,

By: *s/ Robert J. McKennon*

Robert J. McKennon
rm@mckennonlawgroup.com
Joseph S. McMillen
jm@mckennonlawgroup.com
McKennon Law Group PC
20321 SW Birch Street, Suite 200
Newport Beach, CA 92660
Tel: 949-387-9595
Fax: 949-385-5165
CROWN CAPITAL SECURITIES, L.P.,

DEMAND FOR JURY TRIAL

Plaintiff hereby demands trial by jury.

Dated: July 24, 2015 Respectfully submitted,

By: *s/ Robert J. McKennon*

Robert J. McKennon
rm@mckennonlawgroup.com
Joseph S. McMillen
jm@mckennonlawgroup.com
McKennon Law Group PC
20321 SW Birch Street, Suite 200
Newport Beach, CA 92660
Tel: 949-387-9595
Fax: 949-385-5165
CROWN CAPITAL SECURITIES, L.P.,

CERTIFICATE OF SERVICE

I am employed in the County of Orange, State of California. I am over the age of 18 and not a party to the within action; my business address is 20321 SW Birch St., #200, Newport Beach, California 92660; Fax 949-464-9714; E-mail address: xx@ mckennonlawgroup.com.

I hereby certify that on July 24, 2015, I served the foregoing documents described as: **AMENDED COMPLAINT** on the interested parties as follows:

Kevin Mattesich
Daniel Brody
Kauffman Dolowich & Volack, LLP
60 Broad Street, 36th Floor
New York, New York 10004
Tel: 212-485-9600
Email: *kmattessich@ksvlaw.com*

Attorneys for Liberty Surplus Insurance Corporation
☒ ECF Participant

Dean B. Herman
Hee Young Lee
Kaufman Dolowich & Voluck, LLP
11755 Wilshire Blvd, Suite 2400
Los Angeles, CA 90025
Tel: 310-775-6511
Email: *dharman@kdvlaw.com*
hylee@kdvlaw.com

Attorneys for Liberty Surplus Insurance Corporation
☒ ECF Participant

☒ **ECF/CM:** I caused a true and correct copy thereof to be electronically filed using the Court's Electronic Court Filing ("ECF") System and service was completed by electronic means by transmittal of a Notice of Electronic Filing on the registered participants of the ECF System. I served those parties who are not registered participants of the ECF System as indicated below.

☐ I placed the ☐ original ☐ a true copy thereof enclosed in sealed envelope(s) to the notification address(es) of record and caused such envelope(s) to be delivered by ☐ **FIRST-CLASS MAIL** ☐ **OVERNIGHT DELIVERY**.

☐ **BY E-MAIL:** I electronically transmitted a true and correct copy thereof to the notification electronic mail address(es) of record before close of business for the purpose of effecting service and the transmission was reported as complete and without error.

☐ **FACSIMILE:** Based on ☐ courtesy ☐ court order ☐ agreement of the parties, I caused a true copy thereof to be served by transmitting via facsimile machine to the notification facsimile number(s) of record before close of business. The transmission was reported as complete, without error.

☐ **PERSONAL DELIVERY:** I caused ☐ the original ☐ a true copy thereof to be delivered by hand to the notification address(es) of record by an employee or independent contractor of a registered process service.

I am employed in the office of a member of the bar of this court at whose direction the service was made. I declare under penalty of perjury under the laws of the Unites States of America and the State of California that the above is true and correct. Executed at Newport Beach, California on July 24, 2015.

NAME: s/ Brent L. Vossler
(Signature)

DOCUMENT1

LIBERTY INTERNATIONAL UNDERWRITERS

PRESIDENT
David A. Cohen

VICE PRESIDENT AND SECRETARY
Dexter R. Legg

BROKER DEALER AND REGISTERED INVESTMENT ADVISER PROFESSIONAL LIABILITY POLICY



Liberty International Underwriters
Member of Liberty Mutual Group

Exhibit 1

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy



Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")
175 Berkeley Street, Boston, MA 02117
Toll-free number: 1-800-677-9163

DECLARATIONS

NOTICE: THIS IS A CLAIMS MADE AND REPORTED POLICY. SUBJECT TO ITS TERMS AND CONDITIONS, THIS POLICY ONLY COVERS CLAIMS FIRST MADE AGAINST THE INSUREDS AND REPORTED TO THE INSURER DURING THE POLICY PERIOD, BUT IN NO EVENT LATER THAN THIRTY (30) DAYS AFTER EXPIRATION OR TERMINATION OF THIS POLICY, OR DURING THE EXTENDED REPORTING PERIOD, IF APPLICABLE. CLAIMS EXPENSES ARE INCLUDED IN, AND WILL REDUCE, THE LIMITS OF LIABILITY. PLEASE READ THE ENTIRE POLICY CAREFULLY, AND CONSULT YOUR BROKER/AGENT OR OTHER PROFESSIONAL TO THE EXTENT YOU DO NOT UNDERSTAND ANY TERMS OR CONDITIONS OF THE POLICY.

POLICY NUMBER: EO5NAADF7W002 **RENEWAL OF:** EO5NAADF7W001

ITEM 1. FIRST NAMED INSURED – BROKER-DEALER AND ADDRESS:

Crown Capital Securities, L.P.
725 Town & Country Road
#530
Orange, CA 92868

ITEM 2. POLICY PERIOD:

EFFECTIVE DATE: April 1, 2012 **EXPIRATION DATE:** April 1, 2013

(At 12:01 a.m. local time at the address shown in Item 1.)

ITEM 3. LIMITS OF LIABILITY (INCLUSIVE OF CLAIMS EXPENSES):

a. Each **Claim**:	$ 2,000,000
b. **Registered Representative** Aggregate:	$ 2,000,000
c. **Maximum Policy Aggregate**:	$ 10,000,000

ITEM 4. DEDUCTIBLE (SUBJECT TO CLAIMS EXPENSES):

a. Each **Registered Representative** Each **Claim**:	$ 5,000
b. **Named Insured** Each **Claim**:	$ 25,000

ITEM 5. RETROACTIVE DATE:

FIRST NAMED INSURED: April 1, 1999
REGISTERED REPRESENTATIVE: The later of the First Named Insured's **Retroactive Date** or the first contract with the **Broker-Dealer**

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy



Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

ITEM 6. PREMIUM:

$594,425

ITEM 7. ADDITIONAL PREMIUM FOR EXTENDED REPORTING PERIOD:

150% of Annual Premium

ITEM 8. NOTICE OF CLAIM:

In the event of a **Claim**, notice should be sent to:
Liberty Surplus Insurance Corporation
55 Water Street, 18th Floor
New York, NY 10041
Attention: Financial Services Professional Liability Claim Department.

ITEM 9. PRODUCER NAME AND ADDRESS:

E&O Professional Risk Management & Insurance Services
26461 Crown Valley Parkway
Suite 200
Mission Viejo, CA 92691

ITEM 10. FORMS AND ENDORSEMENTS:

1. Service of Suit Clause – California
2. Privacy Coverage Endorsement
3. Trade Error/Cost of Corrections Coverage Endorsement
4. Unregistered Securities Coverage Endorsement
5. Additional Insured Endorsement
6. Outside RIA Coverage Endorsement
7. Selling Away Coverage Endorsement
8. Retroactive Date Amendment Endorsement
9. Claim/Entity Exclusion Endorsement
10. Auction Rate Securities Exclusion Endorsement
11. Fiduciary Adviser Coverage Endorsement
12. Structured CD Endorsement
13. Discretionary Authority Endorsement
14. Long Puts and Calls Coverage Endorsement
15. Severability Endorsement
16. Extended Reporting Period for Retiring Representative Endorsement
17. Tax Preparation Endorsement
18. High Yield Bond Endorsement
19. Promissory Notes Coverage Endorsement
20. Delete Exclusion N. Endorsement
21. Amend Exclusion T. Endorsement
22. Amend Exclusion K. Endorsement
23. Amend Exclusion M. Endorsement

24. Registered Non-Traded REIT Endorsement
25. OFAC Endorsement
26. Cap on Losses From Certified Acts of Terrorism
27. 2011 TRIA Policy Disclosure Endorsement

This Declarations Page, together with the **Application** for this policy, the attached Policy Form and all Endorsements thereto, shall constitute the contract between the Insurer and the Named Insured. The policy is valid only if signed below by a duly authorized representative of the Insurer.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy



Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A member of Liberty Mutual Group and hereinafter "the Insurer")

THIS IS A CLAIMS-MADE AND REPORTED POLICY. SUBJECT TO ITS TERMS AND CONDITIONS, THIS POLICY ONLY COVERS **CLAIMS** FIRST MADE AGAINST THE **INSUREDS** AND REPORTED TO THE INSURER DURING THE **POLICY PERIOD**, BUT IN NO EVENT LATER THAN THIRTY (30) DAYS AFTER EXPIRATION OR TERMINATION OF THIS POLICY, OR DURING THE **EXTENDED REPORTING PERIOD**, IF APPLICABLE. **CLAIMS EXPENSES** ARE INCLUDED IN, AND WILL REDUCE, THE LIMITS OF LIABILITY. PLEASE READ THE ENTIRE POLICY CAREFULLY, AND CONSULT YOUR BROKER/AGENT OR OTHER PROFESSIONAL TO THE EXTENT YOU DO NOT UNDERSTAND ANY TERMS OR CONDITIONS OF THIS POLICY.

WORDS THAT APPEAR IN BOLD PRINT HAVE SPECIAL MEANINGS AND ARE DEFINED SEPARATELY. WHENEVER A SINGULAR FORM OF A WORD IS USED, THE SAME WILL INCLUDE THE PLURAL WHEN REQUIRED BY CONTEXT.

In consideration of and subject to the payment of the premium, the agreement of the **Insured** to pay the Deductible amount referenced in the Declarations and described herein, and in reliance upon the particulars, statements, representations, attachments and exhibits contained in and submitted with the **Application**, which shall be the basis of this Policy and deemed to be incorporated herein, and subject to all the terms, conditions, limitations and any endorsements to this Policy, the Insurer and the **Insureds** agree as follows:

I. INSURING AGREEMENTS

The Insurer shall pay on behalf of the **Insured** all sums in excess of the Deductible amount referenced in the Declarations which the **Insured** shall become legally obligated to pay as **Damages** and/or **Claims Expenses** resulting from **Claims** first made during the **Policy Period** or **Extended Reporting Period**, if applicable, as a result of a **Wrongful Act** by an **Insured** or an entity for whom the **Insured** is legally liable, provided that such **Wrongful Act** was committed on or after the **Retroactive Date** and before the end of the **Policy Period.**

As a condition precedent to coverage under this Policy, the **Insured** shall report such **Claim** in writing to the Insurer, as soon as practicable, during the **Policy Period**, but in no event later than thirty (30) days after expiration or termination of this Policy, or during the **Extended Reporting Period**, if applicable, and that prior to the inception date of the **Policy Period**, no **Insured** knew or could have reasonably foreseen that such **Wrongful Act** might give rise to a **Claim**.

II. DEFINITIONS

A. **Affiliated Entity** means:

1 an entity owned or controlled by an **Insured**;

2 a person or entity which owns or controls an **Insured**;

3 an entity which is under common ownership or control with an **Insured**; or

4 an entity of which an **Insured** is a director, officer, partner or principal shareholder;

Affiliated Entity does not mean a **Registered Representative Company**.

B. **Application** means all signed Applications, including any documents/information attached or incorporated by reference thereto, in connection with this Policy or any policy of which this Policy is a renewal or replacement. **Application** includes any documents filed by the **Broker-Dealer** with any governmental or quasi-governmental entity or self regulatory organization including, but not limited to, the Financial Industry Regulatory Authority or the Securities and Exchange Commission, which documents are deemed attached and incorporated into such **Application**.

C. **Broker-Dealer** shall mean the **Broker-Dealer** identified in Item 1. of the Declarations and shall have the the same meaning as the term used by the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, or the Investment Advisers Act of 1940, as amended.

D. **Claim** means a written demand for **Damages** alleging a **Wrongful Act**, including a complaint, arbitration proceeding, or civil lawsuit.

E. **Claims Expenses** means reasonable and necessary fees, costs and expenses incurred by the Insurer, or by the **Insured** with the prior written consent of the Insurer, subject to the limitations set forth in Part IV. Section B. 2. - Consent and Settlement, consisting of fees, costs and expenses resulting from the investigation, adjustment, defense and appeal of a **Claim**, including the cost of appeal bonds; however, the Insurer shall not be obligated to apply for or furnish appeal bonds. **Claims Expenses** do not include salary charges, wages or expenses of partners, principals, officers, directors, members or employees of the **Insured**.

F. **Covered Call** means an exchange-traded short call option on stock, the full amount of which is actually owned, throughout the option's life, by a client of the **Broker-Dealer**.

G. **Damages** means a compensatory monetary amount for which an **Insured** may be held legally liable, including judgments (inclusive of any pre- or post-judgment interest), awards, or settlements negotiated with the prior approval of the Insurer, but shall not include:

1 any disgorgement, return, withdrawal, restitution or reduction of any sums which are or were in the possession or control of any **Insured**, or any amounts credited to any **Insured's** account;

2 fines, sanctions, taxes, penalties or awards deemed uninsurable pursuant to any applicable law;

3 punitive, exemplary, treble damages or any other damages resulting from the multiplication of compensatory damages;

4 equitable relief, or fees, costs or expenses incurred by an **Insured** to comply with any such equitable relief.

H. **Insured** means:

1. an entity referenced as a Named Insured in Item 1. of the Declarations;

2. any past, present or future director, officer, partner or employee of a Named Insured, solely while performing **Professional Services**;

3. the legal heir, executor, administrator or legal representative of any entity which qualifies as an **Insured** under Sub-sections 1. or 2., above, in the event of such **Insured's** death, incapacity or bankruptcy;

4. the lawful spouse or domestic partner of any individual which qualifies as an **Insured** under Sub-section 2., above, for a **Claim** arising solely out of spousal or domestic partner status, and not out of any alleged independent **Wrongful Acts**, of such individual;

5. any present **Registered Representative** of the **Broker-Dealer**, solely while performing **Professional Services**;

6. any future **Registered Representative** of the **Broker-Dealer**, subject to Part V. C. – Acquisitions/Creations, solely while solely while performing **Professional Services**;

7. a **Registered Representative Company**, and its employees, but only for their vicarious liability for the covered acts of a **Registered Representative**, solely while performing **Professional Services**.

I. **Interrelated Wrongful Acts** means **Wrongful Acts** that have as a common nexus any fact, circumstance, situation, or event, or which are the same, related or continuous acts, regardless of whether the **Claim** or **Claims** alleging such acts involve the same or different claimants, **Insureds** or legal causes of action. Further, without limiting the foregoing, the following events shall automatically be deemed to allege **Interrelated Wrongful Acts**:

1. **Claims** based upon, arising out of, directly or indirectly, or in any way involving any insurance products, **Securities** or financial products of any entity which becomes the subject of any bankruptcy, insolvency, liquidation or reorganization proceeding, or

2. **Claims** based upon, arising out of, directly or indirectly, or in any way involving any **Securities** or financial products purchased in connection with an offering, or series of offerings, of **Securities** or financial products issued by the same entity or affiliated entities.

J. **Investment Banking** means, but is not limited to, underwriting, syndicating, or promoting any **Securities** or partnership interest in connection with any potential or actual merger, acquisition, divestiture, tender offer, proxy contest, leveraged buy-out, public offering, going private transaction, reorganization, restructuring, recapitalization, spin-off, primary or secondary offering of **Securities**, whether public or private, dissolution or sale of all or substantially all of the assets or stock of an entity, or effort to raise or furnish capital or financing for any entity, or any acquisition or sale of **Securities** by a Named Insured for its own account, or any activity by an **Insured** as a specialist or market maker for any **Securities**, or any disclosure requirement in connection with any of the foregoing including, but not limited to, the rendering of advice or recommendations in connection with any of the foregoing.

K. **Late Trading** means any transaction involving mutual fund shares or related variable annuities made after the product's net asset value (as defined in Rule 2a-4 of the Investment Company Act of 1940, as amended, regarding a mutual fund) has been determined or should have been determined.

L. **Market Timing** means the making of short term purchases or sales of mutual fund shares or life insurance company accounts contrary to the mutual fund's or life insurance company's prospectus or any policy or procedure of the mutual fund or life insurance company, or in violation of any governmental, quasi-governmental, or self regulatory organization, law, rule or regulation including, but not limited to: (1) waiving of redemption fees associated with **Short Term Trading**; (2) failing to comply with representations, policies or procedures regarding the permissibility of **Short Term Trading**; (3) receiving of fees or other compensation in exchange for providing certain investors with **Short Term Trading** privileges not available to other investors; or (4) failing to monitor, detect, prevent, identify or remediate any **Short Term Trading.**

M. **Personal Injury** means false arrest, detention or imprisonment, or malicious prosecution; the publication or utterance of a libel or slander or other defamatory or disparaging material; invasion, infringement or interference with rights of privacy or publicity; wrongful entry or eviction; invasion of the right of private occupancy.

N. **Policy Period** means the period referenced in Item 2. of the Declarations or any shorter period that may occur as a result of a cancellation of this Policy, and specifically includes any **Extended Reporting Period** hereunder.

O. **Pollutants** means any solid, liquid, gaseous or thermal irritant or contaminant, including but not limited to, smoke, vapor, soot, fumes, acids, alkalis, chemicals, odors, noise, lead, oil or oil products, radiation, asbestos or asbestos-containing products, waste and any electric, magnetic or electromagnetic field of any frequency. Waste includes, but is not limited to, material to be recycled, reconditioned or reclaimed.

P. **Professional Services** means:

1. the purchase, sale or servicing of **Securities** to a client of the **Broker-Dealer**, provided that these **Securities** are approved and authorized in writing by the **Broker-Dealer** and that these **Securities** are processed or approved for processing by the **Broker-Dealer**;

2. the sale or servicing of fixed annuity products, or life, health, disability, or accident insurance sold by a properly licensed **Insured;**

3. the sale and servicing of individual retirement accounts ("IRAs"), Keogh retirement plans, or employee benefit plans, but solely when such accounts/plans have been funded with the products identified in Sub-sections 1. and/or 2., above.

4. providing financial, investment or economic advice as a **Registered Investment Adviser** in connection with any of the activities or products identified in Sub-sections 1., 2. or 3., above.

5. providing financial planning services including, but not limited to, advice regarding personal risk management or planning for insurance, savings, investments, or retirement.

Q. **Registered Investment Adviser** means an entity, registered with the Securities and Exchange Commission and/or all applicable state governmental or quasi-governmental regulatory authorities, which provides investment advice or management services for a fixed fee, an hourly fee, or a fee based upon a percentage of assets under management. **Registered Investment Adviser** shall also mean a "Person Associated with an Investment Adviser" as that term is defined in the Investment Advisers Act of 1940, and any amendments thereto ("Associated Person").

R. **Registered Representative** means a person who is or was properly registered with the Financial Industry Regulatory Authority and all state governmental or quasi-governmental regulatory authorities as a **Registered Representative** of the **Broker-Dealer.**

S. **Registered Representative Company** means an entity which is owned in its entirety by a **Registered Representative** or in which such **Registered Representative** is an employee.

T. **Retroactive Date** means:

1. As to a Named Insured, the date(s) referenced in Item 5. of the Declarations or any applicable endorsement to this Policy;

2. As to a **Registered Representative**, the later of the date set forth in Sub-section 1., above, or the date of the **Registered Representative's** first contract with the **Broker-Dealer.**

U. **Securities** shall have the same meaning as the term used by the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, or the Investment Advisers Act of 1940, as amended, and shall include, but not be limited to, stocks, mutual funds, bonds, variable annuities, and variable life insurance.

V. **Selling Away Activity** means the sale of **Securities,** or any other financial product, which are not approved and authorized in writing by the **Broker-Dealer.**

W. **Short Term Trading** means any transactions related to a mutual fund or related variable annuity effected in a shorter time period than that provided for in writing by the mutual fund or life insurance company or in violation of law, or any other transaction which takes advantage of the inefficiencies in the pricing methods used by the mutual fund or life insurance company.

X. **Soft Dollar Activity** means payment or receipt of money or any other benefit in exchange for preferential treatment of any **Securities** or any class of mutual fund share.

Y. **Trade Error** means the failure to execute, or incorrect execution of, a transaction as specifically directed by a client of the **Broker-Dealer.**

Z. **Wrongful Act** means any actual or alleged negligent act, error or omission solely while performing **Professional Services,** for others.

III. EXCLUSIONS

This Policy does not apply to any **Claim:**

A. alleging intentional wrongdoing, fraud, dishonesty, or malicious **Wrongful Acts** by an **Insured,** if a judgment or other final adjudication adverse to the **Insured** establishes such conduct. The Insurer shall continue to defend the **Insured,** if these allegations arise out of **Wrongful Acts** otherwise covered under this Policy, but the **Insured** shall reimburse the Insurer for **Claims Expenses** if such conduct is established as a matter of fact in a civil, arbitration, criminal or other proceeding, or is admitted to by the **Insured.**

B. based upon, arising out of, directly or indirectly, or in any way involving:

1. **Professional Services** for an **Insured** or an **Affiliated Entity;** or

2. any **Claim** by or on behalf of an **Insured** or any **Affiliated Entity** against an **Insured** or **Affiliated Entity;** or

3. any **Wrongful Acts** alleged to have been committed by or in any way involving an **Affiliated Entity,** unless such entity is designated as a Named Insured on this Policy.

C. based upon, arising out of, directly or indirectly, or in any way involving any **Wrongful Act** or **Interrelated Wrongful Acts** first occurring before the applicable **Retroactive Date**, even if the **Wrongful Act** or **Interrelated Wrongful Acts** continue after the **Retroactive Date.**

D. based upon, arising out of, directly or indirectly, or in any way involving any **Claim**, demand, suit, litigation or other proceeding against any **Insured** which was pending on or existed prior to the inception of the **Policy Period**, or the same or substantially the same facts, circumstances or allegations which are the subject or the basis for such **Claim**, demand, suit, litigation or other proceeding.

E. based upon, arising out of, directly or indirectly, or in any way involving any circumstances which have been the subject of any notice given under any insurance policy issued by any insurer, including any policy of which this Policy is a renewal or replacement.

F. based upon, arising out of, directly or indirectly, or in any way involving any:

1. Unregistered **Securities** including, but not limited to, Limited Partnerships, Real Estate Investment Trusts ("REITS"), Private Placements, IRS Section 1031 or 1035 Exchanges, or hedge funds; however, this exclusion shall not apply to any governmental **Securities** exempt from registration;
2. Private equity investments;
3. Derivatives including, but not limited to, any type of option contract (except **Covered Call** options), warrants, futures contracts (including but not limited to commodities and currency) forward contracts, or interest rate swaps;
4. Structured financial products including, but not limited to, structured notes, asset-backed or mortgage-backed securities, collateralized mortgage or debt obligations, or credit-linked notes;
5. Promissory notes, or issuer callable, or step-up or step down, Certificates of Deposits;
6. Viatical or Life settlements, reverse mortgages, or any similar transaction in which the present value of a conditional contract is exchanged or sold;
7. Structured Settlements;
8. Proprietary investment products of an **Insured** or **Affiliated Entity**;
9. Tangible personal property, whether directly or indirectly including, but not limited to, any precious metals, gemstones, stamps, sports or other cards, antiques, jewelry, coins, or other collectibles; however, this exclusion shall not apply to gold or silver;
10. **Securities** traded exclusively outside of the U.S., its territories or possessions, or Canada;
11. **Securities** priced under $5.00; however, this exclusion shall not apply if the **Securities** are approved for registration upon issuance on a national securities exchange in the U.S. or authorized for quotation in the NASDQ National Market System or Small Cap Market or issued by a mutual fund.

G. based upon, arising out of, directly or indirectly, or in any way involving any discretionary authority; however, this exclusion shall not apply to asset allocation services provided by a **Registered Investment Adviser** pursuant to a written contract relating to mutual funds, variable annuities, or variable life insurance, provided that the **Insured** retains no custody of funds other than for the limited purpose of paying fees.

H. based upon, arising out of, directly or indirectly, or in any way involving any **Selling Away Activity.**

I. based upon, arising out of, directly or indirectly, or in any way involving any **Trade Error.**

J. based upon, arising out of, directly or indirectly, or in any way involving any **Investment Banking** activity.

K. based upon, arising out of, directly or indirectly, or in any way involving any day trading activity, or short sales activity.

L. based upon, arising out of, directly or indirectly, or in any way involving any **Market Timing, Late Trading**, or **Soft Dollar Activities.**

M. based upon, arising out of, directly or indirectly, or in any way involving any the failure to provide a discount on volume purchases of mutual funds.

N. based upon, arising out of, directly or indirectly, or in any way involving any alleged churning of insurance policies.

O. based upon, arising out of, directly or indirectly, or in any way involving services as, or which may only be performed by, an accountant, actuary, clearing agency, enrolled agent authorized to practice before the I.R.S., investment banker, lawyer, mortgage broker or banker, property/casualty insurance agent, third-party administrator, real estate agent/broker, general agent of a life insurance agency (unless said agent has no subagents and is not supervising any other agents), managing general agent, securities analyst, tax preparer, or trustee; or any Outside Business Activity of an **Insured** that is not approved and authorized in writing by the **Broker-Dealer.**

P. any **Claim** brought by or on behalf of any clearing agency or any Broker-Dealer; however, this exclusion shall not apply to any **Claim** by such entities in their capacity as a client of a Named Insured.

Q. by or on behalf of any governmental or quasi-governmental entity, or Self-Regulatory Organization including, but not limited to, the Financial Industry Regulatory Authority or the Securities and Exchange Commission; however, this exclusion shall not apply to any **Claim** by such entities in their capacity as a client of a Named Insured.

R. based upon, arising out of, directly or indirectly, or in any way involving a financial product, or advice related to such financial product, issued by an entity which is not licensed or authorized to conduct business in the state or jurisdiction with authority to regulate such activity or with respect to any financial or insurance product that is not approved for sale or properly licensed in the state in which it is sold; however, this exclusion shall not apply to the placement of insurance with an eligible surplus lines insurer in the state or jurisdiction with authority to regulate such business.

S. based upon, arising out of, directly or indirectly, or in any way involving the formation, operation, administration or management by an **Insured** of any entity other than the Named Insureds, except as specifically endorsed on this Policy.

T. based upon, arising out of, directly or indirectly, or in any way involving the ownership, formation, sale, servicing, operation, or administration of any insurance company, health maintenance organization, preferred provider organization, risk retention group, self-insurance program, or purchasing group.

U. based upon, arising out of, directly or indirectly, or in any way involving the sale, servicing, or administration of, or advice or planning with respect to, any Multiple Employer Welfare Arrangement or Voluntary Employees Beneficiary Association, both as defined by the Employee Retirement Income Security Act of 1974, as amended, or any similar arrangement involving the pooling of funds for the provision of benefits.

V. based upon, arising out of, directly or indirectly, or in any way involving any employee benefit plan, insurance program or trust, involving self-funding, in whole or in part, by any employer, union, or employee.

W. based upon, arising out of, directly or indirectly, or in any way involving any pension, profit sharing, health/welfare or other employee benefit plan, insurance plan or trust, sponsored by an **Insured** or **Affiliated Entity** or in which an **Insured** or **Affiliated Entity** is a participant, trustee or named fiduciary, as defined under the Employee Retirement Income Security Act of 1974, as amended.

X. based upon, arising out of, directly or indirectly, or in any way involving the financial inability to pay, insolvency, receivership, bankruptcy, or liquidation of any entity; however, this exclusion shall not apply to a **Claim** in connection with the investment of stock in any such entity, or with respect to any insurer, self-insurer, insurance plan, trust or any other vehicle or instrumentality which provides coverage or benefits or in which an **Insured** has placed or obtained insurance coverage, or placed the funds of a client, provided at the time the **Insured** placed or obtained insurance coverage or placed the funds of a client, the insuring entity was rated A- or better by A. M. Best.

Y. based upon, arising out of, directly or indirectly, or in any way involving the liability of others assumed by an **Insured** under any contract or agreement, unless such liability would have attached to an **Insured** even in the absence of such an agreement; or any guarantees or warranties.

Z. based upon, arising out of, directly or indirectly, or in any way involving the gaining of any personal profit or advantage to which an **Insured** is not legally entitled, or any disputes involving an **Insured's** fees, charges, entitlements, or other compensation, or client lists or other information.

AA. based upon, arising out of, directly or indirectly, or in any way involving any commingling or use of client funds or accounts, or the illegal use of non-public information.

BB. based upon, arising out of, directly or indirectly, or in any way involving any failure to disclose a potential or actual conflict of interest with any entity in which an **Insured** has made an investment;

CC. based upon, arising out of, directly or indirectly, or in any way involving any mechanical or electronic failure, breakdown or malfunction or machines or systems including, but not limited to, hardware or software.

DD. based upon, arising out of, directly or indirectly, or in any way involving any infringement of copyright; plagiarism, piracy or misappropriation of ideas; or infringement of title, slogan, trademark, trade name, trade dress, service mark or service name; or any patent or trade secret; or any unfair competition, deceptive advertising, anticompetitive acts, restraint of trade, price fixing, or antitrust.

EE. based upon, arising out of, directly or indirectly, or in any way involving bodily injury, sickness, disease, emotional distress, mental anguish, outrage, humiliation or death; injury to or destruction of any tangible property including loss of use thereof; or **Personal Injury**.

FF. based upon, arising out of, directly or indirectly, or in any way involving alleged discrimination, humiliation, harassment, or misconduct by an **Insured** because of race, creed, color, age, gender, sex, sexual preference or orienration, national origin, religion, disability, handicap, marital status, or any other class protected under federal, state, local or other law; or by an employee, former employee, or job applicant, of an **Insured** in their capacity as such.

GG. based upon, arising our of, directly or indirectly, or in any way involving any actual, alleged or threatened discharge, dispersal, release or escape of **Pollutants** or any governmental or regulatory directive or request to test for, monitor, clean up, remove, contain, treat, detoxify or neutralize **Pollutants**.

IV. CLAIMS

A. Notice of Claims and Potential Claims

In the event of a **Claim,** an **Insured** shall as a condition precedent to the coverage afforded by this Policy:

1. Immediately forward to the Insurer every demand, notice, summons and/or pleading received by an **Insured**;
2. Give written notice, as soon as practicable, but in no event later than thirty (30) days after expiration or termination of this Policy, containing particulars sufficient to identify the **Insured** and claimant, and complete and comprehensive information regarding the facts and circumstances surrounding the **Wrongful Act**;
3. Notice shall he forwarded to Liberty Surplus Insurance Corporation, 55 Water Street, 18th Floor, New York, NY 10041, Attention: Financial Services Professional Liability Claims Department, with reference to the Policy number as set forth in the Declarations. All other notices under this Policy shall be given in writing to the same addressee but to the attention of the Professional Liability Department.
4. If notices are mailed, the date of mailing of such notice shall constitute the date such notice was given and proof of mailing shall be sufficient proof of notice;
5. If notice of a **Claim** is provided pursuant to this Section, any **Claim** subsequently made and reported to the Insurer alleging, arising out of, based upon or attributable to the prior noticed **Claim** or alleging any **Interrelated Wrongful Acts**, shall be considered related to the prior **Claim** and deemed to have been made at the time notice of the prior **Claim** was provided.

If an **Insured** becomes aware of a **Wrongful Act** that may reasonably be expected to give rise to a **Claim**, and if the **Insured** reports such **Wrongful Act** to the Insurer during the **Policy Period** in writing, then any **Claim** subsequently arising from such **Wrongful Act** duly reported in accordance with this paragraph shall be deemed under this Policy to be a **Claim** made during the **Policy Period** in which such written notice of a **Wrongful Act** is received by the Insurer. Such written notice to the Insurer shall include a complete and comprehensive statement of the facts and circumstances surrounding the **Wrongful Act**.

B. Defense, Consent and Settlement

1. Defense

The Insurer has the sole right to appoint defense counsel and the right and duty to defend any **Claim** made against an **Insured**.

2. Consent and Settlement

As a condition precedent to coverage under this Policy, the **Insured** shall not admit liability for or settle any **Claim** or incur any **Claims Expenses**, without the prior written consent of the Insurer. However, the **Insured** must take all reasonable actions within its ability to prevent or mitigate any **Claim** which would be covered under this Policy. The Insurer has the right to make such investigation and conduct negotiations and, with the written consent of the **Insured**, effect settlement of any **Claim** as the Insurer deems reasonable.

If the **Insured** refuses to consent to a settlement or compromise recommended by the Insurer and elects to contest or continue to contest the **Claim**, the Insurer's liability shall not exceed the amount for which the Insurer would have been liable for **Damages** and **Claims Expenses** if the **Claim** had been so settled when and as so recommended, and the Insurer shall have the right to withdraw from the further defense of the **Claim** by tendering control of the defense thereof to the **Insured**.

The Insurer shall not be obligated to pay any **Damages** or **Claims Expenses**, or to undertake or continue the defense of any **Claim**, after the applicable limit of the Insurer's liability has been exhausted by payment of **Damages** and **Claims Expenses** or after deposit of the applicable limit of the Insurer's liability with or subject to control of a court of competent jurisdiction.

C. Cooperation and Subrogation

The **Insured** shall provide the Insurer with such cooperation, assistance and information as the Insurer may request, all without charge to the Insurer.

In the event of any payment under this Policy, the Insurer shall be subrogated to all of the **Insured's** rights of recovery, and the **Insured** shall preserve and secure, and not prejudice, such rights.

D. Territory

This Policy applies to **Wrongful Acts** committed by an **Insured** anywhere in the world; provided, however, that any **Claim** made as a result of such **Wrongful Acts** must be brought and held against the **Insured** in the United States of America, its territories or possessions.

V. GENERAL CONDITIONS

A. Limits of Liability, Deductible, and Claims First Made

1. Limits of Liability

The Insurer's maximum liability for each **Claim** arising from a **Wrongful Act** or **Interrelated Wrongful Acts** shall be the Limits of Liability for Each **Claim** referenced in Item 3.a. of the Declarations. The Insurer's maximum aggregate Limits of Liability for all **Damages** and **Claims Expenses** resulting from all **Claims** made against any one **Registered Representative** covered by this Policy shall be the **Registered Representative** Aggregate referenced in Item 3.b. of the Declarations. The Insurer's maximum aggregate Limits of Liability for all **Damages** and **Claims Expenses** resulting from all **Claims** covered by this Policy shall be the Maximum Policy Aggregate referenced in Item 3. c. of the Declarations.

The Limits of Liability of the Insurer for any **Extended Reporting Period** shall be part of, and not in addition to, the Limits of Liability of the Insurer for the **Policy Period**.

2. **Deductible**

The Insurer shall only be liable for **Damages** and **Claims Expenses** which are in excess of the Deductible(s) referenced in Item 3. of the Declarations. This Deductible shall apply separately to each **Claim** and shall be borne by the **Insured** and remain uninsured. For purposes of the Deductible, **Claims** arising out of one **Wrongful Act** or **Interrelated Wrongful Acts** shall be considered as arising out of one **Wrongful Act**, and only one Deductible amount shall apply thereto. The Deductible shall not reduce or increase the Limits of Liability. If a **Claim** is made against both a Named Insured and a **Registered Representative**, the applicable Deductible shall be the greater of the amounts referenced in Item 4. of the Declarations.

3. **Claims First Made**

All **Claims** arising out of the same **Wrongful Act** or **Interrelated Wrongful Acts** shall be deemed one **Claim**, and such **Claim** shall be deemed to be first made on the earliest date that:

a. any of the **Claims** is first made against an **Insured** under this Policy or any prior policy; or

b. valid notice was given by the **Insured** under this Policy or any prior policy of any **Wrongful Act** or any fact, circumstance, situation, event, transaction or cause which underlies such **Claim**.

B. **Extended Reporting Periods**

If during the **Policy Period** the contract between a **Registered Representative** and the First Named Insured is terminated, the insurance under this Policy shall cease as of the date of such contract termination as to such **Registered Representative**. If the contract is cancelled because a **Registered Representative** becomes disabled, retires from the business of providing **Professional Services**, or dies, the **Registered Representative**, or its legal representative, shall be entitled to a period of sixty (60) days after the date of termination of the contract or the end of the Policy Period, whichever is shorter, to report to the Insurer any **Claim** which is first made during this period and which arises from a **Wrongful Act** committed prior to the termination and on or after the **Retroactive Date**.

In the event of cancellation or non-renewal of this Policy by the Insurer, the First Named Insured shall have, on behalf of itself and all other **Insureds**, and upon payment of an additional premium, a period of one (1) year after the date of such cancellation or non-renewal to report to the Insurer any **Claim** which is first made during this one (1) year period and which arises from a **Wrongful Act** committed prior to cancellation or non-renewal and on or after the **Retroactive Date**. However, the Fitst Named Insured shall not be entitled to this Extended Reporting Period if it has any other applicable insurance, including a policy issued subsequent to this Policy.

The offer of renewal terms, conditions, Limits of Liability and/or premiums different from those of this Policy shall not constitute a cancellation or non-renewal.

As a condition precedent to the right to purchase the Extended Reporting Period, the full premium for this Policy and **Policy Period** must have been paid.

The First Named Insured's right to purchase the Extended Reporting Period must be exercised by notice in writing not later than sixty (60) days following the non-renewal or cancellation date of this Policy, and must include payment of premium for the applicable Extended Reporting Period, as well as payment of all premiums due the Insurer. If such notice is not so given to the Insurer, the First Named Insured shall not, at a later date, be entitled to exercise such right.

At the commencement of any Extended Reporting Period, the entire premium thereafter shall be deemed earned and in the event the First Named Insured terminates the Extended Reporting Period before its expiration date, the Insurer shall not be liable to return any portion of the premium for the Extended Reporting Period.

The fact that this Policy may be extended by virtue of an Extended Reporting Period shall not in any way increase the Limits of Liability as set forth in the Declarations. The Extended Reporting Period shall be renewable at the sole option of the Insurer.

C. **Acquisitions/Creations**

If during the **Policy Period**, a Named Insured acquires, or is acquired, or is merged with, any other entity, notice must be provided to the Insurer at least thirty (30) days prior to such transaction. There shall be no coverage under this Policy for any **Wrongful Acts** occurring subsequent to such event, or for any newly formed entity, unless provided for by an endorsement to this Policy.

D. **Other Insurance**

If any **Claim** or **Wrongful Act** noticed to the Insurer under this Policy is insured by another valid policy or policies, then this Policy shall apply only in excess of the amount of any deductibles, retentions and limits of liability under such other policy or policies, whether such other policy or policies are stated to be primary, contributory, excess, contingent or otherwise, unless such other insurance is written specifically excess of this Policy by reference in such other policy to the Policy Number indicated on this Policy's Declarations.

E. **Subrogation**

In the event of any payment under this Policy, the Insurer shall be subrogated to all of the **Insured's** rights of recovery against any person or organization, and the **Insured** shall execute and deliver instruments and papers and do whatever else is necessary to preserve and secure such rights. The **Insured** shall do nothing to prejudice such rights.

F. **Allocation**

If a **Claim** gives rise to both covered **Damages** and uncovered damages under this Policy, the **Insured** and the Insurer shall allocate such amount between covered **Damages** and uncovered damages.

If there can be no agreement between the Insurer and the **Insured** as to the amount of **Claims Expenses** to be paid in connection with such **Claim**, the Insurer shall pay **Claims Expenses** which it reasonably believes to be covered under this Policy until a different allocation is negotiated or determined.

Any negotiated or determined allocation of **Claims Expenses** in connection with a **Claim** shall be applied retroactively, notwithstanding any allocation applied with respect to any prior advancement. Any allocation or advancement of **Claims Expenses** in connection with a **Claim** shall not apply to or create any presumption with respect to the any other allocation.

G. **Reimbursement of the Insurer**

If the Insurer has paid any **Damages** and/or **Claims Expenses** in excess of the applicable Limits of Liability or within the amount of the applicable Deductible, the **Insured** shall be liable to the Insurer for any and all such amounts and, upon demand, shall pay such amounts to the Insurer promptly. If it is negotiated or determined that any **Claims Expenses** are not covered under this Policy, the **Insured** agrees to repay the Insurer the amount of such **Claims Expenses** not covered.

H. **Entire Contract**

By acceptance of this Policy, the **Insured** agrees that the statements in the Declarations and Application are its agreements and representations, that this Policy is issued in reliance upon the truth of such representations and that this Policy embodies all agreements existing between the **Insured** and the Insurer.

I. **Notice of Cancellation**

This Policy may be cancelled by the Named Insured by surrender of this Policy to the Insurer or by giving written notice to the Insurer stating when thereafter such cancellation shall be effective. This Policy may also be cancelled by the Insurer by mailing to the Named Insured by registered, certified, or other first class mail, at the Named Insured's address referenced in Item 1. of the Declarations, written notice stating when, not less than sixty (60) days thereafter (or ten (10) days thereafter when cancellation is due to non-payment of premium), the cancellation shall be effective. The mailing of such notice as aforesaid shall be sufficient proof of notice and this Policy shall terminate at the date and hour specified in such notice. If this Policy shall be cancelled by the Named Insured, the Insurer shall retain the customary short rate proportion of the premium hereon. If this Policy shall be cancelled by the Insurer, the Insurer

shall retain the pro-rata proportion of the premium hereon. Premium adjustments and returns shall be made at the time cancellation is effective or as soon as possible after that time. Payment or tender of unearned premium shall not be a condition of cancellation.

J. **First Named Insured - Sole Agent**

The First Named Insured shall be the sole agent of all **Insureds** hereunder for the purpose of effecting or accepting any amendments to or cancellation of this Policy, for the purpose of receiving such notices as may be required by law and/or any provision(s) of this Policy, for the completing of any Application and the making of any representations, for the payment of any premium and the receipt of any return premium that may become due under this Policy, for the payment of any Deductible obligations that may become due under this Policy, and the exercising or declining to exercise any right under this Policy, including declining or exercising any Extended Reporting Period.

K. **Registered Representatives**

The premium charged by the Insurer is based, in part, upon the number of **Registered Representatives** employed or affiliated with the **Broker-Dealer** at the inception of this Policy.

If the number of **Registered Representatives** decreases during the **Policy Period**, there shall be no refund of premium.

If the number of **Registered Representatives** increases by more than twenty (20) percent of the number at the time of inception, the Named Insured may seek coverage for these new **Registered Representatives** for an additional premium equal to the rate charged each **Registered Representative** at the inception of this Policy.

The Named Insured shall provide notice, along with any relevant documentation, regarding such increase, within thirty (30) days of such event. If such notification is not provided, there shall be no coverage for the new **Registered Representatives**.

The Insurer reserves the right to request any further documentation it deems necessary. In the event that the Named Insured does not comply with this further request within thirty (30) days, it is agreed that the Insurer may terminate this Policy upon thirty (30) days written notice and retain the full Policy premium.

L. **Alteration and Assignment**

No change in, modification of, or assignment of, interest under this Policy shall be effective except when made by written endorsement signed by an authorized representative of the Insurer.

M. **Action Against the Insurer**

No action shall be taken against the Insurer unless, as a condition precedent thereto, the **Insured** has fully complied with all the terms and provisions of this Policy. In addition, no action shall be taken against the Insurer until the amount of any **Insured's** obligation or liability to a third party has been finally determined by an award or judgment against any **Insured** in an actual adjudicatory proceeding;

No entity shall have the right under this Policy to join any **Insured** in any action or proceeding against an Insurer to determine the Insurer's liability nor shall the Insurer be impleaded in an action or proceeding by any **Insured** or its legal representative.

N. **Dispute Resolution Process**

In the event a dispute arises out of this Policy, the Insurer and the **Insured** shall participate in a non-binding mediation. The parties shall share costs, but bear their own legal fees and expenses. Either the Insurer or the **Insured** may commence a judicial proceeding or binding arbitration proceeding after ninety (90) days has passed from the termination of the mediation. In the event of a binding arbitration, such proceeding shall be pursuant to such rules and procedures as the parties may agree. If the parties cannot agree, the arbitration shall be administered by the American Arbitration Association in accordance with its then prevailing Commercial Arbitration Rules. The arbitration panel shall consist of one arbitrator selected by the **Insured**, one selected by the Insurer, and the third independent arbitrator selected by the two party-appointed arbitrators. In any such arbitration, each party will bear

its own legal fees and expenses. The arbitration or any court proceeding shall take place in New York, New York and New York law shall apply, without application of any applicable conflict of law analysis.

O. **Titles**

The titles of paragraph sections or endorsements in, or of, this Policy are intended solely for convenience and reference, and are not deemed in any way to modify the provisions to which they relate.

IN WITNESS WHEREOF, the Insurer has caused this Policy to be executed and attested, but this Policy shall not be valid unless countersigned by a duly authorized representative of the Insurer, to the extent required by applicable law.

PRESIDENT
David A. Cohen

VICE PRESIDENT and
SECRETARY
Dexter R. Legg

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 1

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

SERVICE OF SUIT CLAUSE – CALIFORNIA

This endorsement modifies insurance provided under the following:

ALL COVERAGE PARTS IN THIS POLICY

The Liberty Surplus Insurance Corporation hereby appoints the Corporation Service Company (which will be doing business in California as CSC-Lawyers Incorporating Service), 2730 Gateway Oaks Drive, Suite 100, Sacramento, CA 95833 as the true and lawful attorney of Liberty Surplus Insurance Corporation in and for the State of California, upon whom all lawful process may be served in any action, "suit" or proceeding instituted in the said State by or on behalf of any insured or beneficiary against the Liberty Surplus Insurance Corporation, arising out of the insurance policy to which this provision is attached, provided a copy of any process, "suit", complaint or summons is sent by certified or registered mail to Dexter R. Legg, Secretary, Liberty Surplus Insurance Corporation, 175 Berkeley St., Boston, MA 02117.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 2

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

PRIVACY COVERAGE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that any policy amendments effectuated by this endorsement apply solely to the coverage being extended herein:
It is further agreed and understood that the following coverage extension is hereby added to the policy:

The Insurer shall pay on behalf of the **Insured** all sums in excess of the Deductible amount referenced in the Declarations which the **Insured** shall become legally obligated to pay as **Claims Expenses**, and not **Damages**, resulting from a **Disciplinary Proceeding**, first made during the **Policy Period** or **Extended Reporting Period**, if applicable, as a result of a **Wrongful Act** by an **Insured** or an entity for whom the **Insured** is legally liable, provided that such **Wrongful Act** was committed on or after the **Retroactive Date** and before the end of the **Policy Period**.

It is further agreed and understood that Part II., DEFINITIONS, of the above referenced policy is hereby amended by the addition of the following:

- **Disciplinary Proceeding** means a proceeding brought by a governmental authority or self-regulatory body to investigate actual or alleged wrongdoing committed by an **Insured** in the rendering of **Professional Services**.

- **Personal Information** means the identity of an individual as expressed or contained in any of the following:

  - Social Security Number;
  - Passport Identification Number;
  - Driver's License Number or other state-issued identification number;
  - any financial account identification number, including any credit or debit card number, together with security or access codes or passwords pertaining thereto, that permit access to such financial account of an individual;
  - any medical or healthcare data or information, or other confidential health-related information, protected as to privacy under applicable law; or
  - any other non-public personal information that is protected under any privacy law or regulation.

- **Privacy Breach** means the unintentional violation of an **Insured's** policies and procedures designed to protect confidential business information and personal information, and the negligent failure to provide notices in connection with the foregoing violation.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy



Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

It is further agreed that Part II., DEFINITIONS, Sections M. and Z., of the above referenced policy, are hereby deleted in their entirety and replaced with the following:

- **Personal Injury** means:
    - false arrest, detention or imprisonment, or malicious prosecution;
    - the publication or utterance of a libel or slander or other defamatory or disparaging material;
    - wrongful entry or eviction;
    - invasion of the right of private occupancy;
    - transmission of any computer virus to another;
    - any violation of an individual or other party's right of privacy;
    - any **Privacy Breach**;
    - any violation of any privacy law or misappropriation of **Personal Information**.
    - Negligent failure to implement specific data security and privacy controls.

- **Wrongful Act** means any actual or alleged negligent act, error or omission solely while performing **Professional Services**, including **Personal Injury**, for others.

It is further agreed and understood that Part III., EXCLUSIONS, EE., of the above referenced policy is hereby deleted in its entirety and replaced by the addition of the following:

- based upon, arising out of, directly or indirectly, or in any way involving bodily injury, sickness, disease, emotional distress, mental anguish, outrage, humiliation or death; injury to or destruction of any tangible property including loss of use thereof.

Coverage under this Endorsement is subject to the following Sub-Limit of Liability (which is part of and not in addition to the Limits of Liability) and Deductible:

Each **Claim:**	$100,000
Registered Representative Aggregate	$100,000
Maximum Policy Aggregate:	$100,000

Deductible Each **Claim:**	$100,000

Coverage for Each **Disciplinary Proceeding** only under this Endorsement is subject to the following Deductible:

Deductible:	$5,000

The Sub-limit is part of and not in addition to the Limits of Liability set forth in the Declarations

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy



Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 3

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

TRADE ERROR/COST OF CORRECTIONS COVERAGE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III.I., EXCLUSIONS, of the above referenced Policy is deleted.

It is further agreed and understood that this Policy shall apply to the **Insured's** correction of a **Trade Error**, provided that:

1. such error takes place on or after the **Retroactive Date** and before the end of the **Policy Period**;
2. such error arises in the ordinary course of the **Insured**'s operations and, if not corrected, may have resulted in direct out-of-pocket monetary damages to such customer or client and may have resulted in a covered **Claim** under this Policy;
3. such amount paid by the **Insured** would otherwise constitute covered **Damages** under this policy if such a **Claim** had been made:
4. such error is reported to the Insurer within 4 business days of its discovery; and
5. the **Insured** provides a sworn proof of loss setting forth all the circumstances of the loss and explaining why the **Insured** believes it is entitled to coverage under this Endorsement to the Policy.

It is further agreed and understood that, for purposes of the application of this Endorsement only, Part II.D., DEFINITIONS, of the above referenced Policy is hereby deleted in its entirety and replaced with the following:

- **Claim** means a written demand for **Damages** alleging a **Wrongful Act**, including a complaint, arbitration proceeding, or civil lawsuit, or the **Insured's** correction of a **Trade Error**.

It is further agreed and understood that Part III., EXCLUSIONS of the above referenced Policy is hereby amended by the addition of the following:

- based upon, arising out of, directly or indirectly, or in any way involving any wire or electronic transfer of funds.

Coverage under this Endorsement is subject to the following Sub-Limit of Liability, which is part of and not in addition to the Limits of Liability, Deductible, and Co-Insurance:

Each **Claim**:	$500,000
Registered Representative Aggregate	$500,000
Maximum Policy Aggregate:	$500,000

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy



Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

Deductible: (A) $25,000 (applicable to all **Insureds** if reported within 10 days of such error)
(B) $75,000 (applicable to all **Insureds** if reported after 10 days of such error)

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy



Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 4

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

UNREGISTERED SECURITIES COVERAGE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III., EXCLUSIONS, Section F. 1. of the above referenced Policy is hereby deleted and replaced by the following:

Unregistered **Securities**, including , but not limited to, Private Placements, Limited Partnerships, Real Estate Investment Trusts ("REITS"), IRS Section 1031 Exchanges, or hedge funds; however, this exclusion shall not apply to governmental **Securities** exempt from registration or to the products thar appear on the Named Insured's "Approved Specialty Products List."

Coverage under this Endorsement is subject to the following Sub-Limit of Liability (which is part of and not in addition to the Limits of Liability) and Deductible:

Each **Claim:**	$1,000,000
Registered Representative Aggregate	$2,000,000
Maximum Policy Aggregate:	$7,500,000
Deductible Each **Claim:**	$50,000

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 5

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

ADDITIONAL INSURED ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part II., DEFINITIONS, Section H., of the above referenced Policy is hereby amended to add the following:

- Delta Capital Holdings, LLC
- Delta Broker Holdings, LLC
- Consolidated Brokerage Services, Inc.
- Crown Capital Insurance Agency, LLC
- Jewel Insurance Agency, Inc.
- CCIA Insurance Agency of Alabama, LLC
- CCIA Insurance Agency of Oregon , LLC
- CCIA Insurance Agency of Washington, LLC
- Crown Capital Insurance Agency of Nevada, Inc.
- CCIA Insurance Agency of Kentucky, LLC
- CCIA Insurance Agency of Massachusetts, LLC

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 6

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

OUTSIDE REGISTERED INVESTMENT ADVISER COVERAGE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part II.P., DEFINITIONS, of the above referenced Policy, is hereby amended by adding the following:

- providing financial, investment or economic advice as a **Registered Investment Adviser** provided that these activities are approved and authorized in writing by the **Broker-Dealer.**

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 7

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

SELLING AWAY COVERAGE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III., EXCLUSIONS, Section H. of the above referenced Policy, is hereby deleted in its entirety.

It is further agreed and understood that Part II., DEFINITIONS, Section Z., of the above referenced Policy, is hereby deleted in its entirety and replaced by the following:

Z. "Wrongful Act" means any actual or alleged negligent act, error or omission alleged to have been committed by an Insured, solely while performing Professional Services for others. "Wrongful Act" shall also mean the failure of the Broker-Dealer to supervise its Registered Representatives with respect to Selling Away Activity; however, this coverage shall not apply if the Broker-Dealer had knowledge of this activity prior to the Policy inception or acquiesced in this activity after its discovery subsequent to the Policy inception. The Insured Registered Representative itself is not covered for any **Selling Away Activity**.

Coverage under this Endorsement is subject to the following Sub-Limit of Liability, which is part of and not in addition to the Limits of Liability, and Deductible:

Each **Claim**:	$1,000,000
Registered Representative Aggregate	$1,000,000
Maximum Policy Aggregate:	$1,000,000
Deductible Each **Claim**:	$250,000

All other terms and conditions remain unchanged.

1 1

BDRIA xx14 (Ed. 06 08)

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 8

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

RETROACTIVE DATE AMENDMENT ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part II., DEFINITIONS, Sections P. 1.and T. of the above referenced Policy is hereby deleted and replaced by the following:

P. Professional Services means:

1. the purchase, sale or servicing of **Securities** to a client of the **Broker-Dealer**, provided that these **Securities** are approved and authorized in writing by the **Broker-Dealer** and/or the **Registered Representative's** prior Broker-Dealer and that these **Securities** are processed or approved for processing by the **Broker-Dealer**;

T. Retroactive Date means:

1. As to a Named Insured, the date(s) referenced in Item 5. of the Declarations;
2. As to a **Registered Representative**, the earlier of the date of first contract with the **Broker-Dealer** or the inception date of the **Registered Representative's** first claims-made professional liability policy from which date coverage has been maintained in force without interruption.

Coverage under this Endorsement is Subject to the following Deductible:

Deductible Each **Claim**: $25,000

All other terms and conditions remain unchanged

1 1

BDRIA xx14 (Ed. 06 08)

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 9

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

CLAIM/ENTITY EXCLUSION ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part 4, EXCLUSIONS, of the above referenced Policy is hereby amended by the addition of the following:

4.15 based upon, arising out of, directly or indirectly, or in any way involving:

- Bernard L. Madoff, Bernard L. Madoff Investment Securities, LLC or any related or affiliated entity;
- Stanford International Bank, Stanford Group Company, Stanford Capital Management or any related or affiliated entity.
- DBSI, Inc. or any related or affiliated entity.
- Desert Capital Real Estate Investment Trust, Inc. or any related or affiliated entity.
- Black Diamond Energy, Inc. or any related or affiliated entity.
- Core Realty Holdings, LLC or any related or affiliated entity.
- Land America Financial Group, Inc. or any related or affiliated entity.
- Leverage Exchange Traded Funds.
- Inverse Exchange Traded Funds.
- Medical Capital Corporation, Medical Capital Holdings, Inc., or Medical Provider Funding Corporation VI or any related or affiliated entity.
- Provident Royalties, L.L.C., Provident Asset Management, L.L.C., Provident Energy 1, L.P., Provident Resources 1, L.P., Provident Energy 2, L.P., Provident Energy 3, L.P, Provident Operating Company, LLC., or any related or affiliated entity.
- Shale Royalties, Inc., Shale Royalties II, Inc., Shale Royalties 3 – 22, or any related or affiliated entity.
- IMH Secured Loan Fund, LLC.
- Somerset Lease Holdings, Inc., Somerset Development, Inc. or any related or affiliated entity.
- MetCap Securities, LLC. or any related or affiliated entity.
- Crown Forex or any related or affiliated entity.
- W. Knowles
- Michael D. Laws
- Annette J. Miller
- Christopher Sullivan
- James Geis

All other terms and conditions remain unchanged.

1 1

BDRIA xx14 (Ed. 06 08)

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 10

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

AUCTION RATE SECURITY EXCLUSION ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III., EXCLUSIONS, of the above referenced policy is hereby amended by the addition of the following:

- based upon, arising out of, directly or indirectly, or in any way involving any **Auction Rate Security.**

It is further agreed and understood that Part II., DEFINITIONS, of the above referenced policy is hereby amended by the addition of the following:

- **Auction Rate Security** means long-term municipal bonds, corporate bonds or preferred stocks that are traded at auctions that set the instruments' interest rate and ultimately the price of the security.

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 11

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

FIDUCIARY ADVISER COVERAGE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part II., DEFINITIONS, Section P. 4. of the above referenced Policy is hereby deleted in its entirety and replaced with the following:

4. providing financial, investmenr or economic advice in connection with any of the activities or products cited in sub-section 1., 2., or 3., above or as a **Registered Investment Adviser** , including services as a fiduciary adviser as defined under sections 601 of the Pension Protection Act of 2006 or (2) as a functional fiduciary commonly defined or described in Section 3(21) of ERISA solely arising out of rendering investment advice for a fee or other compensation, or (3) as a fiduciary as an investment manager defined or described in Section 3(38) of ERISA

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 12

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

STRUCTURED CERTIFICATE OF DEPOSIT ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III., EXCLUSIONS, Section F.4., of the above referenced Policy, is hereby deleted in its entirety and replaced with the following:

4. Structured financial products including, but not limited to, structured notes, asset-backed or mortgage-backed securities, collateralized mortgage or debt obligations, or credit- linked notes; however, this exclusion shall not apply to FDIC insured structured certificates of deposit;

Coverage under this Endorsement is subject to a Sub-Limit of Liability, which is part of and not in addition to the Limits of Liability, and Deductible:

Each **Claim**:	$250,000
Registered Representative Aggregate:	$250,000
Maximum Policy Aggregate:	$250,000
Deductible each **Claim**:	$50,000

All other terms and conditions remain unchanged.

1 1

BDRIA xx14 (Ed. 06 08)

Exhibit 1
Page 30 of 45

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 13

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

DISCRETIONARY AUTHORITY COVERAGE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III., EXCLUSIONS, Section G., of the above referenced Policy is hereby deleted and replaced by the following:

- based upon, arising out of, directly or indirectly, or in any way involving, any discretionary authority; however, this exclusion shall not apply to services provided by a **Registered Investment Adviser.**

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy



Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 14

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

LONG PUTS AND CALLS COVERAGE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Parr III., EXCLUSIONS, Section F. 3. of the above referenced Policy is hereby deleted and replaced by the following:

- Derivatives including, but not limited to, any type of option contract (except **Covered Call** options or long put or call options), warrants, futures contracts (including bur not limited to commodities and currency) forward contracts, or interest rate swaps;

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 15

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

SEVERABILITY ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Section III., EXCLUSIONS is amended by adding the following paragraph:

For purposes of determining the applicability of any exclusions set forth in Section III. EXCLUSIONS the **Wrongful Act** of any **Insured** shall not be imputed to any other **Insured**, and only the **Wrongful Act** of any officer of the **Broker-Dealer** shall be imputed to the **Broker-Dealer** as defined by Section H.1.

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy



Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 16

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

EXTENDED REPORTING PERIOD FOR RETIRING REPRESENTATIVE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part V., CONDITIONS, Section B. of the above referenced policy is amended by adding the following:

If, during the **Policy Period**, a **Registered Representative** retires (pursuant to and in accordance with the formal retirement procedures of Crown Capital Securities, L.P.), or becomes disabled or deceased, within 30 days of such event, the **Registered Representative** or legal representative may elect to purchase an Extended Reporting Period for a period of (3) years or five (5) years, for an additional premium equal to 300% or 500%, respectively, of the **Registered Representative's** last annual premium, to report to the Insurer any **Claim** which is first made during the applicable period and which arises out of a **Wrongful Act** committed prior to the event and on or after the **Retroactive Date**.

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 17

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

TAX PREPARATION ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part II. DEFINITIONS, P. is hereby amended by adding the following:

Tax Preparation Services,

It is further agreed and understood that Part II. EXCLUSIONS, O., is hereby amended as follows:

O. based upon, arising out of, directly or indirectly, or in any way involving services as, or which may only be performed by, an accountant, actuary, clearing agency, investment banker, lawyer, mortgage broker or banker, property/casualty insurance agent, third-party administrator, real estate agent/broker, general agent of a life insurance agency (unless said agent has no subagents and is nor supervising any other agents), managing general agent, securities analyst, or trustee; or any Outside Business Activity of an **Insured** that is not approved and authorized in writing by the **Broker-Dealer** or the **Registered Representatives** prior Broker-Dealer.

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 18

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

JUNK OR HIGH YIELD BOND ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III., EXCLUSIONS, of the above referenced Policy is hereby amended to add the following:

- based upon, arising out of, directly or indirectly, or in any way involving the purchase, sale, or the giving of advice regarding **Junk Bonds** or **High Yield Bonds**; however, this Exclusion shall not apply to products which are approved by or placed through the **Broker-Dealer** or the **Registered Representatives** prior Broker-Dealer transacted on an approved platform of the **Broker-Dealer** or the **Registered Representatives** prior Broker-Dealer.

For purposes of this Exclusion, **Junk Bonds** or **High Yield Bonds** shall mean bonds which, at the time of purchase or sale, were unrated or rated as below investment grade by any rating agency (including but limited to Moody's rated bonds of Ba or lower or S&P rated bonds of BB or lower).

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 19

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

PROMISSORY NOTES COVERAGE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is agreed and understood that Part III., EXCLUSIONS, Section F.5 of the above referenced Policy is hereby deleted and replaced with the following:

This Policy does not apply to any **Claim:**

- Issuer callable, or step-up or step down, Certificates of Deposits

Coverage under this Endorsement for promissory notes approved by Crown Capital Securities, L.P. is subject to the following Sub-Limit of Liability (which is part of and not in addition to the Limits of Liability) and Deductible:

Each **Claim:**	$500,000
Registered Representative Aggregate	$500,000
Maximum Policy Aggregate	$1,000,000
Deductible Each **Claim:**	$75,000

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy



Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 20

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

DELETE EXCLUSION N. ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III., EXCLUSIONS, N. of the above referenced Policy are hereby deleted in its entirety.

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 21

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

AMEND EXCLUSION T. ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III., EXCLUSIONS, T. of the above referenced Policy is hereby deleted in its entirety and replaced with the following:

T. based upon arising out of, directly or indirectly, or in any way involving the ownership, formation, servicing, operation, or administration of any insurance company, health maintenance organization, preferred provider operation, risk rerention group, self-insurance program, or purchasing group.

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 22

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

AMEND EXCLUSION K. ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III., EXCLUSIONS, K. of the above referenced Policy is hereby deleted in its entirety and replaced with the following:

K. based upon, arising out of, directly or indirectly, or in any way involving any **Pattern Day Trading** activity, or short sales activity.

Pattern Day Trading means the execution of 4 or more round-trip day trades within any five (5) successive business days. If, however, the number of day trades is less than or equal to 6% of the total number of trades that trader has made for that five (5) business day period, the trades will nor be considered pattern day trading.

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 23

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

AMEND EXCLUSION M. ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III., EXCLUSIONS, M. of the above referenced Policy is hereby deleted in its entirety and replaced with the following:

M. based upon, arising out of, directly or indirectly, or in any way involving the failure to provide a discount on volume purchases of mutual funds. This exclusion shall apply to all **Insureds** except for the entity defined by Section H.1. as the Named Insured.

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 24

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

NON TRADED REIT COVERAGE ENDORSEMENT

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

In consideration of the premium paid, it is hereby agreed and understood that Part III.F EXCLUSIONS, of the above referenced Policy is hereby amended by adding the following:

- Registered Non-Traded REITs

Notwithstanding the above exclusion, coverage is available under this Endorsement subject to the following Sub-Limit of Liability (which is part of and not in addition to the Limits of Liability) and Deductible for Registered Non-Traded REITs. It is further understood and agreed that coverage under this Endorsement applies solely to financial product(s) which comprise no more than 15% of the client's portfolio at the time of the sale.

Each **Claim**:	$1,000,000
Registered Representative Aggregate:	$1,000,000
Maximum Policy Aggregate:	$7,500,000
Deductible Each **Claim**:	$25,000

All other terms and conditions remain unchanged.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 25

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

U.S. ECONOMIC AND TRADE SANCTIONS ENDORSEMENT

Whenever coverage provided by this policy would be in violation of any U.S. economic or trade sanctions such as, but not limited to, those sanctions administered and enforced by the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC"), such coverage shall be null and void.

Similarly, any coverage relating to or referred to in any certificates or other evidences of insurance or any claim that would be in violation of U.S. economic or trade sanctions as described above shall also be null and void.

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 26

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

CAP ON LOSSES FROM CERTIFIED ACTS OF TERRORISM

This endorsement modifies insurance provided under the above captioned policy.

A. Cap On Certified Terrorism Losses

"Certified act of terrorism" means an act that is certified by the Secretary of the Treasury, in concurrence with the Secretary of State and the Attorney General of the United States, to be an act of terrorism pursuant to the federal Terrorism Risk Insurance Act. The criteria contained in the Terrorism Risk Insurance Act for a "certified act of terrorism" include the following:

1. The act resulted in insured losses in excess of $5 million in the aggregate, attributable to all types of insurance subject to the Terrorism Risk Insurance Act; and
2. The act is a violent act or an act that is dangerous to human life, property or infrastructure and is committed by an individual or individuals as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States Government by coercion.

If aggregate insured losses attributable to terrorist acts certified under the Terrorism Risk Insurance Act exceed $100 billion in a Program Year (January 1 through December 31) and we have met our insurer deductible under the Terrorism Risk Insurance Act, we shall not be liable for the payment of any portion of the amount of such losses that exceeds $100 billion, and in such case insured losses up to that amount are subject to pro rata allocation in accordance with procedures established by the Secretary of the Treasury.

B. Application Of Exclusions

The terms and limitations of any terrorism exclusion, or the inapplicability or omission of a terrorism exclusion, do not serve to create coverage for any loss which would otherwise be excluded under this Coverage Part or Policy, such as losses excluded by the Nuclear Hazard Exclusion or the War And Military Action Exclusion.

Includes copyrighted material of Insurance Services Office, Inc., with its permission

Broker-Dealer and Registered Investment Adviser Professional Liability Insurance Policy

Liberty Surplus Insurance Corporation
Member of Liberty Mutual Group

LIBERTY SURPLUS INSURANCE CORPORATION

(A New Hampshire Stock Insurance Company, hereinafter the "Insurer")

ENDORSEMENT NO. 27

Effective Date:	April 1, 2012
Policy Number:	EO5NAADF7W002
Issued To:	Crown Capital Securities, L.P.

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

DISCLOSURE – TERRORISM RISK INSURANCE ACT

THIS ENDORSEMENT IS MADE PART OF YOUR POLICY PURSUANT TO THE TERRORISM RISK INSURANCE ACT.

In accordance with the Terrorism Risk Insurance Act, including all amendments, ("TRIA" or the "Act"), we are required to provide you with a notice of the portion of your premium attributable to coverage for "certified acts of terrorism," the federal share of payment of losses from such acts, and the limitation or "cap" on our liability under the Act.

Disclosure of Premium

The Company has made available coverage for "certified acts of terrorism" as defined in the Act. If purchased, the portion of your premium attributable to coverage for "certified acts of terrorism" is shown in the Declarations, Declarations Extension Schedule or elsewhere by endorsement in your policy.

Federal Participation In Payment Of Terrorism Losses

If an individual insurer's losses exceed a deductible amount specified in the Act, the federal government will reimburse the insurer for 85% of losses paid in excess of the deductible, provided that aggregate industry losses from a "certified act of terrorism" exceed $100 million.

Cap On Insurer Participation In Payment Of Terrorism Losses

If aggregate insured losses attributable to "certified acts of terrorism" exceed $100 billion in a calendar year and we have met our deductible under the Act, we shall not be liable for the payment of any portion of the amount of such losses that exceeds $100 billion. Nor shall Treasury make any payment for any portion of the amount of such losses that exceeds $100 billion. In such case, insured losses up to that amount are subject to pro rata allocation in accordance with procedures established by the Secretary of the Treasury.

SECURITIES & EXCHANGE COMMISSION EXAMS, FINRA OVERSIGHT, AND WHISTLEBLOWER OFFICE

Celiza P. Braganca, Esq.

SEC Office of Compliance Inspections and Examinations (OCIE)

I. OCIE has staff of about 1,000 in 11 SEC regional offices and headquarters.

II. OCIE is responsible for overseeing over 13,200 investment advisers, 10,000 mutual funds and exchange traded funds, 3,800 broker-dealers, 330 transfer agents, 7 active clearing agencies, 21 national securities exchanges, nearly 600 municipal advisors, FINRA, MSRB, SIPC, and the Public Company Accounting Oversight Board.

a. OCIE completed over 3,150 examinations in FY2018 – 10% increase over FY2017

b. OCIE examined approximately 17 percent of SEC-registered investment advisers – up from about 15% in FY2017

c. Number of registered investment advisers has grown by nearly 5% with assets managed of about $84 trillion.

d. Broker-dealers operate more than 156,000 branch offices and about 10% of all broker-dealers are dually-registered with the SEC as investment advisers.

III. OCIE Communications and Risk Alerts

a. Risk Alert: Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisors https://www.sec.gov/ocie/announcement/ocie-risk-alert-advisory-fee-expense-compliance.pdf

b. Risk Alert: Observations from Investment Adviser Examinations Relating to Electronic Messaging https://www.sec.gov/ocie/announcement/ocie-risk-alert-electronic-messaging OCIE observed advisers who did not do any testing or monitoring to ensure compliance with firm policies and procedures. As a result, the Staff offered examples of practices that may assist advisers in meeting their obligations.

IV. OCIE's 2019 Examination Priorities – Six themes

a. Matters of importance to retail investors, including seniors and those saving for retirement

i. Fraud and High Risk Securities: Priority is prevention of fraud to retail investors, particularly seniors and those saving for retirement. "OCIE conducted retail-targeted examinations of broker-dealers focused on preventing fraud, such as potential misappropriation and the sale of high risk securities by broker-dealers who may not conduct sufficient research into an investment and its appropriateness for a client." 2019 Examination Priorities at 3. OCIE also identified

advisers who recommended more expensive mutual fund share classes and who had branch office compliance issues.

ii. Senior Investors: "OCIE will conduct examinations that review how broker-dealers oversee their interactions with senior investors, including their ability to identify financial exploitation of seniors. In examinations of investment advisers, OCIE will continue to review the services and products offered to seniors and those saving for retirement. These examinations will focus on, among other things, compliance programs of investment advisers, the appropriateness of certain investment recommendations to seniors, and the supervision by firms of their employees and independent representatives." 2019 Examination Priorities at 7.

iii. Wrap Fee Programs: OCIE remains focused on investment advisers participating in wrap fee programs "which charge investors a single bundled fee for both advisory and brokerage services." 2019 Examination Priorities at 6.

iv. Conflicts of Interest: Use of affiliated service providers and products, securities-backed non-purpose loans and lines of credit, borrowing funds from clients.

b. Other five themes:

i. Compliance and risk of registrants responsible for critical market infrastructure

ii. Select areas and programs of FINRA and MSRB

iii. Digital Assets

iv. Cybersecurity

v. Anti-Money Laundering.

SEC Oversight of FINRA – 2019 Risk Monitoring and Examination Priorities

I. Online Distribution Platforms

a. Reliance on Rule 506(c) of Regulation D and Regulation A. Some may be operated by unregistered entities.

b. FINRA will "evaluate how firms conduct their reasonable basis and customer-specific suitability analyses."

i. Risk of sales to unaccredited investors

ii. Risk of excessive or undisclosed compensation arrangements

II. Sales Practice Risks

a. Suitability

i. Deficient quantitative suitability determinations or related supervisory controls

ii. Overconcentration in illiquid securities, such as variable annuities, non-traded alternative investments and private placements

iii. Recommendations to purchase share classes that are not in line with customer's time horizon

b. Senior Investors

i. FINRA will assess firms' supervision of accounts where registered representatives serve in a fiduciary capacity, including holding a power of attorney, acting as a trustee or co-trustee, or having some type of beneficiary relationship with a non-familial customer account. FINRA is concerned about registered representatives taking control of trusts or assets to direct funds to themselves. FINRA will assess supervisory systems firms employ to place heightened scrutiny over those accounts.

ii. FINRA Rule 4512 – identifying a trusted contact

iii. FINRA Rule 2165 – permitting temporary holds when exploitation of senior or disabled customer may be taking place

c. Outside business activities and private securities transactions

i. FINRA is particularly concerned about associated persons raising funds from customers away from the firm and outside of firm's supervision.

ii. FINRA published Regulatory Notice 18-08 soliciting comment on proposed FINRA Rule 3290, which would replace current FINRA Rules 3270 (Outside Business Activities of Registered Persons) and 3280 (Private Securities Transactions of an Associated Person). FINRA received 52 comments on Regulatory Notice 18-08.

SEC Office of the Whistleblower

I. Who is a Whistleblower?

a. Any individual or group of individuals who possess a reasonable belief that there has been a violation of the federal securities laws.

i. Can be anonymous – reporting a tip through an attorney

ii. Whistleblower does not have to be US resident, can be multiple persons, but cannot be a business entity

iii. Dodd-Frank protections of whistleblowers and procedures are different from Sarbanes-Oxley (SOX) protections and procedures. Statutes of limitation and remedies are different. https://www.sec.gov/whistleblower/retaliation

iv. Note there are many other state and federal whistleblower statutes, each with its own unique requirements and processes. A violation of federal securities laws could be market manipulation, misrepresentations or omission of material information, stealing customer funds, selling unregistered securities, bribing foreign officials.

b. Basis of tip can be private information obtained through personal experience (like employment) or from personal analysis of public information.

c. Important for employees to qualify as whistleblowers for anti-retaliation protections

II. Reporting a Tip – Potential Monetary Award

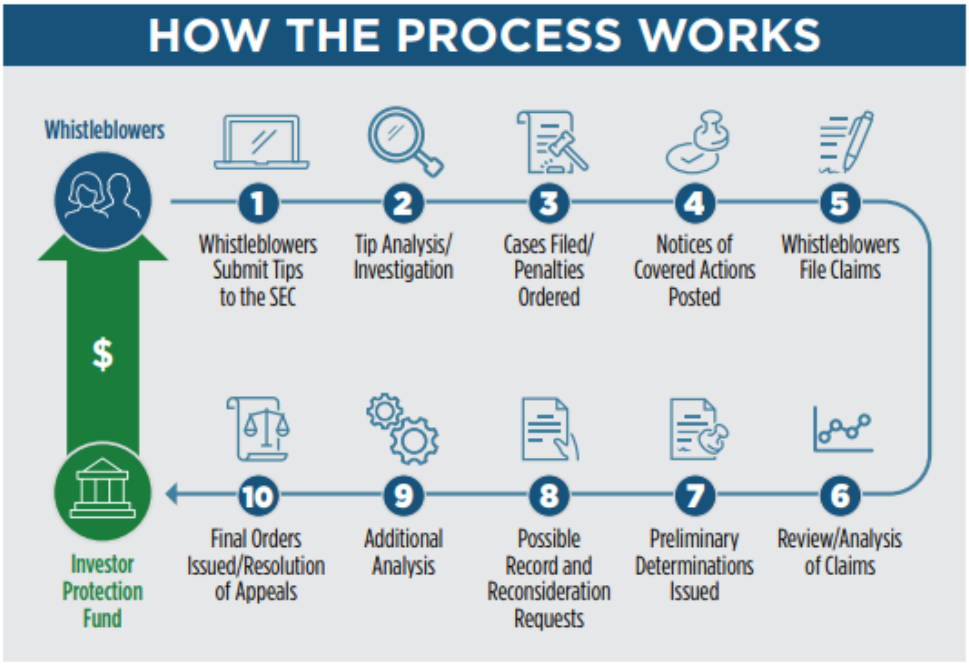
a. Voluntarily provide to SEC original information about possible violation of federal securities laws that leads to a successful enforcement action resulting in monetary sanctions over more than one million dollars

b. Specific process for reporting – important that you do it properly https://www.sec.gov/whistleblower/submit-a-tip You are not a "whistleblower" if you just pick up the phone and call the SEC with a tip.

c. Claiming an award - https://www.sec.gov/whistleblower/claim-award - Can be 10-30%. Paid from a separate Investor Protection Fund so that it does not decrease the amount available to return to investor-victims. It is the whistleblower's obligation to claim the award. SEC posts a notice on its website and a whistleblower is required to "claim" the award. Here is an SEC summary of the whistleblower award process:

Overview of Award Process

For a whistleblower to receive an award, there are a number of preconditions that must be met. The diagram below provides a snapshot of the overall process, from the filing of the whistleblower tip to payment of the whistleblower award. As reflected, the time between the submission of a whistleblower tip and when an individual may receive an award payment can be several years, particularly where the underlying investigation is especially complex, where there are multiple, competing award claims, or where there are claims for related actions. OWB undertakes extensive due diligence to ensure a careful and thorough evaluation of all award claims.



The discussion below focuses on the award claims process, from the posting of the NoCA (Step #4 above) to the issuance of a Final Order by the Commission (Step #10 above).

d. Some significant whistleblower awards made by the SEC during 2018:

Below is an overview of the whistleblower awards made by the Commission during the past fiscal year.

Three Individuals Receive Largest-Ever Awards Totaling Almost $83 Million

On March 19, 2018, the Commission announced two of its largest-ever whistleblower awards, with two individuals sharing a nearly $50 million joint award and another whistleblower receiving more than $33 million.[15] The first two individuals jointly provided significant information that prompted the Commission to open the first of two investigations and ongoing assistance that saved the Commission a substantial amount of time and resources. The third individual supplied the Commission with additional information that initiated and acted as the cornerstone of the Commission's second investigation resulting in the Covered Action.

More Than $54 Million to Two Whistleblowers

On September 6, 2018, the Commission announced an award of more than $54 million to two whistleblowers, $39 million to one whistleblower and $15 million to another, whose critical information and continued assistance helped the agency bring an important enforcement action.[16] The $39 million award is the second-largest individual award in the history of the program.

More Than $16 Million Awarded to Two Whistleblowers

On November 30, 2017, the Commission announced an award of more than $16 million to two whistleblowers.[17] The first whistleblower alerted the staff to the particular misconduct that was the focus of the staff's investigation and the cornerstone of the subsequent action and provided continuing assistance, including the identification of potentially relevant documents and witnesses. The second whistleblower provided additional significant information and ongoing cooperation to the staff during the investigation that saved a substantial amount of time and agency resources.

Former Company Insider and Foreign National Receives $4.1 Million Award

On December 5, 2017, the Commission announced an award of more than $4.1 million to a former company insider who both alerted the Commission to a widespread, multi-year securities law violation and continued to provide important information and assistance throughout the SEC's investigation.[18] The whistleblower was a foreign national working outside of the United States.

III. Confidentiality and Restrictions on Whistleblowing – *de facto* gag clauses

a. SEC has clearly established that companies that seek to discourage employees from reporting violations through restrictive employment agreements will be prosecuted - Matter of KBR, Inc, BlueLinx Holdings, Inc., Health Net, Inc., InBev, NeuStar Inc., Sandridge Energy, BlackRock, and HomeStreet Inc. *See* Labaton Sucharow, Reporting Without Regrets: The SEC Whistleblower Handbook – prepared for PIABA Mid-Year Meeting for citations, footnotes 49-57.

b. OCIE issued an alert reminding investment advisers and broker-dealers (among others) that it would be examining compliance manuals, codes of ethics, employment agreements, severance agreements to determine whether they violate Rule 21F-17 of the SEC's whistleblower regulations:

IV. Proposed amendments to the Whistleblower Rules were published in the Federal Register on July 20, 2018. https://www.sec.gov/rules/proposed/2018/34-83557.pdf The public comment period ended in mid-September 2018. The SEC received about 100 unique letters and two form letters from commenters. The proposed rule amendments include:

i. Permitting awards based on deferred prosecution agreements and non-prosecution agreements or a settlement agreement entered into by the SEC in a non-judicial, non-administrative proceeding setting

ii. Providing additional considerations for small and exceedingly large awards

iii. Defining a whistleblower as not including one who reports securities law violations internally, rather than directly to the SEC

iv. Barring certain individuals from submitting whistleblower tips where they have been found to have submitted false information or where they have repeatedly made frivolous award

v. Creating a more efficient summary disposition procedure for certain types of likely denials, such as untimely award applications.

vi. Guidance concerning a tip that is based upon "independent analysis." Under the proposed guidance, in order to qualify as "independent analysis," a whistleblower's submission must provide evaluation, assessment, or insight beyond what would be reasonably apparent to the SEC from publicly available information.

There is a great deal of information about the SEC Whistleblower Program in 2018 Annual Report to Congress – Whistleblower Program - https://www.sec.gov/files/sec-2018-annual-report-whistleblower-program.pdf

NASAA 2018

Enforcement Report

Based on 2017 Data



Introduction

For more than 100 years, North American Securities Administrators Association (NASAA) members — state, provincial, and territorial securities regulators in the United States, Canada and Mexico — have cooperated and shared information with one another to fulfill their mission of protecting investors and ensuring the integrity of the securities markets.

One of the ways NASAA members seek to accomplish their mission is through the vigorous enforcement of their respective civil and criminal securities laws.

While the securities markets are global, securities are sold locally. NASAA members, as the "cops on the beat," are often the first line of defense against investment fraud in their respective jurisdictions. Although not all of the enforcement actions brought by NASAA members receive national headlines, they all directly impact their communities and, as a whole, impact the global securities markets.

As such, each year NASAA conducts a survey of NASAA U.S. members[1] to quantify the tremendous impact that NASAA members have by conducting investigations and bringing legal actions against those who harm investors and our securities markets. NASAA's Canadian members participate in a different enforcement survey; an overview is provided on page 10.

This report provides a summary of the enforcement actions of its members in 2017. And while the amount of money returned to investors, financial sanctions, and years in prison identified in this report are the direct result of NASAA members' enforcement actions, the numbers do not reflect the deterrent effect these actions have on would-be fraudsters or the confidence that NASAA members help instill in the markets.

This report also identifies enforcement trends, highlights the cooperation among NASAA members in multi-jurisdictional investigations and combatting frauds involving emerging technologies, and notes the ways that NASAA members are responding to securities frauds involving seniors.

Securities fraud is a constant, ongoing, ever-evolving battle that will always pose a risk to investors. But as this report demonstrates, NASAA members are well-prepared, well-organized, and ready to continue aggressively protecting investors from fraud and policing the integrity of our capital markets.

Sincerely,

Christopher W. Gerold
NASAA Enforcement Section Chair
Bureau Chief, New Jersey Bureau of Securities

[1] *The survey requests that each NASAA U.S. member provide statistics using that member's most recent full reporting year. Some members collect and report data on a calendar basis, while other members collect and report data on a fiscal year basis. This report is based on data collected from 51 NASAA U.S. members.*

Enforcement Overview

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



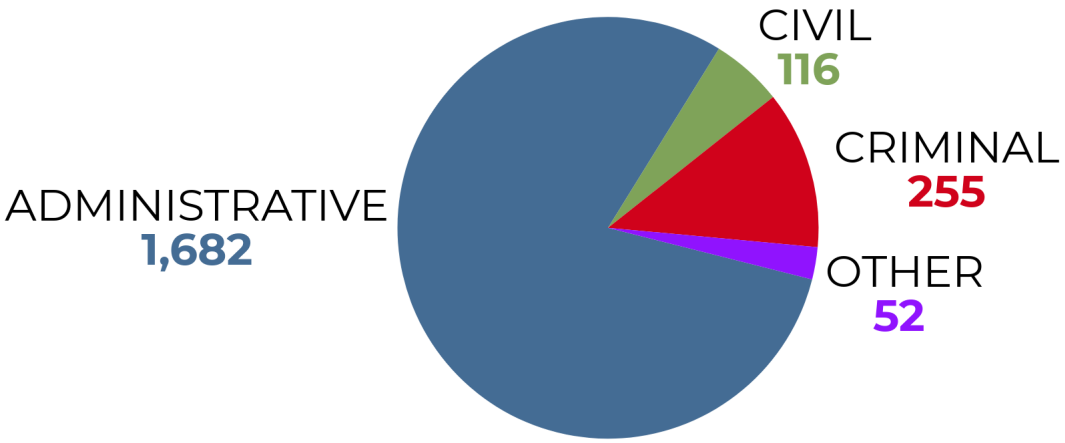
COMPLAINTS & INVESTIGATIONS

COMPLAINTS RECEIVED
7,988

INVESTIGATIONS INITIATED
4,790

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

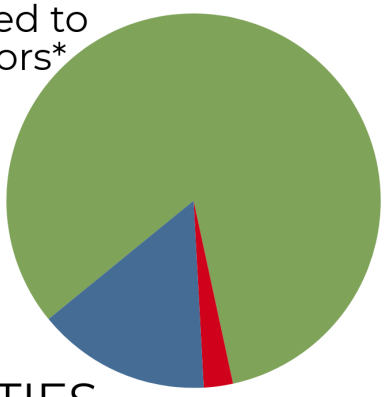
ENFORCEMENT ACTIONS



MONETARY RELIEF

Nearly **$486 Million** Ordered Returned to Investors*

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



FINES/PENALTIES
Nearly **$79 Million** Assessed

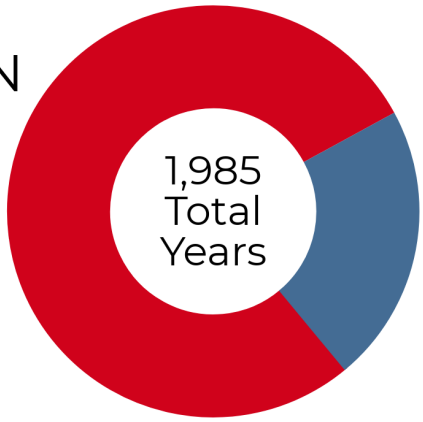
OTHER

INVESTOR EDUCATION
Nearly **$7.5 Million** Ordered

COSTS
More Than **$7.3 Million** Ordered

CRIMINAL RELIEF

INCARCERATION
1,551 Years



PROBATION
434 Years

RELIEF ORDERED

The sanctions imposed by state securities regulators can vary considerably from year to year, depending on the nature of the cases pursued. In addition to monetary restitution to investors, common types of sanctions include fines and penalties, criminal sentences, and restrictions or prohibitions on participation in the securities industry. In 2017, NASAA U.S. members reported nearly $486 million ordered returned to investors and reported a continued high level of specific and general deterrence through criminal sanctions. The number of overall licensing sanctions increased over recent years, and is detailed below at pages 7-8 and 11.

Enforcement Coordination Among NASAA Members

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

For example, in early 2018 NASAA members in the United States and Canada launched a coordinated international initiative focused on cryptocurrencies and initial coin offerings (ICOs). Separately, a 2017 investigation led by state securities regulators from Alabama and Massachusetts led to a significant multistate settlement.



From the Files . . .

OPERATION CRYPTOSWEEP

In May 2018, U.S. state securities regulators joined with Canadian securities regulators to launch a coordinated international sweep of promoters and issuers of illegal and fraudulent cryptocurrency offerings. NASAA organized the participation of more than 40 agencies in "Operation Cryptosweep," an initiative that included more than 200 inquiries and investigations of suspicious cryptocurrency offerings.

NASAA members quickly uncovered extensive fraud in this new market. Regulators secured voluminous evidence proving many promoters were not complying with registration laws and were concealing important information from investors, including the significant risks associated with investing in the cryptocurrency market, the true identity of the promoters and managers of investment programs, the actual location of issuers' business operations, and the premises for promises of lucrative profits and returns.

Operation Cryptosweep resulted in the entry of many enforcement actions to stop these illegal and fraudulent schemes, including nearly 50 as of the date of this report. As NASAA President Joe Borg pointed out when he announced the sweep, these actions "are just the tip of the iceberg" and members will continue to pursue legal remedies to protect investors in this emerging market.

MULTISTATE INVESTIGATION & SETTLEMENT

In March 2017, a representative of LPL Financial LLC contacted a representative of the Massachusetts Securities Division regarding the firm's intent to offer rescission of five transactions in Massachusetts that it had belatedly identified as not being compliant with state securities law. The matter was referred to NASAA's Enforcement Section.

In July 2017, NASAA established a task force with **Massachusetts** and **Alabama** as lead states to investigate the firm's failure to establish and maintain reasonable policies and procedures to prevent the sale of unregistered, non-exempt securities by LPL to its customers. LPL fully cooperated with the NASAA task force.

The investigation focused on LPL's retention, use, and subsequent cancellation of certain third-party services integral to LPL's compliance with state securities registration requirements. State securities regulators also looked into certain other legacy deficiencies within LPL's compliance structure related to LPL's controls, monitoring and reporting tools, and escalation protocols regarding the firm's response to significant compliance issues.

State securities regulators concluded that LPL offered and sold unregistered, non-exempt securities and failed to reasonably supervise the flow of information to ensure full and proper compliance with state securities registration requirements.

The lead states negotiated a settlement with LPL that was executed in May 2018. Terms of the settlement included a Cease and Desist Order, customer restitution back to October 1, 2006 and an administrative fine of $499,000 to each participating jurisdiction, totaling $26 million.

NASAA Model Act Leads to More Reporting & Investigations

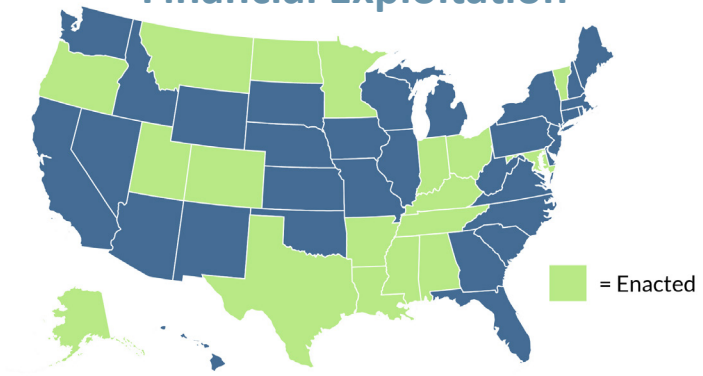
NASAA's 2018 Enforcement Survey reveals that seniors remain a primary target of fraudsters. NASAA U.S. member jurisdictions reported bringing formal enforcement actions involving more than 1,100 senior victims in 2017, demonstrating an unwavering commitment to protecting senior investors. NASAA members also identified the offer and sales of unregistered securities offerings as the scheme used most often to victimize seniors and other vulnerable adults. Regarding the chart below, "other" schemes include but are not limited to internet romance scams, lottery or sweepstakes scams, Nigerian schemes, and identity theft.

NASAA and its members, however, have continued to prioritize senior financial exploitation through both their enforcement efforts and by promoting and adopting the NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation. The model act, for example, mandates reporting to a state securities regulator and state adult protective services agency when an agent or representative has a reasonable belief that financial exploitation of an eligible adult has been attempted or has occurred.

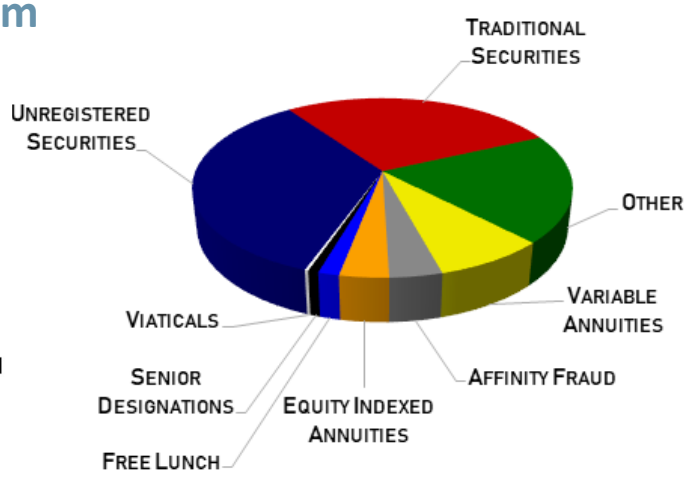
Currently, 18 states have passed a version of the NASAA Model Act. While designed to prevent financial exploitation before it's too late and someone's money is gone, the model act also can play an important role in helping to identify potential targets for enforcement actions. Through the reporting efforts of financial firms and the coordination among NASAA members, Adult Protective Services, and local/state law enforcement, a great number of potential victims have been identified.

States that have adopted the NASAA Model Act, or similar statutes, have received more than 500 reports of potential senior financial abuse. These reports often lead to investigations, which, in turn, has led some states to bring actions to prevent or stop senior financial exploitation or punish those responsible. Since September 2017, for example, the **Texas State Securities Board** has received more than 100 reports of financial exploitation pursuant to its version of the NASAA Model Act. As a result of these reports, Texas has opened 24 investigations, and brought an action against an individual acting as an unregistered investment adviser that may have illegally recieved nearly $30,000 from the account of an 88 year-old Texan.

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



Schemes and Products Used to Target Seniors



Continued Focus on Bad Actors

This year's enforcement survey reflects a large increase in enforcement actions against unregistered individuals and firms. NASAA U.S. members reported actions in 2017 against 675 unregistered individuals and firms (an increase of 24 percent over the prior year) and 647 registered individuals and firms (a 9 percent increase). The surge in cases against unregistered actors reversed a two-year trend in which registered individuals and firms in the securities industry (broker-dealers and investment advisers) had constituted the majority of respondents in state enforcement actions.

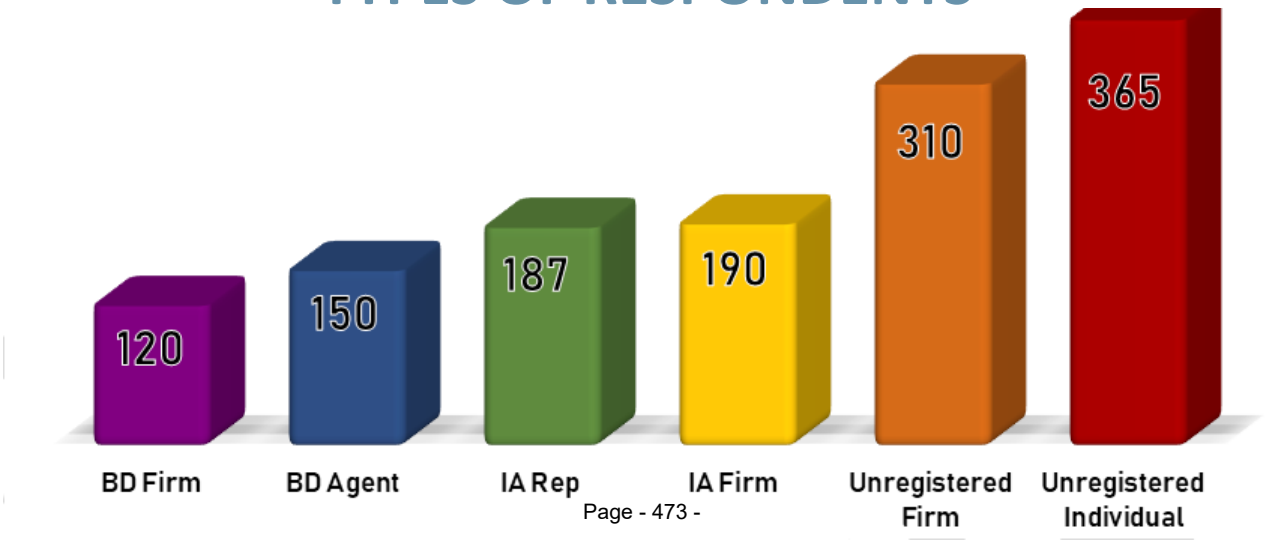
2017 was also the first year in which investment adviser (IA) firms and representatives significantly outnumbered broker-dealer (BD) firms and agents as respondents in state enforcement actions. Over the three-year period from 2014 to 2016, NASAA U.S. members reported taking actions against roughly an even number of BD firms and agents (1,050 total) and IA firms and representatives (982 total). In 2016, however, participating jurisdictions reported that the number of IA firms and representatives under investigation had increased by nearly a third year-over-year. Those investigations bore fruit in 2017, resulting in 377 IA firms and representatives named in enforcement actions, a 32 percent increase over the prior year. In contrast, the number of BD firms and agents named as respondents in 2017 enforcement actions fell to 270, an 11 percent decline year-over-year.

Overall, state securities regulators continued to take strong steps to prevent bad actors from operating within the licensed securities industry, and to condition the activity of licensees and registrants. In 2017, NASAA U.S. members revoked, barred or suspended the licenses/registrations of more than 300 individuals and firms, and denied or conditioned the licenses/registrations of more than 575 others.

In addition, nearly 3,600 license/registration requests were withdrawn as a result of state action or attention, the most in the last 4 years. While not always the case, many license/registration requests are withdrawn as a state is preparing to take action to deny, suspend, condition, or revoke a license/registration.

NASAA U.S. members also reported a growing number of investigations of unregistered individuals. For 2017, participating jurisdictions reported 515 unregistered individuals were the subjects of pending investigations. This number has climbed steadily in recent years, increasing nearly 40 percent between 2015 and 2017. In light of recent state enforcement efforts against fraudulent activity involving cryptocurrencies, it would not be surprising to see a sustained high level of investigations and actions against unregistered individuals and firms in the coming months.

TYPES OF RESPONDENTS



From the Files . . .

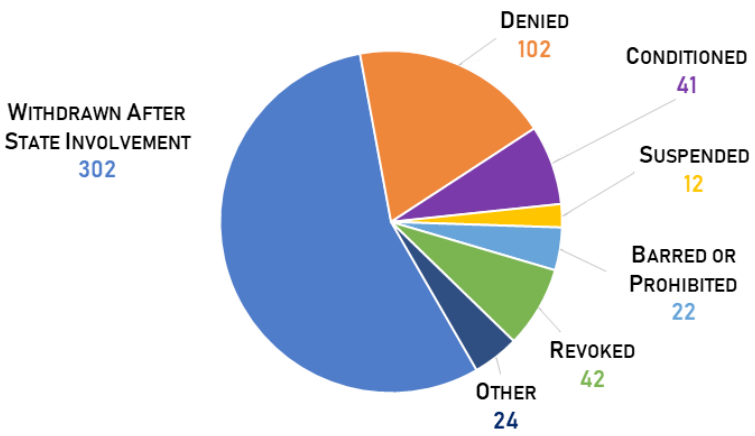
The **Maine Office of Securities** recently helped bring a fugitive Ponzi-scheme fraudster to justice after more than a decade at large. In the early 2000s, Maine investigated insurance agent Robert Edmunds III for the unlicensed sale of risky unregistered securities. In 2004, the Office of Securities entered into a consent judgment with Edmunds that required him to repay certain investor losses. Shortly afterwards, Maine learned that Edmunds was continuing to sell investments in known Ponzi schemes. After receiving a follow-up subpoena from the Office of Securities, Edmunds sold his house and business, divorced his wife, and fled the state, taking up residence for a time in Belize. Office of Securities Senior Investigator Jackie Drouin never stopped trying to locate Edmunds. Thanks to her persistent and determined efforts, Edmunds was arrested in Virginia in late 2016. He pled guilty to several counts of violating Maine's securities laws, and in 2017 was sentenced to an 18-month term of imprisonment.

The **Wisconsin Department of Financial Institutions** recently entered into a consent order and payment agreement with Malorie Berceau, her company MFB Investments, LLC, and her accomplices Martin Berceau and Travis Ebert after the trio conned family and friends out of $350,000. Ms. Berceau claimed the investors' funds would be invested in binary options, penny stocks, and foreign currency exchanges. Despite never having been registered, Ms. Berceau held out MFB Investments as an investment adviser, and sometimes falsely claimed to be a current or former employee of Merrill Lynch. Ms. Berceau represented that potential investors could earn a 200 percent return in as little as 90 days.

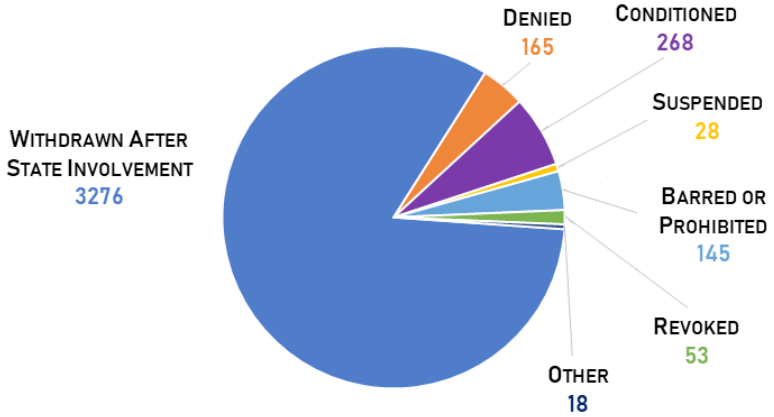
None of the money Ms. Berceau obtained was ever invested in any legitimate security on behalf of investors; instead, Ms. Berceau deposited the funds into accounts she and Ebert controlled and spent the money on personal expenditures. To further the fraud, Ms. Berceau created false account documents using the logos of legitimate financial companies. She also created brokerage and bank accounts under investors' names without their consent, substituting her own contact information for that of the investors. In at least one case, Ms. Berceau impersonated one of her investors using a falsified power of attorney which Mr. Berceau and Mr. Ebert signed as witnesses, and forged the investor's signature on multiple transfer forms.

Following an investigation, DFI entered a summary cease and desist order in October 2017. Ms. Berceau, Mr. Ebert, and Mr. Berceau later agreed to the entry of a consent order in which Ms. Berceau admitted liability, Ms. Berceau and Mr. Ebert agreed to pay over $200,000 in restitution and a $30,000 civil penalty, and Mr. Berceau agreed to pay over $68,000 in restitution and a $10,000 civil penalty. All three respondents also agreed to cease and desist from the offering of unregistered securities and from violating Wisconsin securities laws.

LICENSING SANCTIONS: FIRM



LICENSING SANCTIONS: INDIVIDUAL



Investor Threats Stemming From Emerging Financial Technologies

NASAA members recognize that bad actors often attempt to capitalize on the hype associated with exciting new markets and trendy financial products.

Not surprisingly, enforcement personnel began increasingly focusing their efforts on cryptocurrencies, as the price of Bitcoin sharply increased from approximately $2,364 in July 2017 to nearly $20,000 in December 2017, and the market capitalization of all cryptocurrencies skyrocketed to more than $500 billion during the same time period.

Although some legitimate businesses were attempting to properly raise capital by selling securities tied to cryptocurrencies and related blockchain technologies, state authorities quickly learned the market was saturated with fraud.

NASAA members began conducting swift investigations of suspect ICOs and other investments involving cryptocurrencies, and they started pursuing those enforcement actions necessary to protect the investing public from imminent harm.



From the Files . . .

On December 20, 2017, the **Texas State Securities Board** secured an emergency action against USI-Tech Limited, the first state enforcement action against a promoter of illegal and fraudulent investments tied to cryptocurrencies. Around the same time, the **Securities Division of the North Carolina Department of the Secretary of State** and the Texas State Securities Board began investigating BitConnect's offer of investments in a cryptocurrency lending program.

The agencies learned that BitConnect promised investors that the purchase of an investment in the cryptocurrency lending program would entitle them to upwards of 40 percent interest per month over a specified term and an additional rate of interest calculated on a daily basis.

Although these investments constituted securities, the regulators found that BitConnect was failing to comply with the appropriate securities and dealer registration laws. They also found that BitConnect was engaging in fraud by failing to disclose important material facts, including the identity of the principals of BitConnect, the true location of BitConnect's operations and management, and financial information that may provide a basis for its promise to pay investors extraordinary returns.

North Carolina and Texas swiftly entered emergency actions to protect the investing public from BitConnect.

These enforcement actions not only stopped BitConnect's scheme to defraud residents of North Carolina and Texas, but also led to the swift collapse of the fraudulent investment scheme.

Immediately before the entry of both orders, BitConnect claimed a market capitalization of more than $2.5 billion. On January 16, 2018, BitConnect publicly recognized its receipt of the orders entered by state securities regulators, and it promptly stopped unlawfully selling investments in its cryptocurrency lending program. Over the next few weeks, BitConenct's market capitalization plummeted, falling more than 98.5 percent before its cryptocurrencies were delisted from public exchanges.

2017 Canadian NASAA Member Enforcement Activity

Canadian Securities Administrators' (CSA) investigation and enforcement teams work efficiently and collaboratively to protect the integrity of Canada's capital markets, and protect Canadian investors from unfair, improper, or fraudulent practices. Enforcement efforts comprise a number of specialized committees, task forces and working groups.

Combatting Binary Options Fraud

In 2017 and 2018, the CSA's Binary Options Fraud Task Force led global discussions on best practices, and worked closely with investor education and communications divisions to build and launch a wide-reaching public awareness campaign across Canada.

The Task Force built stronger connections with finance and tech industry companies like Google, Facebook, Apple, Visa, and MasterCard. These connections were vital in efforts to block fraudsters from accessing digital channels and online advertising, and to reduce or block payments to fraudulent companies. The Task Force's work resulted in a multilateral ban on offering, selling or trading binary options shorter than 30 days with any individual in Canada, and a reduction in complaints and advertisements/activities involving binary options in Canada.

CSA Enforcement Summits

The first-ever Canadian Pump-and-Dump Summit for securities regulators and law enforcement agencies was held in Calgary, Alberta, in September 2017. Enforcement specialists from across Canada, the U.S. Securities and Exchange Commission, and the FBI, explored innovative, effective approaches to detecting and investigating pump-and-dump schemes, which cause substantial loss to investors and reputational damage to Canada's capital markets each year.

In November, CSA members met in Toronto for a two-day Data Analytics Think Tank. The forum highlighted the critical role data analytics plays in enforcement. The conference gathered experts from prominent data-driven organizations from around the world to discuss topics such as artificial intelligence, open-source technology solutions, building data-science-driven teams, and storing and analyzing evidence in the cloud.

CSA Enforcement Overview

From January 1 to December 31, 2017, CSA members concluded 111 matters involving 259 respondents (individuals and companies). The largest number of respondents by category was 149 for illegal distribution, 23 for fraud, 23 for market manipulation, and 21 for registrant misconduct.

Cooperation across provincial borders played a key role in a range of cases in 2017, with CSA members providing formal assistance to one another 88 times, and referring 35 files *(fiscal year 2017/2018)* to other jurisdictions for further enforcement action.

Securities regulators and courts ordered total fines, administrative penalties, and voluntary payments of $69 million. Fraud represented $20.5 million of this total, followed by market manipulation ($19.9 million), and illegal distribution ($13.6 million). Restitution, disgorgements, and investor compensation ordered amounted to $68 million in 2017. Fraud offences represented much of this total ($13.8 million), as well as disclosure violations ($10 million), while no-contest settlements represented $37.3 million.

There has also been an increase in CSA members' enforcement efforts in the courts. Efforts to prosecute serious cases in the courts resulted in several significant jail terms in 2017. Canadian courts ordered jail terms for 17 individuals, ranging from 30 days to five years, for a total of over 33 years of jail time handed down to offenders.

Other preventive measures were interim cease-trade and asset-freeze orders. Under the 49 interim and asset freeze orders issued, trading and other restrictions were placed on 127 respondents. In 2017, 30 asset-freeze orders were issued relating to 50 respondents, including a total of $88 million in bank accounts and property liens.

CSA members issued 54 investor alerts during the calendar year to warn Canadians not to invest with certain individuals, companies, or types of investments.

U.S. NASAA Member Enforcement Activity 2013-2017

Category	2013	2014	2015	2016	2017	5-Year Total
Investigations	5,302	4,853	4,112	4,341	4,790	23,398
Overall Enforcement Actions[1]	2,184	2,042	2,060	2,017	2,105	10,408
Administrative	1,740	1,634	1,593	1,606	1,682	8,255
Civil	183	137	151	138	116	725
Criminal	262	271	261	241	255	1,290
Other	*not collected*	*not collected*	55	32	52	139
Overall Criminal Relief [2]	2,495 years	2,122 years	1,246 years	1,346 years	1,985 years	9,194 years
Incarceration	1,816 years	1,624 years	838 years	824 years	1,551 years	6,653 years
Probation	679 years	498 years	408 years	522 years	434 years	2,541 years
Restitution [3]	$494 million	$405 million	$536 million	$231 million	$486 million	$3 billion
Fines/Penalties [4]	$71 million	$174 million	$230 million	$682 million	$79 million	$1.2 billion
Overall License Sanctions [5]	3,657	3,585	4,265	3,500	4,498	19,515
Withdrawn	2,498	2,857	3,380	2,843	3,578	15,156
Denied/Revoked/ Suspended/ Conditioned/Barred	1,159	728	885	657	878	4,307

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

2017-2018 NASAA Enforcement Section and Project Groups

SECTION COMMITTEE

Christopher Gerold (NJ), Chair
Joseph Rotunda (TX), Vice-Chair
Patrick Ahearn (MA)
Jesse Devine (NY)
Ricky Locklar (AL)
Jake van der Laan (NB)
Jason Roy (MB), Canadian Liaison
A. Valerie Mirko, NASAA Liaison

PROJECT GROUPS

COMMODITIES & DERIVATIVES ENFORCEMENT

David Cheval (CO), Chair
Paula Bouldon (IL)
Max Brauer (MD)
Vincent Ledlow (IA)
Ann Rankin (VA)

DEPOSITION & LITIGATION SKILLS TRAINING

Don Young (AB), Chair
Michael Cameron (NE)
Yvonne Chisholm (ON)
Zesely Haislip (NC)
William Healy (MD)
Janice Hitzeman (OH)
Travis Iles (TX)
Robin Jacobs (WI)
Christie Johnson (ON)
Ryan Millecam (AZ)
Gerald Rome (CO)
Amanda Senn (AL)
Benjamin Schrope (NM)
Jesse Devine (NY), Enforcement Section Liaison

ENFORCEMENT PUBLICATIONS AND MANUALS

Harvey McClesky (OH), Chair
Michael Cameron (NE)
Amy Folk (NC)
Kelsey Heaton (TX)
Emily Kisicki (VT)
Holly Mack-Kretzler (WA)
Caroline L. Smith (OR)
Vincent Smith (WV)
Danielle Stoumbos (CA)
Joseph Rotunda (TX), Enforcement Section Liaison

ENFORCEMENT TECHNOLOGY

Jake van der Laan (NB), Chair
Rodney Griess (NE), Vice-Chair
Taylor Faw (SC)
Vince La Marca (ON)
Adrian LaRochelle (NH)
Paul Lock (KS)
Marion Quick (DE)
Heidi Schedler (NS)
Brodie Mark Shannon (NB)
Jason Wolf NASAA Liaison

ENFORCEMENT TRAINING

Jeffrey Spill (NH), Co-Chair
Tracy Meyers (SC), Co-Chair
Shawn Beck (NM)
Alex Calero (CA)
Michael Gantt (AL)
Jeramy Heintz (TX)
James Moore (AB)
Rebecca Reilly (NY)
Glenn Skreppen (PA)
Lori Toledano (ON)
Jason Roy (MB), Enforcement Section Liaison

ENFORCEMENT ZONES

Zone 1 (Northeast) Eric Forcier (NH)
Zone 2 (Southeast) Tracy Meyers (SC)
Zone 3 (Mid-Atlantic) Jonathan Hawkins (VA)
Zone 4 (Central) Roger Patrick (OH)
Zone 5 (South/Central) Campbell McLaurin (AR)
Zone 6 (Mountain) (Vacant)
Zone 7 (Western) Jack McClellan (WA)
Zone 8 (Canadian) Christie Johnson (ON)
Patrick Ahearn (MA), Enforcement Section Liaison

NASAA

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

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

For more information, visit: www.nasaa.org



NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
750 First Street N.E., Suite 1140
Washington, D.C. 20002
202-737-0900
Fax: 202-783-3571
www.nasaa.org

August 7, 2018

Submitted electronically to rule-comments@sec.gov

Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: Proposed Regulation Best Interest, File No. S7-07-18; Proposed Form CRS Relationship Summary, File No. S7-08-18; Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers, File No. S7-09-18

Dear Mr. Fields:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am submitting this initial letter regarding the above-referenced proposals published by the Commission on April 18, 2018. NASAA is continuing its review of the proposals and is preparing a comment letter responding to specific components of the proposals. We anticipate filing our comment letter with the Commission on or before August 30 and, based on discussions with SEC staff, understand that the delayed filing of our detailed comment letter will not preclude consideration of NASAA's views with respect to any potential final rulemakings.

NASAA supports the SEC's efforts to elevate the current suitability standard for broker-dealers and address practices by investment advisers that may not be consistent with their fiduciary duties. We believe the Commission's approach of raising the standard for broker-dealers while not weakening investment advisory standards is the correct one. The proposals represent a good initial step; however, we believe the proposals need significant improvements to serve the best interests of investors.

NASAA is particularly supportive of the Commission's effort to raise the broker-dealer standard of care through focusing on greater transparency, restricting the use of misleading broker-dealer titles, and implementing strong conflict mitigation standards. In each area, however, the proposals would leave broker-dealers in a position to put their own interests ahead

[1] NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as the forum for these regulators to work with each other in an effort to protect investors at the grassroots level and to promote fair and open capital markets.

President: Joseph Borg (Alabama)
President-Elect: Michael Pieciak (Vermont)
Executive Director: Joseph Brady
Secretary: Gerald Rome (Colorado)
Treasurer: Tom Cotter (Alberta)
Directors: Pamela Epting (Florida)
Bryan Lantagne (Massachusetts)
Melanie Senter Lubin (Maryland)
Tanya Solov (Illinois)

of their clients. For instance, Regulation Best Interest should explicitly prohibit certain conflicts tied to agents' financial incentives, not merely leave it to broker-dealers to evaluate whether they have cured such conflicts through adequate disclosures and mitigative measures.

The Commission's proposal to address the proliferation of misleading titles is also to be commended. The use of the word "advisor" or "adviser" by persons whose primary goal is to sell a product and whose compensation is based on the sale of such products is misleading and confusing. To fully address this issue, the Commission should take a regulatory approach that addresses how a person "holds out" to the public as well as the person's title.

Additionally, any best interest standard imposed on broker-dealers must be applied as broadly as possible under the securities laws and must become operative early in the client relationship. As we will discuss in our comment letter, allowing broker-dealers to otherwise limit the application of the heightened standard to any of the services they provide will only serve to diminish the important protections to be gained with the implementation of a heightened standard of care. Further, investors' rights of redress must be fully protected under the standard and investors must be provided information regarding how violative conduct by firms and associated persons may be addressed.

It is similarly important that the efficacy of the proposed investor disclosure be validated. Consequently, we reiterate our initial request that the SEC make public the results of its investor testing and provide sufficient additional time to comment on the results of that testing. We encourage the SEC to conduct testing on the Form CRS (or a CRS-like disclosure document) as we believe the document in its current form is difficult to follow and will, therefore, be of limited use to investors.

NASAA appreciates the Commission's effort to address this complex issue and we look forward to sharing our detailed comments in our forthcoming letter.

Sincerely,



Joseph Borg
NASAA President
Director, Alabama Securities Commission

January 23, 2019

The Honorable Maxine Waters
Chair
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Patrick McHenry
Ranking Member
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

RE: H.R. 624, the Promoting Transparent Standards for Corporate Insiders Act

Dear Chair Waters and Ranking Member McHenry:

On behalf of the North American Securities Administrators Association ("NASAA"),[1] I am writing to express support for H.R. 624, the Promoting Transparent Standards for Corporate Insiders Act, which the House is scheduled to consider later this week.

Illegal insider trading generally refers to the buying or selling of a security on the basis of material nonpublic information regarding the security in breach of a duty of trust and confidence owed to the source of the information.[2] The securities laws prohibit insider trading because, among other things, it undermines investor confidence in the fairness and integrity of our securities markets.

Securities and Exchange Commission ("SEC") Rule 10b5-1[3] provides an affirmative defense to insider trading liability for insiders who, in good-faith, enter into prearranged plans to buy or sell securities in the future and who are not at the time in possession of material nonpublic information. Although simple in concept, the rule has proven extremely difficult to enforce. As a practical matter, because all information related to Rule 10b5-1 trading plans is maintained by a corporation, insiders – *i.e.*, the corporate officers or directors – are in effect policing themselves. It is comparatively easy for corporate insiders to manipulate the rule in order to engage in conduct that is tantamount to insider trading by, for example, belittling the potential materiality of nonpublic information or instituting trading plans that can be modified or cancelled prior to execution.

The Promoting Transparent Standards for Corporate Insiders Act would require the SEC to more closely scrutinize practices of corporate insiders by mandating that the SEC study whether the adoption of certain amendments to Rule 10b5-1 would enhance existing prohibitions against insider

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] *See* SEC, *Insider Trading*, *available at* https://www.investor.gov/additional-resources/general-resources/glossary/insider-trading.

[3] 17 C.F.R. § 240.10b5-1.

trading. Specifically, H.R. 624 would direct the SEC to examine the benefit of new restrictions, including: when issuers and issuer insiders can establish trading plans within an issuer-adopted trading window, how many trading plans they can adopt, and the number of modifications to those trading plans.

NASAA strongly shares Congress's interest in preventing insider trading and strengthening protections for retail investors within the securities marketplace. The study required by H.R. 624 is an important step in this direction.[4] We are pleased to support the bill, and we urge its passage.

Thank you for your attention to NASAA's views. Please do not hesitate to contact me, or Michael Canning, NASAA Director of Policy & Government Affairs, at (202) 737-0900, if we may be of any additional assistance.

Sincerely,



Michael S. Pieciak
NASAA President
Commissioner, Vermont Department of Financial Regulation

[4] NASAA notes that Section 2(a)(1)(C) and (D) contemplates amending Rule 10b5-1 to "establish a mandatory delay between the adoption of a trading plan and the execution of the first trade pursuant to such a plan . . ." and "limit the frequency that issuers and issuer insiders may modify or cancel trading plans[.]" Based on that line of reasoning, Congress may wish to consider whether the bill should be amended to also include a delay between a modification to a trading plan and the first trade executed after such modification.

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
750 First Street N.E., Suite 1140
Washington, D.C. 20002
202/737-0900
Fax: 202/783-3571
www.nasaa.org

August 23, 2018

By electronic mail to rule-comments@sec.gov

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Consolidated Comments in Response to SEC Proposed Rulemakings: Regulation Best Interest (File No. S7-07-18), Form CRS Relationship Summary, Amendments to Form ADV, Required Disclosures, and Restrictions on the Use of Certain Names or Titles (File No. S7-08-18), and Standards of Conduct for Investment Advisers (File No. S7-09-18)

Dear Mr. Fields:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am submitting the following consolidated comments and recommendations in response to the proposed rulemakings of the U.S. Securities and Exchange Commission ("SEC" or the "Commission") announced on April 18, 2018: Regulation Best Interest,[2] Form CRS Relationship Summary, Amendments to Form ADV, Required Disclosures, and Restrictions on the Use of Certain Names or Titles,[3] and Standards of Conduct for Investment Advisers[4] (collectively, the "Proposals").

In sum, we believe the Proposals represent a good initial step but that significant improvements are needed in order to promulgate final rules that will serve the best interest of

[1] NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as a forum for these regulators to work with each other to protect investors at the grassroots level and promote fair and open capital markets.

[2] Regulation Best Interest, SEC Release No. 34-83062, File No. S7-07-18 (Apr. 18, 2018), *available at* https://www.sec.gov/rules/proposed/2018/34-83062.pdf.

[3] Form CRS Relationship Summary, Amendments to Form ADV, Required Disclosures in Retail Communications and Restrictions on the Use of Certain Names or Titles, SEC Release No. 34-83063, File No. S7-08-18 (Apr. 18, 2018), *available at* https://www.sec.gov/rules/proposed/2018/34-83063.pdf.

[4] Proposed Commission Interpretation of Conduct for Investment Advisers, SEC Release No. IA-4889, File No. S7-09-18 (Apr. 18, 2018), *available at* https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

President: Joseph Borg (Alabama)
President-Elect: Michael Pieciak (Vermont)
Treasurer: Tom Cotter (Alberta)
Secretary: Gerald Rome (Colorado)
Executive Director: Joseph Brady

Directors: Pamela Epting (Florida)
Bryan Lantagne (Massachusetts)
Melanie Lubin (Maryland)
Tanya Solov (Illinois)

investors as the Commission intends. NASAA encourages the Commission to make modifications to the text of the proposed rules and to substantially reform its guidance on the Proposals prior to their adoption. NASAA agrees that the Commission should act to address investor confusion regarding the different roles of investment advisers and broker-dealers and that the Commission should raise the current standard of care applicable to broker-dealer recommendations from suitability to a standard akin to the fiduciary duties owed by investment advisers. We believe the Commission's approach of raising the standard for broker-dealers, while not weakening the current standard applicable to investment advisers, is the correct one. NASAA supports the Proposals' effort to address conflicts of interest, improve fee transparency, restrict the use of potentially misleading professional titles, and clarify investment adviser conflict of interest obligations.

NASAA especially appreciates Chairman Clayton's leadership in advancing this important regulatory priority. We look forward to further engagement with Chairman Clayton, the Commissioners, and the SEC staff as the Commission develops the Proposals into final rulemakings. Given our members' shared responsibility with the SEC for oversight of the firms and individuals that will be impacted by the Proposals, NASAA is anxious to work closely with the Commission on further refinements to the Proposals and we hope our constructive comments are well received and considered fully.

I) Executive Summary

As set out more fully below in the body of this letter, we encourage the Commission to revise the Proposals so they will be more consistent with a standard designed to align broker-dealer conduct with the best interests of investors and investors' reasonable expectations. Our comments below are aimed at clarifying and expanding the scope of the new conduct standard for broker-dealers, specifying the types of practices that would be prohibited under the new broker-dealer standard, establishing clearer lines of demarcation between investment advisory and broker-dealer activities, preserving investor rights and remedies, improving the effectiveness of proposed Form CRS, and expanding how the Commission proposes to move forward on the use of certain professional titles.

Generally, our recommendations on proposed Regulation Best Interest include the following:

- Label the new regulation and its new eponymous duty obligation to act in customer's best interest the "Broker-Dealer Standard of Conduct" rather than "Regulation Best Interest" to avoid conflations of broker-dealer's best interest duties and investment adviser's fiduciary duties.
- Define the new broker-dealer standard of conduct as Commissioner Stein has proposed and expand the scope of this duty to encompass all investors and all securities products.

- Clarify the requirements necessary to satisfy the new broker-dealer standard of conduct by adding specific factors that must be met and by broadening broker-dealer conflict of interest mitigation and disclosure obligations.
- Prohibit certain practices by broker-dealers and their associated persons (particularly those involving financial incentives) as *per se* incompatible with the new broker-dealer standard of conduct.
- Establish through rulemaking guidance more definite borderlines between investment advisory and broker-dealer activities so as to effectuate longstanding congressional intent underlying the broker-dealer incidental practice exclusion from the Investment Advisers Act.
- Require broker-dealers and their associated persons to consider securities products beyond just those offered by the firm itself when making recommendations under the new broker-dealer standard of conduct.
- Clarify through rulemaking guidance the rights and remedies the Commission anticipates investors will have in pursuing violations of the new broker-dealer standard of conduct and expressly declare that the new standard is not intended to preempt any state laws or regulations.
- Limit the scope of impermissible broker-dealer titles beyond just "adviser" or "advisor" to address how associated persons of broker-dealers hold themselves out to the public.
- Conduct comprehensive testing of proposed Form CRS to evaluate its usefulness to investors and, at such time as the form is adopted, allow firms some flexibility in implementing the disclosures so as to tailor the content for their customers' needs.
- Defer to state securities regulators regarding registration of investment adviser representatives and any potential continuing education requirement for these persons.

We look forward to further engagement with the SEC on our comments as the Commission moves forward with these important rulemakings.

II) Regulation Best Interest

NASAA supports raising the broker-dealer standard of care for recommendations to customers about securities or investment strategies provided the end result is enhanced protection and recourse for investors subject to abusive advice and sales practices. Moving from the current investor protection floor of FINRA's suitability standards to a true heightened standard akin to an investment adviser's fiduciary duty should necessarily change the status quo by curbing abusive sales and advisory practices. Unfortunately, much of the Commission's guidance surrounding the new broker-dealer standard of care indicates it will be interpreted (at least by the SEC) to preserve

the status quo so that all existing business models, products, and practices can persist notwithstanding their known potential for investor harm.

The guidance in the Proposals, and in particular the guidance on proposed Regulation Best Interest, appears to give broker-dealers free rein to offer advisory services beyond what the broker-dealer incidental practice exclusion from the Investment Advisers Act reasonably should be interpreted to permit.[5] The Commission characterizes the type and frequency of advice provided by broker-dealers as a regular function of the relationship between broker-dealers and their customers.[6] While we agree that access to a variety of products and services is important for investors and that broker-dealers should be able to provide very limited advice, the questionable goal of preserving an antiquated broker-dealer business model should not undermine investor protection necessities nor undercut existing registration requirements. We believe this foundational defect in proposed Regulation Best Interest can be remedied by revising proposed Rule 15*l*-1 and the Commission's guidance thereto. Separately, the Commission should also spell out the rights and remedies available to investors harmed by a broker-dealer's failure to act consistent with their obligations under the new conduct standard as any effort to elevate the broker-dealer standard of care will be in vain without clear remedies for breach of the standard.

For the most part, NASAA supports proposed Rule 15*l*-1 as well as the structure and language utilized in Regulation Best Interest. We believe the proposal should be revised in five general areas, though:

1. changing the title of the regulation and the labeling of the duty throughout from "Regulation Best Interest" to "Broker-Dealer Standard of Conduct" (to avoid conflating broker-dealer and investment adviser duties and lessen investor confusion on this issue);
2. broadening the scope of the new duty to apply to recommendations made to any broker-dealer customer, striking the "retail" qualifier throughout the text of proposed Rule 15*l*-1;[7]
3. clarifying the requirements necessary to meet the broker-dealer standard of conduct by emphasizing specific metrics that must be reviewed in assessing whether a recommendation is in the best interest of a particular customer (by adding "risks" and "costs," where currently omitted, to the factors enumerated in subparagraph (a)(2)(i));

[5] *See* 15 U.S.C. § 80b-2(a)11(C).

[6] *See* Regulation Best Interest, *supra* note 2, at 21 ("There is broad acknowledgement of the benefits of, and support for, the continuing existence of the broker-dealer model as an option for retail customers seeking investment advice . . . .") and 39 ("We also share concerns raised by commenters about retail customers losing access to advice they receive through recommendations from broker-dealers . . . ."

[7] *See id.* at 91 ("Should the Commission broaden or limit the scope of individuals to whom Regulation Best Interest applies? For example, should it apply to small business entities such as a sole proprietorship? Why or why not?").

4. broadening broker-dealers' conflict of interest obligations under subparagraph (a)(2)(iii) of the proposed rule to include policy, procedure *and practice* obligations applicable to both firms and their associated persons on a transaction-by-transaction basis; and

5. inserting a new subsection defining the standard of conduct for broker-dealers.

These revisions to Rule 15*l*-1 as proposed are reflected in the Attachment to this letter.

NASAA also has significant concerns with the guidance developed by the Commission as part of proposed Regulation Best Interest. At its core, a rule purporting to require firms and investment professionals act in the "best interest" of their clients must have a merit component that would presumptively require those professionals to recommend products and strategies that are, in the professional's informed and expert judgment, the best or most prudent fit for their clients. Where there is a plethora of suitable alternatives (as is often the case), the expectation should be that the professional will recommend the product or strategy that is best suited to achieving the client's financial goals. As the proposing release makes clear, the Commission does not interpret the phrase "best interest" along those lines. Rather, the Commission interprets "best interest" in such a manner that, with disclosure, brokers can continue recommending investments and strategies that are high cost, complex, illiquid and risky as nonetheless in a customer's "best interest" even where there are cheaper, simpler, more liquid and safer alternatives. It is difficult to square this outcome with a regulation intended to put investors' interests first.

In NASAA's view, such conduct would not satisfy the fiduciary duties of care and loyalty that investment advisers have to act in their clients' best interests. To be sure, the Commission's proposing rule release cites no controlling case law or supporting interpretive guidance that has ever found such conduct by an investment adviser to be consistent with (much less satisfy) the principles underlying a fiduciary standard of care. (And, to the extent the Commission is aware of investment advisers routinely engaging in such conduct without consequence, it should utilize its examination and enforcement authority to redirect and, if necessary, remove such actors.) In light of the foregoing, NASAA understands and shares Commissioner Stein's concern that the Commission's proposed guidance on Regulation Best Interest would result in a "best interest" standard for broker-dealers that is not meaningfully better than existing suitability standards. To guard against that, NASAA supports Commissioner Stein's recommendation that the new standard be specifically defined so that calls are made in favor of investors and, as suggested above, that the care and conflict of interest obligations be clarified to ensure that key factors are weighed in the investor's favor.

The following are specific areas responsive to the Commission's proposed rulemaking and guidance related to the overarching "best interest" obligation that NASAA believes should be reformed to effectively elevate the broker-dealer standard of care and ameliorate investor confusion regarding the comparative roles and duties owed by broker-dealers and investment

advisers. Americans increasingly rely on their own savings to secure their retirement and to fund significant expenditures such as a child's education. Research shows investors mistakenly believe they are paying broker-dealers and their agents to provide advice in their best interests and that investment professionals are obligated by law to do so.[8] Securities regulations should catch up with these reasonable expectations.

1. Scope of the new Broker-Dealer Standard of Conduct

Under the proposed broker-dealer standard of conduct outlined in Regulation Best Interest, broker-dealers and their agents would be obligated to ensure any recommendations they make to retail customers regarding securities or investment strategies are in the customers' "best interests." This duty is described as "act[ing] in the best interest of the retail customer at the time the recommendation is made without placing the financial or other interest of the broker, dealer, or a natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer."[9] The duty would contain subsidiary disclosure, care and conflict of interest obligations.[10]

With respect to what it means for a broker-dealer to act in a customer's "best interest," we support – and encourage the Commission to adopt – the functional definition of the term offered by Commissioner Stein in her April 18, 2018, Public Statement on the Proposals, with two minor revisions.[11] We believe the term "best interest," if it is retained by the Commission to brand this rulemaking, should be described as follows:

> "To act in the best interest" means when a broker, dealer, or natural person who is an associated person of a broker or dealer, makes a recommendation, the recommendation reflects the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use taking into consideration all of the facts and circumstances, including the costs and risks of the recommendation, in light of the investment profile of the Customer to whom the recommendation is made.[12]

---

[8] *E.g.*, Regulation Best Interest, *supra* note 2, at 20 n.28 (discussing research into investor expectations by the RAND Corporation and by the Consumer Federation of America and other organizations).

[9] Regulation Best Interest, *supra* note 2, at 44.

[10] *See id.* at 44-45.

[11] *See* Commissioner Kara Stein, Statement on Proposals Relating to Regulation Best Interest, Form CRS, Restrictions on the Use of Names or Titles, and Commission Interpretation Regarding the Standards of Conduct for Investment Advisers (Apr. 18, 2018), https://www.sec.gov/news/public-statement/stein-statement-open-meeting-041818.

[12] This definition modifies Commissioner Stein's proposal by making clear the "best interest" standard applies to all customers, not just retail customers, and that the factors to consider in evaluating compliance with the duty include costs and risks in light of the customer's investment profile.

Adopting this functional definition would accomplish several things.

First, our proposed definition would expand the scope of Regulation Best Interest, making it universally applicable for all investors. Second, our proposed definition would make clear that the best interest duty is objective, not subjective to the broker-dealer or agent, and that it must be exercised reasonably. Third, this functional definition expressly invokes the principles of care, skill, prudence, and diligence that a broker-dealer or agent's conduct will be evaluated against. Fourth, it includes a temporal component, expressly requiring that the conduct be evaluated as of the time the recommendation is made and in light of all relevant facts and circumstances including the customer's investment profile. These changes would help "level the playing field" between sophisticated and retail investors and would do so in ways that would be easy for retail investors to understand.[13]

Regulation Best Interest as proposed is principles-based; the Commission has not elected to proscribe certain specific types of activities. If the Commission maintains this principles-based approach, it should provide clearer guidance on the types of conduct that would be permissible or impermissible under the new standard. Such guidance would be necessary for firms to understand their compliance obligations and for investors to better understand the contours of the duty owed to them. As discussed below, we believe the Commission should declare certain conflicts of interest tied to compensation and practices that incentivize broker-dealers and their associated persons to put their interests ahead of their customers' as *per se* impermissible under Regulation Best Interest as proposed.

The proposal would require broker-dealers to use "reasonable diligence" in fulfilling their duty of care. The proposal describes this as "similar to the standard of conduct that has been imposed on broker-dealers found to be acting in a fiduciary capacity"[14] and states the required amount of diligence "will vary depending on, among other things, the complexity of and risks associated with the recommended security or investment strategy and the broker-dealer's familiarity with the recommended security or investment strategy."[15] Commission guidance should clarify these points further, though. We encourage the Commission to diagram in detail several hypothetical examples of sufficient or insufficient diligence in the context of fulfilling the best interest obligation.

---

[13] *See* Commissioner Robert Jackson, Statement on Proposed Rulemakings Relating to Investment Adviser / Broker-Dealer (IABD) Standards of Conduct (Apr. 18, 2018), https://www.sec.gov/news/public-statement/proposed-rulemaking-retail-investor-relationships-investment-professionals.

[14] Regulation Best Interest, *supra* note 2, at 134 n.222.

[15] *Id.* at 139.

The proposal requests feedback on the scope of the "retail customer" definition.[16] A retail customer is defined as any "person, or the legal representative of such person," who receives "a recommendation of any securities transaction or investment strategy involving securities" from a broker, dealer or associated person thereof and who "uses the recommendation primarily for personal, family, or household purposes."[17] A "person" can include a natural person as well as a non-natural persons (such as a trust) that exists for the benefit of a natural person.[18] We believe Regulation Best Interest should be extended to include *all* customers, not just "retail customers," as we can think of no reason why all investors should not receive the benefit of this new standard regardless of their wealth, sophistication, or legal personhood.

Among the many questions posed in the proposal is whether a broker-dealer's "best interest" duty should apply to recommendations as to the type of account the customer opens or maintains with the firm.[19] We believe that, notwithstanding the premise underlying this request for comment, proposed Regulation Best Interest would indeed apply to such recommendations because they bear directly on the investment strategy being used for the customer. We believe that *any* recommendation from a broker-dealer or agent related to a securities transaction or investment strategy involving securities will fall under Regulation Best Interest unless it is expressly exempted from such treatment by the SEC.[20] There need only be a minimal nexus to a security or investment strategy for the "best interest" duty to attach.[21] Regulation Best Interest therefore will apply, for example, to sales of variable annuities and other nontraditional securities consistent with existing Commission guidance. It will also apply to recommendations to hold or to not engage in a particular securities transaction or strategy. In sum, we encourage the Commission to acknowledge in any final rulemaking what we believe existing law already implies, namely that Regulation Best Interest will apply to all recommendations regarding securities or investment strategies, including recommendations regarding account types and variable annuity sales.

---

[16] *Id.* at 83-91.

[17] *See* Proposed Rule 15(l)-1(b)(1).

[18] Regulation Best Interest, *supra* note 2, at 85.

[19] *Id.* at 93-94 ("Should the Commission extend Regulation Best Interest to recommendations of account types even if the recommendation is not tied to a securities transaction? If so, what factors should a broker-dealer consider in making a recommendation of an account type? Should the factors differ if the account type recommended is discretionary versus nondiscretionary? Should they differ for dual-registrants versus standalone broker-dealers?").

[20] For example, FINRA Rule 2111.03 expressly exempts certain communications from treatment as recommendations as a matter of policy in order that these activities not be included within the scope of Rule 2111.

[21] Regulation Best Interest as proposed would apply well tread standards of what constitutes a "recommendation" under FINRA rules. *See* Regulation Best Interest, *supra* note 2, at 73 – 83. FINRA rules interpret this term broadly and apply it to all manner of securities contexts. *See, e.g.*, FINRA Regulatory Notice 12-25, *Suitability*, at 4 – 5 (May 2012); FINRA Rule 2111 (Suitability) FAQs, http://www.finra.org/industry/faq-finra-rule-2111-suitability-faq.

2. Scope of Products Offered By a Broker-Dealer and Comparison with Alternatives

NASAA strongly disagrees with the Commission's apparent position that a broker-dealer could satisfy its "best interest" duties by recommending securities from a very limited menu of products without any comparison whatsoever to alternatives beyond this limited menu.[22] How could a broker-dealer or an associated person of the broker-dealer ever make a good faith statement that a recommendation is in a customer's best interest without first exploring whether there are cheaper, simpler, more liquid, and less risky alternatives available to achieve the customer's investment objectives? Such an interpretation of a "best interest" conduct standard is contrary to the care obligation articulated in the text of the proposed rule, which requires broker-dealers and associated persons to "exercise reasonable diligence" and "prudence" in recommending products. There is nothing reasonable or prudent about a firm or its associated persons recommending only the product offerings at his or her firm while ignoring alternative investment opportunities and products elsewhere that may better serve the customer's overall investment needs. The Commission should revise the language in the proposing release to make clear that broker-dealers and associated persons do in fact need to look outside the firm in considering factors such as cost, complexity, liquidity, and risk of readily available products and investment strategies that meet the customer's investment profile for purposes of making a best interest recommendation. This change would not require that broker-dealers and their associated persons become knowledgeable about every investment that is offered or sold; we are not suggesting such a maximalist application of the basic principle underlying a best interest duty. Rather, broker-dealers and their associated persons should be held accountable for knowing broadly about competing asset classes and investment strategies to ensure that the products offered at the firm, whether limited or expansive in scope, are not merely suitable but are truly in their customers' best interests.

3. Mitigation and *Per Se* Violations of the Best Interest Duty

The proposal identifies several broker-dealer practices whose validity would be questionable under Regulation Best Interest (including sales contests and preferential treatment in the allocation of investment opportunities), noting that these practices would be neither *per se* prohibited nor *per se* acceptable.[23] Rather, the Commission will evaluate such practices on a case-by-case basis to determine whether a broker-dealer's disclosures and efforts to mitigate or eliminate conflicts of interest are sufficient. The proposal concedes, though, that retail customer confusion about the obligations of broker-dealers can "exacerbate the potential for investor harm (such as through a misalignment of investor expectations regarding the level of protection received and the level of protection actually provided)."[24]

---

[22] *See* Regulation Best Interest, *supra* note 2, at 69 ("Are any changes in Regulation Best Interest necessary to make it clear that broker-dealers who offered a limited scope of products nevertheless can satisfy the standard?").

[23] Regulation Best Interest, *supra* note 2, at 53-54.

[24] *Id.* at 37.

Having opened this door, we encourage the Commission to proceed further by declaring these two practices – sales contests and preferential treatment of allocations – *per se* impermissible under Regulation Best Interest. Sales contests are a pernicious feature of brokerage sales activities and necessarily require agents, consciously or not, to put their own interests ahead of customers. We can envision no circumstances under which any sales contest would ever be consistent with a broker-dealer's duties under Regulation Best Interest as proposed, even if the broker-dealer tried to mitigate and fully disclose the conflict.[25] What is more, the continued existence of sales contests and other abusive practices will undermine investors' faith in the basic principles underlying Regulation Best Interest. Sales contests therefore should be banned outright. In addition, there should be no room under Regulation Best Interest for preferential treatment of customers in the allocation of investment opportunities such as initial public offerings. It should be clear that broker-dealers have no freedom to favor their richest or best-connected customers when allocating investment opportunities. Investment allocations should instead be made based upon objective, fair criteria, immune from a broker-dealer's own business self-interest. We also encourage the Commission to provide additional guidance on when other potentially abusive sales practices would fail a best interest analysis.

The Commission requested comment on whether neutral compensation across products could constitute appropriate mitigation.[26] We believe it could. Neutral compensation coupled with full and fair disclosure of material conflicts of interest and fees would be an appropriate way for broker-dealers to satisfy their best interest obligations. This would eliminate the potential for a broker-dealer to favor one product over another based on the broker's own self-interest and, coupled with the duty recommended above to ensure recommendations cover the waterfront with respect to the type of securities in which investors could invest, the Commission would truly place customers on the pedestal to which they should be held by their brokers.

If the Commission is unwilling to take this step and retains the current approach permitting such activities, the Commission should at a minimum provide additional guidance on what types of conflict mitigation measures must be included in a firm's policies and procedures to combat harms associated with these practices. Specifically, a firm's policies and procedures must, at a minimum, require an analysis of the costs and risks of the product as well as the client's financial goals in order to satisfy the "best interest" standard. These factors are especially important given that the proposal would not prohibit selling from a limited menu of products or require an associated person to recommend a product beyond those available on her firm's platform.

[25] These practices would also perforce violate an investment advisers' fiduciary duties. The Commission thus could extend the *per se* scope of broker-dealer prohibited practices under Regulation Best Interest to apply to investment advisers as well.

[26] Regulation Best Interest, *supra* note 2, at 196.

4. Complying with the Best Interest Duty – Account Monitoring

The Regulation Best Interest proposal states that while broker-dealers do not have an ongoing duty to monitor investments or investment recommendations, broker-dealers and their customers may contractually agree for the broker-dealer to do so. The Commission requested comment on whether such ongoing monitoring duties should be subject to a "best interest" duty or deemed to be investment advisory in nature and therefore subject to fiduciary duty standards under the Investment Advisers Act.[27]

Ongoing account monitoring is a *sine qua non* of an investment adviser's fiduciary duty to clients. Broker-dealer duties by comparison are transactional and episodic, as made clear by the Commission's characterization of the relationship and limited duties prescribed as a result.[28] The provision of ongoing monitoring services therefore should be a triggering event for the commencement of an investment advisory relationship to which the Investment Advisers Act should apply.

5. Complying with the Best Interest Duty – Compliance and Supervisory Systems

The proposal states that it would be reasonable for a broker-dealer to use a risk-based compliance system to comply with its "best interest" duties rather than conducting transaction-by-transaction assessments of every recommendation.[29] We urge the Commission to reconsider this approach. No compliance system should ever be treated as satisfying Regulation Best Interest on its own. Rather, implementation of an appropriate compliance system should be treated as a necessary, but not necessarily sufficient, step to comply with the regulation. Broker-dealers must be held to a high standard when executing their "best interest" obligations.

6. Broker-Dealer Exclusion and Discretionary Authority

Section II.F of proposed Regulation Best Interest requests comment on the broker-dealer exclusion and the extent to which broker-dealers should be exempt from the Investment Advisers Act in their exercise of discretionary authority over customer accounts. The current proposal is an excellent opportunity for the Commission finally to commit itself to treating broker-dealers that exercise discretionary trading authority as investment advisers. The Commission thus should undertake to implement its 2007 rule proposal in this regard and ensure "any account over which a broker-dealer exercises investment discretion is subject to the Advisers Act."[30] The broker-dealer

[27] Regulation Best Interest, *supra* note 2, at 70.

[28] *Id.* at 329.

[29] *Id.* at 171.

[30] Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, SEC Release No. IA-2652 at 8 (Sept. 24, 2007), *available at* https://www.sec.gov/rules/proposed/2007/ia-2652.pdf.

exclusion from the Advisers Act should apply only to non-discretionary brokerage accounts in which the only forms of discretion exercised by a broker-dealer is as to: (i) the time and price of execution, (ii) the management of cash, (iii) transactions to satisfy customer margin obligations, and (iv) the selection of securities (such as bonds) according to specific, narrowly defined criteria established by a customer.

7. Dual Registrants

Dually-registered broker-dealers and investment advisers present unique challenges to effective investor protection in a Regulation Best Interest paradigm. The proposal's guidance to dual registrants is that they must comply with the proposed regulation when they act as a broker-dealer but must comply with the Investment Advisers Act when they act as an investment adviser.[31] The proposal does not provide specific instructions for firms walking this tightrope, though, and consequently dually-registered firms will inevitably falter and fail to satisfy their legal duties. Managing such 'hat switching' and remaining compliant with applicable securities laws and regulations is concededly difficult, but financial services firms that voluntarily choose to undertake such business opportunities must abide by the concomitant regulatory obligations this entails.

The Commission should provide guidance in Regulation Best Interest to explain how associated persons should disclose the capacity in which they are acting and whether the information they are providing is a recommendation (subject to "best interest" duties) or advice (subject to a fiduciary duty). Alternatively, the Commission could go a long way toward resolving the problems associated with dual registration by simply stating through guidance that firms with clients that maintain both advisory accounts and brokerage accounts must be treated as advisory clients *in toto*. (This alternative is, in NASAA's view, the substantially preferable approach.)

8. Investor Rights and Remedies

As noted above, the Commission should expressly elaborate on the remedies available to investors when broker-dealers violate their conduct standard. The Commission states in the proposal, "we do not believe proposed Regulation Best Interest would create any new private right of action or right of rescission, nor do we intend such a result."[32] Private claims by investors against their brokers generally proceed through arbitration under rules established by the Financial Industry Regulatory Authority ("FINRA") (though they may in limited instances proceed in federal or state courts as well). We believe the obligations imposed on broker-dealers under the proposal will be enforceable in such arbitrations or litigation under well-established legal theories that exist today. We ask the Commission to expressly affirm its support for this basic principle through its guidance.

[31] *See* Regulation Best Interest, *supra* note 2, at 199-205.

[32] *Id.* at 42.

In any final rulemaking, the Commission should state in guidance that the duties and obligations it is creating under the new conduct standard will be enforceable by customers through existing legal theories and venues open to them. Moreover, the Commission should emphasize the point made in the proposing release that "[s]cienter would not be required to establish a violation of Regulation Best Interest."[33] Regulation Best Interest is being proposed pursuant to the Commission's authority under Section 10 of Securities Exchange Act of 1934 (among others),[34] but it would be extremely unfortunate if a judge or arbitrator interpreted Regulation Best Interest as including a scienter component merely because the SEC included Section 10 as one of its legal authorities for issuing the regulation.

9. Disclosure Obligations

Regulation Best Interest would include an express obligation for broker-dealers to disclose the scope of the proposed customer relationship and material conflicts of interest related thereto.[35] This obligation could be complied with through a relationship summary (*i.e.*, Form CRS) and other standardized disclosures.[36]

We believe this proposed disclosure regime is insufficient. Separate and apart from a broker-dealer's standardized disclosure obligations under the separate Form CRS rulemaking, the Commission should require that broker-dealers disclose under Regulation Best Interest all material facts and conflicts associated with the specific transaction being recommended. Only a transaction-by-transaction disclosure obligation will ensure that broker-dealers are meeting their "best interest" duties and provide investors the level of protection they deserve. Any contrary standard would conflict with the underlying purpose of the proposal of leveling the playing field between investment advisers and broker-dealers, thereby holding broker-dealers to functionally inequivalent legal duties.

With respect to the types of fees that must be disclosed and the standardization of such disclosures, the SEC should consider mandating the use of a version of the Schedule of Miscellaneous Account and Service Fees (the "Model Fee Table") established by a working group

[33] *Id.*

[34] The Commission proposes to issue Regulation Best Interest pursuant to its authority under Section 913(f) of the Dodd-Frank Act and Exchange Act sections 3, 10, 15, 17, 23 and 36. We believe the inclusion of Section 10 is unnecessary; the Commission has more than adequate authority under these other sections. The Commission should ensure that by naming Section 10 as among the proposal's stated bases of authority it is not opening the gates to a Trojan horse of scienter.

[35] Regulation Best Interest, *supra* note 2, at 97-99.

[36] *Id.* at 353.

of NASAA members and brokerage industry representatives in 2014.[37] The version adopted by the Commission should, however, include the fees the customer will pay for all of the services provided by the firm and any other remuneration paid by third parties to the broker-dealer that are related to those services. The Model Fee Table has been successful for those brokerage firms that have adopted it and it provides a clear, concise and standardized approach to the disclosure of miscellaneous broker-dealer fees.

10. No Preemption of State Law

There is no indication in proposed Regulation Best Interest that the Commission is seeking to impact broker-dealer duties under state law in any respect. This is eminently appropriate. It is well settled that federal and state securities laws co-exist and that past and present Congresses intend to maintain only limited preemption of state laws in this field. The SEC rule proposal acknowledges that the duties it proposes would align with duties imposed by state law.[38] There is thus no conflict of laws. Assuming *arguendo* that the Commission could, as a legal principle, preempt state securities laws through the adoption of Regulation Best Interest, we request that the Commission affirm in any final rulemaking that it has no intention of doing so. To the extent this issue ever is litigated, it would be useful to future triers of fact for the Commission to speak to this issue, even if merely in a footnote.

III) Form CRS Relationship Summary, Amendments to Form ADV, Required Disclosures, and Restrictions on the Use of Certain Names or Titles

1. Form CRS Relationship Summary, Amendments to Form ADV and Required Disclosures

NASAA fully supports the Commission's objective of reducing investor confusion as to the differences between broker-dealers and investment advisers. The Commission proposes Form CRS as a means to this end. We appreciate the SEC's efforts to develop Form CRS, however we believe a better approach would be to engage in a comprehensive bottom-up review and revision of the Form ADV and Form BD to incorporate investor education objectives into these existing forms, rather than bolting an entirely new form onto the existing disclosure structure. Form ADV and Form BD are long overdue for reformatting and rewriting (for many reasons). Incorporating an investor education component and updating these forms for the 21st century would be the best long-term solution to the problem of investor confusion. This would also reduce or eliminate duplication across these various forms. (In particular, investment advisers will necessarily duplicate some disclosures between Form ADV Parts 1 & 2 and proposed Form CRS.) But

[37] *See* NASAA Model Fee Disclosure Resource Center, http://www.nasaa.org/industry-resources/broker-dealers/model-fee-disclosure-resource-center/.

[38] *See* Regulation Best Interest, *supra* note 2, at 202, 277.

because we recognize a holistic redesign of Forms ADV and BD is unlikely in the near term, we provide specific comments on the proposed Form CRS below.

The Commission staff included three mock-up Form CRS's in Appendices C through E of the proposal. These examples were drafted for a hypothetical broker-dealer, an investment adviser, and a dually-registered firm. These examples should be withdrawn from the proposal. For while they are avowedly not intended as safe harbors or schoolbook solutions to preparing a Form CRS, their mere existence as an approved expression of the Commission would tend to cabin the stylistic freedom of broker-dealers and investment advisers to craft their own Form CRS disclosures in ways that best speak to their customers. (For instance, we find the comments of Susan Kleiman during the SEC Investor Advisory Committee's June 14, 2018, meeting in Atlanta, Georgia, to be compelling with regard to the need for flexibility and clarity in these disclosures.)[39] Because of the criticality of setting proper standards for the structure and content of Form CRS, we reiterate a request we and numerous other organizations made in a May 21, 2018, letter to Chairman Clayton that the Commission delay implementation of Form CRS until thorough analysis of the form can be completed.[40] Form CRS is unlikely to become palatable to retail investors without thorough pre-release product testing.

This testing should consist, at a minimum, of professionally managed focus groups of retail investors being presented with examples of CRS-like disclosures and queried for their assessments of the form's format, content, and utility. Participants in the focus group should be given various model disclosures and asked to evaluate the clarity of the forms and information. Participants should be further queried as to their comprehension of the content in the disclosure documents. Expending resources in retaining experts to assist the Commission in the design and testing of such disclosures would, in our opinion, be a prudent step to take given the importance of these potential new disclosure documents.

Furthermore, we see no benefit in a "one size fits all" enterprise-wide disclosure document summarizing all the services and fees offered by the firm, as it is likely customers will simply disregard the disclosures. Instead, firms should have some level of flexibility in crafting their own Form CRS so that it is tailored for the different types of customers they service. This would make the forms much more useful to retail investors. Also, while we are not opposed to the SEC setting out required language and placement of certain aspects of the form, as this approach will make it easier for clients to locate this information and make side-by-side comparisons, meaningful Form CRS disclosures cannot be 'cookie cutter' and thus necessarily will have to differ from one firm to the next.

---

[39] *See* Investor Advisory Committee Meeting Webcast (Part 2), June 14, 2018, Statement of Susan Kleiman (beginning at 21:00 mins.), *available at* https://www.sec.gov/video/webcast-archive-player.shtml?document_id=061418iac-2.

[40] *See* Letter to Hon. Jay Clayton (May 21, 2018), *available at* https://consumerfed.org/wp-content/uploads/2018/05/groups-ask-SEC-to-delay-comment-deadline-for-best-interest-proposal.pdf.

In the event the SEC nonetheless moves forward to adopt Form CRS as proposed, we recommend the following revisions to make it more digestible for consumers. First, Form CRS should specify minimum account size and include information on miscellaneous fees different categories of investors can expect to pay. Firms should also have the flexibility to use Form CRS for disclosure of state law requirements that they may be subject to.

Second, the elements of Form CRS should be revised. Currently, Form CRS contemplates disclosure in Item 7, "Additional Information," of where retail investors can find more information about a firm's disciplinary events, services, fees, and conflicts. The descriptor "Additional Information" is too vague to describe the important information in this section. Item 7 should be recast as "Disciplinary History and Customer Rights and Remedies" and this section should include three things: (a) an overview of the firm's disciplinary history (including embedded hyperlinks to the firm's most recent disclosure report on FINRA BrokerCheck or the Investment Adviser Registration Depository ("IARD") when the form is delivered electronically so these reports are just a mouse-click away); (b) a discussion of customer's legal rights and the remedies available to customers in the event of breach (including whether the customer will be subject to mandatory arbitration); and (c) contact information for regulators where investors may file complaints or ask questions about disciplinary history.[41]

Finally, the SEC should amend certain delivery and procedural aspects of Form CRS as proposed. The proposal would require investment advisers to deliver Form CRS to each retail investor at or before entering into an investment advisory agreement and require broker-dealers to deliver the form at or before providing any services.[42] To be effective, Form CRS must be delivered to customers in a timely fashion. Delivery should always precede the provision of any advisory or brokerage services with sufficient time for the customer to review the form and ask questions. Thus, the SEC should not permit Form CRS delivery "at" the time of service but rather should always require delivery "before" the provision of services. As to updates to Form CRS, we would urge the Commission to amend proposed Rule 204-5(b)(4) and proposed Rule 17a-14(c)(4) to require that firms deliver updated Form CRS's whenever there is a change, rather than permitting firms to potentially communicate the information to investors in other ways as has been proposed.[43] In addition, broker-dealers should not use the SEC's Electronic Data Gathering, Analysis and Retrieval System ("EDGAR") to file Form CRS as has been proposed. Rather, broker-dealers should file Form CRS on the WebCRD platform maintained by FINRA for its BrokerCheck reports (and which is related to IARD).

[41] Investors could be directed to www.nasaa.org, where they can find contact information for state regulators.

[42] Form CRS Relationship Summary, *supra* note 3, at 138.

[43] *See id.* at 146 – 47.

2. Restrictions on the Use of Certain Names or Titles

The proposal would prohibit broker-dealers and their associated persons from labeling themselves as an "adviser" (or "advisor") to a retail customer unless they were also licensed as an investment adviser or investment adviser representative. This is appropriate and should be adopted. This rule change will help forestall retail investors' confusion about the different roles and duties owed by broker-dealers/agents and investment advisers/investment adviser representatives.

The Commission requested comment, though, on whether additional terms should be restricted as well or whether other limitations on practice by broker-dealers should be adopted.[44] As a threshold matter, we believe restricting just two words – "adviser" and "advisor" – is insufficient. There are many more terms broker-dealer agents can use to clothe themselves in a fiduciary guise. But rather than creating a lengthy list of additional restricted terms, we believe an approach that combines both an explicit prohibition on the use of "advisor" and "adviser" with enumerated factors aimed at limiting the use of other potentially misleading titles is the better approach.

The Commission thus should adopt a rule along the following lines: broker-dealers and their agents that are not dually-registered as investment advisers or investment adviser representatives cannot use the words "adviser" or "advisor" in their titles or otherwise hold themselves out in a way that could reasonably be expected to convey inaccurate information to any person as to: (i) the nature of the person's registration status; (ii) the person's proficiency, experience or qualifications; (iii) the nature of the person's relationship, or potential relationship, with a registrant; or (iv) the products or services that are provided or that may be provided by the person. (As an example of such a holding out rule, see Rule 13.18, "Misleading Communications," recently proposed by the Canadian Securities Administrators ("CSA") for potential use by provincial securities regulators in that country.)[45]

---

[44] *Id.* at 186.

[45] *See* Reforms to Enhance the Client-Registrant Relationship, CSA Notice and Request For Comment, June 21, 2018 (Annex A, page 9), *available at* https://docs.mbsecurities.ca/msc/registration/en/312021/1/document.do:

> *13.18 Misleading communications*
> *(1) A registered individual must not hold himself or herself out, and a registered firm must not hold itself or its registered individuals out, in a manner that could reasonably be expected to deceive or mislead a person as to any of the following matters:*
> *(a) the proficiency, experience, or qualifications of the registrant;*
> *(b) the nature of the person's relationship, or potential relationship, with the registrant;*
> *(c) the products or services provided, or to be provided, by the registrant.*
> *(2) Without limiting subsection (1), a registered individual must not use any of the following:*

IV) Standards of Conduct for Investment Advisers

We appreciate the SEC's encapsulation of investment adviser duties in the Standards of Conduct for Investment Advisers release.[46] The release is a useful resource. More importantly, though, it should become an enforceable expression of investment adviser law once it is adopted by the Commission pursuant to the Administrative Procedures Act ("APA").[47] The proposal would thereafter stand on its own as a legal expression of the duties owed by investment advisers.

1. Duty to Mitigate Conflicts of Interest

We agree with the proposal that mere disclosure of actual or potential conflicts of interest may not always satisfy an investment adviser's duties under federal or state securities laws.[48] An investment adviser cannot, for example, cure fraudulent conduct through disclosure.[49] The scope of an investment adviser's duty to mitigate conflicts is not well developed in the law and this has not been a source of litigation. We would accordingly encourage the SEC to develop this issue more thoroughly in the investment adviser conduct proposal. In particular, the proposal should incorporate other sources of law to clarify that an investment adviser's duty to mitigate conflicts is an affirmative obligation[50] which must be performed in an objectively reasonable manner.[51] In addition, we encourage the Commission to make the following change to the text of the proposed rulemaking (at footnote 30):

> *"For example, if an adviser advises its clients to invest in a mutual fund share class that is more expensive than other available options when the adviser is receiving compensation that creates a potential conflict and that may reduce the client's*

> *(a) a title, designation, award, or recognition that is based partly or entirely on that registered individual's sales activity or revenue generation;*
> *(b) a corporate officer title unless their sponsoring firm has appointed that registered individual to that corporate office pursuant to applicable corporate law;*
> *(c) a title or designation, unless the individual's sponsoring firm has approved the use by that registered individual of that title or designation.*

[46] Proposed Commission Interpretation of Conduct for Investment Advisers, *supra* note 4.

[47] *Cf. NRDC v. EPA*, 643 F.3d 311 (D.C. Cir. 2011) (vacating regulatory guidance regarding compliance with the federal Clean Air Act by the Environmental Protection Agency because it had not been issued pursuant to public notice and comment as required by the APA).

[48] *See* Proposed Commission Interpretation of Conduct for Investment Advisers, *supra* note 4, at 23.

[49] *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 190 (1963) (discussing congressional intent underlying the Investment Advisers Act of 1940 to "mitigate and, so far as is presently practicable to eliminate" fraudulent practices by requiring disclosure of all actual or potential conflicts of interest).

[50] *United States v. Brookridge Farm*, 111 F.2d 461, 466 (10th Cir. 1940).

[51] *Austin Hill County Realty v. Palisades Plaza*, 948 S.W.2d 293, 299 (Tex. 1997).

> *return, the adviser ~~may violate~~ would violate its fiduciary duty and the antifraud provisions of the Advisers Act if it does not, at a minimum, provide full and fair disclosure of the conflict and its impact on the client and obtain informed client consent to the conflict."*[52]

2. Minimum Financial Requirements for SEC-Registered Advisers

The investment adviser proposal requests comment on whether SEC-registered investment advisers should be subject to a financial responsibility obligation (such as broker-dealers are under the net capital rule).[53] The proposal posits NASAA's own Model Rule 202(d)-1 (the "NASAA Model Rule") as a potential guidepost.[54]

The NASAA Model Rule was designed for smaller investment advisers registered and regulated by state securities administrators. It is not geared for larger investment advisers overseen by the SEC. Accordingly, to the extent the SEC seeks to implement financial responsibility standards for investment advisers, the broker-dealer net capital rule is likely a more appropriate guidepost than the NASAA Model Rule.

3. Investment Adviser Representative Registration and Continuing Education

The proposal requests comment on whether investment adviser representatives should be "subject to federal continuing education and licensing requirements" by the SEC.[55] Today there are approximately 350,000 investment adviser representatives associated with SEC-registered or state-registered investment advisers. State securities administrators license these individuals; the SEC does not. (Many of these individuals are also dually-registered broker-dealer agents registered with FINRA.) This apportioning of regulatory responsibilities is entirely appropriate.

The SEC already regulates thousands of broker-dealers and investment advisers. It should not stretch its limited resources even further by taking on direct regulatory responsibility for hundreds of thousands of investment adviser representatives. Rather, state securities regulators should continue performing this function. NASAA and its members have developed robust rules and processes (including a testing regime) to oversee investment adviser representatives. As the Commission is aware, NASAA is also studying a potential continuing education requirement for

---

[52] *See* Proposed Commission Interpretation of Conduct for Investment Advisers, *supra* note 4, at 12.

[53] *Id.* at 35 – 37.

[54] Minimum Financial Requirements for Investment Advisers, NASAA Model Rule 202(d)-1 (as amended Sept. 11, 2011), *available at* http://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Minimum-Financial-Requirements.pdf.

[55] Proposed Commission Interpretation of Conduct for Investment Advisers, *supra* note 4, at 28 – 31.

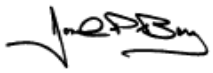
these investment adviser representatives. NASAA welcomes continued dialogue with the SEC staff as NASAA develops this issue, but SEC rulemaking on this front is wholly unnecessary.

* * *

The Commission seeks through the Proposals to raise the duties of care owed by broker-dealers, address the confusion among investors regarding the differing conduct standards, and make clearer the various aspects of the fiduciary duty standard applicable to investment advisers. The Commission is seeking to do all of this without favoring or disfavoring the broker-dealer or investment advisory business models. We recognize that threading this needle is not easy. As the SEC staff and Commissioners work to review stakeholder comment letters and consider potential revisions for what ultimately may become a final rule, we want to emphasize that it is more important that the Proposals be implemented appropriately than that this be done quickly. Investor protection should be the first priority and industry objections to cost or the impacts on business should be taken with the proverbial "grain of salt," as regulators have heard similar complaints in the face of new regulatory requirements in the past. The financial services industry is adaptive and can modify operations to account for new regulatory requirements as demonstrated by their work to comply with the Department of Labor's now defunct 2016 fiduciary duty rule.[56]

In conclusion, for the reasons discussed herein, we generally support the Proposals, however we recommend the Commission undertake certain revisions to the Proposals to improve them prior to adoption. If you have any questions about this letter or would like to discuss these issues, please contact me (joseph.borg@asc.alabama.gov or 334-242-2984) or NASAA Executive Director Joseph Brady (jb@nasaa.org or 202-737-0900).

Sincerely,



Joseph P. Borg
NASAA President
Director, Alabama Securities Commission

[56] *See* Deloitte, The DOL Fiduciary Rule: A Study on How Financial Institutions Have Responded and the Resulting Impacts on Retirement Investors, (Aug. 9, 2017), https://www.sifma.org/wp-content/uploads/2017/08/Deloitte-White-Paper-on-the-DOL-Fiduciary-Rule-August-2017.pdf (finding that, among the 21 financial services firms surveyed, implementation of the DOL rule resulted at most in only temporary business disruptions).

ATTACHMENT

17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

Text of the Proposed Rules

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 is revised by adding sectional authorities for section 240.15*l*-1 to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78dd, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 *et seq.*, and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; Pub. L. 111-203, 939A, 124 Stat. 1887 (2010); and secs. 503 and 602, Pub. L. 112-106, 126 Stat. 326 (2012), unless otherwise noted.

* * * * *

Section 240.15*l*-1 is also issued under Pub. L. 111-203, sec. 913, 124 Stat. 1376, 1827 (2010).

* * * * *

2. Add § 240.15l-1 to read as follows:

§ 240.15*l*-1 ~~Regulation Best Interest~~Broker-Dealer Standard of Conduct.

(a) Best Interest Obligation.

(1) A broker, dealer, or a natural person who is an associated person of a broker or dealer, when making a recommendation of any securities transaction or investment strategy involving securities to a ~~retail~~ customer, shall act in the best

interest of the ~~retail~~ customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the ~~retail~~ customer.

(2) The best interest obligation in paragraph (a)(1) shall be satisfied if:

(i) Disclosure Obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, prior to or at the time of such recommendation, reasonably discloses to the ~~retail~~ customer, in writing, the material facts relating to the scope and terms of the relationship with the ~~retail~~ customer~~, including~~ and all material facts, including risks, costs, and conflicts of interest, that are associated with the recommendation.

(ii) Care Obligation. The broker, dealer, or natural person who is an associated person of a broker or dealer, in making the recommendation exercises reasonable diligence, care, skill, and prudence to:

(A) Understand the potential risks and rewards associated with the recommendation, and have a reasonable basis to believe that the recommendation could be in the best interest of at least some ~~retail~~ customers;

(B) Have a reasonable basis to believe that the recommendation is in the best interest of a particular ~~retail~~ customer based on that ~~retail~~ customer's investment profile and the potential risks, costs, and rewards associated with the recommendation; and

(C) Have a reasonable basis to believe that a series of recommended transactions, even if in the ~~retail~~ customer's best interest when viewed in isolation, is not excessive and is in the ~~retail~~ customer's best interest when taken together in light of the ~~retail~~ customer's investment profile.

(iii) Conflict of Interest Obligations.

(A) The broker, ~~or~~ dealer, or natural person who is an associated person of a broker or dealer ~~establishes, maintains, and enforces written~~

~~policies and procedures reasonably designed to~~ identifies~~y~~ and at a minimum discloses, or eliminates, all material conflicts of interest that are associated with such recommendations in accordance with policies and procedures established, maintained, and enforced by the broker or dealer.

(B) The broker, ~~or~~ dealer, or natural person who is an associated person of a broker or dealer ~~establishes, maintains, and enforces written policies and procedures reasonably designed to~~ identifies~~y~~ and discloses and mitigates, or eliminates, material conflicts of interest arising from financial incentives associated with such recommendations in accordance with policies and procedures established, maintained, and enforced by the broker or dealer.

(b) *Definitions*. Unless otherwise provided, all terms used in this rule shall have the same meaning as in the [Securities Exchange Act of 1934]. In addition, the following definitions shall apply:

(1) *Act in the Best Interest* means making recommendations that reflect the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use taking into consideration all of the facts and circumstances, including costs, in light of the investment profile of the customer to whom the recommendation is made.~~-~~

(2) ~~*Retail*~~ *Customer* means any person, or the legal representative of such person, who~~:~~

~~(A) R~~ receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer, or a natural person who is an associated person of a broker or dealer~~; and~~

~~(B) Uses the recommendation primarily for personal, family, or household purposes~~.

(3~~2~~) ~~*Retail*~~ *Customer Investment Profile* includes, but is not limited to, the ~~retail~~ customer's age, where applicable, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the broker, dealer, or a natural person who is an associated person of a broker or dealer in connection with a recommendation.

3. Amend § 240.17a-3 by adding new paragraph (a)(25) to read as follows:

§ 240.17a-3 Records to be made by certain exchange members, brokers and dealers.
(a)***

(25) For each retail customer to whom a recommendation of any securities transaction or investment strategy involving securities is or will be provided:
(i) A record of all information collected from and provided to the retail customer pursuant to § 240.15*l*-1, as well as the identity of each natural person who is an associated person, if any, responsible for the account.

(ii) For purposes of this paragraph (a)(25), the neglect, refusal, or inability of the retail customer to provide or update any information required under paragraph (a)(25)(i) of this section shall excuse the broker, dealer, or associated person from obtaining that required information.

* * * * *

4. Amend § 240.17a-4 by revising paragraph (e)(5) to read as follows:

§ 240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.

* * * * *
(e) ***
(5) All account record information required pursuant to § 240.17a-3(a)(17) and all records required pursuant to § 240.17a-3(a)(25), in each case until at least six years after the earlier of the date the account was closed or the date on which the information was collected, provided, replaced, or updated.

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
750 First Street N.E., Suite 1140
Washington, D.C. 20002
202/737-0900
Fax: 202/783-3571
www.nasaa.org

January 30, 2019

By Email to: shareholderproposals@sec.gov

U.S. Securities and Exchange Commission
Division of Corporation Finance
Office of Chief Counsel
100 F Street, N.E.
Washington, D.C. 20549

RE: Johnson & Johnson's December 11, 2018, Rule 14a-8 Letter

Ladies and Gentlemen:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am writing in reference to the December 11, 2018, letter from Johnson & Johnson's outside counsel (the "Johnson & Johnson Letter") requesting the Staff of the Division of Corporation Finance (the "Staff") of the U.S. Securities and Exchange Commission ("SEC") concur with Johnson & Johnson's view that the company may exclude a shareholder proposal submitted by The Doris Behr 2012 Irrevocable Trust (the "Proposal") from the company's 2019 proxy materials.[2] We agree that the Proposal should be excluded from the company's 2019 proxy materials. We have not consulted with the company or its legal counsel and are independently submitting this letter to share the reasons why we support rejection of the Proposal.

NASAA has long supported efforts to protect, and in some cases expand, the means by which harmed investors can recover losses. This includes advocating for measures that provide investors with choice in the dispute resolution process and against mandatory arbitration agreements in the securities industry. Investor confidence in fair and equitable markets is critical to the stability of the securities markets and long-term investments.[3] The Proposal precludes

[1] Organized in 1919, NASAA is the oldest international organization devoted to investor protection. NASAA's membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] The Johnson & Johnson Letter is publicly available on the SEC's website at: https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2018/dorisbehr121118-14a8-incoming.pdf.

[3] NASAA remains concerned with the widespread use of mandatory pre-dispute arbitration clauses in customer contracts used by broker-dealers and, most recently, investment advisers. NASAA believes that investors must have a choice of forum when it comes to resolving disputes with their investment professionals. *See, e.g.*, Letter from

President: Michael Pieciak (Vermont)
President-Elect: Frank Borger-Gilligan (Tennessee)
Past-President: Joseph Borg (Alabama)
Executive Director: Joseph Brady
Secretary: Pamela Epting (Florida)
Treasurer: Tom Cotter (Alberta)
Directors: William Beatty (Washington)
Travis Iles (Texas)
Melanie Senter Lubin (Maryland)
Tanya Solov (Illinois)

choice of forum in an even more draconian way, as it would also bar defrauded investors' rights to class action and appeal remedies.

As outlined in the Johnson & Johnson Letter, the Proposal would require the company to put to shareholder vote a resolution that the company's Board of Directors should "take all practicable steps to adopt a mandatory arbitration bylaw" amendment to the company's bylaws.[4] This putative bylaw amendment would require that any future disputes between shareholders and the company under the federal securities laws be brought in an arbitral forum and not in federal court. The Proposal would furthermore require that "any disputes subject to arbitration may not be brought as a class and may not be consolidated or joined" and that the results of the arbitration proceedings be final and unappealable.[5]

The company has rightfully sought to exclude this drastic and misguided Proposal from its 2019 proxy materials because the Proposal would cause the company to violate federal law.[6] Specifically, as the Johnson & Johnson Letter outlines, the Proposal is incompatible with the anti-waiver provisions in Section 29(a) of the Securities Exchange Act of 1934 (the "Exchange Act") because the Proposal would cause shareholders to lose substantive rights under the Exchange Act, namely their right to bring Section 10(b) claims as a class action and subject to appellate review by a court of law.[7] We would note further, though, that the Proposal also would cause the company to violate the anti-waiver provisions in Section 14 of the Securities Act of 1933 (the "Securities Act").[8] Although the Johnson & Johnson Letter does not discuss this companion anti-waiver provision to Section 29(a), the Proposal is written broadly and would apply to all claims "under federal securities laws in connection with the purchase or sale of any securities issued by the Corporation."[9] The Proposal thus would also deny shareholders

---

NASAA President Mike Rothman to Hon. Keith Ellison (Jan. 30, 2017), *available at* http://www.nasaa.org/wp-content/uploads/2013/10/NASAA-letter-to-Rep.-Keith-Ellison-Re-Investor-Choice-Act-of-2017.pdf; Letter from NASAA President William Beatty to Hon. Keith Ellison (Feb. 26, 2015), *available at* http://www.nasaa.org/wp-content/uploads/2015/02/NASAA-Letter-in-Support-of-Investor-Choice-Act-of-2015-FINAL-2-26-2015.pdf. The Proposal's underlying policy aims raise similar concerns for NASAA as do restricting investor choice for broker-dealer customers and investment adviser clients.

[4] *See* Johnson & Johnson Letter, *supra* note 2, at 2.

[5] *See id*.

[6] The Proposal is also likely prohibited by state corporate laws as well. The Delaware Chancery Court recently held in *Sciabacucchi v. Salzberg*, Case No. 2017-0931-JTL, slip op. (Del. Ch. Dec. 19, 2018), that Delaware corporate law does not permit a company chartered in the state to include in its governing corporate documents a requirement that all shareholder claims under the Securities Act of 1933 be filed in federal court. (Section 22 of the Securities Act of course allows claims under the title to be brought in federal or state courts.) Under *Sciabacucchi*, therefore, a corporate forum selection provision – such as a mandatory arbitration clause – that impairs shareholders' ability to pursue their statutory remedies under the federal securities laws is void under Delaware law.

[7] *See* Johnson & Johnson Letter, *supra* note 2, at 3-4.

[8] 15 U.S.C. § 77n.

[9] *See* Johnson & Johnson Letter, *supra* note 2, at 2.

substantive rights to bring potential claims against the company under Section 11[10] or Section 12[11] of the Securities Act.

In addition, we note that state securities laws also routinely include anti-waiver provisions similar to those under the federal securities laws. For example, anti-waiver provisions were written-in as Section 410(d)(i) of the Uniform Securities Act of 1956[12] and as Section 509(l) of the Uniform Securities Act of 2002.[13] To the extent the Proposal was interpreted as applying to state securities laws, it would violate those laws as well.

The Johnson & Johnson Letter additionally reminds the Staff of the SEC's longstanding animosity to mandatory arbitration provisions.[14] The Staff has a history of resisting issuers' attempts to include mandatory arbitration clauses in their governing corporate documents.[15] We ardently agree that mandatory arbitration is bad public policy and the Staff should not now change course on its well-placed position. In fact, Chairman Clayton explained to Congress that he sees no need to revisit this well-settled issue.[16]

Forcing investors into mandatory arbitration of shareholder/issuer disputes or otherwise precluding investors from joining class actions is bad policy because it would harm retail investors and be disruptive to the marketplace. The Supreme Court has "long recognized" that securities class action litigation is "an essential supplement" to the enforcement powers of federal and state regulators.[17] Congress also considers private rights of action to be an indispensable tool for investors.[18] Put simply, the SEC and state securities regulators do not possess unlimited resources and cannot combat all securities fraud entirely on their own. Securities class actions serve as a deterrent to violative conduct and are furthermore a primary mechanism by which investors are compensated for the misconduct of fraudsters. While funds recovered by federal and state regulators can be returned to investors, such as through an SEC

---

[10] 15 U.S.C. § 77k.

[11] 15 U.S.C. § 77l.

[12] Section 410(d)(i) states: "Any condition, stipulation, or provision binding any person acquiring any security or receiving any investment advice to waive compliance with any provision of this act or any rule or order hereunder is void."

[13] Section 509(l) states: "A condition, stipulation, or provision binding a person purchasing or selling a security or receiving investment advice to waive compliance with this Act or a rule adopted or order issued under this Act is void."

[14] *See* Johnson & Johnson Letter, *supra* note 2, at 5-6.

[15] *See, e.g.*, Kevin Roose, *Carlyle Drops Arbitration Clause from I.P.O. Plans*, DealBook (Feb. 3, 2012), available at: https://dealbook.nytimes.com/2012/02/03/carlyle-drops-arbitration-clause-from-i-p-o-plans/.

[16] *See* Letter from Chairman Jay Clayton to The Honorable Carolyn B. Maloney (Apr. 24, 2018), *available at* https://maloney.house.gov/sites/maloney.house.gov/files/MALONEY%20E]T%20AL%20-%20FORCED%20ARBITRATION%20-%20ES156546%20Response.pdf; Transcript of Senate Banking, Housing and Urban Affairs Committee Hearing on Virtual Currencies, SEC and CFTC Oversight (Feb. 6, 2018) (Chairman Clayton, stating in part, "I can't dictate whether this issue comes before us or not, because of the way it has come before the SEC in the past. But I'm not anxious to see a change in this area.").

[17] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007).

[18] *See, e.g.*, S. Rep. No. 104-98 (June 19, 1995), reprinted at 1995 U.S.C.C.A.N. 679.

fair fund or a court appointed receiver, these amounts have historically paled in comparison to the amounts recovered directly by investors.[19]

Shareholder class action litigation also serves an important role in maintaining investor confidence and supporting an efficient capital market system. Class action litigation is the primary means of upholding securities disclosure standards and contributes materially to the development of the common law. In contrast, arbitrators can deviate from the law, their opinions may be unexplained, and their decisions are essentially unreviewable[20] even when they are not expressly made so such as through the Proposal.[21] What is more, basic questions of shareholder rights are foundational "rules of the game" issues that should be kept uniform across publicly-traded companies. To require that investors research every issuer's articles of incorporation and bylaws to know what their rights are vis-à-vis the company would be grossly inefficient and contrary to investors' reasonable expectations when making investment decisions.

For all these reasons, we support the Johnson & Johnson Letter and ask that the Staff respond to the company by confirming it would not recommend enforcement action if the company excludes the Proposal from its 2019 proxy materials.

Thank you for considering our views on this important issue and we look forward to working with you in our shared mission to protect investors.

Sincerely,



Michael Pieciak
NASAA President
Commissioner, Vermont Department of Financial Regulation

Copy: The Honorable Jay Clayton
Chairman, U.S. Securities Exchange Commission

[19] *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 Colum. L. Rev. 1534, 1542-43 (2006).

[20] *See AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 350 (2011).

[21] *See supra* note 4 and accompanying text.



NASAA'S LEGISLATIVE AGENDA FOR THE 116th CONGRESS

North American Securities Administrators Association
Washington, D.C.
www.nasaa.org

Learn More About NASAA

The North American Securities Administrators Association, Inc. (NASAA) is the oldest international organization devoted to investor protection. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands, and its mission is to serve as the voice of securities agencies responsible for grassroots investor protection and responsible capital formation. The Association's members have carried out this mission for over a century through various administrations in Washington, D.C.

- Collectively and individually, state securities regulators enforce state securities laws by investigating suspected investment fraud, and, where warranted, pursuing enforcement actions.

- State securities regulators ensure honest financial markets by licensing registrants – both firms and investment professionals – and conducting ongoing compliance inspections and examinations.

- State securities regulators also work with issuers to ensure that securities offerings include legally required disclosures, resulting in a transparent securities market.

Contact Us

For more information about NASAA's legislative priorities, contact:

Michael Canning | Director of Policy & Government Affairs
202-737-0900 | mc@nasaa.org

Suzanne Riopel | Government Affairs Analyst
202-737-0900 | sr@nasaa.org

CONTENTS

PRINCIPLE 1: Putting Main Street Investors First

- Support Enhanced Standards of Conduct for Broker-Dealers
- Encourage, Monitor, and Responsibly Regulate Financial Innovation
- Address Intergenerational Investor Issues

PRINCIPLE 2: Ensuring the Integrity of our Capital Markets

- Maintain Enforcement Independence of State Securities Regulators
- Protect Regulatory Remedies
- Ensure Oversight of Private Placement Brokers and Finders
- Provide State Securities Regulators Access to Suspicious Activity Reporting
- Prevent and Deter Fraud through Effective Penalties

PRINCIPLE 3: Fostering Capital Formation and Market Transparency

- Examine Public and Private Offering Regimes
- Enact Responsible Policies to Encourage Small Business Capital Formation
- Modernize the Accredited Investor Definition
- Reduce Fraud and Improve Transparency in the Private Markets

PRINCIPLE 4: Ensuring Investor Rights in a 21st Century Marketplace

- Secure Investor Choice and Transparency in Dispute Resolution
- Make Harmed Investors Whole
- Safeguard Shareholder Rights
- Data Security and Privacy

PRINCIPLE 1
Putting Main Street Investors First

In crafting and prioritizing policies that affect securities markets and securities professionals, Congress must place the interests of the investing public front-and-center by strengthening investor protection and participation in the U.S. capital markets.

Support Enhanced Standards of Conduct for Broker-Dealers. Investors deserve a duty of care that requires financial professionals, such as broker-dealers and investment advisers, to act in their clients' best interests. NASAA strongly supports efforts to elevate the broker-dealer standard of care for recommendations to investors about securities or investment strategies. At a minimum, the 116th Congress should conduct rigorous oversight of the SEC's Regulation Best Interest rulemaking process to ensure that any final rule has robust investor protection and, if a final rule is adopted, to make sure it is being effectively implemented. Congress should also examine investment adviser fiduciary standards and evaluate the gaps that exist between broker-dealer and investment adviser duties. To the extent Congress concludes that investors are not being adequately protected, Congress should consider whether additional legislative strengthening of these duties is warranted.

Encourage, Monitor, and Responsibly Regulate Financial Innovation. The rapid expansion of technological innovation in the financial services industry ("Fintech") has brought new opportunities to the financial marketplace but also significant investor protection concerns. Fintech holds the potential to improve and expand access to investment services and products. At the same time, the public's interest in the benefits of innovation cannot supersede its risk or justify exempting innovators from the requirements of longstanding investor protection laws and regulations. The 116th Congress must carefully evaluate proposed legislation designed to promote innovation to ensure that it does so in an informed and thoughtful way that adequately protects investors and users. Investor protections must not be diminished at the state or federal levels for the sake of potential yet unproven innovation in the financial services industry. Congress should, therefore, refrain from preempting any protections afforded to investors under state law.

- *Regulatory "Sandbox" Proposals.* Congress should be cautious in considering proposals to establish so-called regulatory sandboxes.[1] Sandbox proposals that are not carefully constructed may create new risks, including regulatory arbitrage, and it is often not clear that such policies are necessary or beneficial. Further, many federal agencies already have flexibility under their existing authority to establish sandboxes or similar arrangements to accommodate and encourage bona fide financial innovation without the need for federal legislation.[2] To the extent federal agencies do exercise such flexibility, the 116th Congress has a duty to carefully review agency actions to ensure that they reflect appropriate investor protection safeguards. Finally, risks arising from financial innovation generally should be shouldered by sophisticated or institutional investors, not retail investors who can ill-afford the consequences of a failed investment.

- *Cryptocurrency and ICOs.* Congress should conduct rigorous oversight of fraud and investor exploitation regarding the sale of digital instruments such as coins, tokens, and cryptocurrencies. Scams in this marketplace were the subject of numerous coordinated state enforcement actions in 2018, and the risk in this area is not receding.[3] Further, Congress should consider taking additional steps to require the SEC to provide guidance about the treatment of ICOs under federal securities laws and take other steps to limit the risk to investors that is inherent in these products, including minimizing opportunities for price manipulation of cryptocurrencies and similar assets.

Address Intergenerational Investor Issues. Intergenerational issues range from a general distrust of the capital markets by millennials to the scourge of financial exploitation of senior investors. The 116th Congress should proactively confront these and related challenges. Securities markets must serve the needs of all investors, and most especially those who do not have the bargaining power to gain the advantages enjoyed by some investors. This is especially true for generational groups, such as seniors and millennials, who are very different in many respects but are disproportionately at risk of being targeted by bad actors.

- *Elderly Investors.* The 116th Congress should give special attention to policies that will address the unique challenges and risks associated with aging. As a starting point, Congress should direct the GAO to initiate a comprehensive study exploring all aspects of senior financial exploitation and evaluating the problem in terms of the cost to victims and society. By doing so, the study would help inform and guide future policy initiatives aimed at reducing increased financial exploitation of the elderly in the United States. Second, Congress should hold hearings to examine current industry efforts to better protect senior investors and deal with an aging workforce. Finally, Congress should promptly reauthorize and fund the senior financial exploitation grant program established by Section 911 of the Dodd-Frank Act.[4]

- *Millennial Investors.* Congress should also increase its focus on the unique challenges and potential risks arising from the emergence of the millennial generation both in the workforce and in the marketplace. Investor education is the first line-of-defense in protecting millennial investors, who disproportionately lack experience with investment options and risks.[5] As a starting point, Congress should direct the GAO to conduct a study on the state of financial literacy programs in workplaces and secondary and higher education targeted to Millennials (defined as persons born between 1981 and 1996) and Generation Z (persons born from 1997 to present), respectively. Based on GAO findings and Congress's own oversight, Congress should consider whether legislation in this area is necessary and appropriate.

PRINCIPLE 2
Ensuring the Integrity of our Capital Markets

Congress must protect the U.S. capital markets by fully supporting state and federal efforts to prevent and deter fraud and other forms of misconduct.

Maintain Enforcement Independence of State Securities Regulators. Strong enforcement is the best deterrence. Investors and markets are best served by robust enforcement of securities laws at the state and federal levels. Congress must not enact any laws that will weaken or diminish existing regulatory oversight of the capital markets or any participants, such as issuers, broker-dealers, or investment advisers. States are leaders in civil and administrative enforcement actions and criminal prosecutions of securities violators.[6] States regulators also serve a vital gatekeeper function by screening out bad actors before they have a chance to conduct business with unsuspecting investors.[7] Congress must never take state regulators off the securities beat, or any portion thereof, or otherwise limit a state's discretion and autonomy in pursuing bad actors through enforcement actions and prosecutions.

Protect Regulatory Remedies. Congress should promptly pass legislation authorizing disgorgement claims brought by the SEC, which the agency currently requests as an equitable remedy. Any statute of limitations attached to disgorgement should correct the harmful impact of the U.S. Supreme Court's decision in *Kokesh v. SEC*, which bars the agency from seeking disgorgement past five years. The SEC has reportedly not been able to seek disgorgement of at least $800 million in ill-gotten gains since the decision, which is a significant amount considering that the agency collected $3 billion in disgorgement and penalties in FY 2016.[8]

Ensure Oversight of Private Placement Brokers and Finders. Congress must refrain from taking any action that could limit state regulatory oversight of "finders" and "private placement brokers."[9] While significant differences exist in the functions commonly associated with traditional broker-dealer representatives, private placement brokers, and finders, such differences do not support exempting any of these individuals from regulatory oversight. The securities laws correctly recognize that individuals who receive compensation directly tied to the sale of securities are functioning as securities brokers, regardless of any actual or apparent differences in the services or functions performed by particular securities salespersons and promoters.[10]

Provide State Securities Regulators Access to Suspicious Activity Reporting. Suspicious Activity Reports ("SARs") are an effective tool for regulators of financial institutions to identify and investigate possible violations of the Bank Secrecy Act. Since the enactment of the Bank Secrecy Act, financial institutions (including broker-dealers) are now able to notify regulators of suspected elder financial abuse, and the Treasury Department has proposed subjecting investment advisers to the same rules.[11] However, many state securities regulators do not directly have access to SARs, and Congress should consider amending the Bank Secrecy Act to allow them to have access to it.

Prevent and Deter Fraud through Effective Penalties. Federal securities laws limit the amount of civil penalties the SEC can impose on an institution or individual. Hearings in the wake of the financial crisis established that these statutory limitations significantly constrain the SEC in performing its enforcement duties and deterring fraudulent conduct.[12] NASAA urges the 116th Congress to enact legislation that will update and strengthen the SEC's authority to impose civil penalties for securities law violations, including linking such penalties to the scope of harm and associated investor losses, increasing the statutory limits on monetary penalties, and increasing the cap for repeat securities law violators.

PRINCIPLE 3
Fostering Capital Formation and Market Transparency

Congress must examine the relationship between public securities markets, quasi-public securities markets and private securities markets, and promote more cohesive policies that balance investor protection and capital formation.

Examine Public and Private Offering Regimes. Decisions by policymakers and federal agencies have enormous implications for decisions by issuers on when, how, and from whom to raise capital, and in turn, for investors. Recently enacted laws and rules designed to expand the private markets have come at the expense of the public markets, and ultimately, retail investors. Congress should hold hearings to examine the impact of the JOBS Act of 2012 and other laws that expanded the private markets along with the appropriate role of and relationship between the different types of offering registration exemptions. Congress should consider measures to halt the "blurring" of the distinction between the public and private securities marketplace.[13]

Enact Responsible Policies to Encourage Small Business Capital Formation. NASAA members are at the forefront of fostering capital formation for small businesses, entrepreneurs, and investors in their states. State regulators provide a level of accessibility to small businesses and investors that is unavailable from any federal regulator. We wholeheartedly share Congress's desire to enhance the U.S. economy by improving access to capital for small and emerging businesses and strongly support efforts by Congress to enact sensible reforms to securities laws this area that are consistent with investor protection. One step that 116th Congress should take in is enacting common sense legislation that exempts M&A brokers from federal registration requirements. Congress might also consider limited adjustments to federal crowdfunding laws, including authorizing certain special purpose vehicles ("SPVs") in the fundraising process.[14] Further, we urge Congress to direct the SEC to coordinate with the states more closely in this area in order to unify or harmonize certain federal and state exemptions.

Modernize the Accredited Investor Definition. The 116th Congress should take steps to expand opportunities for retail investors to participate in U.S. private markets without exposure to unnecessary or undue risk. To that end, Congress should modernize the "accredited investor" definition, as it relates to individual investors, in a manner that reflects both an investor's financial wherewithal to invest in private offerings and ability to measure the amount of risk involved in such offerings.[15] NASAA has offered detailed suggestions to the SEC and Congress on how to revise the current accredited investor definition to more accurately measure investor sophistication and improve regulatory oversight of this important segment of the capital markets.[16] To the extent Congress retains any income or net worth standards under the current rule, it must account for some portion of the inflation that has occurred since the standards were originally adopted in 1982, and index them to account for inflation going-forward.[17] For certain investors, Congress should also consider limiting the investment amounts to a percentage of their income or net worth, either in the aggregate, or per offering.

Reduce Fraud and Improve Transparency in the Private Markets. The 116th Congress should make it a priority to reduce fraud and promote greater transparency in the marketplace for private offerings under Rule 506 of Regulation D. Revisions to the rule stand to benefit, not only investors, but legitimate issuers and promoters who rely on the exemption. Specifically, Congress should direct the SEC to immediately develop meaningful penalties for issuers that fail to file Form D.[18] Congress should also ensure state regulators have the information needed to police the private offering marketplace to discourage fraud and protect retail investors by mandating the filing of Form D prior to or concurrent with the first sale of a security in a 506(b) offering, and prior to or concurrent with the commencing of general solicitation in a 506(c) offering.[19] Finally, in order to provide some measure of transparency, Congress should mandate the filing of a closing amendment upon the conclusion of such offerings.[20]

PRINCIPLE 4
Ensuring Investor Rights in a 21st Century Marketplace

Congress must reaffirm the rights of investors in the modern securities marketplace and ensure our securities laws effectively protect these rights.

Secure Investor Choice and Transparency in Dispute Resolution. Investor confidence in fair and equitable recourse is critical to the success of the securities markets and long-term participation in these markets by retail investors. Among other things, investor confidence means that they have a choice of forum when it comes to resolving disputes with their investment professionals. Unfortunately, investors have little-to-no choice today, as virtually all disputes against broker-dealers must be resolved in an arbitration forum administered by the Financial Industry Regulatory Authority ("FINRA"). Investor rights are limited in this way because almost all broker-dealers include a mandatory arbitration clause in their customer service agreements.

- *Mandatory Arbitration.* The 116th Congress should discourage the proliferation of mandatory arbitration provisions in contracts used by financial services firms. Broker-dealers enjoy powerful advantages over retail investors in dispute resolution, and their use of mandatory arbitration contracts to deprive investors of access to the judicial system only serves to compound that inequity, which makes it difficult or impossible for investors to obtain fair and equitable recourse. NASAA supports legislation that would ban the use of mandatory pre-dispute agreements by broker-dealers and investment advisers that limit investors' ability to pursue recourse in any forum.[21]

- *Transparency and Accuracy in Dispute Resolution.* Investors deserve transparency when it comes to the financial professionals they entrust with their hard-earned money, and regulators must have access to accurate, complete information on the individuals they register and license. Today, financial professionals can seek expungement of customer complaint information from their regulatory records, using arbitration proceedings and uncontested civil actions. The 116th Congress should examine this process and consider measures to prevent the removal of this important information from the records of financial professionals.

- *Forced Arbitration in IPOs.* The 116th Congress should make clear that mandatory arbitration clauses limiting shareholder recourse have no place in initial public offerings. SEC Chairs and Commissioners appointed by both political parties have for decades recognized and affirmed the vital role that private litigation plays in compensating fraud victims and supplementing its own enforcement efforts. However, the Commission has not formed a definitive view on mandatory arbitration clauses included in a company's governing documents submitted in connection with an IPO, and currently reviews these clauses on a case-by-case basis.[22] To remedy this, Congress should enact legislation requiring the SEC to ensure that these clauses are not included in pre-IPO filings, or

alternatively, prohibit acceleration of the effective date of an issuer's registration statement pursuant to Section 8(a) of the Securities Act of 1933.

Make Harmed Investors Whole. The 116th Congress should take steps to reduce and eventually eliminate unpaid judgments resulting from disputes between investors and securities firms. Unpaid arbitration awards are an on-going, well-documented investor protection concern.[23] By failing to pay arbitration awards, broker-dealers fail to comply with their legal, regulatory, and ethical obligations, and gain an unfair competitive advantage over those broker-dealers who honor their financial responsibilities to customers. NASAA has long supported measures to address the problem of unpaid awards, and we encourage Congress to make it a priority to fix this problem.[24]

Safeguard Shareholder Rights. The 116th Congress should affirm its commitment to shareholder rights through increased scrutiny of practices that may be employed by issuers and others that disadvantage or limit shareholder rights.

- *Multiclass Shares.* The 116th Congress should scrutinize multi-class securities structures that concentrate voting power with small groups of company insiders, especially in connection with public offerings. [25] While these structures can have certain advantages, they fundamentally contradict the traditional "one-share, one-vote" principle of corporate governance and limit the ability of shareholders to hold company officers and executives accountable. The 116th Congress should evaluate measures to address this problem including whether to require public companies with dual-class share structures to attach "sunset clauses," which would require – at some pre-determined time after the IPO and/or upon some event occurring – that shareholders of low-vote share classes vote on whether to extend the dual-class structure.

- *Proxy Advisor Oversight.* Proxy advice is critical for investors as they decide how to vote their shares on important corporate governance matters, such as director elections or the sale of the company, and proxy advisory firms are an essential tool for investors. However, relative lack of transparency at proxy firms makes it difficult to understand how they are impacting shareholder return, and how they manage conflicts of interest. Given that proxy advisor firms exert considerable influence over shareholder decisions, while at the same time operating as for-profit entities, with inherent potential for conflicts of interest, the 116th Congress should consider whether legislative action may be warranted in order to better ensure that investors can confidently rely on their advice. One avenue Congress should explore is legislation that would require SEC registration of proxy advisory firms and enactment of fiduciary standards of conduct for such firms. Such steps could help ensure proxy advisory firms act in investors' best interests.

Data Security and Privacy. Cyberattacks on U.S. companies continue to increase in both frequency and sophistication. The 116th Congress should continue to explore multiple avenues to encourage the financial services industry and publicly-traded companies to proactively limit their cybersecurity risk, and thereby, limit the exposure of their clients, customers, and investors. At the same time, Congress must be very careful about imposing any federal requirements and account for how cybersecurity risk varies among different types of firms and market participants.

- *Responsibilities of Public Companies and Financial Firms.* NASAA supports legislation that would promote greater attention to cybersecurity risk by public corporations. Investors and the financial industry as a whole are well-served by policies that encourage companies to consider such risks proactively rather than after a data breach has occurred and the harm has been done.

- *State Securities Registrants.* State securities authorities, who regulate almost two-thirds of investment advisory firms, ensure that those firms and their representatives address cybersecurity risks inherent in their business model. NASAA appreciates Congress's exploration of new structures that allow information-sharing and consistency between law enforcement agencies and regulators, and government and the financial services industry.[26] To be effective, state regulators need to be a part of such a framework, and to that end, NASAA continues to urge Congress to include state securities, insurance, and banking regulators as part of state and federal multi-agency working groups. Furthermore, any federal framework developed by Congress must, at a minimum, provide that state securities regulators continue to exercise exclusive administrative, examination, and enforcement authority with respect to state-registered advisers.[27]

###

[1] The term "regulatory sandbox" refers to a special framework set up by one or more regulators to allow Fintech startups or other innovators to experiment in a controlled environment under a regulator's supervision. The goal of sandboxes is to "allow fintech firms to offer products on a limited scale and provide valuable knowledge about products and risks to both firms and regulators." See: https://www.gao.gov/assets/700/691290.pdf.

[2] For example, the CFTC's LabCFTC, the OCC's Fintech Bank Charter, and the CFPB's Project Catalyst are initiatives that encourage innovator-regulator engagement based upon the concept of a regulatory sandbox.

[3] In April 2018, NASAA organized a task force of its member state and provincial securities regulators to begin a coordinated series of investigations into ICOs and cryptocurrency-related investment products. NASAA members from more than 40 jurisdictions participated in this coordinated initiative, known as "Operation Cryptosweep," which to date has resulted in more than 200 inquiries and investigations and nearly 50 enforcement actions related to ICOs or cryptocurrencies since the beginning of May. NASAA members are conducting additional investigations that may result in enforcement actions. Additional information is accessible at http://www.nasaa.org/regulatory-activity/enforcement-legal-activity/operation-cryptosweep/.

[4] In July 2010, Congress enacted legislation to establish a program within the CFPB to award grants to states for the purpose of protecting investors. Unfortunately, although Congress authorized funding for such grants, the CFPB's exclusion from the appropriations process precluded Congress from appropriating resources for the program. Nonetheless, the basic framework envisioned by Congress in 2010 was sound and, had the program been implemented and funded as intended, senior investors would have benefited greatly. The 116th Congress should reauthorize and fund this program and consider expanding the scope of the program to include protection of millennial investors. See: Section 989A, "Senior Investor Protections" of the Dodd-Frank Act, available at http://www.dodd-frank-act.us/Dodd_Frank_Act_Text_Section_989A.html.

[5] According to a recent study by the FINRA Foundation and CFA Institute, most millennials surveyed lacked financial literacy and did not own investment accounts other than a 401K, which means that if they do choose to invest, they may be subject to exploitation.

[6] NASAA's most recently compiled enforcement statistics reflect that in 2017 alone, state securities regulators conducted 4,790 investigations, leading to more than 2,000 enforcement actions, including 255 criminal actions. Moreover, in the same year, among licensed financial professionals, NASAA members reported 270 broker-dealer firms and agents named in enforcement actions (-11% from 2016) and 377 investment adviser firms and representatives named in enforcement actions (+32% from 2016).

[7] In 2017, a total of 3,578 securities license applications were withdrawn as a result of state action, and an additional 878 licenses were denied, revoked, suspended, or conditioned.

[8] As SEC Chairman Jay Clayton recently testified to the Senate Banking Committee, "The unanimous Supreme Court decision in *Kokesh v. SEC*, however, has impacted our ability to return funds fraudulently taken from Main Street investors… as I look across the scope of our actions, including most notably Ponzi schemes and affinity frauds, I am troubled by the substantial amount of losses that we may not be able to recover for retail investors… I welcome the opportunity to work with Congress to address this issue to ensure defrauded retail investors can get their investment dollars back." See: hearing entitled, "Oversight of the U.S. Securities and Exchange Commission," on December 11, 2018, available at https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%2012-11-18.pdf)

[9] The term "private placement broker" typically describes a person who act as a broker of privately issued securities while the term "finder" may be used to describe an intermediary who assists a broker in identifying accredited investors who may purchase the securities.

[10] There is a well-documented relationship between private offerings sold by brokers and an elevated risk of fraud, and a disproportionate percentage of persons acting as brokers in the private offering marketplace are brokers with red flags in their record. For example, based on a 2018 analysis performed by the Wall Street Journal, one in eight brokers marketing private placements in the past decade had three or more red flags on their records, such as an investor complaint, regulatory action, criminal charge, or firing, compared to one in 50 for active brokers. Furthermore, brokers selling private placements are six times more likely as the average broker to have at least one reported regulatory action against them. See: Jean Eaglesham and Coulter Jones, A Private Market Deal Gone Bad: Sketchy Brokers, Bilked Seniors and a Cosmetologist, The Wall Street Journal (May 7, 2018).

[11] In August of 2015, the U.S. Treasury Department's Financial Crimes Enforcement Network ("FinCEN") proposed a rule to add registered investment advisers to the definition of "financial institution" for the purposes of anti-money laundering ("AML")

program requirements established by the Bank Secrecy Act. The proposed rule would apply only to investment advisers that are required to register with the U.S. SEC. FinCEN did indicate, however, that it may consider a future expansion of the BSA to include investment advisers that are not registered or required to be registered with the SEC. See: https://www.fincen.gov/news_room/nr/html/20150825.html.

[12] See, for example, hearing entitled "Examining the Important Role of the Securities and Exchange Commission in Protecting Investors by Aggressively Enforcing Federal Securities Laws." U.S. Senate Committee on Banking, Housing and Urban Affairs. (May 7, 2009). Available at https://www.govinfo.gov/content/pkg/CHRG-111shrg53779/pdf/CHRG-111shrg53779.pdf

[13] While the JOBS Act was broadly designed to facilitate access to capital, it ultimately had competing priorities – allowing more companies to stay private, while at the same time, encouraging a greater number of companies to become public. Despite the JOBS Act's well-intentioned goals, recent studies have shown that the number of U.S. publicly listed companies has continued to decline significantly since its peak in 1997. As University of Mississippi Law School Professor Mercer Bullard explained in testimony to the Senate Banking Committee in July 2018,

> "The JOBS Act required the SEC to authorize general solicitation and advertising under the nonpublic offering exemption despite the fact that these were inherently incompatible concepts. In other words, although general solicitation and advertising are quintessentially "public" in nature, Congress chose to cram the square peg of an essentially public offer into the round hold of the nonpublic offering exemption... The JOBS Act further diluted the public-private distinction by authorizing online crowdfunding, raising the Reg A offering limit from $5 to $50 million and precluding state regulation of large Reg A offerings. Crowdfunding sites now offer a combination of crowdfunding, Reg A and Reg D offerings, each with different disclosures and investor eligibility requirements. Crowdfunding issuers have routinely raised capital under the Reg A, Reg D, crowdfunding, and intrastate exemptions, and through donative funding on Kickstarter and Indiegogo. They promote their offerings on Facebook and Twitter. This mingling of different offerings and freewheeling public distribution has further undermined nonpublic nature of private offerings."

See: https://www.banking.senate.gov/imo/media/doc/Bullard%20Testimony%206-26-18.pdf.

[14] See S. 488, 115th Congress, Title XXXII - Crowdfunding Amendments (addressing some problematic requirements in the SEC's final rule, promulgated pursuant to Title III of the JOBS Act, by authorizing special purchase vehicles ("SPVs") as investors).

[15] The "accredited investor" definition is a central component of Regulation D. The definition is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary." Qualifying as an accredited investor is significant because accredited investors may, under SEC rules, participate in investment opportunities that are generally not available to non-accredited investors, such as investments in private companies and offerings by hedge funds, private equity funds and venture capital funds. Under existing SEC rules, adopted in 1982, individuals are accredited investors if their income exceeds $200,000 in each of the two most recent years (or $300,000 in joint income with a person's spouse) and they reasonably expect to reach the same income level in the current year or, if their net worth exceeds $1 million, excluding the value of their primary residence. (See: Regulation D Revisions; Exemption for Certain Employee Benefit Plans, Release No. 33-6683. Jan. 16, 1987).

[16] For example, See NASAA's November 1, 2017 letter to House Leadership regarding H.R. 1585, the Fair Investment Opportunities for Professional Experts Act of 2017. See: http://www.nasaa.org/wp-content/uploads/2013/10/NASAA-Letter-to-House-Leadership-Re-HR-1585-11-1-17.pdf.

[17] According to the SEC's Division of Economic and Risk Analysis, 1.8% of American households qualified as "accredited investors" in a 1983 survey, while 9.9% of American households qualified as such in a 2013 survey. See: https://www.sec.gov/news/statement/spch121714laa.html#_ednref3.

[18] Office of Inspector General, U.S. Securities and Exchange Commission, *Regulation D Exemption Process* 10 (2009) (stating that "there are simply no tangible consequences when a company fails to file a Form D").

[19] NASAA has consistently advocated that the SEC require the filing of Form D prior to the sale of securities in reliance on Rule 506 – especially prior to the use of any type of general solicitation. The information contained in a Form D is crucial to state securities regulators who regularly encourage investors to "investigate before you invest." When investors contact their state regulators with questions about an offering they may have learned about through an advertisement or solicitation, a Form D filing is often the only information the state can use to determine if an issuer is conducting the offering in compliance with a lawful exemption.

[20] In July 2013, the SEC proposed rules that would have established precisely these reforms. Unfortunately, the SEC has never acted on the proposed rules. See: http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm.

[21] For example, NASAA was pleased to support the Investor Choice Act of 2017 and would support similar legislation should it be introduced in the 116th Congress.

[22] Brief Amici Curiae of Former SEC Commissioners: Chairmen William Donaldson and Arthur Levitt, and Commissioner Harvey Goldschmid, Stoneridge Investment Partners v. Scientific-Atlantic, 552 U.S. 148 (2008), https://bit.ly/2nEFozM.

[23] According to FINRA, in the five years from 2012 through 2016, a total of 268 awards (27% of the cases where investors were successful) or $199 million in awards (29% of total damages awarded to investors) have gone unpaid. See: https://www.finra.org/arbitration-and-mediation/statistics-unpaid-customer-awards-finra-arbitration.

According to data from the Public Investors Arbitration Bar Association (PIABA), in 2017, 36% of the investors who won their cases collected nothing, and 28 cents of each dollar awarded have gone unpaid. (See: https://piaba.org/piaba-newsroom/unpaid-awards). The data reveal that the problem is not fixing itself, and the steps taken by FINRA thus far have not effectively addressed the problem.

[24] The question of what to do about unpaid awards was the subject of an SEC Investor Advisory Committee meeting on December 13, 2018. The recommendations from this discussion could help frame NASAA's position on the question in the Agenda. It should also be noted that Sen. Warren has sponsored legislation in the Senate that would address the problem by effectively requiring firms to pay them and FINRA to backstop the firms.

[25] Multi-class, dual-class, and other entrenching governance structures allow for a concentration of voting power in the hands of company insiders through a disproportionate allocation of voting rights among shareholders. Under such structures, insiders can control the company while owning a smaller number of shares than would be necessary in a traditional one-share, one-vote structure. Recently, an influential 50-member Investor Stewardship Group ("ISG"), overseeing $22 trillion in assets, demanded a total elimination of dual-class stock. The U.S. Council of Institutional Investors (CII), representing managers of $25 trillion assets, recently demanded limiting any company's dual-class share structure to seven years. See: Letter from Council of Institutional Investors to Elizabeth King, Chief Regulatory Officer, Intercontinental Exchange Inc. (Oct. 24, 2018).

[26] NASAA is an active member of the Treasury Department's Financial and Banking Information Infrastructure Committee ("FBIIC"), which develops procedures and systems to allow federal and state regulators to communicate among themselves and with the private sector.

[27] For further explanation of NASAA's views on the question, see: NASAA Letter to Honorable Randy Neugebauer Regarding amendments to the Data Security Act of 2015, (Dec. 8, 2015).



NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION
750 First Street NE, Suite 1140 | Washington, D.C.
202-737-0900 | www.nasaa.org



2018 ANNUAL REPORT TO CONGRESS

Whistleblower Program



U.S. SECURITIES AND EXCHANGE COMMISSION

DISCLAIMER

This is a report of the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

CONTENTS

Message from the Chief of the Office of the Whistleblower 1

History and Purpose 4

Activities of the Office of the Whistleblower 6

Claims for Awards 9
- Whistleblower Awards Made in Fiscal Year 2018 9
- Overview of Award Process 12

Profiles of Award Recipients 16

Preserving Individuals' Rights to Report to the Commission and Shielding Employees from Retaliation 18

Whistleblower Tips Received 20
- Increase in Whistleblower Tips 20
- Whistleblower Allegation Type 21
- Geographic Origin of Whistleblower Tips 22

Processing of Whistleblower Tips 24
- TCR Evaluation 24
- Assistance by OWB 25

Proposed Whistleblower Rule Amendments 26

Securities and Exchange Commission Investor Protection Fund 29

Appendix A. Whistleblower Tips by Allegation Type Comparison of Fiscal Years 2015–2018 32

Appendix B. Whistleblower Tips Received by Geographic Location, United States and its Territories, Fiscal Year 2018 33

Appendix C. Whistleblower Tips Received by Geographic Location International, Fiscal Year 2018 34

Report available on the Web at: www.sec.gov/whistleblower

MESSAGE FROM THE CHIEF OF THE OFFICE OF THE WHISTLEBLOWER

Fiscal Year (FY) 2018 was a record-breaking year for the U.S. Securities and Exchange Commission's (SEC or Commission) whistleblower program. The whistleblower program continued to grow and make substantial contributions to the Commission's enforcement and investor protection efforts. The Commission ordered its largest whistleblower awards to date this past fiscal year. In fact, the Commission awarded more dollars in FY 2018 to meritorious whistleblowers who provided new and critical information than in all prior years combined. The Commission also received more whistleblower tips in FY 2018 than in any other previous year.

> "... the Commission awarded more dollars in FY 2018 to meritorious whistleblowers who provided new and critical information than in all prior years combined."

While the dollars awarded and volume of tips received are reflections of the program's success, we are most proud of the program's added value in the protection of the Main Street investor. Since the program's inception, the SEC has ordered wrongdoers in enforcement matters brought with information from meritorious whistleblowers to pay over $1.7 billion in total monetary sanctions, including more than $901 million in disgorgement of ill-gotten gains and interest, of which approximately $452 million has been, or is scheduled to be, returned to harmed investors.

Finally, FY 2018 also saw proposed changes to the program's implementing regulations (Whistleblower Rules), following the Supreme Court's ruling in *Digital Realty Trust, Inc. v. Somers*[1] (*Digital Realty*), as well as other changes proposed by the Commission.

Substantial Dollars Awarded in Fiscal Year 2018

The Commission has awarded over $326 million to 59 individuals since the beginning of the whistleblower program. In FY 2018 alone, the SEC awarded more than $168 million in whistleblower awards to 13 individuals whose information and cooperation assisted the Commission in bringing successful enforcement actions. This amount exceeds the total amount awarded in all prior years combined and reflects the significance of the information that whistleblowers are reporting to the Commission.

In addition, the SEC made two of its largest-ever whistleblower awards this past fiscal year—a total combined $83 million award shared by three individuals, and an award of almost $54 million shared by two individuals. The recipients of these large awards provided significant information regarding serious violations that otherwise may have gone unnoticed and resulted in substantial enforcement actions.

Prioritizing Meritorious Claims

The main goal of the whistleblower program is to incentivize the reporting of specific, timely, and credible information to the Commission. Therefore, one of the top priorities of the Office of the Whistleblower (OWB) has been, and will continue to be, processing meritorious award claims. As such, OWB prioritizes those claims that, based on our initial triaging and communications with investigative staff, appear to be award-eligible.

1 138 S. Ct. 767 (2018).

As demonstrated by the awards made this fiscal year, meritorious whistleblowers have, among other things, helped the Commission by alerting the agency to widespread, multi-year securities violations, and supplying information and documentation of violations that impacted retail customers. Meritorious whistleblowers in FY 2018 were diverse and included, among others, a company outsider and whistleblowers residing or working overseas. We hope that by rewarding whistleblowers who provide valuable information to the Commission staff, more individuals will come forward and report information of securities violations, which in turn, helps the Commission better protect investors and the marketplace.

"Anti-retaliation protections continue to be a critical component in the success of the Commission's whistleblower program."

Increase in Whistleblower Tips Received in Fiscal Year 2018

The Commission received over 5,200 whistleblower tips in FY 2018. This represents the highest increase in tips since the beginning of the program—a nearly seventy-six percent increase since FY 2012. Additionally, there was an increase in tips received in the months following the Supreme Court ruling in the *Digital Realty* case, which may have been attributable, in part, to the ruling.

Whistleblower Protections in Fiscal Year 2018

In *Digital Realty*, the Supreme Court held that the whistleblower provisions of the Securities Exchange Act of 1934 (Exchange Act) require that a person report a possible securities law violation to the Commission in order to qualify as a whistleblower protected against employment retaliation under Section 21F(h) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), thus invalidating the Commission's rule interpreting that provision's anti-retaliation protections to apply regardless of whether a report of possible securities law violations was made to the Commission, to a different government agency, or internally to an employer. The ruling resolved a Circuit Court split regarding whether individuals who had reported only to their employers, rather than to the Commission, were protected under Dodd-Frank's anti-retaliation protections. This is a significant change in whistleblower protections, and potential whistleblowers should be mindful of this ruling when deciding when to report their concerns to the Commission. Following the ruling, the Commission proposed amendments to bring the Whistleblower Rules in line with the holding of the Court.

Anti-retaliation protections continue to be a critical component in the success of the Commission's whistleblower program. Individuals who fear reprisal from their companies for reporting will be less likely to bring their information to the Commission. Supporting enforcement actions against companies and individuals who retaliate against whistleblowers or take actions to impede whistleblowers' communications with the Commission will remain a focus of OWB's mission in the upcoming fiscal year. We will continue to work to ensure that whistleblowers can freely report information to the Commission without fear of reprisal.

Proposed Amendments to Whistleblower Rules

Capitalizing on its nearly seven years of experience administering the whistleblower program, the Commission proposed amendments to the Whistleblower Rules during FY 2018 to build upon the success of the program. In addition to clarifying the requirements for anti-retaliation protection under the whistleblower statute, the proposed amendments would provide the Commission with additional discretion in making whistleblower awards to ensure that meritorious whistleblowers are appropriately rewarded for their efforts and increase efficiencies in the whistleblower claims review process.

The proposing release was published in the Federal Register on July 20, 2018, and the comment period ended on September 18, 2018.[2] Pages 26–28 of this report provide a fuller discussion of the proposed rule amendments.

Conclusion

The impact of the whistleblower program on the Commission's enforcement efforts and its contributions to the protection of Main Street investors continue to be strong. We are proud of the accomplishments of the whistleblower program in FY 2018. We look forward to the enduring success of the program in the years ahead.

We encourage those who believe they have credible information concerning a potential federal securities law violation to expeditiously submit a tip via the Commission's online portal (www.sec.gov/whistleblower).

If individuals or their counsel have any questions about the program, including questions about how to submit a tip to the Commission, we encourage them to call OWB's whistleblower hotline at (202) 551-4790.



JANE NORBERG
Chief, Office of the Whistleblower
November 15, 2018

2 Amendments to the Commission's Whistleblower Program Rules, 83 Fed. Reg. 34,702 (proposed July 20, 2018).

HISTORY AND PURPOSE

Dodd-Frank[3] amended the Exchange Act[4] by, among other things, adopting Section 21F,[5] entitled "Securities Whistleblower Incentives and Protection." Section 21F directs the Commission to make monetary awards to eligible individuals who voluntarily provide original information that leads to successful Commission enforcement actions resulting in monetary sanctions over $1 million and successful related actions.[6]

"It is OWB's mission to administer a vigorous whistleblower program that will help the Commission identify and halt securities frauds early and quickly to minimize investor losses."

Awards must be made in an amount equal to 10 to 30 percent of the monetary sanctions collected.[7] To ensure that whistleblower payments would not diminish the amount of recovery for victims of securities law violations, Congress established a separate fund, called the Investor Protection Fund (Fund), from which eligible whistleblowers are paid.

The Commission established OWB, an office within the SEC's Division of Enforcement (Enforcement), to administer and effectuate the whistleblower program. It is OWB's mission to administer a vigorous whistleblower program that will help the Commission identify and halt securities frauds early and quickly to minimize investor losses.

In addition to establishing an awards program to encourage the submission of high-quality information, Dodd-Frank and the Commission's Whistleblower Rules[8] also establish confidentiality protections for whistleblower submissions,[9] including the ability to file a whistleblower tip anonymously with the assistance of an attorney. Employers are prohibited from retaliating against whistleblowers for providing information to the Commission.[10] The Commission's proposed rule amendments would modify the Whistleblower Rules to comport with the ruling in the *Digital Realty* case that an employee must report possible securities law violations to the Commission to qualify for protection against retaliation.[11]

Dodd-Frank's Section 924(d) requires OWB to report annually to Congress on OWB's activities, whistleblower complaints received, and the response of the Commission to such complaints.[12] In addition, Section 21F(g)(5) of the Exchange Act requires the Commission to submit an annual report to Congress that addresses the following subjects:

- The whistleblower award program, including a description of the number of awards granted and the types of cases in which awards were granted during the preceding fiscal year;
- The balance of the Fund at the beginning of the preceding fiscal year;

3 Pub. L. No. 111-203, § 922(a), 124 Stat. 1841 (2010).
4 15 U.S.C. § 78a, *et seq*.
5 *Id*. § 78u-6.
6 "Related actions" is defined at 15 U.S.C. § 78u-6(a)(5) and 17 C.F.R. § 240.21F-3.
7 15 U.S.C. § 78u-6(b)(1).
8 17 C.F.R. §§ 240.21F-1 through 21F-17.
9 *Id*. § 240.21F-7.
10 15 U.S.C. § 78u-6(h)(1).
11 *See* Amendments to the Commission's Whistleblower Program Rules, 83 Fed. Reg. 34,702 (proposed July 20, 2018).
12 15 U.S.C. § 78u-7(d).



- The amounts deposited into or credited to the Fund during the preceding fiscal year;
- The amount of earnings on investments made under Section 21F(g)(4) during the preceding fiscal year;
- The amount paid from the Fund during the preceding fiscal year to whistleblowers pursuant to Section 21F(b);
- The balance of the Fund at the end of the preceding fiscal year; and
- A complete set of audited financial statements, including a balance sheet, income statement, and cash flow analysis.[13]

OWB, in consultation with other offices within the Commission, has prepared this report, which covers the period October 1, 2017 through September 30, 2018, to satisfy the reporting requirements of Section 924(d) of Dodd-Frank and Section 21F(g)(5) of the Exchange Act. The sections in this report addressing the activities of OWB, the whistleblower tips received during FY 2018, and the processing of whistleblower tips primarily address the requirements of Dodd-Frank's Section 924(d). The sections addressing the Fund and whistleblower incentive awards made during FY 2018 primarily address the requirements of Section 21F(g)(5) of the Exchange Act.

13 15 U.S.C. § 78u-6(g)(5).

ACTIVITIES OF THE OFFICE OF THE WHISTLEBLOWER

Section 924(d) of Dodd-Frank directed the Commission to establish a separate office within the Commission to administer and enforce the provisions of Section 21F of the Exchange Act. Jane Norberg heads the Office as Chief of OWB. There are two Assistant Directors and twelve attorneys who are dedicated to the work of the Office, including, among other things, processing award claims, as well as an attorney devoted to communications with the public. OWB is also staffed by four paralegals and an administrative assistant. Following is an overview of OWB's primary responsibilities and activities over the past fiscal year.

Assessment of Award Applications

The whistleblower program was designed, in part, to provide monetary incentives to individuals with relevant information concerning potential securities violations to report their information to the Commission. As such, much of OWB's work relates to the assessment of claims for whistleblower awards.

OWB posts a Notice of Covered Action (NoCA) on its webpage (www.sec.gov/whistleblower/claim-award) for every Commission enforcement action that results in monetary sanctions of over $1 million. Those individuals who have submitted whistleblower tips pursuant to the program's requirements and whose information significantly advanced the particular investigation that led to the Covered Action may submit an application in response to a posted NoCA.

Although it is ultimately a whistleblower's responsibility to make a timely application for an award, OWB may contact whistleblowers who have been actively working with investigative staff—or who have previously contacted OWB about the posting of a particular Covered Action—to confirm they are aware of the posting and applicable deadline for submitting claims for award.

Based on an initial review, as well as communications with the relevant investigative staff, OWB prioritizes those claims that appear to be award-eligible. OWB attorneys assess the application and the eligibility of the claimant and confer with relevant investigative or other Commission staff to understand the contribution of the claimant, if any, to the success of the Covered Action. OWB then makes recommendations to the Claims Review Staff, currently comprised of five senior officers in Enforcement, as to award eligibility. Pages 9–15 of this report provide a fuller explanation of how applications for awards are processed at the Commission, as well as what awards were made during this past fiscal year.

Advancing Anti-Retaliation Protections and Combating Efforts to Impede Reporting

OWB identifies and monitors whistleblower complaints alleging retaliation by employers or former employers in response to an employee's reporting of possible securities law violations. The Commission may bring an enforcement action against companies or individuals who violate the anti-retaliation provisions of Dodd-Frank. But, in a change from prior years, such enforcement actions can only be brought when a whistleblower reports to the Commission. This change reflects the Supreme Court's ruling in *Digital Realty* regarding who qualifies as a whistleblower covered by Section 21F(h)'s anti-retaliation protections, which is discussed more in depth at pages 18–19 of this report. OWB continues to view anti-retaliation protections as a high priority to ensure that whistleblowers can report to the Commission without fear of reprisal. OWB will continue to work with investigative staff to identify cases where companies take reprisals for whistleblowing efforts that may be appropriate for enforcement action.

In addition, OWB monitors the usage of confidentiality, severance, and other kinds of agreements, or engagement in other practices, to interfere with individuals' ability to report potential wrongdoing to the SEC. Exchange Act Rule 21F-17(a) provides that "[n]o person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcement, or threatening to enforce, a confidentiality agreement…with respect to such communications."[14] OWB continues to work closely with investigative staff to identify and investigate practices in the use of confidentiality and other kinds of agreements, or other actions, that may violate Rule 21F-17(a).

> "OWB continues to view anti-retaliation protections as a high priority to ensure that whistleblowers can report to the Commission without fear of reprisal."

Intake of Whistleblower Tips

The Commission's Tips, Complaints, and Referrals Intake and Resolution System (TCR System) serves as a central repository for all tips and complaints received by the Commission, as well as referrals from self-regulatory organizations and other government agencies. In January 2018, the Commission released an updated, more user-friendly version of the TCR System. OWB encourages all individuals to submit their whistleblower tips and any additional information electronically through the Commission's online portal. There are several benefits of using the online portal, including the fact that individuals receive an immediate acknowledgement of their submission along with a confirmation number. The tip is also automatically populated in a queue for staff who triage tips and complaints. For greater efficiency and quicker review, OWB recommends electronic submission over hard-copy submission.

For more information on the number and types of tips received, please refer to pages 20–23 of this report.

14 17 C.F.R. § 240.21F-17(a).

Communications with Whistleblowers

OWB serves as the primary liaison between the Commission and individuals who have submitted information or are considering whether to submit information to the agency concerning a possible securities violation. OWB created a whistleblower hotline, in operation since May 2011, to respond to questions from the public about the whistleblower program. Individuals may leave messages on the hotline by calling (202) 551-4790. All calls to the hotline are returned by OWB attorneys within 24 business hours.

"During FY 2018, the Office returned nearly 2,770 phone calls from members of the public."

During FY 2018, the Office returned nearly 2,770 phone calls from members of the public. Since the hotline was established, OWB has returned over 21,380 calls from the public.

Many of the calls OWB receives relate to how the caller should submit a tip to be eligible for an award, how the Commission will maintain the confidentiality of a whistleblower's identity, requests for information on the investigative process or tracking an individual's complaint status, and whether the SEC is the appropriate agency to handle the caller's tip. OWB provides a menu of options with answers to frequently asked questions on the voicemail hotline.

In addition to communicating with the public through the hotline, the Office communicates with whistleblowers who have submitted tips, claims for awards, and other correspondence to OWB.

Public Outreach and Education

One of OWB's primary goals is to promote public awareness of the Commission's whistleblower program. As part of that outreach effort, the Office aims to promote the program and educate the public about the program through OWB's webpage (www.sec.gov/whistleblower). The webpage contains information about the program, copies of the forms required to submit a tip or claim an award, a listing of enforcement actions for which a claim for award may be made, links to helpful resources, including a section dedicated to retaliation-related issues, and answers to frequently asked questions.

OWB also actively participates in numerous webinars, media interviews, presentations, press releases, and other public communications. In FY 2018, OWB participated in many public engagements aimed at promoting and educating the public about the Commission's whistleblower program. The Office's target audience generally includes potential whistleblowers, whistleblower counsel, and corporate compliance counsel and professionals. OWB's Chief also participates in legal panels and other forums with other federal agencies with similar whistleblower programs.

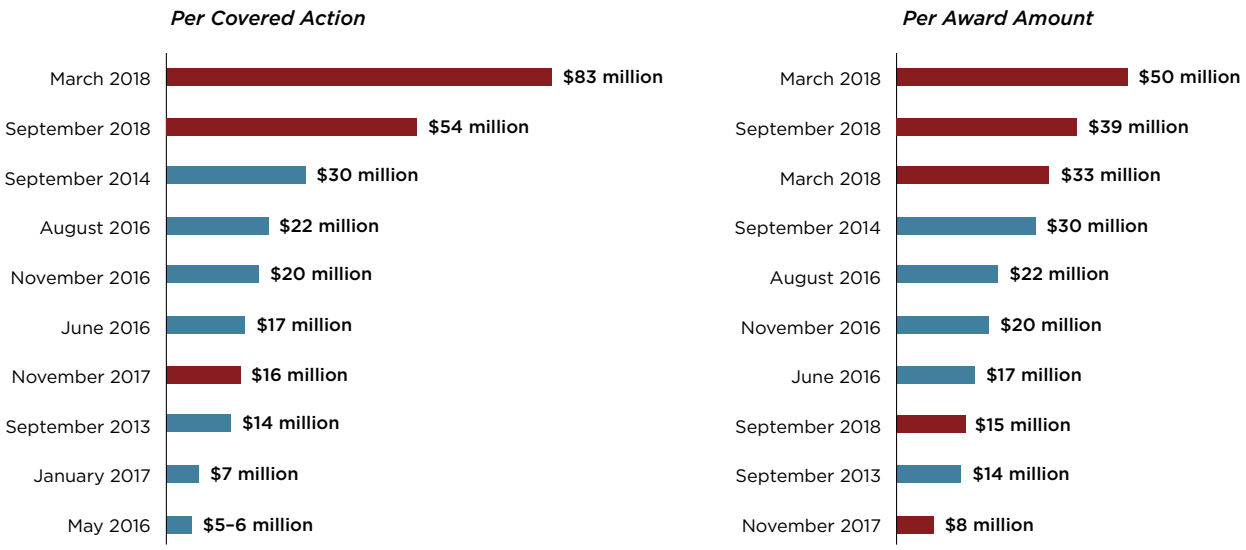
CLAIMS FOR AWARDS

Whistleblower Awards Made in Fiscal Year 2018

In FY 2018, the Commission ordered whistleblower awards of approximately $168 million to 13 individuals, each of whom voluntarily provided original information that either led to the opening of an investigation or significantly contributed to a successful enforcement action.

Below are the top ten highest awards made under the SEC's whistleblower program both by Covered Action (*i.e.*, considering all awards made within a single Covered Action) and by award amount through FY 2018. The awards highlighted in red were made this past fiscal year.

TOP 10 SEC WHISTLEBLOWER AWARDS



From program inception to end of Fiscal Year 2018, the SEC awarded over $326 million to 59 individuals.

The Commission's $83 million award in March 2018 included an almost $50 million joint award to two individuals, which is also the Commission's highest award to date, as well as an award of $33 million to a third individual. The Commission also made a $54 million award in September 2018, with a $39 million award to one individual, and a $15 million award to a second individual.

Below is an overview of the whistleblower awards made by the Commission during the past fiscal year.

Three Individuals Receive Largest-Ever Awards Totaling Almost $83 Million

On March 19, 2018, the Commission announced two of its largest-ever whistleblower awards, with two individuals sharing a nearly $50 million joint award and another whistleblower receiving more than $33 million.[15] The first two individuals jointly provided significant information that prompted the Commission to open the first of two investigations and ongoing assistance that saved the Commission a substantial amount of time and resources. The third individual supplied the Commission with additional information that initiated and acted as the cornerstone of the Commission's second investigation resulting in the Covered Action.

More Than $54 Million to Two Whistleblowers

On September 6, 2018, the Commission announced an award of more than $54 million to two whistleblowers, $39 million to one whistleblower and $15 million to another, whose critical information and continued assistance helped the agency bring an important enforcement action.[16] The $39 million award is the second-largest individual award in the history of the program.

More Than $16 Million Awarded to Two Whistleblowers

On November 30, 2017, the Commission announced an award of more than $16 million to two whistleblowers.[17] The first whistleblower alerted the staff to the particular misconduct that was the focus of the staff's investigation and the cornerstone of the subsequent action and provided continuing assistance, including the identification of potentially relevant documents and witnesses. The second whistleblower provided additional significant information and ongoing cooperation to the staff during the investigation that saved a substantial amount of time and agency resources.

Former Company Insider and Foreign National Receives $4.1 Million Award

On December 5, 2017, the Commission announced an award of more than $4.1 million to a former company insider who both alerted the Commission to a widespread, multi-year securities law violation and continued to provide important information and assistance throughout the SEC's investigation.[18] The whistleblower was a foreign national working outside of the United States.

15 *See* Order Determining Award Claim, Exchange Act Rel. No. 82897, File No. 2018-6 (Mar. 19, 2018); SEC Press Rel. No. 2018-44, "SEC Announces Its Largest-Ever Whistleblower Awards."

16 *See* Order Determining Award Claim, Exchange Act Rel. No. 84046, File No. 2018-11 (Sept. 6, 2018); SEC Press Rel. No. 2018-179, "SEC Awards More Than $54 Million to Two Whistleblowers."

17 *See* Order Determining Award Claim, Exchange Act Rel. No. 82181, File No. 2018-2 (Nov. 30, 2017); SEC Press Rel. No. 20187-216, "More Than $16 Million Awarded to Two Whistleblowers."

18 *See* Order Determining Award Claim, Exchange Act Rel. No. 82214, File No. 2018-3 (Dec. 5, 2017); SEC Press Rel. No. 2017-222, "Former Company Insider Earns More Than $4.1 Million for Whistleblower Tip."

Nearly $4 Million to Overseas Whistleblower

On September 24, 2018, the Commission announced an award of nearly $4 million to an overseas whistleblower whose tip prompted the Commission to open an investigation.[19] The whistleblower provided continuing and extensive assistance that helped the Commission bring a successful enforcement action.

$2.2 Million Award to Whistleblower Who First Reported to Another Federal Agency Before the SEC

On April 5, 2018, the Commission announced an award of more than $2.2 million to a former company insider who first reported the information to another federal agency but later provided the same information to the SEC, which helped the SEC bring the successful action.[20] This was the first award paid under the "safe harbor" of Exchange Act Rule 21F-4(b)(7), which provides that if a whistleblower first submits information to another federal agency but submits the same information to the SEC within 120 days, the SEC will treat the information as though it had been submitted to the SEC at the same time that it was submitted to the other agency.

Former Company Insider Receives $2.1 Million Award

On April 12, 2018, the Commission announced an award of more than $2.1 million to a former company insider who provided information that led to multiple successful enforcement actions and who provided ongoing assistance during the investigation.[21]

Award of Approximately $1.5 Million

On September 14, 2018, the Commission announced an award of more than $1.5 million to a whistleblower who provided the SEC with vital information and ongoing assistance that proved important to the overall success of the enforcement action.[22]

Award of More Than $1 Million

On October 12, 2017, the Commission announced an award of more than $1 million to a company outsider who provided new information and substantial corroborating documentation of a securities law violation by a registered entity that impacted retail customers.[23]

19 *See* Order Determining Award Claim, Exchange Act Rel. No. 84270, File No. 2018-13 (Sept. 24, 2018); SEC Press Rel. No. 2018-209, "SEC Awards Almost $4 Million to Overseas Whistleblower."

20 *See* Order Determining Award Claim, Exchange Act Rel. No. 82996, File No. 2018-8 (Apr. 5, 2018); SEC Press Rel. No. 2018-58, "SEC Awards More Than $2.2 Million to Whistleblowers Who First Reported Information to Another Federal Agency Before SEC."

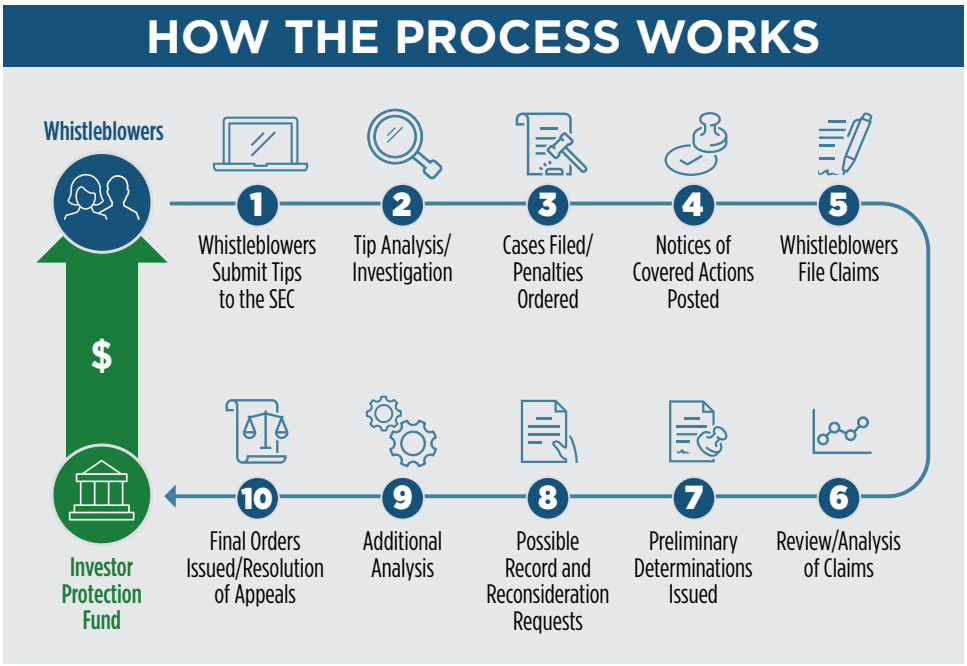
21 *See* Order Determining Award Claim, Exchange Act Rel. No. 83037, File No. 2018-9 (Apr. 12, 2018); SEC Press Rel. No. 2018-64, "SEC Awards Whistleblower More Than $2.1 Million."

22 *See* Order Determining Award Claim, Exchange Act Rel. No. 84125, File No. 2018-12 (Sept. 14, 2018); SEC Press Rel. No. 2018-194, "Whistleblower Receives Award of Approximately $1.5 Million."

23 *See* Order Determining Award Claim, Exchange Act Rel. No. 81857, File No. 2018-1 (Oct. 12, 2017); SEC Press Rel. No. 2017-195, "SEC Announces Whistleblower Award of More Than a Million Dollars."

Overview of Award Process

For a whistleblower to receive an award, there are a number of preconditions that must be met. The diagram below provides a snapshot of the overall process, from the filing of the whistleblower tip to payment of the whistleblower award. As reflected, the time between the submission of a whistleblower tip and when an individual may receive an award payment can be several years, particularly where the underlying investigation is especially complex, where there are multiple, competing award claims, or where there are claims for related actions. OWB undertakes extensive due diligence to ensure a careful and thorough evaluation of all award claims.



The discussion below focuses on the award claims process, from the posting of the NoCA (Step #4 above) to the issuance of a Final Order by the Commission (Step #10 above).

NoCA Posted

OWB posts on its webpage a NoCA for each Commission enforcement action where a final judgment or order, by itself or together with other judgments or orders in the same action issued after July 21, 2010, results in monetary sanctions exceeding $1 million.[24] During FY 2018, OWB posted 142 NoCAs.

OWB sends email alerts to GovDelivery when the NoCA listing is updated.[25] Whistleblowers and other members of the public may sign up to receive an update via email every time the list of NoCAs on OWB's webpage is updated. OWB posts new NoCAs on its webpage on the last business day of each month.

24 By posting a NoCA for a particular case, the Commission is not making a determination either that a whistleblower tip, complaint, or referral led to the Commission opening an investigation or filing an action with respect to the case or that an award to a whistleblower will be paid in connection with the case.

25 GovDelivery is a vendor that provides communications for public-sector clients.

Whistleblowers File Claims

Once a NoCA is posted, claimants have 90 calendar days to apply for an award by submitting a completed award application on Form WB-APP to OWB.[26] Only claimants who have a clear nexus between the information they submitted on their whistleblower tip to the Commission and the charges in the underlying action should apply for an award in any given matter. In making that determination, claimants are encouraged to (i) consider whether they had any communications with the relevant Enforcement staff who brought the action and (ii) review the relevant charging documents and consider the proximity between the Commission's specific charges and the claimant's tip. As discussed in more detail at pages 26–28 of this report, the proposed amendments to the Whistleblower Rules include tools that could deter frivolous claims, which drain resources and slow down the review process for meritorious claims. Frivolous claims can substantially complicate and delay the award process.

While OWB endeavors to contact whistleblowers who have worked with investigative staff to inform them of the application deadline, it is the responsibility of the claimant to make a timely application for award. The Commission has denied late-filed award claims. The Court of Appeals for the Second Circuit upheld the Commission's denial of two claimants whose award applications were submitted approximately two years after the required deadline.[27] As such, OWB encourages whistleblowers and their counsel to regularly review the monthly NoCA postings or to sign up to receive emails to alert them as to when new NoCAs are posted.

Review and Analysis of Award Claims

Based on an initial review of the award application and in consultation with investigative staff, OWB makes a preliminary assessment of the whistleblower claim. In keeping with OWB's goal of processing meritorious claims, claims that appear to be eligible for an award are prioritized for processing.

OWB attorneys evaluate each application for a whistleblower award. In addition to analyzing the information provided by the claimant on the Form WB-APP, OWB attorneys look at prior correspondence between the claimant and the Commission and consult intra-agency databases to understand the origin of the case and what tips or other correspondence the claimant may have submitted to the Commission. In addition, whenever possible, OWB attorneys work closely with investigative staff responsible for the relevant action, and/or other Commission staff who may have interacted with the claimant or have other relevant knowledge, to understand the contribution or involvement the claimant may have had in the matter.

Utilizing the information and materials provided by the claimant in support of the application, as well as other relevant materials reviewed, OWB attorneys prepare a recommendation to the Claims Review Staff as to whether the claimant meets the criteria for receiving an award, and if so, the recommended percentage of the award. Depending on the complexity of the award claim and the number of claimants who applied, this due diligence process may take a significant amount of time for OWB attorneys to conduct. While a less diligent process could result in quicker determinations for claimants, OWB strives to reach the soundest, not the quickest, result.

26 17 C.F.R. §§ 240. 21F-10(a), (b).

27 *See* Order Determining Whistleblower Award Claim, Exchange Act Release No. 77368 (Mar. 14, 2016), *pet. for rev. denied sub nom. Cerny v. SEC*, 707 F. App'x 29 (2d Cir. 2017), *cert. denied*, 138 S. Ct. 2005 (2018).

Most award claim recommendations also generally go through a multi-tiered, robust review process, including review and comment by Enforcement's Office of Chief Counsel and the Commission's Office of General Counsel.

> "Award percentages are based on the particular facts and circumstances of each case, and are not based on any predetermined mathematical formula."

Preliminary Determinations Issued

The Claims Review Staff, designated by the Co-Directors of Enforcement, considers OWB's recommendation on the award application in accordance with the criteria set forth in Dodd-Frank and the Whistleblower Rules. The Claims Review Staff currently is composed of five senior officers in Enforcement, including the Co-Directors of Enforcement. The Claims Review Staff then issues a Preliminary Determination setting forth its assessment of whether the claim should be approved or denied and, if approved, setting forth the proposed award percentage amount.[28]

The Whistleblower Rules outline a number of positive and negative factors that the Commission and Claims Review Staff may consider in assessing an individual's award percentage.[29] Award percentages are based on the particular facts and circumstances of each case, and are not based on any predetermined mathematical formula.

Factors that may increase an award percentage include the significance of the information provided by the whistleblower, the level of assistance provided by the whistleblower, the law enforcement interests at stake, and whether the whistleblower reported the violation internally through his or her firm's internal reporting channels or mechanisms.[30]

Factors that may decrease an award percentage include whether the whistleblower was culpable or involved in the underlying misconduct, interfered with internal compliance systems, or unreasonably delayed in reporting the violation to the Commission.

Possible Record and Reconsideration Requests

A claimant may submit a written request within 30 calendar days of the date of the Preliminary Determination asking for a copy of the record that formed the basis of the Claims Review Staff's decision as to the claim for award. As a precondition to receiving a copy of the record, OWB requires claimants and their counsel, if the claimant is represented, to execute a confidentiality agreement limiting the use of such materials to the claims review process.[31] In keeping with our statutory obligation of confidentiality, OWB carefully redacts each record to remove any information that could identify another whistleblower in the matter. A claimant also has 30 calendar days to request a meeting with OWB, which OWB may grant at its discretion.

Claimants may seek reconsideration of the Preliminary Determination by submitting a written response to OWB within 60 calendar days of the later of (i) the date of the Preliminary Determination, or (ii) if the record was requested, the date when OWB made the record available for a claimant's review.[32] If a claim is denied and the claimant does not object within the time period prescribed under the Whistleblower Rules, then the Preliminary Determination of the Claims Review Staff becomes the Final Order of the Commission.

---

28 17 C.F.R. § 240.21F-10(d).
29 *Id.* § 240.21F-6.
30 *But see* the discussion of the *Digital Realty* decision on pages 18–19 of this report.
31 *Id.* § 240.21F-12(b). Rule 21F-12(b) states, "The Office of the Whistleblower may also require you to sign a confidentiality agreement, as set forth in § 240.21F-(8)(b)(4) of this chapter, before providing [Preliminary Determination] materials."
32 17 C.F.R. § 240.21F-10(e).

Requests for reconsideration should include new information or argument and not simply restate what was included in the original award claim application. OWB attorneys may spend a considerable amount of time evaluating requests for reconsideration. OWB attorneys analyze claimants' legal arguments and take other steps before recommending a Proposed Final Determination for the Claims Review Staff to submit to the Commission. Because of the amount of time it takes to process reconsideration requests, OWB encourages claimants and their counsel to consider the merits of their reconsideration request in a particular matter and not to ask for reconsideration as a matter of course.

Final Order Issued and Resolution of Appeals

After considering any requests for reconsideration, the Claims Review Staff makes a Proposed Final Determination, and the matter is submitted to the Commission for its decision.[33]

All Preliminary Determinations of the Claims Review Staff that involve granting an award are submitted to the Commission for consideration as Proposed Final Determinations irrespective of whether the claimant objected to the Preliminary Determination.[34]

Within 30 days of receiving the Proposed Final Determination, any Commissioner may request that the Proposed Final Determination be reviewed by the Commission. If no Commissioner requests such a review within the 30-day period, then the Proposed Final Determination becomes the Final Order of the Commission. Claimants who are issued a denial have a right to appeal the Commission's Final Order within 30 days of issuance to the United States Court of Appeals for the District of Columbia Circuit, or to the circuit where the claimant resides or has his or her principal place of business.[35]

Final Orders of the Commission are publicly-available on the Commission's website and OWB's webpage. The public Final Orders are redacted to protect award claimants' confidentiality.

There are a number of factors that may affect the length of time it takes for OWB to review an award claim and for the Commission to issue a Final Order. For example, the number of claimants, both meritorious and non-meritorious, applying for an award in connection with a Covered Action affects the time it takes to process a claim. Similarly, the presence of novel issues, or the need to supplement the record with additional information from the claimant, may also lengthen the time it takes to process a claim. There may be a delay when there is a claim for an award in connection with a related action, requiring OWB to coordinate with or receive assistance from another regulator to understand what contribution the whistleblower may have made in the related action. Additionally, requests for the record and for reconsideration can substantially delay the issuance of a Final Order. We anticipate increased efficiencies in the claims review process if certain proposed rule amendments are adopted by the Commission.

For more information about the proposed rule amendments, please see pages 26–28 of this report.

33 *Id.* §§ 240.21F-10(g)-(h).
34 *Id.* §§ 240.21F-10(f), (h).
35 *Id.* § 240.21F-10(h). A whistleblower's rights of appeal from a Commission Final Order are set forth in Section 21F(f) of the Exchange Act, 15 U.S.C. § 78u-6(f), and Exchange Act Rule 21F-13(a), 17 C.F.R. § 240.21F-13(a).

PROFILES OF AWARD RECIPIENTS

"Since program inception, the Commission has issued awards of over $326 million to 59 individuals in connection with 48 Covered Actions, as well as in connection with several related actions."

Protecting whistleblower confidentiality is an integral component of the whistleblower program. Dodd-Frank prohibits the Commission and its staff from disclosing any information that reasonably could be expected to reveal the identity of a whistleblower, subject to certain exceptions. Consequently, information that may tend to reveal a whistleblower's identity is redacted from Commission orders granting or denying awards before they are issued publicly. This may include redacting the name of the enforcement action upon which the award is based.

Consistent with our statutory obligation to maintain whistleblower confidentiality but in an effort to provide more transparency, this section provides information about the profiles of past award recipients—from the whistleblower program's inception to the end of FY 2018—while still protecting the identity of any particular individual.

Since program inception, the Commission has issued awards of over $326 million to 59 individuals in connection with 48 Covered Actions, as well as in connection with several related actions. Many of the tips or complaints that were submitted by these successful whistleblowers share similar characteristics. The information provided by each award recipient was specific. For example, the whistleblowers identified particular individuals involved in the misconduct, or provided specific documents that substantiated their allegations or explained where such documents could be located. In some instances, the whistleblowers identified specific financial transactions that evidenced fraud, or provided detailed assessment of the wrongdoing. The misconduct reported by award recipients is often relatively current or ongoing at the time it was reported to the Commission. Additionally, nearly all of the award recipients provided Commission staff with additional assistance and/or information (*e.g.*, answered staff questions or provided testimony) after they submitted their initial tips.

An individual may be eligible to receive an award where her or his information leads to a successful enforcement action—meaning generally that the original information either caused the staff to open an examination or investigation, or the original information significantly contributed to a successful enforcement action where the matter was already under examination or investigation. Of the whistleblowers who have received awards under the program, approximately 67% provided original information that caused staff to open an investigation or examination, and approximately 33% received awards because their original information assisted with an already-existing investigation or examination. In assessing whether information assisted with an ongoing matter, the Commission considers factors such as whether the information allowed the Commission to bring an action in significantly less time or with fewer resources, and whether it supported additional successful charges, or successful claims against additional individuals or entities.[36] When the Commission has found claimants to be ineligible for awards on non-procedural grounds, it is often because the claimants' information did not result in the opening of an investigation or examination, opening of a new line of inquiry in an existing investigation or examination, nor significantly contribute to an ongoing investigation or examination.

36 Securities Whistleblower Incentives and Protections, 76 Fed. Reg. 34,300, 34,325 (June 13, 2011).

There is no requirement under the Whistleblower Rules that an individual be an employee or company insider to be eligible for an award. However, approximately 69% of the award recipients to date were current or former insiders of the entity about which they reported information of wrongdoing to the SEC. Of the award recipients who were current or former employees of a subject entity, approximately 83% raised their concerns internally to their supervisors, compliance personnel, or through internal reporting mechanisms, or understood that their supervisor or relevant compliance personnel knew of the violations, before reporting their information of wrongdoing to the Commission.

Award recipients have also included investors who had been victims of the fraud, professionals working in the same or related industry, or other types of outsiders, such as individuals who had a personal relationship with the wrongdoer or individuals who have a special expertise in the market.

Whistleblowers have helped the Commission bring cases against a variety of individuals and entities, many of which are involved in the financial services industry. Individuals comprised approximately 44% of the defendants and respondents in cases resulting in whistleblower awards. Approximately 34% of the defendants and respondents in cases in which a whistleblower received an award concerned entities registered with the Commission, including broker-dealers, investment advisers, or other registered market participants. Unregistered entities comprised approximately 22% of the defendants and respondents.

In addition, whistleblowers have assisted the Commission in bringing enforcement cases involving an array of securities violations. A number of the award recipients reported information to the Commission concerning offering frauds, such as Ponzi, or Ponzi-like, schemes. Other award recipients provided tips to the Commission relating to false or misleading statements in a company's offering memoranda or marketing materials, false pricing information, accounting violations, internal controls violations, and FCPA violations, among other types of misconduct.

Under the Whistleblower Rules, individuals are permitted to jointly submit a tip to the Commission. Seven of the matters for which whistleblower awards were ordered involved two or more whistleblowers jointly submitting information to the Commission.

Individuals who provide information that leads to successful SEC actions resulting in monetary sanctions over $1 million also may be eligible to receive an award if the same information led to a related action, such as a parallel criminal prosecution. Six of the award recipients to date have received payments based, in part, on collections made in related criminal or other qualifying related actions.

Past whistleblower award recipients hail from several different parts of the United States, and twelve recipients were foreign nationals or residents of foreign countries at the time they submitted their tips to the Commission.

"... whistleblowers have assisted the Commission in bringing enforcement cases involving an array of securities violations."

PRESERVING INDIVIDUALS' RIGHTS TO REPORT TO THE COMMISSION AND SHIELDING EMPLOYEES FROM RETALIATION

Section 21F(h)(1) of Dodd-Frank expanded protections for whistleblowers and broadened prohibitions against retaliation.[37] Following the passage of Dodd-Frank, the Commission implemented rules that enabled the SEC to take legal action against employers who have retaliated against whistleblowers. To date, the Commission has brought three anti-retaliation enforcement actions.

Exchange Act Rule 21F-17(a) prohibits any person from taking any action to prevent an individual from contacting the SEC directly to report a possible securities law violation. The Rule states that "[n]o person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications."[38] To date, the Commission has brought nine enforcement actions involving violations of Rule 21F-17.

FY 2018 saw a major shift with respect to the scope of the Dodd-Frank anti-retaliation protections. Under the Commission's Whistleblower Rules, the anti-retaliation protections applied to employees who reported possible securities law violations, whether internally, to other law enforcement agencies, or to the SEC. Recognizing the important role that internal compliance programs play in helping the Commission prevent, detect, and stop securities law violations, there are multiple provisions in the Whistleblower Rules meant to support individuals who choose to report internally in the first instance, including a potential increase in award percentage.

The federal courts of appeals, however, were divided over whether the Dodd-Frank anti-retaliation protections applied to employees who report potential violations of the securities laws internally without also reporting to the Commission. The United States Supreme Court granted certiorari in *Digital Realty* to address the scope of the Dodd-Frank anti-retaliation protections.

In February 2018, the Court in *Digital Realty* held that the whistleblower provisions of the Exchange Act require that an employee report a possible securities law violation to the Commission to qualify for protection against employment retaliation under Section 21F. The Court thus invalidated the Commission's rule interpreting Section 21F's anti-retaliation protections to apply in cases where an employee had reported only internally. In the months following the *Digital Realty* decision, there was an increase in the number of whistleblower tips received by the Commission, which may have been attributable, in part, to the decision.

37 15 U.S.C. § 78u-6(h)(1).
38 17 C.F.R. § 240.21F-17(a).

Following the *Digital Realty* decision, the Commission issued proposed rule amendments to Rule 21F-2. The proposed rule would modify Rule 21F-2 so that it comports with the Court's holding by, among other things, establishing a uniform definition of "whistleblower" that would apply to all aspects of Exchange Act Section 21F.

Retaliation protection remains a key tenet of the whistleblower program, and OWB will continue to support enforcement investigations where retaliation occurred after the whistleblower reported securities violations to the Commission. Furthermore, OWB will continue to support the enforcement of the whistleblower protections of Exchange Act Rule 21F-17(a), which prohibits any person from taking any action to prevent an individual from contacting the SEC directly to report a possible securities law violation. OWB will continue to work closely with investigative staff to identify and investigate practices in the use of confidentiality and other kinds of agreements, or engagement in other practices, to interfere with individuals' ability to report potential wrongdoing to the SEC.

"OWB will continue to support enforcement investigations where retaliation occurred [and] . . . will continue to support the enforcement of the whistleblower protections of Exchange Act Rule 21F-17(a) . . ."

WHISTLEBLOWER TIPS RECEIVED

"From FY 2012 . . . to FY 2018, the number of whistleblower tips received by the Commission has grown by approximately seventy-six percent."

The Whistleblower Rules specify that individuals who would like to be part of the whistleblower program must submit their tip via the Commission's online portal or by mailing or faxing their tip on Form TCR to OWB.[39] Whistleblowers who use the online portal to submit a tip receive a computer-generated confirmation of receipt with a TCR submission number. For those who submit a hard-copy Form TCR by mail or fax, OWB sends an acknowledgement letter, which includes a TCR submission number, or a deficiency letter explaining that the information was not properly submitted under the Whistleblower Rules. All whistleblower tips referring to potential securities law violations received by the Commission are entered into the TCR System and are evaluated by the Commission's Office of Market Intelligence (OMI) within Enforcement. The Commission's TCR System was recently updated to include more user-friendly features, including the ability to upload much larger attachments. OWB encourages individuals and their counsel to submit tips using the Commission's online portal, rather than through a hard-copy Form TCR. Furthermore, claimants and their counsel are encouraged to submit their tip via only one method. For example, the same tip should not be entered through the online portal and then mailed in hard copy to the office. This can create duplication of work for OWB intake staff.

Increase in Whistleblower Tips

Throughout the history of the whistleblower program, the Commission's receipt of whistleblower tips has reflected an upward trajectory, and the number of tips received this past fiscal year proves to be no exception to this trend. Since August 2011, the Commission has received over 28,000 whistleblower tips, and in FY 2018 alone, received more than 5,200 tips. The table below shows the number of whistleblower tips received by the Commission on a yearly basis since the inception of the whistleblower program.[40]

FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018
334	3,001	3,238	3,620	3,923	4,218	4,484	5,282

As reflected in this table, from FY 2012, the first year for which we have full-year data,[41] to FY 2018, the number of whistleblower tips received by the Commission has grown by approximately seventy-six percent.[42]

39 17 C.F.R. § 240.21F-9(a).

40 The Commission also receives tips from individuals who do not wish to be part of the whistleblower program. The data in this report is limited to whistleblower tips and does not reflect all tips or complaints received by the Commission during the fiscal year.

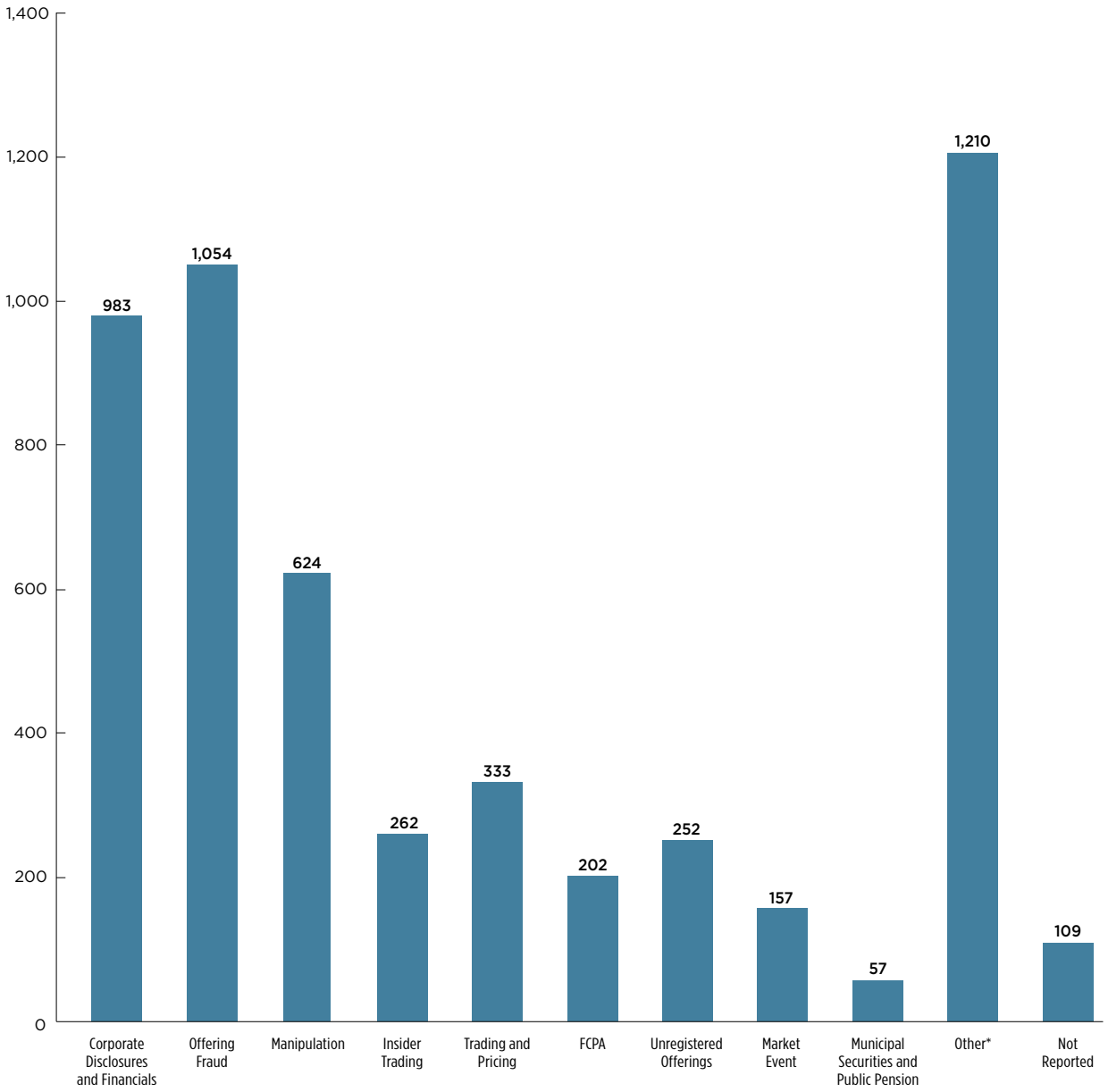
41 Because the Whistleblower Rules became effective on August 12, 2011, only seven weeks of whistleblower data is available for FY 2011.

42 In FY 2016 and FY 2017, the Commission received an unusually high number of whistleblower tips from two individuals, and received an unusually high number of whistleblower tips from one individual in FY 2018. The data for these fiscal years excludes tips received from these individuals—both in this section of the report and in the appendices to this report.

Whistleblower Allegation Type

Whether submitting tips on Form TCR or through the online portal, whistleblowers should identify the nature of their complaint allegations. In FY 2018, the most common complaint categories reported by whistleblowers were Offering Fraud (20%), Corporate Disclosures and Financials (19%), and Manipulation (12%).[43]

The following graph reflects the number of whistleblower tips received in FY 2018 by allegation type.[44]



43 This breakdown reflects the categories selected by whistleblowers and, thus, the data represents the whistleblower's own characterization of the violation type.

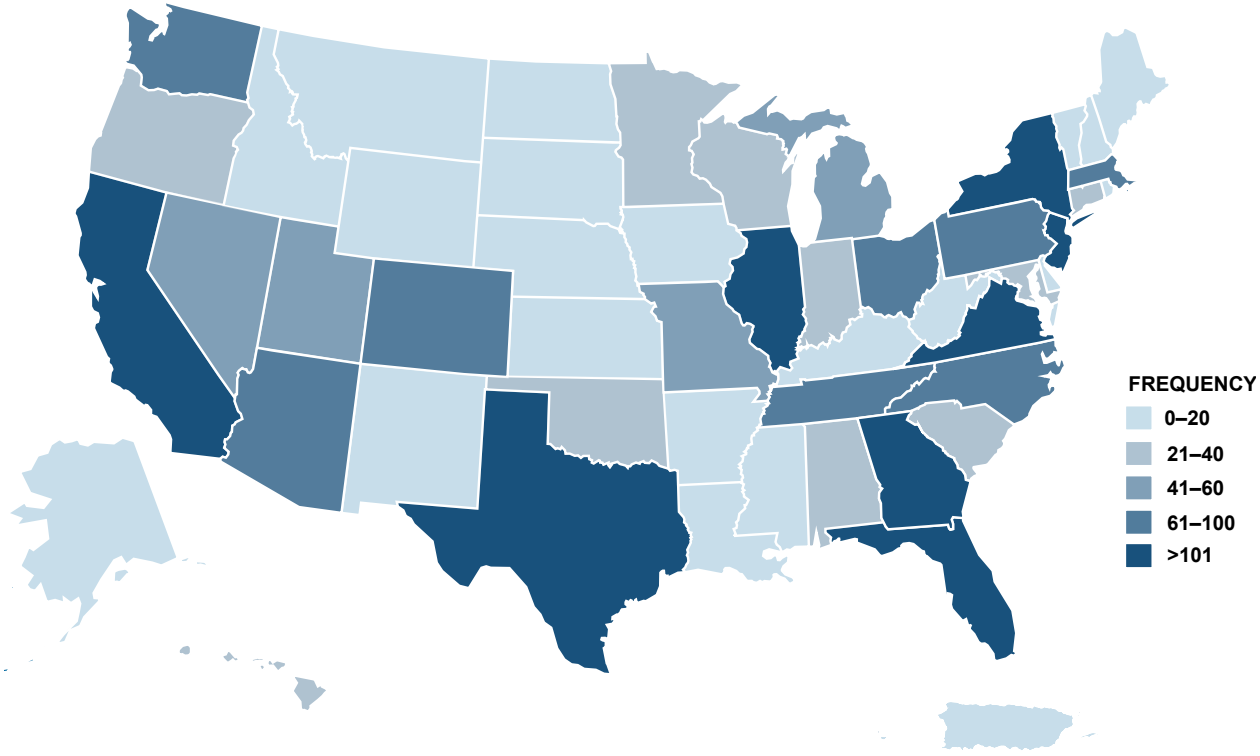
44 The category of "Other" indicates that the submitter identified the whistleblower TCR as not fitting into any allegation category that is listed on the questionnaire.

The types of securities violations reported by whistleblowers have remained generally consistent over the last seven years. Since the beginning of the program, Corporate Disclosures and Financials, Offering Fraud, and Manipulation have consistently ranked as the three highest allegation types reported by whistleblowers. Appendix A to this report provides a comparison among the number of whistleblower tips by allegation type that the Commission received during FY 2015 through FY 2018. In addition, in this past fiscal year, 39 tips were submitted as involving "Initial Coin Offerings and Cryptocurrencies," an allegation category added to the TCR System in the fourth quarter of FY 2018. The addition of this allegation category reflects a desire to refine data capture to better understand misconduct in the developing digital asset arena.

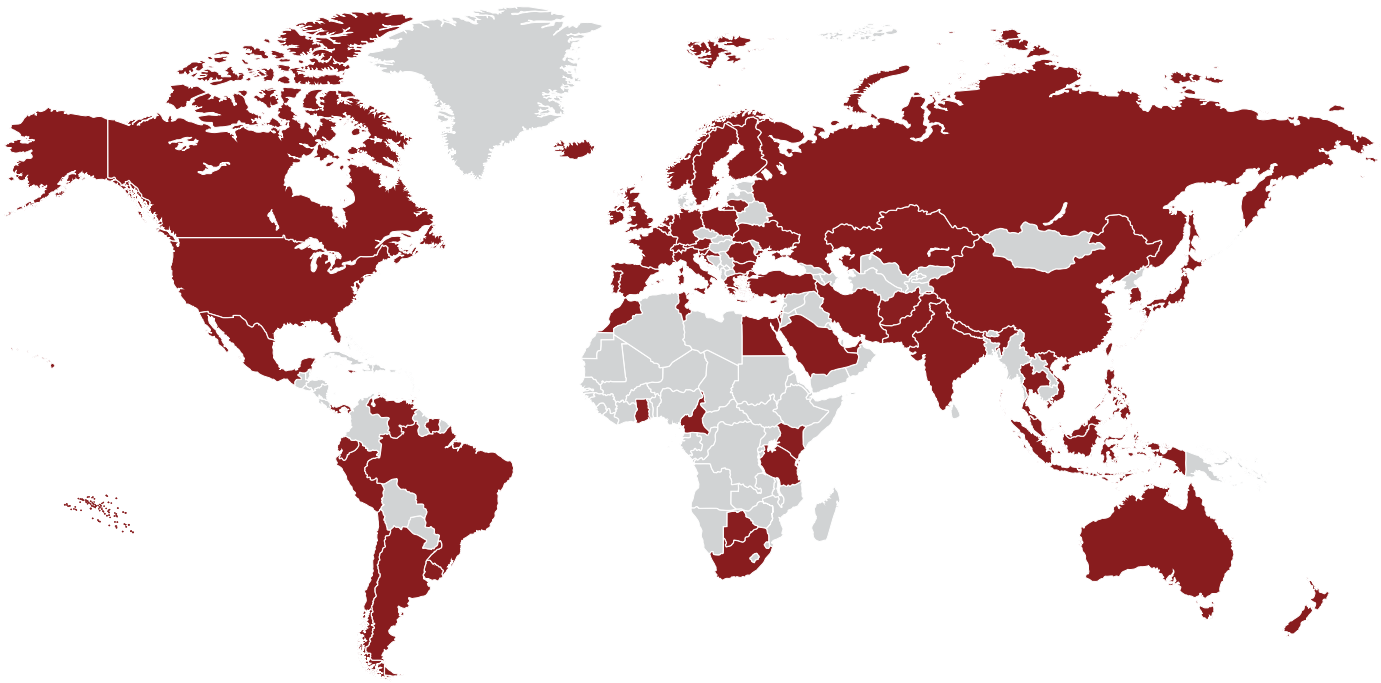
Geographic Origin of Whistleblower Tips

Through OWB's extensive outreach efforts to publicize and promote the Commission's whistleblower program, the Commission continues to receive whistleblower submissions from individuals throughout the United States, as well as internationally.

During FY 2018, California, New York, Florida, Texas and New Jersey yielded the highest number of whistleblower tips.



Since the beginning of the whistleblower program, the Commission has received whistleblower tips from individuals in 119 countries outside the United States. In FY 2018 alone, the Commission received whistleblower submissions from individuals in 72 foreign countries. After the United States, OWB received the highest number of whistleblower tips this past fiscal year from individuals in Canada, the United Kingdom, and Australia. The map below reflects the countries in which whistleblower tips originated during FY 2018.



Appendices B and C to this report provide detailed information concerning the sources of domestic and foreign whistleblower tips that the Commission received during FY 2018.

PROCESSING OF WHISTLEBLOWER TIPS

OMI evaluates incoming whistleblower TCRs and assigns specific, credible, and timely TCRs to members of the Commission staff for further analysis or investigation.

> "... whistleblower tips that are specific, credible, and timely, and which are accompanied by corroborating documentary evidence, are more likely to be forwarded to investigative staff for further analysis or investigation."

TCR Evaluation

OMI reviews every TCR submitted by a whistleblower to the Commission that references a possible securities law violation. OMI examines each tip to identify those with high-quality information that warrant the additional allocation of Commission resources. Generally, when the evaluation of a tip could benefit from the specific expertise of another Division or Office within the SEC, the tip is forwarded to staff in that Division or Office for further analysis. When OMI determines that a tip should be considered for investigation, OMI assigns the tip to one of the Commission's eleven regional offices, a specialty unit, or to an Enforcement group in the Home Office. Tips that relate to an existing investigation are forwarded to the staff working on the matter.

The Commission may use information from whistleblower tips in several different ways. For example, the Commission may initiate an enforcement investigation based on the whistleblower's tip. Even if the tip does not cause an investigation to be opened, it may still help lead to a successful enforcement action if the whistleblower provides additional information that significantly contributes to an ongoing or already-existing investigation. Tips may also prompt the Commission to commence an examination of a regulated entity, which may lead to an enforcement action or to the entity correcting the problem or clarifying an issue.

OWB tracks whistleblower tips that are referred to Enforcement staff for investigation. OWB currently is tracking over 900 matters in which a whistleblower's tip has caused a Matter Under Inquiry or investigation to open, or has been forwarded to Enforcement staff for review and consideration in connection with an ongoing investigation. Not all of these matters, however, will result in an enforcement action, or an enforcement action where the required threshold of over $1 million in monetary sanctions will be ordered. Whistleblower tips may also be used to open an examination or referred to examination staff in connection with a planned or ongoing exam.

In general, whistleblower tips that are specific, credible, and timely, and which are accompanied by corroborating documentary evidence, are more likely to be forwarded to investigative staff for further analysis or investigation. For instance, if the tip identifies individuals involved in the scheme, provides examples of particular fraudulent transactions, or points to non-public materials evidencing the fraud, the tip is more likely to be assigned to Enforcement staff for investigation. Tips that make blanket assertions or general inferences based on market events are less likely to be forwarded to or investigated by Enforcement staff.

In certain instances, OMI or other Enforcement staff may determine it is more appropriate that a whistleblower's tip be investigated by another regulatory or law enforcement agency. When this occurs, the tip is referred to the other agency in accordance with the Exchange Act's whistleblower confidentiality requirements.

Tips that relate to the financial affairs of an individual investor or a discrete investor group usually are forwarded to the Commission's Office of Investor Education and Advocacy (OIEA) for resolution. Comments or questions about agency practice or the federal securities laws also are forwarded to OIEA.

Assistance by OWB

OWB supports the tip allocation and investigative processes in several ways. When whistleblowers submit tips on a Form TCR in hard-copy by mail or fax, OWB enters the information into the TCR System so it can be evaluated by OMI. Tips submitted by whistleblowers through the Commission's online portal are automatically forwarded to OMI for evaluation. During the evaluation process, OWB may assist by contacting the whistleblower to obtain additional information to help in the triage process.

After submitting an initial tip, a whistleblower is free to, and often does, submit additional information or materials to buttress his or her earlier allegations. Additional information may be submitted through the online portal, with reference to the original TCR submission number (if known), or may be submitted directly to the investigative staff if the whistleblower is working with staff on the matter. To the extent additional information is sent to OWB in hard-copy by mail or fax, OWB then uploads the additional information to the TCR System. While OWB sends acknowledgement letters confirming receipt of Form TCRs or deficiency letters where appropriate, due to the increasing volume of additional information submitted in paper form to OWB, and the ready availability of electronic submissions, OWB does not provide acknowledgement letters in response to additional information.

PROPOSED WHISTLEBLOWER RULE AMENDMENTS

"The proposed amendments are intended to increase efficiencies in the whistleblower claims review process . . ."

The proposed amendments to the Whistleblower Rules were published in the Federal Register on July 20, 2018. The public comment period ended on September 18, 2018.[45] The Commission received approximately 100 unique letters and two form letters from commenters. Commission staff is currently reviewing the comments.[46] The proposed amendments are intended to increase efficiencies in the whistleblower claims review process, provide the Commission with additional tools in making whistleblower awards to ensure that meritorious whistleblowers are appropriately rewarded for their efforts, and align the requirements for anti-retaliation protection under the Whistleblower Rules with the holding in *Digital Realty*. The proposed amendments would make certain modifications and clarifications to the existing rules, as well as several technical amendments.

Increased Efficiencies in Claims Review Process

The proposed rule amendments are intended to increase efficiencies in the claims review process by clarifying the Commission's ability to bar individuals from submitting whistleblower applications where they are found to have submitted false information to the Commission or where they repeatedly make frivolous award claims in Commission actions. The proposed rules would codify the Commission's current practice with respect to barring applicants who submit false, fictitious, or fraudulent statements in their dealings with the Commission and permit the Commission to permanently bar any applicant from seeking an award after the Commission determines that the applicant has abused the process by submitting three award applications that the Commission finds to be frivolous or lacking a colorable connection between the tip (or tips) and the Commission action. The proposed rule would expressly provide, however, that OWB shall advise any claimant of the Office's assessment that the claimant's award application for a Commission action is frivolous or lacking a colorable connection between the tip and the action for which the individual has sought an award. If the applicant withdraws the application at that time, it would not be considered by the Commission in determining whether to exercise its authority to impose a bar for three or more frivolous applications or applications lacking a colorable connection between the tip and the Commission action for which the award was sought.

In addition, the proposed rule amendments would provide the Commission with a summary disposition procedure for certain types of likely denials, such as untimely award applications, applications that involve a tip that was not provided to the Commission in the form and manner that the rules require, and applications where the claimant's information was never provided to or used by investigative staff. The proposed summary disposition procedure is intended to help facilitate a more timely resolution of such relatively straightforward denials, while freeing up staff resources to focus on processing potentially meritorious award claims.

45 *See* Amendments to the Commission's Whistleblower Program Rules, 83 Fed. Reg. 34,702 (proposed July 20, 2018).
46 Comments to the proposed rules are available at: https://www.sec.gov/comments/s7-16-18/s71618.htm

Additional Tools in Award Determinations

The proposed rule amendments would provide the Commission with additional tools in making awards, including by: (i) allowing awards based on deferred prosecution agreements (DPAs) and non-prosecution agreements (NPAs) entered into by the U.S. Department of Justice or a state attorney general in a criminal case, or a settlement agreement entered into by the Commission outside of the context of a judicial or administrative proceeding to address violations of the securities laws; (ii) providing additional considerations for small and exceedingly large awards; and (iii) eliminating potential double recovery under the current definition of "related action."

Allowing awards based on NPAs, DPAs, and settlement agreements outside of the context of a judicial or administrative proceeding would help ensure that whistleblowers are not disadvantaged because of the particular form of an action that was pursued.

In the context of potential awards that could yield a payout of less than $2 million to a whistleblower, the proposed rules would authorize the Commission in its discretion to adjust the award percentage upward under certain circumstances (subject to the 30% statutory maximum) to an amount up to $2 million.

Under the proposed rules, if a potential award could yield total collected monetary sanctions of at least $100 million, the Commission could exercise its discretion to adjust the award percentage so that it would yield a payout (subject to the 10% statutory minimum) that does not exceed an amount that is reasonably necessary to reward the whistleblower and to incentivize other similarly situated whistleblowers. In no event, however, would the award be adjusted below $30 million (or below the 10% statutory minimum). This proposed rule would apply to award applications that are connected to a NoCA posted on or after the effective date of the rules.

In addition, the proposed amendments would clarify that a law-enforcement or separate regulatory action would not qualify as a "related action" if the Commission determines that there is a separate whistleblower award scheme that more appropriately applies to the enforcement action.

Uniform Definition of "Whistleblower"

As discussed elsewhere in this report, the proposed amendments would modify Rule 21F-2 so that it comports with the Supreme Court's holding in *Digital Realty*. The Court in *Digital Realty* held that the whistleblower provisions of the Exchange Act require that a person report a possible securities law violation to the Commission in order to qualify for protection against employment retaliation, thus invalidating the Commission's rule interpreting Section 21F's anti-retaliation protections to apply in cases of internal reports. The proposed amendments would, among other things, establish a uniform definition of "whistleblower" that would apply to all aspects of Exchange Act Section 21F—*i.e.*, the award program, the heightened confidentiality requirements, and the employment anti-retaliation protections. To qualify for anti-retaliation protection, the rule proposal notes that the individual must have submitted his or her information to the Commission "in writing."

Interpretive Guidance

In addition to the proposed rule amendments, the Commission published proposed interpretive guidance to help clarify the meaning of "independent analysis" as that term is defined in Exchange Act Rule 21F-4(b)(3) and utilized in award applications. To be considered "analysis," the Commission's rule requires that a whistleblower's examination and evaluation of publicly available information "reveal[] information that is not generally known or available to the public."[47] Under the proposed guidance, in order to qualify as "independent analysis," a whistleblower's submission must provide evaluation, assessment, or insight beyond what would be reasonably apparent to the Commission from publicly available information.

The full text of the proposed rule amendments is available at:
https://www.sec.gov/rules/proposed/2018/34-83557.pdf

47 17 CFR § 240.21F-4(b)(3).

SECURITIES AND EXCHANGE COMMISSION INVESTOR PROTECTION FUND

Section 922 of Dodd-Frank established the Investor Protection Fund to provide funding for the Commission's whistleblower award program, including the payment of awards in related actions.[48] As required by statute, all payments are made out of this Fund, which is financed entirely through monetary sanctions paid to the SEC by securities law violators. No money has been taken or withheld from harmed investors to pay whistleblower awards. The Fund also is used to finance the operations of the suggestion program of the SEC's Office of Inspector General.[49] The suggestion program is intended for the receipt of suggestions from SEC employees for improvements in work efficiency, effectiveness, productivity, and the use of resources at the Commission, as well as allegations by SEC employees of waste, abuse, misconduct, or mismanagement within the Commission, and is operated outside of OWB.[50]

Section 21F(g)(5) of the Exchange Act requires certain Fund information to be reported to Congress on an annual basis. Below is a chart containing Fund-related information for FY 2018.

	FY 2018
Balance of Fund at beginning of fiscal year[51]	$ 297,387,453.49
Unavailable amounts from FY 2017 available during fiscal year[52]	$ 310,478.00
Amounts deposited into or credited to Fund during fiscal year	$ 179,626,352.60
Amount of interest receipts from investments during fiscal year	$ 5,746,262.10
Amount of receipts during fiscal year that are unavailable[52]	$ (12,234,592.57)
Amounts paid from Fund during fiscal year to whistleblowers	$ (94,348,311.00)
Amounts estimated to be paid from Fund during fiscal year to whistleblowers	$ (77,127,230.29)
Amount disbursed to Office of the Inspector General during fiscal year	$ (26,430.51)
Balance of Fund at end of fiscal year	$ 299,333,981.82

48 Section 21F(g)(2)(A) of the Exchange Act, 15 U.S.C. § 78u-6(g)(2)(A).

49 Section 21F(g)(2)(B) of the Exchange Act, 15 U.S.C. § 78u-6(g)(2)(B), provides that the Fund shall be available to the Commission for "funding the activities of the Inspector General of the Commission under section 4(i)." The Commission's Office of General Counsel has interpreted this section to refer to Exchange Act Section 4D, which established the Inspector General's suggestion program. That section provides that the "activities of the Inspector General under this subsection shall be funded by the Securities and Exchange Commission Investor Protection Fund established under Section 21F." *Id.* § 78d-4(e).

50 Section 4D(a) of the Exchange Act, *id.* § 78d-4(a).

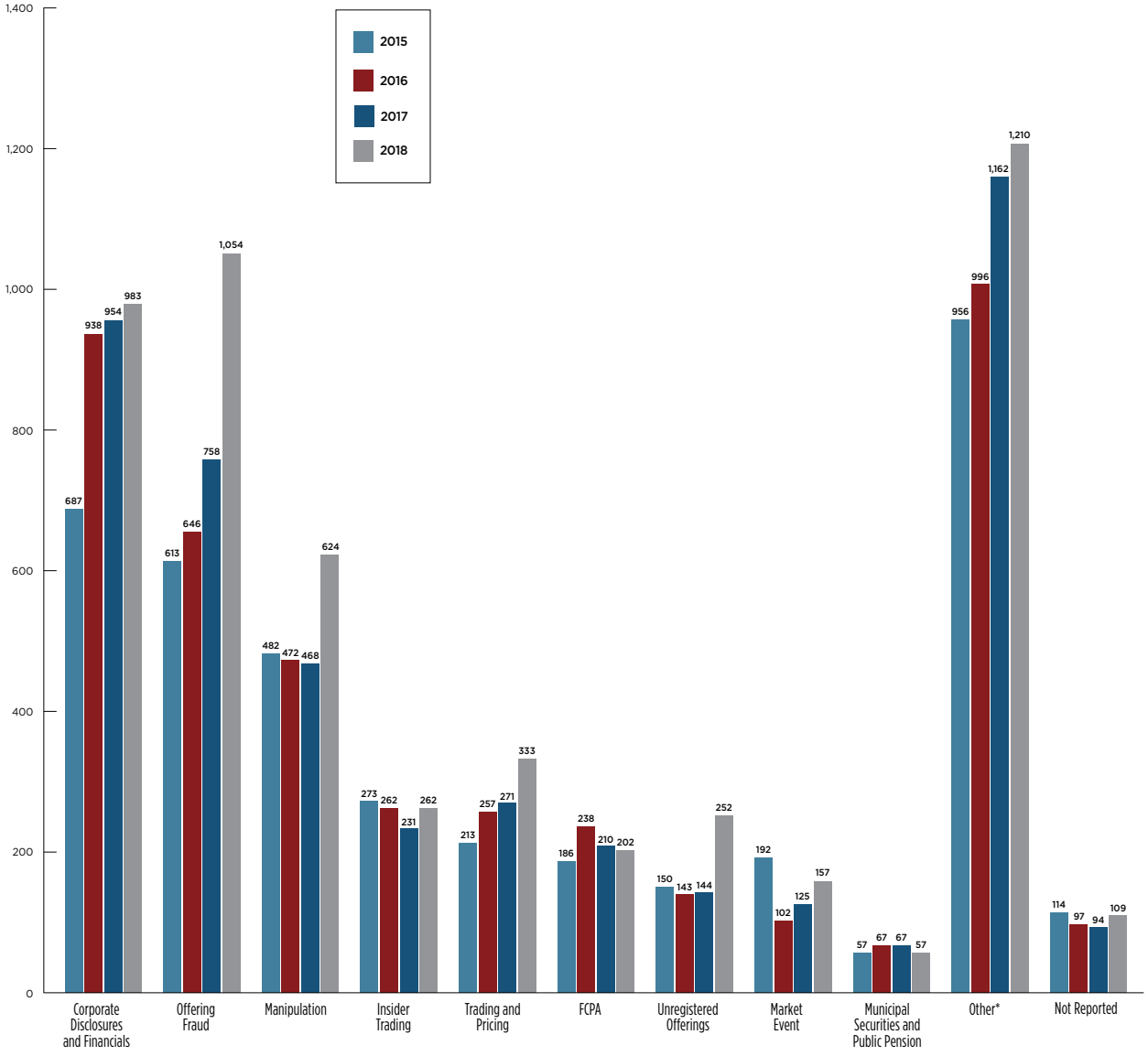
51 During FY 2018, the SEC changed how the balance of the Fund is defined for replenishment purposes. Prior to FY 2018, the balance was defined as total assets of the Fund. Beginning in FY 2018, the SEC changed to the available unobligated balance. As a result, the beginning balance differs from what was previously reported as the ending balance for FY 2017.

52 Amounts relate to available resources temporarily reduced during the fiscal year as a result of the Budget Control Act of 2011. These amounts become available at the beginning of the following fiscal year.

Whenever the balance of the Fund falls below $300 million, a statutory replenishment mechanism is triggered. For a complete description of the mechanisms that Congress established to replenish the Fund, see Section 21F(g)(3) of the Exchange Act, 15 U.S.C. 78-6(g)(3).

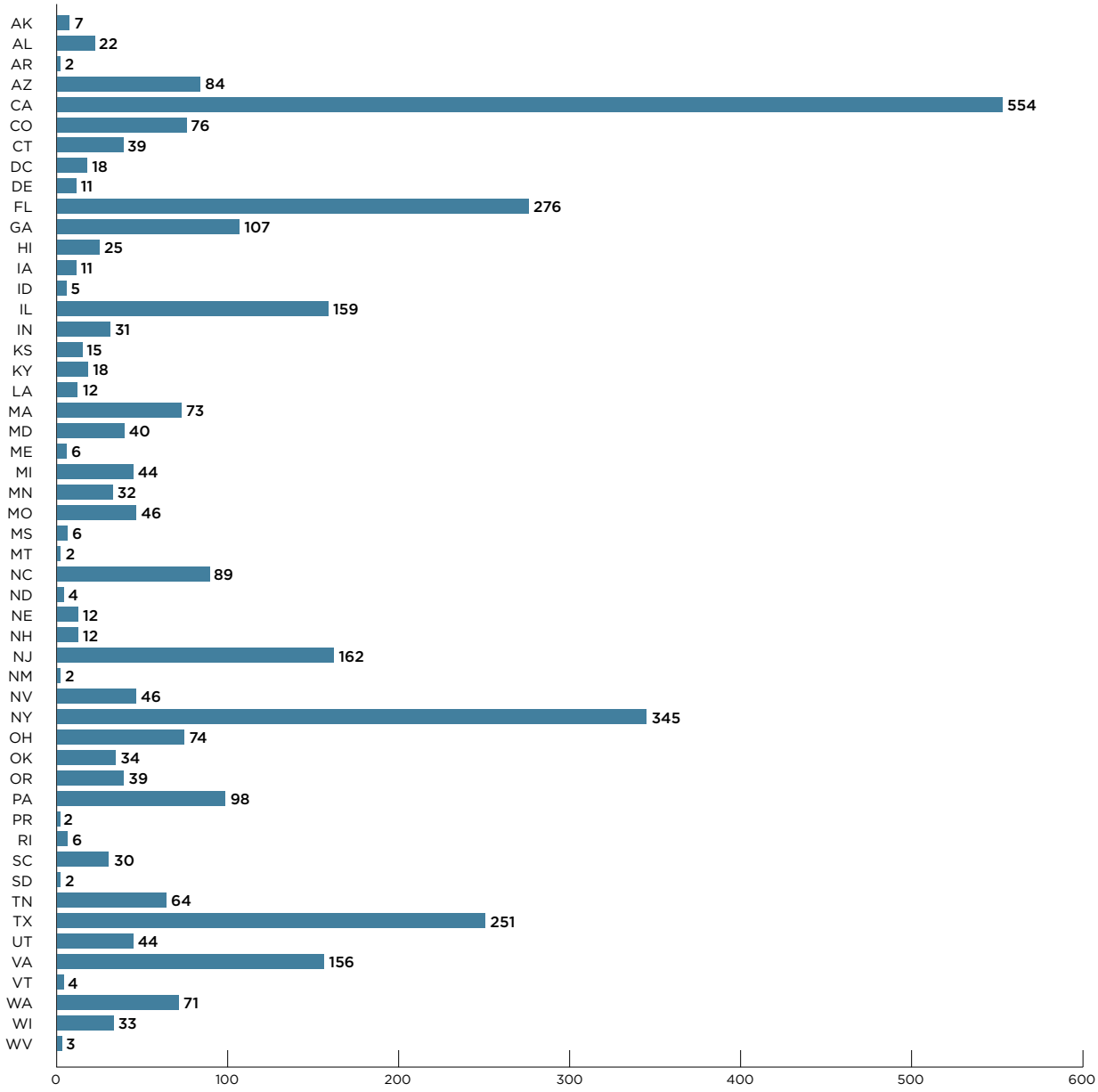
Section 21F(g)(5) of the Exchange Act also requires a complete set of audited financial statements for the Fund, including a balance sheet, income sheet, income statement, and cash-flow analysis. That information will be included in the Commission's Agency Financial Report, which will be separately submitted to Congress.

APPENDIX A
WHISTLEBLOWER TIPS BY ALLEGATION TYPE
COMPARISON OF FISCAL YEARS 2015–2018



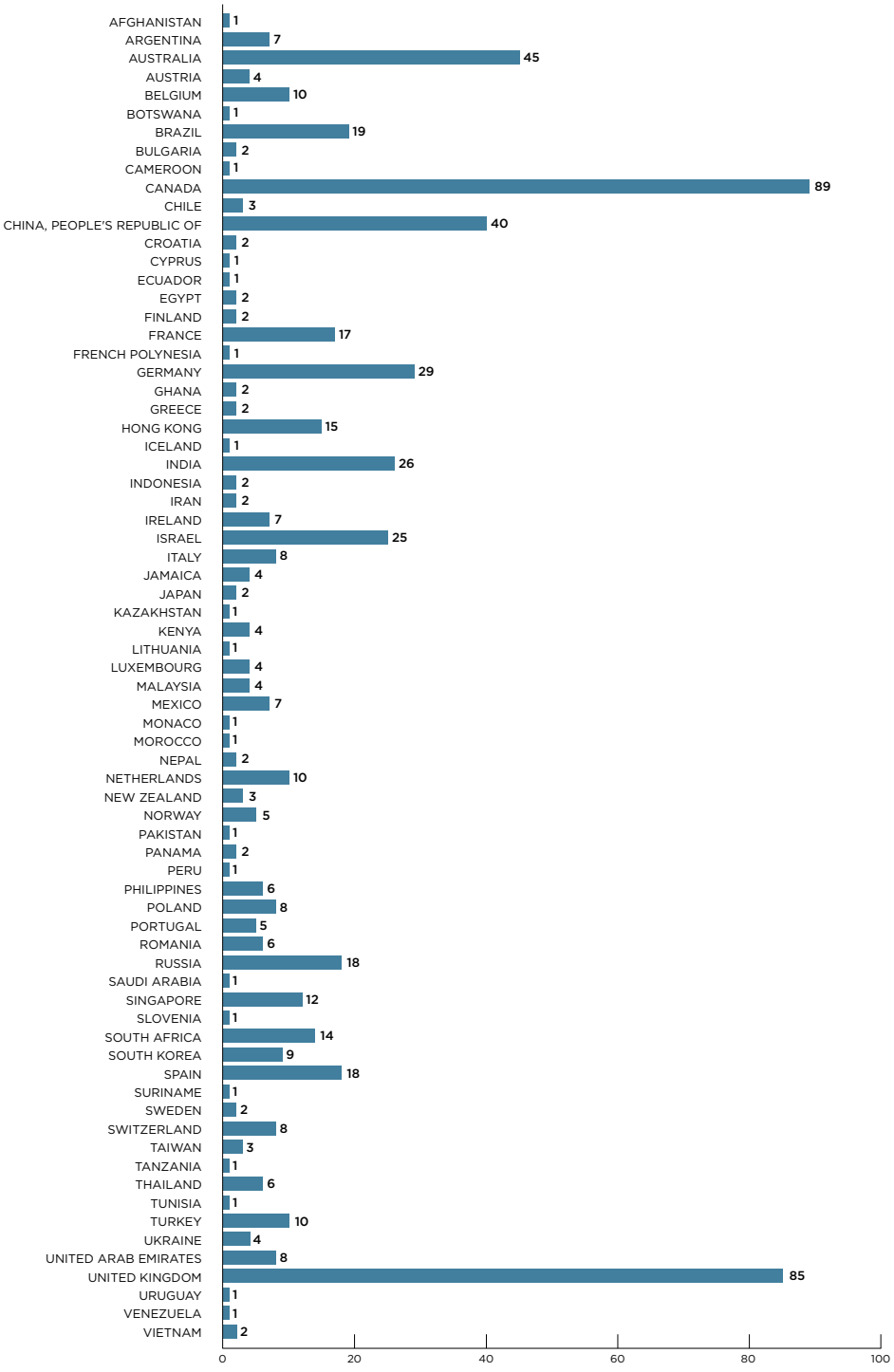
*The category of "Other" indicates that the submitter identified the whistleblower TCR as not fitting into any allegation category that is listed on the questionnaire. Also, in the interest of space, this chart does not reflect 39 tips submitted under "Initial Coin Offerings and Cryptocurrencies," an allegation category introduced during the fourth quarter of FY 2018.

APPENDIX B
WHISTLEBLOWER TIPS RECEIVED BY GEOGRAPHIC LOCATION UNITED STATES AND ITS TERRITORIES, FISCAL YEAR 2018*

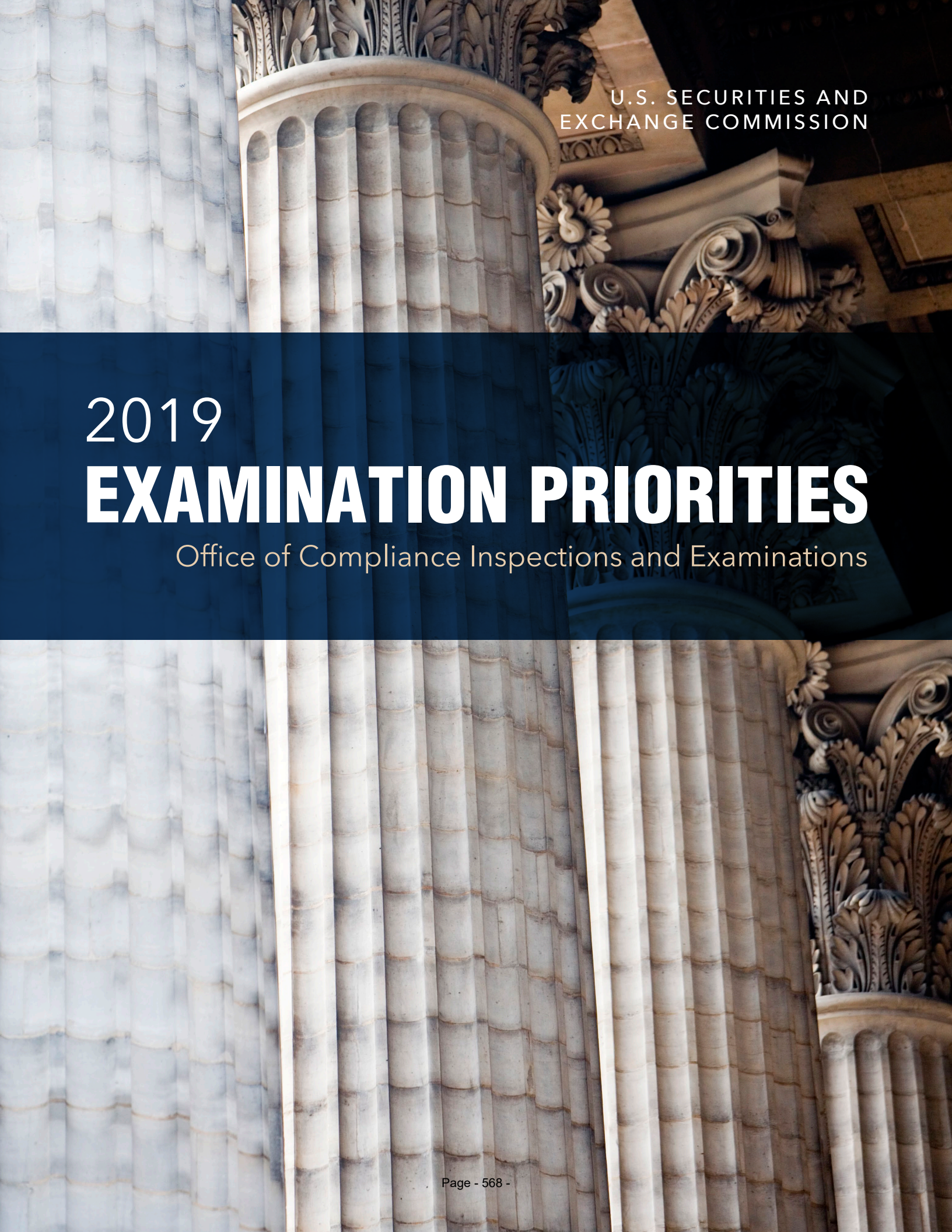


*Multiple individuals may jointly submit a TCR under the Commission's whistleblower program. Appendix B reflects the number of individuals submitting WB TCRs to the Commission within the United States, or one of its territories, and not the total number of domestic WB TCRs received by the Commission during FY 2018. For example, a WB TCR that is jointly submitted by two individuals—one in New York and one in New Jersey—would be reflected in Appendix B as a submission from both New York and New Jersey. The total number of individuals submitting WB TCRs in the United States or a U.S. territory during FY 2018 exceeded 3,300 and constituted about 62% of the individuals participating in the Commission's whistleblower program for this period. Additionally, over 1,350 individuals, constituting approximately 26% of the total number of persons participating in the Commission's whistleblower program in FY 2018, submitted WB TCRs without any foreign or domestic geographical categorization or submitted them anonymously through counsel.

APPENDIX C
WHISTLEBLOWER TIPS RECEIVED BY GEOGRAPHIC LOCATION INTERNATIONAL, FISCAL YEAR 2018*



*As with domestic WB TCRs, multiple individuals from abroad may jointly submit a TCR under the Commission's whistleblower program. Appendix C reflects the number of individuals submitting WB TCRs to the Commission from abroad, and not the total number of foreign WB TCRs received during FY 2018. The number of individuals submitting WB TCRs from abroad during FY 2018 exceeded 650, and constituted approximately 12% of the individuals participating in the Commission's whistleblower program.



U.S. SECURITIES AND EXCHANGE COMMISSION

2019

EXAMINATION PRIORITIES

Office of Compliance Inspections and Examinations

CONTENTS

Message from OCIE's Leadership Team 1
- Promoting Compliance 2
- Preventing Fraud 3
- Identifying and Monitoring Risk 3
- Informing Policy 4
- The Coming Year 4

Introduction 5

Retail Investors, Including Seniors and Those Saving for Retirement 6
- Fees and Expenses: Disclosure of the Costs of Investing 6
- Conflicts of Interest 6
- Senior Investors and Retirement Accounts and Products 7
- Portfolio Management and Trading 7
- Never-Before or Not Recently-Examined Investment Advisers 7
- Mutual Funds and Exchange Traded Funds 8
- Municipal Advisors 8
- Broker-Dealers Entrusted with Customer Assets 8
- Microcap Securities 8

Compliance and Risk in Registrants Responsible for Critical Market Infrastructure 9
- Clearing Agencies 9
- Entities Subject to Regulation Systems Compliance and Integrity 9
- Transfer Agents 10
- National Securities Exchanges 10

Focus on FINRA and MSRB 10

Digital Assets 11

Cybersecurity 11

Anti-Money Laundering Programs 11

Conclusion 12

Disclaimer

This document was prepared by SEC staff, and the views expressed herein are those of OCIE. The Commission has expressed no view on this document's contents. It is not legal advice; it is not intended to, and does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal.

MESSAGE FROM OCIE'S LEADERSHIP TEAM

The Office of Compliance Inspections and Examinations (OCIE) of the U.S. Securities and Exchange Commission (SEC) is pleased to announce its 2019 examination priorities.

With approximately 1,000 staff in the Commission's 11 regional offices and headquarters, OCIE is responsible for overseeing more than 13,200 investment advisers, approximately 10,000 mutual funds and exchange traded funds, roughly 3,800 broker-dealers, about 330 transfer agents, 7 active clearing agencies, 21 national securities exchanges, nearly 600 municipal advisors, the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board (MSRB), the Securities Investor Protection Corporation, and the Public Company Accounting Oversight Board.

OCIE completed over 3,150 examinations in Fiscal Year (FY) 2018, which is a 10 percent increase over FY 2017. Coverage of investment advisers increased to approximately 17 percent of SEC-registered investment advisers, up from approximately 15 percent in 2017. Examinations of investment companies were also up this year, increasing by approximately 45 percent. OCIE completed over 300 examinations of broker-dealers and actively oversaw FINRA and other regulated entities.

DID YOU KNOW?

OCIE's work stands on four "pillars": promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy.

The financial markets, products and services offered, and innovation in advanced technology continue to grow at a rapid pace. Operations of registered entities have also grown more complex, diverse, and interconnected, becoming more dependent on linkages to other organizations located throughout the world. In addition, the demands on OCIE's resources continue to grow with continued increases in the number of firms, particularly investment advisers registered with the SEC.

Over the past year, the number of registered investment advisers grew by nearly 5 percent, while the amount of assets managed by these advisers increased to approximately $84 trillion. The complexity of these advisers also continues to grow: more than 3,700 advisers have over one billion dollars in assets under management; approximately 35 percent manage a private fund; more than 50 percent have custody of client assets; more than 60 percent are affiliated with other financial industry firms; and approximately 12 percent provide advisory services to a mutual fund, exchange traded fund, or other registered investment company. For the broker-dealer community, despite the overall number of registered broker-dealers decreasing slightly, there were over 100 firms newly registered last year. Overall, broker-dealers operate more than 156,000 branch offices and approximately 10 percent of all broker-dealers are dually-registered with the SEC as investment advisers.

In 2019, OCIE will continue to stay abreast of changes in the SEC's registrant base, the markets, and investor needs and preferences, and will adjust its risk-based program in response to these changes. To this end, OCIE is increasingly leveraging technology and data analytics as well as human capital to fulfill its mission. This includes continually adding to and refining the expertise, tools, and applications that help identify areas of risk, firms that may present heightened risk of non-compliance, and activities that may harm investors.

The SEC's recently adopted Strategic Plan reiterated the importance of examinations. It described using examination resources to bolster regulatory requirements and protect investors as a "core principle" that the SEC has applied over the past 84 years to carry out its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. The SEC's Strategic Plan also is clear that future success requires the SEC to be efficient and nimble in the allocation of its resources. OCIE contributes to the fulfillment of the SEC's Strategic Plan by putting its limited resources to their highest and best use and performing high-quality, effective, efficient, and risk-targeted exams.

The priorities provide a preview of key areas where OCIE intends to focus its limited resources, but they do not encompass all of the areas that will be covered in examinations. To ensure the effective and efficient allocation of examination resources, OCIE proactively engages with registrants through outreach events, including national and regional compliance seminars. In FY 2018, OCIE staff participated in or held more than 100 such industry and regulatory outreach events.

OCIE also believes in the importance of engaging with senior leadership and boards of directors at registered entities. These efforts provide insight into evolving markets, including changes in risks to the markets and investors, market dynamics, and investor preferences. They also provide an opportunity to discuss with industry participants mission-related regulatory and market-impacting developments. The information obtained is also shared across the SEC through intra-agency working groups. These efforts have helped OCIE develop its risk-based approach and execute its examinations more effectively. The input received at these outreach and monitoring efforts were incorporated into the selection of the 2019 priorities.

OCIE measures performance in multiple ways and always against the backdrop of its four pillars: promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy. Through the over 3,150 examinations, joint initiatives, outreach events and other efforts in 2018, OCIE's five program areas—Investment Adviser/Investment Company, Broker-Dealer and Exchanges, Clearance and Settlement (OCS), FINRA and Securities Industry Oversight, and the Technology Controls Program (TCP)—have advanced each pillar to the benefit of retail investors and the markets.

Promoting Compliance

- In response to the areas of concern and weaknesses identified in deficiency letters, firms often revised compliance policies and procedures, changed business practices, clarified a regulatory filing, or otherwise enhanced their disclosures.
- OCIE continued to prioritize transparency to investors, registrants, and the broader financial industry regarding its exam observations. Information about common compliance issues identified during examinations helps firms evaluate their own compliance policies and procedures and better identify weaknesses and areas for improvement. To foster transparency, OCIE has published the following five risk alerts since the publication of the 2018 priorities:
  - » Most Frequent Best Execution Issues Cited in Adviser Exams
  - » Most Frequent Advisory Fee and Expense Compliance Issues Identified in Examinations of Investment Advisers
  - » Risk-Based Examination Initiatives Focused on Registered Investment Companies
  - » Investment Adviser Compliance Issues Related to the Cash Solicitation Rule
  - » Observations from Investment Adviser Examinations Relating to Electronic Messaging

- TCP issued a first-of-its-kind letter summarizing select examination findings from FYs 2016 and 2017 to entities subject to Regulation Systems Compliance and Integrity (Regulation SCI), a rule intended to help strengthen the technology infrastructure of the U.S. securities markets. The letter highlighted issues OCIE believes these entities would benefit from considering when assessing and improving cyber security, IT system resiliency, and technology-related policies and procedures.
- OCIE promoted compliance through thousands of investment adviser examinations as well as with staff discussions at the National Compliance Outreach Seminar for Investment Advisers and Investment Companies. At this outreach event, staff discussed a wide variety of topics, including program priorities, issues related to fees and expenses, portfolio management trends, cybersecurity, compliance, regulatory hot topics, and rulemaking.
- OCS promoted compliance during exams of Systemically Important Financial Market Utilities and other registered clearing agencies, identifying areas for improvement in governance, operational risk management, and public disclosure.

DID YOU KNOW?

In FY 2018, OCIE completed over 3,150 examinations—representing a 10 percent increase over FY 2017.

Preventing Fraud

- Examinations led to more than 160 enforcement referrals and resulted in firms returning more than $35 million to investors.
- OCIE conducted retail-targeted examinations of broker-dealers focused on preventing fraud, such as potential misappropriation and the sale of high risk securities by broker-dealers who may not conduct sufficient research into an investment and its appropriateness for a client.
- Examinations of investment advisers also aimed to prevent harm to retail investors, particularly seniors and those saving for retirement. For example, examinations identified advisers that selected or recommended more expensive mutual fund share classes for clients when lower cost share classes were available, and either failed to disclose or made inadequate disclosure about financial incentives they had to select or recommend the more expensive share classes. Examinations also identified compliance issues regarding advisory activities in branch offices, which resulted in enhancements to oversight practices.

Identifying and Monitoring Risk

- Examinations of firms required to comply with Regulation SCI, including the national securities exchanges, registered clearing agencies, FINRA, the MSRB, plan processors, and certain alternative trading systems (collectively, "SCI entities") identified many issues that, if left unresolved, could increase the risk of systems compromise or disruption at SCI entities and, in turn, increase risks to investors and the markets. Among other issues, certain SCI entities had insufficient policies and procedures related to: data loss prevention; vendor risk management; inventory management; and timely, consistent, and effective implementation of vendor-issued security patches. In addition, certain firms failed to report system disruptions or outages in a timely manner.
- Focused reviews of fixed income best execution obligations were conducted to identify and monitor risks, and examiners observed that many broker-dealers were not conducting sufficient reviews of execution quality to ensure that retail investors were receiving best execution.

- Investment adviser examinations identified emerging risks at advisers selling or recommending digital assets, such as concerns related to custody and safekeeping of investor assets, valuation, omitted or misleading disclosures regarding the complexities of the products and technology, and the risks of dramatic price volatility.

Informing Policy

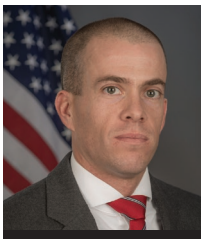
- Examinations helped inform policy by providing further insight to other SEC Divisions and Offices regarding how registered entities have implemented the SEC's rules, the practical difficulties and challenges faced in complying with these rules, and common areas of non-compliance.
- Examinations into third party vendor management provided insight into, among other things, the use and management of cloud-based computing services.
- Examinations of compliance with the amended money market fund rules, disclosure relating to target fund glide path allocations, and fixed income cross trading practices provided valuable information about current practices in these areas.

The Coming Year

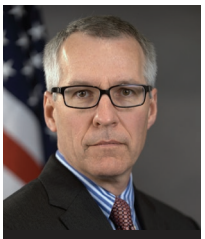
- In 2019, many of OCIE's priorities have changed as new risks have emerged and existing risks have heightened or been mitigated. While priorities shift, OCIE's commitment to the SEC's mission and doing the utmost to protect investors and serve the American people will never change.



Peter B. Driscoll
Director



Keith E. Cassidy
National Technology Controls Program Director



Kevin W. Goodman
National FINRA and Securities Industry Oversight Director



Daniel R. Gregus
National Clearing Agency Director



Daniel S. Kahl
Co-Deputy Director, Chief Counsel



John S. Polise
National Broker Dealer and Exchange Director



James R. Reese
Chief Risk Officer



Kristin A. Snyder
Co-Deputy Director, National Investment Adviser/Investment Company Director

INTRODUCTION

In 2019, OCIE will prioritize certain practices, products, and services that it believes present potentially heightened risk to investors or the integrity of the U.S. capital markets. Designed to support the SEC's mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation, the six themes for OCIE's 2019 Examination Priorities, which include perennial risk areas and developing products and services, are:

1. Matters of importance to retail investors, including seniors and those saving for retirement;
2. Compliance and risk in registrants responsible for critical market infrastructure;
3. Select areas and programs of FINRA and MSRB;
4. Digital Assets;[1]
5. Cybersecurity; and
6. Anti-Money Laundering.

DID YOU KNOW?

In FY 2018, OCIE achieved examination coverage of approximately 17 percent of registered investment advisers, up from 9 percent just five years ago.

These priorities are not exhaustive and will not be the only issues OCIE addresses in its examinations, risk alerts, and investor and industry outreach. While the priorities drive many of OCIE's examinations, the scope of any examination is determined through a risk-based approach that includes analysis of the registrant's operations, products offered, and other factors. This risk-based approach often results in examinations that address key aspects of the SEC's regulatory oversight, such as the disclosure of services, fees, expenses, conflicts of interest for investment advisers, and trading and execution quality issues for broker-dealers.

OCIE's risk-based approach, both in selecting registered entities to examine and determining the scope of risk areas to examine, remains flexible in order to cover emerging and exigent risks to investors and the marketplace as they arise. OCIE is continually evaluating changes in market conditions, industry practices, and investor preferences to assess risks to both investors and the markets.

Although change may be continual, OCIE's analytic efforts and examinations remain firmly grounded in its four pillars: promoting compliance, preventing fraud, identifying and monitoring risk, and informing policy.

1 Digital Assets include cryptocurrencies, coins, and tokens.

RETAIL INVESTORS, INCLUDING SENIORS AND THOSE SAVING FOR RETIREMENT

OCIE prioritizes the protection of retail investors, particularly seniors and those saving for retirement, and pursues examinations of firms that provide products and services to these investors.

DID YOU KNOW?

In FY 2018, OCIE held a national investment adviser/investment company compliance outreach program, a compliance outreach program for municipal advisors, and participated in more than a hundred other outreach events in order to promote and improve industry compliance.

In furtherance of OCIE's commitment to retail investors, examinations will focus on the following areas:

Fees and Expenses: Disclosure of the Costs of Investing

Every dollar an investor pays in fees and expenses is a dollar not invested. It is critically important that investors are provided with proper disclosures of the fees and expenses they pay for products and services and that financial professionals accurately calculate and charge fees in accordance with these disclosures. OCIE will continue to review fees charged to advisory accounts, ensuring that the fees are assessed in accordance with the client agreements and firm disclosures.

For these examinations, OCIE will select firms with practices or business models that may create increased risks of inadequately disclosed fees, expenses, or other charges. With respect to mutual fund share classes, OCIE will continue to evaluate financial incentives for financial professionals that may influence their selection of particular share classes. In addition, OCIE remains focused on investment advisers participating in wrap fee programs, which charge investors a single bundled fee for both advisory and brokerage services. Continued areas of interest include the adequacy of disclosures and brokerage practices.

Conflicts of Interest

As fiduciaries, investment advisers have a duty to act and provide advice in the best interests of their clients. Ensuring that investment advisers are acting in a manner consistent with their fiduciary duty and meeting their contractual obligations to their clients is paramount to maintaining investor confidence in the markets and investment professionals.

Conflicts of interest provide incentives for financial professionals to recommend certain types of products and services. Examinations will review policies and procedures addressing the following:

Use of Affiliated Service Providers and Products: Advisers in some cases utilize services or products provided by affiliated entities. These arrangements present conflicts of interest related to, among other areas, portfolio management practices and compensation arrangements. OCIE will examine such arrangements, focusing on the impact to clients and the related disclosures of conflicts of interest that may be present.

Securities-Backed Non-Purpose Loans and Lines of Credit: A non-purpose loan or line of credit allows borrowers to use the securities in their brokerage or advisory accounts as collateral to obtain a loan, the proceeds of which cannot be used for purchasing or trading securities. OCIE has observed that advisers, broker-dealers, and their employees receive certain financial incentives to recommend these products to clients and/or customers. OCIE will assess this practice to determine whether registrants are, among other things, adequately disclosing the risks to clients and any conflicts of interest presented by recommending these loans.[2]

Borrowing Funds from Clients: Borrowing funds from clients presents a number of conflicts of interest for an investment adviser. Where examiners observe this practice, emphasis will be on whether adequate disclosures, including the potentially poor or failing financial condition of the investment adviser, are made to the client and the investment adviser has acted consistently with these disclosures.

Senior Investors and Retirement Accounts and Products

OCIE will conduct examinations that review how broker-dealers oversee their interactions with senior investors, including their ability to identify financial exploitation of seniors. In examinations of investment advisers, OCIE will continue to review the services and products offered to seniors and those saving for retirement. These examinations will focus on, among other things, compliance programs of investment advisers, the appropriateness of certain investment recommendations to seniors, and the supervision by firms of their employees and independent representatives.

Portfolio Management and Trading

Reviewing portfolio management processes is an integral component to investment adviser examinations. OCIE will review firms' practices for executing investment transactions on behalf of clients, fairly allocating investment opportunities among clients, ensuring consistency of investments with the objectives obtained from clients, disclosing critical information to clients, and complying with other legal restrictions.

OCIE will also examine investment adviser portfolio recommendations to assess, among other things, whether investment or trading strategies of advisers are: (1) suitable for and in the best interests of investors based on their investment objectives and risk tolerance; (2) contrary to, or have drifted from, disclosures to investors; (3) venturing into new, risky investments or products without adequate risk disclosure; and (4) appropriately monitored for attendant risks.

Never-Before or Not Recently-Examined Investment Advisers

OCIE will continue to conduct risk-based examinations of certain investment advisers that have never been examined, including newly-registered investment advisers as well as those registered for several years but that have yet to be examined. OCIE will also prioritize examinations of certain investment advisers that have not been examined for a number of years and may have substantially grown or changed business models.

2 See Investor Alert: Securities-Backed Lines of Credit, issued by the SEC's Office of Investor Education and Advocacy and FINRA, available at https://www.sec.gov/oiea/investor-alerts-bulletins/sbloc.html.

Mutual Funds and Exchange Traded Funds

Mutual funds and exchange traded funds (ETFs) are the primary investment vehicles for many retail investors. OCIE will continue to prioritize examinations of these funds, the activities of their advisers, and oversight practices of their boards of directors. Examinations will assess industry practices and regulatory compliance in various areas that may have significant impact on retail investors.

OCIE will focus on risks associated with the following: (1) index funds that track custom-built or bespoke indexes; (2) ETFs with little secondary market trading volume and smaller assets under management; (3) funds with higher allocations to certain securitized assets; (4) funds with aberrational underperformance relative to their peer groups; (5) funds managed by advisers that are relatively new to managing Registered Investment Companies (RICs); and (6) advisers that provide advice to both RICs and private funds with similar investment strategies.

Municipal Advisors

Municipal advisors (MAs) provide advice to, or on behalf of, a municipal entity with respect to the issuance of municipal securities or municipal financial products. OCIE will continue to conduct select examinations of MAs that have never been examined, concentrating on whether these MAs have satisfied their registration requirements and professional qualifications as well as continuing education requirements. OCIE will also prioritize whether MAs provided the appropriate disclosures regarding their conflicts of interests or otherwise violated their fiduciary duty to a municipal entity. Examinations will also review for compliance with recently-effective MSRB rules, including those relating to advertisements by MAs and the standards of conduct for MAs obtaining CUSIP numbers on behalf of issuers.

DID YOU KNOW?

Broker-dealers operate more than 156,000 branch offices, and approximately 10 percent of all broker-dealers are dually registered with the SEC as investment advisers.

Broker-Dealers Entrusted with Customer Assets

Broker-dealers that hold customer cash and securities must abide by certain rules, including the Customer Protection Rule (Exchange Act Rule 15c3-3), and have a significant responsibility to ensure that those assets are safeguarded and accurately reported. The Customer Protection Rule restricts the use of customer assets and prevents the broker-dealer from using customer assets as working capital. Examinations of select broker-dealers will focus on compliance with this rule, as well as procedures and controls to promote compliance.

Microcap Securities

OCIE will continue examinations of broker-dealers involved in selling stocks of companies with a market capitalization of under $250 million. OCIE will look at a variety of areas, including reviewing for manipulative schemes (i.e., pump and dump schemes), compliance with Regulation SHO, which governs short sales, and compliance with Exchange Act Rule 15c2-11, which governs the submission and publication of quotations by broker-dealers for certain over-the-counter equity securities.

COMPLIANCE AND RISK IN REGISTRANTS RESPONSIBLE FOR CRITICAL MARKET INFRASTRUCTURE

Clearing Agencies

Clearing agencies promote market stability and efficiency and help to reduce risk by performing critical post trade services, including acting as intermediaries between and guarantors for buyers and sellers of securities, facilitating the settlement of investor trades, and acting as a depository for securities and other financial instruments. For example, clearing agencies may reconcile transaction information received from the parties to a trade, calculate settlement obligations, or hold securities as certificates or in electronic form to facilitate automated settlement. As a result, clearing agencies help ensure that trades settle on time and at the agreed upon terms.

DID YOU KNOW?

Clearing agencies perform a variety of services that help ensure trades settle on time and at the agreed upon terms.

OCIE will continue to conduct annual examinations of clearing agencies that the Financial Stability Oversight Council has designated as systemically important and for which, under the Dodd- Frank Act, the Commission is the supervisory agency. OCIE will also conduct risk-based examinations of other registered clearing agencies. Examinations will focus on: (1) compliance with the SEC's Standards for Covered Clearing Agencies and other federal securities laws applicable to registered clearing agencies; (2) whether clearing agencies have taken timely corrective action in response to prior examinations; and (3) other areas identified in collaboration with the SEC's Division of Trading and Markets and with other regulators.

Entities Subject to Regulation Systems Compliance and Integrity

Regulation SCI was adopted by the Commission to strengthen the technology infrastructure of the U.S. securities markets. Among other things, it requires SCI entities to establish, maintain, and enforce policies and procedures designed to ensure that their systems' capacity, integrity, resiliency, availability, and security are adequate to maintain their operational capability and promote the maintenance of fair and orderly markets. If certain events occur, these entities are required to take corrective action as soon as reasonably practical and immediately notify the SEC of the occurrence.

OCIE will continue to examine SCI entities to evaluate whether they have effectively implemented written policies and procedures required by Regulation SCI. OCIE will also focus on, among other things, controls relating to software development life cycles and related governance procedures, effectiveness of internal audit programs, inventory management, and threat management capabilities.

Transfer Agents

Transfer agents serve as agents for securities issuers and play a critical role in the settlement of securities transactions. Among their key functions, transfer agents are responsible for maintaining issuers' securityholder records, recording changes of ownership, canceling and issuing certificates, distributing dividends and other payments to securityholders, and facilitating communications between issuers and securityholders. Efficient transfer agent operations are critical to secondary securities markets and for recordkeeping during primary market activities. Examinations will assess transfers, recordkeeping, and the safeguarding of funds and securities. Examinations will also focus on the requirement for transfer agents to annually file a report by an independent accountant concerning the transfer agency's system of internal accounting controls.

Examination candidates will include transfer agents that serve as paying agents for issuers, transfer agents developing blockchain technology, or transfer agents that provide services to issuers of microcap securities, private offerings, crowdfunded securities, or digital assets.

National Securities Exchanges

With over 20 national securities exchanges facilitating transactions in the marketplace, OCIE will examine internal audit and surveillance programs and funding for regulatory programs.

FOCUS ON FINRA AND MSRB

FINRA

FINRA is a registered national securities association that adopts and enforces rules governing the conduct of its members. These members are also registered with the SEC as broker-dealers. FINRA oversees approximately 3,800 brokerage firms, 156,000 branch offices, and 630,000 registered representatives through examinations, enforcement, and surveillance. In addition, FINRA, among other things, provides a forum for securities arbitration and mediation, conducts market regulation, including by contract for a majority of national securities exchanges, reviews broker-dealer advertisements, administers the testing and licensing of registered persons, and operates industry utilities such as Trade Reporting Facilities. Examinations of FINRA will continue to focus on FINRA's operations and regulatory programs and the quality of FINRA's examinations of broker-dealers and municipal advisors that are also registered as broker-dealers.

DID YOU KNOW?

FINRA oversees approximately 3,800 brokerage firms, 156,000 branch offices, and 630,000 registered representatives through examinations, enforcement, and surveillance.

MSRB

MSRB regulates the activities of broker-dealers that buy, sell, and underwrite municipal securities, and municipal advisors. MSRB establishes rules for municipal securities dealers and municipal advisors, supports market transparency by making municipal securities trade data and disclosure documents available, and conducts education and outreach regarding the municipal securities market. OCIE, in coordination with FINRA, conducts examinations of MSRB members to ensure compliance with MSRB rules. Given MSRB's broad responsibility to regulate municipal securities transactions, OCIE will continue to conduct inspections of MSRB to evaluate the effectiveness of MSRB's policies, procedures, and controls.

DIGITAL ASSETS

The digital asset market has grown rapidly and may present risks to retail investors. The number of digital asset market participants, including broker-dealers, trading platforms, and investment advisers, also continues to increase. Given the significant growth and risks presented in this market, OCIE will continue to monitor the offer and sale, trading, and management of digital assets, and where the products are securities, examine for regulatory compliance. In particular, through high level inquiries, OCIE will take steps to identify market participants offering, selling, trading, and managing these products or considering or actively seeking to offer these products and then assess the extent of their activities. For firms actively engaged in the digital asset market, OCIE will conduct examinations focused on, among other things, portfolio management of digital assets, trading, safety of client funds and assets, pricing of client portfolios, compliance, and internal controls.

CYBERSECURITY

Cybersecurity protection is critical to the operation of the financial markets. The impact of a successful cyber-attack may have consequences that extend beyond the firm compromised to other market participants and retail investors, who may not be well informed of these risks and consequences. OCIE is working with firms to identify and manage cybersecurity risks and to encourage market participants to actively and effectively engage in this effort.

OCIE will continue to prioritize cybersecurity in each of its five examination programs. Examinations will focus on, among other things, proper configuration of network storage devices, information security governance generally, and policies and procedures related to retail trading information security. Specific to investment advisers, OCIE will emphasize cybersecurity practices at investment advisers with multiple branch offices, including those that have recently merged with other investment advisers, and continue to focus on, among other areas, governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response.

ANTI-MONEY LAUNDERING PROGRAMS

The Bank Secrecy Act requires broker-dealers to establish anti-money laundering (AML) programs. These programs must, among other things, include policies and procedures reasonably designed to identify customers, perform customer due diligence, monitor for suspicious activity, and where appropriate, file suspicious activity reports (SARs) with the Financial Crimes Enforcement Network. SARs are used to detect and combat terrorist financing, public corruption, market manipulation, and a variety of other fraudulent behavior.

In 2019, OCIE will continue to prioritize examining broker-dealers for compliance with their AML obligations, including whether they are meeting their SAR filing obligations, implementing all elements of their AML program, and robustly and timely conducting independent tests of their AML program. The goal of these examinations is to ensure that broker-dealers have policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money laundering activities.

CONCLUSION

These priorities reflect OCIE's assessment of certain risks, issues, and policy matters arising from market and regulatory developments, information gathered from examinations, and other sources, including tips, complaints, and referrals, and coordination with other regulators. OCIE welcomes comments and suggestions regarding how it can better fulfill its mission to promote compliance, prevent fraud, identify and monitor risk, and inform SEC policy. OCIE's contact information is available at https://www.sec.gov/ocie/ocie_org.htm. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify SEC staff at https://www.sec.gov/tcr.



U.S. Securities and
Exchange Commission
100 F Street NE
Washington, DC 20549
SEC.gov

2019 Risk Monitoring and Examination Priorities Letter

January 2019

Topics

- Highlighted Items 2
- Sales Practice Risks 3
- Operational Risks 4
- Market Risks 4
- Financial Risks 6
- Endnotes 7

Introduction

The 2019 Risk Monitoring and Examination Priorities Letter identifies topics that FINRA will focus on in the coming year. The letter begins with materially new priorities and then discusses priorities in areas of ongoing concern, but with an emphasis on aspects of those topics we have not articulated in prior letters. Unlike previous Priorities Letters, we do not repeat topics that have been mainstays of FINRA's attention over the years.

Nonetheless, firms should expect that FINRA will review for compliance regarding these ongoing areas of focus, namely obligations related to suitability determinations, including with respect to recommendations relating to complex products, mutual fund and variable annuities share classes, as well as recommendations to use margin or execute trades in a margin account; outside business activities and private securities transactions; private placements; communications with the public; anti-money laundering (AML); best execution; fraud (including microcap fraud), insider trading and market manipulation; net capital and customer protection; trade and order reporting; data quality and governance; recordkeeping, risk management and supervision related to these and other areas.

In addition, FINRA will focus on risks related to associated persons with a problematic regulatory history.[1] Although this is a longstanding priority, we will continue to enhance our examination program to evaluate how firms address these risks in their hiring practices and supervision programs.[2]

FINRA will also continue to review the adequacy of firms' cybersecurity programs to protect sensitive information, including personally identifiable information. FINRA recently published our *Report on Selected Cybersecurity Practices – 2018*, and this document provides additional information on practices that may help some firms strengthen their cybersecurity programs.[3]

In addition, FINRA's *2017* and *2018 Reports on Examination Findings* present observations on concerns and effective practices relevant to many of the topics addressed in this letter, and FINRA encourages firms to use those reports, this letter and other resources FINRA makes available to enhance their compliance, supervisory and risk management programs.[4]

Highlighted Items

Online Distribution Platforms

Firms increasingly are involved in the distribution of securities through online platforms in reliance on Rule 506(c) of Regulation D and Regulation A under the Securities Act of 1933 (Securities Act). While some online distribution platforms are owned and operated by broker-dealers, others are operated by unregistered entities, which may use member firms as selling agents or brokers of record, or to perform activities such as custodial, escrow, back-office and financial technology (FinTech)-related functions.

FINRA is concerned that some member firms assert they are not selling or recommending securities when involved with online distribution platforms despite evidence to the contrary, including handling customer accounts and funds, or receiving transaction-based compensation. We will evaluate how firms conduct their reasonable basis and customer-specific suitability analyses, supervise communications with the public and meet AML requirements. Further, given the broad visibility of offerings distributed through online platforms, FINRA will evaluate how firms are addressing the risk of offering documents or communications with the public that omit material information or may contain false or misleading statements, or promissory claims of high targeted returns. For offerings subject to Regulation D, we will also evaluate how firms address the risk of sales to non-accredited investors and non-compliant escrow arrangements. For offerings subject to Regulation A, FINRA will also assess the risk of excessive or undisclosed compensation arrangements between firms and the issuers.

Fixed Income Mark-Up Disclosure

FINRA will review firms' compliance with their mark-up or mark-down disclosure obligations on fixed income transactions with customers pursuant to amendments to FINRA Rule 2232 (Customer Confirmations) and MSRB Rule G-15, which became effective on May 14, 2018.

To help firms evaluate their compliance with mark-up requirements, FINRA developed a Mark-up/Mark-down Analysis Report that is available to individual firms. The report provides a mark-up summary (including median and mean percentage mark-ups), detailed information such as trade details (*e.g.,* FINRA's calculated markup percentage and dollar profit) and graphical displays of data across longer periods of time for trend analysis. FINRA also made publicly available the Bond Facts Tool, which provides security-specific product data to help retail investors understand the quality of their fixed income securities transactions (*e.g.,* the time, price and size of other transactions in the same bond).

FINRA will also review for any changes in firms' behavior that might be undertaken to avoid their mark-up and mark-down disclosure obligations.

Regulatory Technology

Firms are using a variety of innovative regulatory technology (RegTech) tools to make their compliance efforts more efficient, effective and risk-based.[5] FINRA will engage with firms to understand how they are using such tools and addressing related risks, challenges or regulatory concerns, including those relating to supervision and governance systems, third-party vendor management, safeguarding customer data and cybersecurity.

Sales Practice Risks

Suitability

As always, suitability will remain one of FINRA's top priorities. This year, some of the specific areas on which we may focus include: (1) deficient quantitative suitability determinations or related supervisory controls; (2) overconcentration in illiquid securities, such as variable annuities, non-traded alternative investments and securities sold through private placements; and (3) recommendations to purchase share classes that are not in line with the customer's investment time horizon or hold for a period that is inconsistent with the security's performance characteristics (which could include, for example, a recommendation to purchase and hold a security that is intended for short-term trading or to engage in short-term trading in products designed primarily for long-term holding).

As the exchange-traded product (ETP) market continues to grow with novel and increasingly complex products, FINRA will evaluate whether firms are meeting their suitability obligations and risk disclosure obligations when recommending such products. These include leveraged and inverse exchange-traded funds (ETFs), floating-rate loan ETFs (also known as bank-loan or leveraged loan funds) and mutual funds that invest in loans extended to highly indebted companies of lower credit quality.

In addition, FINRA remains concerned about securities products that package leveraged loans (*e.g.,* collateralized loan obligations). Although these products are typically sold via private placement to qualified institutional buyers, if we observe that firms are selling them to retail investors, we will review how firms are supervising such transactions to ensure their compliance with applicable sales restrictions.

Senior Investors

Protection of senior investors, as well as investors who are retired or approaching retirement, remains a top priority for FINRA and we will continue to focus on how firms are protecting such persons from fraud, sales practice abuses and financial exploitation. FINRA will assess firms' supervision of accounts where registered representatives serve in a fiduciary capacity, including holding a power of attorney, acting as a trustee or co-trustee, or having some type of beneficiary relationship with a non-familial customer account. In particular, we are concerned about registered representatives using their role as a fiduciary to take control of trusts or other assets and direct funds to themselves.[6] FINRA will assess the supervisory systems firms employ to place heightened scrutiny over such accounts.

FINRA will also review firms' controls regarding their obligations under amendments to FINRA Rule 4512 (Customer Account Information) requiring firms to make reasonable efforts to obtain information about trusted contacts for non-institutional accounts and new FINRA Rule 2165 (Financial Exploitation of Specified Adults), to the extent that firms anticipate placing temporary holds on disbursements pursuant to the Rule 2165 safe harbor, including whether firms have clearly defined policies and procedures or practices.

FINRA is also interested in learning about firms' early experiences with these new provisions. FINRA developed them, in large measure, to provide firms with tools to protect seniors and other specified adults, which is especially important for firms that have, or soon will have, a significant number of customers who fall into such categories.[7]

Outside Business Activities and Private Securities Transactions

FINRA will continue to assess firms' controls related to associated persons' outside business activities[8] and private securities transactions, including associated persons raising funds from their customers away from their firm and outside of their firm's supervision. We are particularly concerned about fundraising activities for entities that the associated persons control or in which they have an interest, specifically entities with potentially misleading names that are similar to established issuers.

Operational Risks

Supervision of Digital Assets Business

Some firms have demonstrated significant interest in participating in activities related to digital assets and FINRA encourages firms to notify FINRA if they plan to engage in such activities, even where a membership application is not required.[9] This year, FINRA will review firms' activities through its membership and examination processes related to digital assets and assess firms' compliance with applicable securities laws and regulations and related supervisory, compliance and operational controls to mitigate the risks associated with such activities. Coordinating closely with the U.S. Securities and Exchange Commission, FINRA will consider how firms determine whether a particular digital asset is a security and whether firms have implemented adequate controls and supervision over compliance with rules related to the marketing, sale, execution, control, clearance, recordkeeping and valuation of digital assets, as well as AML/Bank Secrecy Act rules and regulations.

Customer Due Diligence and Suspicious Activity Reviews

FINRA will assess firms' compliance with FinCEN's Customer Due Diligence (CDD) rule, which became effective on May 11, 2018. The CDD rule requires that firms identify beneficial owners of legal entity customers, understand the nature and purpose of customer accounts, conduct ongoing monitoring of customer accounts to identify and report suspicious transactions and, on a risk basis, update customer information. FINRA will focus on the data integrity of those suspicious activity monitoring systems, as well as the decisions associated with changes to those systems.

Market Risks

Best Execution

FINRA is concerned about firms failing to use reasonable diligence to assure that their customer order flow is directed to the best market given the size and types of transactions, the terms and conditions of orders and other factors. In particular, FINRA will review firms' best execution decision-making where the firm routed all or substantially all customer orders to a small number of wholesale market makers from which they received payment for order flow or an affiliated broker-dealer or an

alternative trading system (ATS) in which the firm had a financial interest. FINRA will also assess how firms check additional venues for potential price improvement. FINRA will also review how firms quantify the benefits to customers from firms' receipt of order routing inducements and how firms manage the conflict of interest between their duty of best execution and any inducements or benefits they receive from the routing or internalization of customer orders.

Market Manipulation

FINRA continues to focus on market manipulation by enhancing FINRA's surveillance capabilities and providing firms with tools they can use to identify possible manipulative activities. This year, FINRA will focus on manipulative trading in correlated ETPs, including those that track common, broad market indices. We are using pattern exploration to better identify the exploitation of the unique characteristics of ETPs, such as the creation and redemption process and composition changes to the ETP portfolios, and expanding the use of machine learning to improve our ability to react to changes in the ETP market. Similarly, FINRA will focus on reviews for potential manipulation across correlated options products (*e.g.,* options on broad market indices and options on ETFs overlying the same indices).

FINRA will also continue to help firms with their compliance efforts by providing Cross Market Supervision Report Cards. These report cards help firms identify potential manipulation across multiple firms, markets and products and proactively address related compliance risks.

Market Access

FINRA will continue to review firms' compliance with Rule 15c3-5 (the Market Access Rule) under the Securities Exchange Act of 1934 (Exchange Act), focusing on how firms apply appropriate controls and limits to sponsored access orders; retain the sole authority to determine the boundaries for those controls and limits; test the effectiveness of those controls and limits; and implement and test exception reporting systems covering sponsored access orders. We will also assess how firms monitor their customers' activity and maintain policies and procedures, as well as technical controls, to detect and prevent potentially manipulative or other prohibited trading activity.

Short Sales

FINRA will review whether firms have structured their aggregation units in a manner that is consistent with the requirements of Exchange Act Rule 200(f) and can demonstrate the independence of the units through measures such as separate management structures, location, business purpose, and profit and loss treatment.

Short Tenders

As in 2018, FINRA will review how firms account for their options positions when tendering shares in the offer. Exchange Act Rule 14e-4 provides that if, following the announcement of a tender offer, a market participant sells call options with a strike price less than the tender offer price, the firm must reduce its long position by the shares underlying the options for purposes of calculating its net long position. FINRA will continue to educate firms about these requirements and evaluate their compliance with them.

Financial Risks

Credit Risk

FINRA will review firms' policies and procedures for identifying, measuring and managing credit risk, including risk exposures that may not be readily apparent. For example, a firm may be exposed to credit risk when it becomes responsible for transactions that its customers and correspondents execute "away" from the firm, without the firm's participation until after execution. Such responsibility can be incurred under clearing arrangements, prime brokerage arrangements (especially fixed income prime brokerage), "give up" arrangements, sponsored access arrangements (discussed above under "Market Access") or principal letters. Usually trades under these arrangements are completed without incident, but if they are sizable and conducted in a period of high volatility, they may create large exposures for which the firm holds little or no collateral (and which the firm may need to fund out of its own resources).

FINRA will also assess the extent to which firms identify and address all relevant risks when they extend credit to their customers and counterparties. Since broker-dealers generally extend secured credit, a firm may believe that its margin requirements eliminate counterparty or customer credit risk. A firm, however, can be exposed to sizeable losses in the event of a default by a customer whose margin account contains illiquid, volatile or concentrated securities positions because the firm may not be able to promptly liquidate the positions at a price that fully covers the customer's obligations. Similar risk exposures may exist when firms lend on products or strategies that have potential for large market moves, such as certain options strategies and structured products. In connection with this review, we will also examine firms' compliance with FINRA Rule 4210(f)(1) (Margin Requirements), which requires substantial additional margin on long and short positions in securities that are subject to "unusually rapid or violent changes in value, or do not have an active market on a national securities exchange, or where the amount carried is such that the position(s) cannot be liquidated promptly."

Funding and Liquidity

FINRA will continue to evaluate firms' liquidity planning, including whether they have a reasonable process to regularly assess the adequacy of their liquidity pools and update their stress test assumptions based on changes in their businesses, products and customers. This year, we will focus on whether firms update their stress test assumptions in light of changes in the marketplace, such as the increased volatility experienced at various points in 2018. Among other things, if government securities repo funding has a significant role in a firm's liquidity plan, we will inquire about the firm's contingency plans for disruptions of, or reductions in funding available from, the government securities repo market (which experienced significant quarter-end and year-end rate spikes in 2018). We will also assess the adequacy of firms' liquidity pools and their review of the reasonableness of stress test assumptions on a regular basis in light of all of their business activities and arrangements, including any arrangements where firms become responsible for transactions that their customers and correspondents execute "away" from them.

If you have general comments regarding this letter or suggestions on how we can improve it, please send them to Carlo di Florio, Executive Vice President, Member Supervision/Shared Services, at *carlo.diflorio@finra.org* or Steven Polansky, Senior Director, Member Supervision/Shared Services, at *steven.polansky@finra.org*.

Endnotes

1 FINRA uses "a risk model that takes into account a range of quantitative and qualitative information" to determine whether a registered representative poses additional risk to investors. Robert W. Cook, President and CEO, FINRA, Address at the McDonough School of Business, Georgetown University, Protecting Investors From Bad Actors (June 12, 2017). This information comes "from a variety of sources, including regulatory reports by firms and brokers, our examination program, employment histories, past associations with problematic firms, customer complaints, and any history of informal actions levied by FINRA" and FINRA also reviews "aggravating factors such as patterns of behavior, conflicts of interest, and links to previously disciplined individuals." *Id.*

2 *See Notice to Members 97-19* (providing certain hiring practices when considering for employment an associated person with a history of customer complaints, disciplinary actions or arbitrations from the securities industry); *Regulatory Notice 18-15* (listing the kinds of industry and regulatory-related incidents that firms should consider, and highlighting that statutorily disqualified persons and persons who have been disciplined in disciplinary proceedings raise significant investor protection concerns).

3 Firms can also find additional information about the main elements of a cybersecurity program in FINRA's Report on Cybersecurity Practices.

4 Resources that FINRA makes available to firms include, but are not limited to, the Small Firm Cybersecurity Checklist, the Anti-Money Laundering (AML) Template for Small Firms and the Report Center. For more information about these and other tools, please visit the Compliance Tools page on FINRA's website.

5 The term "RegTech" is generally used to refer to new and innovative technologies designed to facilitate firms' ability to meet their regulatory compliance obligations. *See* the Institute of International Finance defines RegTech as "the use of new technologies to solve regulatory and compliance burdens more effectively and efficiently." *See Technology Based Innovations for Regulatory Compliance ("RegTech") in the Securities Industry* (September 2018).

6 To the extent that the firm allows its registered representatives to engage in these fiduciary appointments for individuals who are not customers of the broker-dealer, firms should consider providing training to registered representatives that outlines or clarifies when the activity should be reported to the firm pursuant to FINRA Rule 3270 (Outside Business Activities of Registered Persons).

7 A "specified adult" under FINRA Rule 2165(a)(1) is defined as "(A) a natural person age 65 or older; or (B) a natural person age 18 or older who the member reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests." The "trusted contact" provision in Rule 4512 is intended to be a resource for a firm in administering a customer's account, protecting assets and responding to possible financial exploitation. *See Regulatory Notice 17-11* (noting that, in addition to responding to possible financial exploitation of seniors and other specified adults, a trusted contact could be helpful if a firm has been unable to contact a customer or there is concern over a customer's wellbeing).

8 Following a retrospective review of the outside business activities and private securities transactions rules, FINRA published *Regulatory Notice 18-08*, soliciting comment on proposed FINRA Rule 3290, which would replace current FINRA Rules 3270 (Outside Business Activities of Registered Persons) and 3280 (Private Securities Transactions of an Associated Person). FINRA received 52 comments on *Regulatory Notice 18-08* and they are available here. FINRA is considering the comments.

9 *See Regulatory Notice 18-20*.

Originally published in ABA J. Labor & Employment Law, Vol. 30, No. 1 © 2014 by the American Bar Association.

De Facto Gag Clauses: The Legality of Employment Agreements That Undermine Dodd-Frank's Whistleblower Provisions

Richard Moberly,* Jordan A. Thomas,** & Jason Zuckerman***

I. Introduction

In 2010, in the wake of the financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] (Dodd-Frank or Act), which established a new whistleblower program for the U.S. Securities and Exchange Commission (SEC or Commission) to more effectively detect, investigate, and prosecute the kind of financial misconduct that has caused repeated and substantial harm to investors.[2] Dodd-Frank's whistleblower provisions implement

* Richard Moberly is the Associate Dean for Faculty and Professor of Law at the University of Nebraska College of Law, where he teaches employment law. He has spoken extensively and published numerous articles on whistleblowing and retaliation. The Secretary of Labor appointed him to serve on OSHA's Whistleblower Protection Advisory Committee in 2012 and reappointed him in 2014.

** Jordan A. Thomas is Chair of the Whistleblower Representation Practice at Labaton Sucharow LLP, New York, NY. He represents federal securities laws whistleblowers internationally. Previously, he served as an Assistant Director in the Enforcement Division of the U.S. Securities and Exchange Commission, where he had a leadership role in the development of the SEC Whistleblower Program.

*** Jason Zuckerman is the founder of Zuckerman Law, where he represents employees and whistleblowers. Previously, he practiced employment law at a national law firm, served as Senior Legal Advisor to the Special Counsel at the U.S. Office of Special Counsel (the federal agency charged with protecting whistleblowers in the federal government) and was appointed by the Secretary of Labor to serve on OSHA's Whistleblower Protection Advisory Committee.

1. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, & 15 U.S.C.).

2. *See* 15 U.S.C. § 78u-6 (2012). Dodd-Frank created a similar program for the Commodity Futures Trading Commission (CFTC). *See* Commodity Whistleblower Incentives and Protection, 7 U.S.C. § 26 (2012). This Article focuses on the SEC Whistleblower Program because of its greater visibility and potential impact; however, the Article's conclusions can be applied equally to the CFTC whistleblower program given the similarity in the programs' statutory and regulatory authority. *Compare* 15 U.S.C. § 78u-6 (2012) *and* 17 C.F.R. § 240.21F.1 et seq. (2013) (SEC Program), *with* 7 U.S.C. § 26 (2012) *and* 17 C.F.R. § 165.1 et seq. *(2013)* (CFTC program).

three incentives to encourage whistleblowers to report securities fraud to the SEC: the availability of substantial monetary awards for reporting,[3] the ability to remain anonymous when reporting to the SEC,[4] and broad protection from employment retaliation.[5] The basic idea of this incentive structure is simple: rewarding and protecting whistleblowers will motivate more individuals to report potentially relevant information about securities violations.[6]

In response, some companies are now seeking to counteract Dodd-Frank by drafting and enforcing a variety of agreements with employees that significantly reduce or eliminate the congressional incentives promoting SEC whistleblowing. These agreements—which seek to alter the statutory risks and rewards of whistleblowing—may have profound consequences not only for current and prospective whistleblowers, but also for the success of the Dodd-Frank whistleblower program itself. The stakes are just as high for employers, who may find themselves facing civil—or, in extreme cases, criminal—liability if they are too aggressive in attempts to shield information from government authorities.

This Article discusses the enforceability of these increasingly prevalent contractual restrictions on whistleblowing, which fall into three broad categories.[7] First, some agreements require an employee to report possible misconduct internally *before* disclosing misconduct to the SEC.[8] Second, some agreements require an employee to waive any monetary award received from blowing the whistle under Dodd-Frank's whistleblower bounty provisions.[9] Both of these types of agreements could significantly limit employees' desire to communicate with the SEC regarding employer misconduct.

In a third type, employers impose general confidentiality provisions in agreements when employment commences or after receiving some benefit, such as a severance package. Although such confidenti-

3. *See* 15 U.S.C. § 78u-6(b) (2012).

4. *See* 15 U.S.C. § 78u-6(d)(2), (h)(2) (2012); 17 C.F.R. §§ 240.21F-7, -9(c) (2013).

5. *See* 15 U.S.C. § 78u-6(h)(1) (2012).

6. SEC. & EXCH. COMM'N, RELEASE NO. 34-64545, IMPLEMENTATION OF THE WHISTLEBLOWER PROVISIONS OF SECTION 21F OF THE SECURITIES EXCHANGE ACT OF 1934, at 101 n.222 (2011) [hereinafter ADOPTING RELEASE].

7. These examples summarize actual provisions several of the authors and other employment attorneys have frequently seen during the course of representing SEC whistleblowers. *See, e.g.*, Letter from Katz, Marshall & Banks, LLP to the U.S. Sec. & Exch. Comm'n, at 4–6, 8–10 (May 8, 2013), *available at* http://kmblegal.com/wordpress/wp-content/uploads/130508-Letter-to-SEC-Commissioners.pdf (provisions in employee severance and settlement agreements that impede reporting); *see also* Scott Higham & Kaley Belval, *Workplace Agreements Appear to Violate Federal Whistleblower Laws*, WASH. POST (June 29, 2014), http://m.washingtonpost.com/investigations/workplace-secrecy-agreements-appear-to-violate-federal-whistleblower-laws/2014/06/29/d22c8f02-f7ba-11e3-8aa9-dad2ec039789_story.html.

8. Higham & Belval, *supra* note 7.

9. *Id.*; *see also* Letter from Katz, Marshall & Banks, *supra* note 7, at 4–8.

ality agreements are usually not problematic and frequently serve legitimate corporate interests, the potential conflict with Dodd-Frank arises when companies use these types of agreements as the basis for a breach of contract claim against a whistleblower. Employers may argue that the whistleblower violated the confidentiality provision in the process of disclosing possible misconduct to the government. This use of a confidentiality agreement not only punishes an employee after the whistle is blown, but also chills the willingness of employees to blow the whistle in the future due to fear of being sued by a current or former employer.

We label these agreements "de facto gag clauses," and courts, the SEC, and counsel on both sides of the employment bar are grappling with the question of whether they are lawful and enforceable in the face of Dodd-Frank's statutory and regulatory requirements. This determination requires a careful balancing of public, personal, and business interests. While no court has ruled on the legality of de facto gag clauses in the Dodd-Frank whistleblower context, we argue that SEC rules and key principles of contract, qui tam, employment, and securities law strongly suggest that courts will, and should, refuse to enforce agreements that preclude voluntary cooperation with the SEC or materially diminish the whistleblower incentives created by Dodd-Frank.

Part II briefly explains the SEC's Dodd-Frank whistleblower program. Part III examines whether the use of the three categories of contractual restrictions on whistleblowing violate Dodd-Frank's public policy purpose. We conclude that courts would find many currently used provisions unenforceable as against public policy. Part IV proposes practical steps that both employers' and employees' attorneys can take to avoid the risks posed by these provisions and, even more importantly, the specific action that the SEC, as well as the Occupational Safety and Health Administration (OSHA), can take to ameliorate the problems these provisions pose to the effectiveness of the SEC's Dodd-Frank whistleblower program. Given the immediate threat that de facto gag clauses pose to the whistleblower program—even if ultimately found unenforceable by courts—we argue that government agencies should not wait for courts to act. Rather, the SEC and OSHA should immediately act to protect the whistleblower program by clarifying its regulations invaliding agreements that, even indirectly, undermine employees' willingness to disclose wrongdoing to the SEC.

II. The SEC Whistleblower Program

Section 922 of Dodd-Frank created the SEC's current whistleblower program (the SEC Whistleblower Program) as part of Congress's response to the sweeping financial crisis that came to the public's attention

in 2008.[10] The SEC Whistleblower Program is a unique blend of approaches taken in previous laws to encourage corporate insiders to report misconduct and to protect them when they do. First, Dodd-Frank adopted a "bounty" model by creating a reward program to incentivize reporting wrongdoing to the SEC.[11] Whistleblowers are eligible to receive a monetary award when they "voluntarily" provide the SEC with "original information" that "leads to successful enforcement" by the Commission, resulting in the recovery of total sanctions in that enforcement action and any related actions that exceed $1 million.[12] If all eligibility criteria are met, the Commission awards the whistleblower an amount equal to ten to thirty percent of the total sanctions collected.[13]

Second, Dodd-Frank incorporates the more commonplace anti-retaliation model by providing a cause of action for corporate whistleblowers who suffer retaliation for disclosing securities violations.[14] The Commission itself may also bring a retaliation action against an employer,[15] a procedure that recently resulted in one company paying a settlement of more than $2.2 million.[16]

Finally, Dodd-Frank incorporated a "structural" model to encourage whistleblowers to report by providing a defined reporting channel.[17] To receive an award under the Act, employees must provide information directly to the SEC.[18] The Act required the SEC to estab-

10. *See* S. REP. NO. 111-176, at 2 (2010) (the bill that would become Dodd-Frank "is a direct and comprehensive response to the financial crisis that nearly crippled the U.S. economy beginning in 2008").

11. *See* Richard E. Moberly, *Sarbanes-Oxley's Structural Model to Encourage Corporate Whistleblowers*, 2006 BYU L. REV. 1107, 1108–09 & n.5 (2006) (the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or SOX) utilizes several models to encourage whistleblowing, including a "bounty" model, an "anti-retaliation model," and a "structural" model). Prior to Dodd-Frank, the bounty model had been used only to reward whistleblowers who reported misconduct that affected the government. *See id.* at 1108 n.5. Dodd-Frank, by contrast, rewards whistleblowers who report wrongdoing directed at private corporations and shareholders.

12. 17 C.F.R. § 240.21F-3 (2013). "Voluntarily," "original information," and "leads to successful enforcement" are defined terms. *See id.* § 240.21F-4.

13. *Id.* § 240.21F-5.

14. *See* 15 U.S.C. § 78u-6(h) (2012).

15. 17 C.F.R. § 240.21F-2(b)(2) (2013).

16. Paradigm Capital Mgmt., Inc., Exch. Act Release No. 72,393, Inv. Advisers Act Release No. 3857 (June 16, 2014).

17. *See* Moberly, *supra* note 11, at 1131–41 (the structural model of many whistleblower laws requires the identification and provision of a specific disclosure channel for whistleblowers). Other laws use the structural model, including Sarbanes-Oxley, which requires corporations to implement a channel for whistleblowers to report misconduct directly to independent directors on the corporation's audit committee of the board of directors. *See* 15 U.S.C. § 78j-1(m)(4)(A) (2012). Also, the Civil Service Reform Act of 1978 created the Office of Special Counsel to receive whistleblower disclosures from federal employees. *See* 5 U.S.C. § 1101 (2012).

18. Dodd-Frank defines a "whistleblower" as one who provides "information relating to a violation of the securities laws to the Commission, in a manner established, by rule or regulation, by the Commission." 15 U.S.C. § 78u-6(a)(6) (2012). The SEC's

lish a new office to fulfill this obligation and to administer the reward program.[19] Subsequently, the SEC created the Office of the Whistleblower,[20] which receives whistleblower disclosures, works with the SEC's enforcement staff regarding those disclosures, and determines whether to make awards for eligible enforcement actions.[21] The Act and its regulations also explicitly provide for anonymous whistleblowing.[22]

The SEC promulgated extensive regulations to implement section 922.[23] In addition to detailing the three whistleblower models incorporated into Dodd-Frank, the regulations also expressly preclude parties, including employers, from interfering with those whistleblower programs. Specifically, Rule 21F-17(a) states:

> No person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications.[24]

While the SEC has not yet brought an enforcement action based on Rule 21F-17, the chief of the SEC's Office of the Whistleblower, Sean McKessy, publicly warned that "we are actively looking for examples of confidentiality agreements, separat[ion] agreements, employee agreements that . . . in substance say 'as a prerequisite to get this benefit you agree you're not going to come to the commission or you're not going to report anything to a regulator.'"[25] McKessy further cautioned that "if we find that kind of language, not only are we going to go to the companies, we are going to go after the lawyers who drafted it," possibly by revoking those attorneys' right to practice before the Commission.[26]

McKessy's remarks and Rule 21F-17 make it clear that employers may not compel employees to waive their whistleblowing rights in exchange for a monetary payment or other benefit. Yet, despite Rule 21F-17, whistleblowers and their counsel continue frequently to

---

regulations further acknowledge that a whistleblower who reports wrongdoing internally before reporting to the SEC may still be eligible for a reward, if the whistleblower ultimately discloses the misconduct to the SEC within 120 days of the whistleblower's initial internal report. *See* 17 C.F.R. § 240.21F-4(c)(3) (2013).

19. *See* 15 U.S.C. § 78u-7(d) (2012).

20. *See* 17 C.F.R. § 240.21F-1 (2013).

21. *See* U.S. Sec. & Exch. Comm'n, 2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program 5–7 (2013), *available at* http://www.sec.gov/about/offices/owb/annual-report-2013.pdf.

22. *See* 15 U.S.C. § 78u-6(d)(2), (h)(2) (2012); 17 C.F.R. §§ 240.21F-7, -9(c) (2013).

23. *See* Adopting Release, *supra* note 6.

24. 17 C.F.R. § 240.21F-17(a) (2013).

25. Brian Mahoney, *SEC Warns In-House Attys Against Whistleblower Contracts*, Law360 (Mar. 14, 2014), http://www.law360.com/articles/518815/sec-warns-in-house-attys-against-whistleblower-contracts.

26. *Id*.

encounter agreements limiting or discouraging whistleblowing in more subtle, yet often equally pernicious, ways, including the three types of de facto gag clauses identified above.[27]

These agreements raise the important question of how far Rule 21F-17 extends. Does it merely prohibit confidentiality agreements purporting to completely restrict all communications with the SEC, or does it also prohibit agreements technically allowing communications with the SEC, but indirectly *impeding* whistleblowing by making it harder, riskier, or otherwise less desirable?

Absent any SEC enforcement actions under Rule 21F-17, or private litigation directly addressing the enforceability of such clauses, courts are very likely to rely on existing contract law to balance the public and private interests that these agreements implicate. This reliance is particularly likely in private litigation between whistleblowers and their employers (as opposed to SEC enforcement actions brought under Rule 21F-17), because—although a court is very likely to find that any contract that violated Rule 21F-17 would be unenforceable—Rule 21F-17 does not supply employees with a private right of action.[28]

Accordingly, the next part of this Article examines whether the types of de facto gag clauses companies use would be enforceable under existing law. Specifically, we conclude that such agreements should not be enforced in the SEC whistleblower context because they violate Dodd-Frank's public policy. Additionally, while preexisting law does not define the limits of Rule 21F-17, a court could find a contract void based on the plain language of the Rule.

III. De Facto Gag Clauses Violate Dodd-Frank's Public Policy

A. The Public Policy Limitation on Contractual Enforcement

The most logical starting point for analyzing the enforceability of agreements affecting an employee's ability to participate in the SEC Whistleblower Program, or to obtain benefits for doing so, is the bedrock principle that contracts between private individuals may be void if they violate public policy.[29] In *Town of Newton v. Rumery*, the

27. *See* Letter from Katz, Marshall & Banks, *supra* note 7, at 4 ("While companies and their counsel are largely avoiding attempts to prohibit outright an individual's communicating with the SEC, our law firm and other [sic] that represent SEC whistleblowers are nonetheless seeing an increase in proposed settlement language that is intended to achieve the same result in a more roundabout and crafty manner.").

28. *See* 17 C.F.R. § 240.21F-17 (2013).

29. *See* Town of Newton v. Rumery, 480 U.S. 386, 392 (1987); RESTATEMENT (SECOND) OF CONTRACTS § 178(1) (1981) ("A promise . . . is unenforceable on grounds of public policy if . . . the interest in its enforcement is clearly outweighed . . . by a public policy against the enforcement of such terms."); Alan Garfield, *Promises of Silence: Contract Law and Freedom of Speech*, 83 CORNELL L. REV. 261, 294–95 (1998) ("The power of courts to deny

Supreme Court provided a framework for applying this long-standing principle, concluding that contracts may not be enforceable under federal common law when the public policy considerations against enforcement outweigh any interests supporting enforcement.[30] Accordingly, it is not enough merely to establish that an agreement is contrary to *some* public policy; instead, *Town of Newton* requires identifying the public interests that militate both for and against enforcement, and comparing those interests to each other.[31]

Courts have applied *Town of Newton*—or the common law principles upon which *Town of Newton* is based—to numerous types of contracts purporting to prohibit individuals from communicating with government authorities about violations of law. They have repeatedly found such blanket bans unenforceable. Courts have rarely hesitated to strike down contracts that conceal crimes, which many SEC violations also are, or suppress evidence.[32] The normal justifications for contractual enforcement—facilitating economic activity and meeting party expectations by encouraging reliance on promises[33]—do not overcome the powerful public desire for law enforcement.[34] In fact, a contract that conceals a crime not only is unenforceable, but also may constitute the state law crime of "compounding"[35] or the federal crime of obstruction of justice.[36]

Even outside the criminal context, courts have often rejected agreements purporting to prohibit voluntarily reporting to the government possible civil violations. For example, in *EEOC v. Astra U.S.A., Inc.*,[37] the First Circuit invalidated provisions in settlement agreements prohibiting employees from communicating with the Equal Employment Opportunity Commission (EEOC).[38] The court explicitly

---

enforcement to a contract on public policy grounds is not only indisputable, but also open-ended.").

30. *See* 480 U.S. at 392 ("The relevant principle is well established: a promise is unenforceable if the interest in its enforcement is outweighed in the circumstances by a public policy harmed by enforcement of the agreement."); Garfield, *supra* note 29, at 295; RESTATEMENT (SECOND) OF CONTRACTS § 178(1).

31. 480 U.S. at 392.

32. *See* Garfield, *supra* note 29, at 307–08.

33. *See* Terry Morehead Dworkin & Elletta Sangrey Callahan, *Buying Silence*, 36 AM. BUS. L.J. 151, 174 (1998) (public policy benefits of enforcing contracts).

34. *Cf.* Richard Moberly, *The Supreme Court's Antiretaliation Principle*, 61 CASE W. RES. L. REV. 375, 378 (2010) (a common theme of the Supreme Court's retaliation jurisprudence is the principle that "protecting employees from retaliation will enhance the enforcement of the nation's laws").

35. Generally, "compounding" is defined as accepting consideration for a promise not to report a crime. *See* Garfield, *supra* note 29, at 307–08.

36. 18 U.S.C. § 1505 (2012); *see also* Stephen Gillers, *Speak No Evil: Settlement Agreements Conditioned on Noncooperation Are Illegal and Unethical*, 31 HOFSTRA L. REV. 1, 15 (2002).

37. 94 F.3d 738 (1st Cir. 1996). *See also* EEOC v. Cosmair, Inc., L'Oreal Hair Care Div., 821 F.2d 1085, 1091 (5th Cir. 1987).

38. *See Astra*, 94 F.3d at 743.

balanced the impact of those agreements on the EEOC's ability to investigate systemic discrimination against the impact that invalidating the provisions would have on private dispute resolution,[39] concluding that limiting the ability of employees to communicate with the EEOC would "sow[] the seeds of harm to the public interest."[40] Similar decisions have been reached when employers use contractual promises of silence to impede government investigations of securities violations,[41] unfair labor practices,[42] and investment advisor misconduct.[43]

These cases confirm that there is a strong public policy in favor of reporting possible violations of the law to the government, which can outweigh competing interests in protecting confidential information and promoting private dispute resolution. Certainly, these cases indicate that any provision designed to prevent an employee from making "any complaint" about the company—as some general releases do—should not and would not be enforced to block communications about possible unlawful activity with the SEC or other law enforcement agencies. They also suggest that courts should give heightened scrutiny to provisions that make reporting to the SEC more onerous to ensure that they do not indirectly pursue a goal that could not be sought directly.[44]

But, as instructive as these cases are, they do not fully answer the question of whether, and to what extent, companies can use agreements that allow whistleblowing, but decrease or eliminate congressional incentives for doing so. To answer that question, it is necessary to look not only to the broad public policies animating *Astra* and its progeny, but also to the specific public policy underlying, and supported by, Dodd-Frank.

---

39. *See id.* at 744.

40. *Id.*

41. *See* SEC v. Lipson, No. 97 C 2661, 1997 WL 801712, at *2 (N.D. Ill. Oct. 28, 1997) (agreement not to speak with SEC without a subpoena void as against public policy).

42. *See* D'Arrigo Bros. of Cal. v. United Farmworkers of Am., 169 Cal. Rptr. 3d 171, 181–83 (Cal. App. 2014) (contractual language purporting to prohibit union from cooperating with government investigation of unfair labor practices unenforceable).

43. *See* Cariveau v. Halferty, 99 Cal. Rptr. 2d 417, 423–24 (Cal. App. 2000) ("The use of confidentiality agreements that purport to restrict a registered member's customers from reporting improper conduct to the [National Association of Securities Dealers (NASD)] serves to perpetuate the improper conduct and is condemned by NASD policies.").

44. Courts have repeatedly rejected contract interpretations that allow parties to do indirectly what they could not do directly. *See, e.g.*, Century Marine Inc. v. United States, 153 F.3d 225, 230 (5th Cir. 1998) ("To allow such recovery would permit Century to do indirectly what it could not do directly."); Safran v. United Steel Workers of Am., AFL-CIO, 678 F. Supp. 1178, 1181 (W.D. Pa. 1988) ("We decline to permit the plaintiffs to do indirectly what they could not contractually do directly."); Ables v. United States, 2 Cl. Ct. 494, 501 (1983), *aff'd*, 732 F.2d 166 (Fed. Cir. 1984) ("What they could not do directly they certainly should not be allowed to do indirectly under the guise of an intended third party beneficiary.").

1. Identifying Dodd-Frank's Public Policy

Dodd-Frank's text and legislative history make clear that one of its primary public interests is better protection for investors and the financial markets themselves following the financial crisis in 2008.[45] In particular, the whistleblower provisions' purpose is to assist the SEC in detecting, investigating, and prosecuting serious securities violations to further the public policy goal of protecting investors and the markets.[46] In this respect, Dodd-Frank also evinces a strong public policy interest in whistleblowing and private cooperation with public law enforcement.

As the First Circuit's decision in *Astra* indicates, however, an analysis of a statute's public policy aims encompasses more than evaluating its general purpose; it also requires a court to assess the specific statutory scheme designed to further that purpose.[47] In *Astra*, the court examined not just the public policy behind Title VII but also *how* Congress intended to protect and advance that public interest by giving the EEOC the power to investigate both individual and systemic discrimination.[48]

Dodd-Frank's statutory scheme reflects an important public policy judgment: incentives are needed to promote whistleblowing because "whistleblowers often face the difficult choice between telling the truth and the risk of committing 'career suicide.'"[49] The SEC, too, recognized that incentives are an integral part of Dodd-Frank's investor-protection scheme:

> [T]he broad objective of the whistleblower program is to enhance the Commission's law enforcement operations by increasing the financial incentives for reporting and lowering the costs and barriers to potential whistleblowers, so that they are more inclined to provide the Commission with timely, useful information that the Commission might not otherwise have received.[50]

In particular, Congress developed three primary incentives to counterbalance the profound personal and professional risks that whistleblowers often face, and to support the public policy of encouraging whistleblower reports to the SEC.[51] First, of course, is the provision of financial awards to whistleblowers. As the Senate Committee

45. *See* S. REP. NO. 111-176, at 36 (2010) ("During the crisis, it became apparent that investors needed better protection . . . and the SEC need[ed] assistance.").

46. *Id*.

47. EEOC v. Astra U.S.A., Inc., 94 F.3d 738, 743–44 (1st Cir. 1996).

48. *Id.* at 744.

49. S. REP. NO. 111-176, at 111.

50. ADOPTING RELEASE, *supra* note 6, at 105.

51. *See id*. at 197 ("The Congressional purpose underlying Section 21F of the Exchange Act is to encourage whistleblowers to report possible violations of the securities laws by providing financial incentives, prohibiting employment-related retaliation, and providing various confidentiality guarantees.").

on Banking, Housing and Urban Affairs noted in its report on Dodd-Frank, "the minimum payout that any individual could look towards in determining whether to take the enormous risk of blowing the whistle in calling attention to fraud" is "the critical component of the Whistleblower Program," particularly because it helps counter the economic harm that whistleblowers may face as a result of employment-related retaliation or blacklisting.[52]

Second, Dodd-Frank and the SEC Whistleblower Rules allow whistleblowers to report possible misconduct to the SEC anonymously.[53] The importance of anonymity can be seen throughout Dodd-Frank's statutory provisions and the implementing regulations. Both the statute and regulations prohibit the SEC from "disclos[ing] any information . . . which could reasonably be expected to reveal the identity of a whistleblower," except in narrow circumstances.[54] Whistleblowers also benefit from the fact that all SEC investigations remain confidential until the Commission files a complaint or begins an administrative proceeding.[55] The anonymity continues even after the SEC issues an award; none of the fourteen whistleblower awards issued as of December 2014 have identified the recipients or provided potentially identifying information.[56]

These anonymity safeguards are significant because they dramatically decrease the risk that whistleblowers will become known to others, in turn decreasing the risk that they will face retaliation or blacklisting. Moreover, the SEC has emphasized that the anonymity protection provides essential encouragement for a whistleblower to come forward, and that fewer people would blow the whistle without

52. S. REP. NO. 111-176, at 111. Indeed, although the Program's results still cannot fully be assessed because of the program's relative newness and the length of time before an award can be issued, it seems to be successfully encouraging whistleblowers to provide tips to the SEC. The SEC has received thousands of complaints under the program each year since it began in 2011. *See* U.S. SEC. & EXCH. COMM'N, 2013 ANNUAL REPORT, *supra* note 21. As of December 1, 2014, the Program has made awards to fourteen whistleblowers, including one award the SEC estimates will be between $30 and $35 million. *See Final Orders of the Commission*, U.S. SEC. & EXCH. COMM'N, OFF. OF THE WHISTLEBLOWERS, http://www.sec.gov/about/offices/owb/owb-final-orders.shtml (last visited Dec. 1, 2014).

53. *See* 15 U.S.C. § 78u-6(d)(2), (h)(2) (2012); 17 C.F.R. §§ 240.21F-7, -9(c) (2013).

54. 15 U.S.C. § 78u–6(h)(2) (2012); 17 C.F.R. § 240.21F-7(a) (2013). Pursuant to 17 C.F.R. § 240.21F-7(b), whistleblowers reporting anonymously must file their complaint through an attorney, follow prescribed certification procedures, and disclose their identities to the Commission only for verification before receiving any award.

55. *See, e.g.*, ADOPTING RELEASE, *supra* note 6, at 126 ("As a general matter, it is the Commission's policy and practice to treat all information obtained during its investigations as confidential and nonpublic."). The SEC is entitled to disclose nonpublic information in narrow circumstances, including to other government entities, self-regulatory organizations, and bankruptcy trustees. *See* 17 C.F.R. § 240.24c-1(b) (2013).

56. *See* SEC. & EXCH. COMM'N, OFFICE OF THE WHISTLEBLOWER, FINAL ORDERS OF THE COMMISSION, *available at* http://www.sec.gov/about/offices/owb/owb-final-orders.shtml (last visited Dec. 1, 2014) (whistleblower award notices).

it.[57] Common sense and social science research also support the conclusion that "individuals are more willing to state a dissenting viewpoint if they can do so anonymously."[58]

Third, Dodd-Frank provides robust remedies to whistleblowers who face retaliation for reporting suspected violations to the SEC.[59] In particular, the statute gives whistleblowers who experience retaliation the right to seek reinstatement, double back pay, and legal fees.[60] The Dodd-Frank protections have procedural advantages as well because a whistleblower can bring a retaliation claim directly to federal court for up to six years after retaliation occurs,[61] while many other federal anti-retaliation provisions require whistleblowers to bring an administrative claim before filing a court action, often within 180 days.[62] These enhanced remedies are particularly important because according to a recent survey, more than twenty percent of employees reporting workplace misconduct experience some form of retribution.[63]

In short, in Dodd-Frank Congress identified a strong public interest in protecting investors and determined that this interest is advanced by (a) protecting from retaliation whistleblowers who report securities violations, (b) allowing whistleblowers to report anonymously, and (c) giving whistleblowers the chance to obtain significant monetary awards. Thus, any balancing of public policy interests under *Town of Newton* must take into account the role that Dodd-Frank's incentives play in protecting investors and, conversely, the potential impact that removing or undercutting these incentives would have on investors.

---

57. *See* ADOPTING RELEASE, *supra* note 6, at 198 (whistleblowers would be "less inclined to report possible securities law violations" if they believed the SEC would disclose the whistleblower's identity to the corporation being investigated).

58. Moberly, *supra* note 11, at 1139, 1143 n.168; *see also* ASS'N CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE 17 (2010); TERANCE D. MIETHE, WHISTLEBLOWING AT WORK: TOUGH CHOICES IN EXPOSING FRAUD, WASTE, AND ABUSE ON THE JOB 54–57 (1999); CASS R. SUNSTEIN, WHY SOCIETIES NEED DISSENT 20 (2003). *But see* MARCIA P. MICELI, WHISTLE-BLOWING IN ORGANIZATIONS 158 (2008) ("[T]here is scant evidence that anonymity promotes whistle-blowing.").

59. *See* Richard Moberly, *Sarbanes-Oxley's Whistleblower Provisions: Ten Years Later*, 64 S.C. L. REV. 1, 14–16 (2012) (Dodd-Frank was one of several new anti-retaliation provisions that "take Sarbanes-Oxley as a baseline and improve upon it").

60. 15 U.S.C. § 78u-6(h)(1)(C) (2012).

61. *See* 15 U.S.C. § 78u-6(h)(1)(B)(i) (2012) (whistleblowers may file claims in federal district court); 15 U.S.C. § 78u-6(h)(1)(B)(iii) (2012) (claims must be filed within six years after retaliation occurs or within three years of when the employee should have reasonably known about the facts material to the right of action, but not more than ten years after the date of the violation).

62. *See* Richard Moberly, *Protecting Whistleblowers by Contract*, 79 UNIV. COLO. L. REV. 975, 1004–05 (2008).

63. *See National Business Ethics Survey of the U.S. Workforce,* ETHICS RES. CTR. 1, 13 (2013), http://www.ethics.org/nbes.

2. Contracts That Undermine Dodd-Frank's Whistleblower Program

With this analytical framework in mind, we turn to the various contractual provisions companies use that may interfere with the SEC Whistleblower Program. As noted above, many of these provisions do not directly bar whistleblowing to the SEC—which would be a clear violation of *Astra* and Rule 21F-17—but instead alter the costs and benefits of whistleblowing, thus changing the likely behavior of prospective whistleblowers. In particular, we will analyze the competing public and private interests raised by three types of commonly observed clauses: (1) provisions that require employees to disclose their communications with the SEC to employers in some manner, (2) provisions waiving employees' ability to obtain an award under the SEC Whistleblower Program, and (3) general confidentiality provisions that may be used to bring a breach of contract claim should a whistleblower disclose confidential information or documents to the SEC.

A. CONTRACTS REQUIRING DISCLOSURE OF SEC COMMUNICATIONS

The first general category of contractual provision is designed to elicit information about whether employees have, or plan to, report possible wrongdoing to the SEC or other government authorities. One particularly common variant allows employees to blow the whistle to the SEC but provides that they must first report the wrongdoing internally, or otherwise alert the company that they have disclosed, or plan to disclose, information to the SEC. Applying *Town of Newton*,[64] it is clear that some legitimate interests weigh in favor of enforcing such provisions. Employers may contend that, because information derived through the course of a party's employment generally belongs to the employer, they should be able to control this information, provided they do not use a confidentiality agreement to conceal unlawful conduct from the government.[65] In particular, obtaining the relevant information before the whistleblower discloses it to the SEC allows the employer to self-report violations, which can minimize the sanctions it faces in any SEC enforcement action.[66] It also helps the company

64. Town of Newton v. Rumery, 480 U.S. 386, 392 (1987).

65. *See* Diamond v. Oreamuno, 248 N.E. 2d 910, 912 (N.Y. 1969) ("As a general proposition, a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit, but must account to his principal for any profits derived therefrom."); *see also* RESTATEMENT (SECOND) OF AGENCY § 388 (1958).

66. *See, e.g.*, Press Release, Sec. & Exch. Comm'n, SEC Announces Non-Prosecution Agreement with Ralph Lauren Corporation Involving FCPA Misconduct (Apr. 22, 2013) ("'When they found a problem, Ralph Lauren Corporation did the right thing by immediately reporting it to the SEC and providing exceptional assistance in our investigation,' said George S. Canellos, Acting Director of the SEC's Division of Enforcement. 'The NPA in this matter makes clear that we will confer substantial and

understand the problem, prepare for a possible SEC investigation, and take quicker remedial action. Indeed, because of these reasons, some commentators suggest that internal whistleblowing is preferable to external whistleblowing.[67]

Additionally, employers may argue that such provisions pose relatively few risks to whistleblowers in light of SEC Rule 21F-4(c)(3), which provides that a whistleblower may be considered the source of "original information," and therefore remain eligible for a monetary award, when that information is first reported internally by the whistleblower and then self-reported to the SEC by the company.[68] In other words, the whistleblower can still reap the monetary benefits of the SEC Whistleblower Program, even by reporting internally first.

Whistleblowers, on the other hand, are likely to argue that these provisions impede whistleblowing and, in so doing, undercut Dodd-Frank's public policy. Most significantly, these provisions take direct aim at the statutory anonymity protections.[69] Employees cannot remain anonymous if they have to inform the company of their plan to report, or that they have reported, to the SEC. Even if employees need only internally disclose the violation and not their intention of reporting to the SEC, the employer can easily trace any subsequent SEC inquiry back to the internal reporter, making Dodd-Frank's guarantee of anonymity an empty promise.

For this and other reasons, the SEC considered, but rejected, mandating internal reporting as a prerequisite for the recovery of a monetary award, concluding that any internal reporting requirement would undermine Dodd-Frank's anonymity mandates.[70] Likewise, the SEC found that "a general requirement that employees report internally . . . would impose a barrier that in some cases would dissuade potential

---

tangible benefits on companies that respond appropriately to violations and cooperate fully with the SEC.'").

67. *See* Dworkin & Callahan, *supra* note 33, at 190. Dworkin and Callahan suggest that the law should enforce confidentiality agreements that require internal reporting first:

> The employer could fashion an agreement which requires that the employee first disclose any information internally. This gives it the advantage of correcting the situation without the confidence being breached. The company can also designate the appropriate recipient to ensure that the information is handled correctly. Since these measures do not thwart whistleblowing and have the advantage of allowing for earlier correction of any wrongdoing, the courts are likely to uphold these promises.

Id.

68. 17 C.F.R. § 240.21F-4(c)(3) (2013).

69. S. Rep. No. 111-176, at 111 (2010).

70. *See* Adopting Release, *supra* note 6, at 105–06 n.230 ("[I]n some cases an anonymous whistleblower's identity can be gleaned from the facts and circumstances surrounding the whistleblower's complaint. . . . [R]equiring the whistleblower to report internally would be in tension with . . . Section 21F that we protect information that could reasonably be expected to reveal the identity of a whistleblower.").

whistleblowers from providing information to the Commission, contrary to the purpose of the whistleblower provision."[71] Instead, the SEC included in the rules features designed to "incentivize whistleblowers to utilize their companies' internal compliance and reporting systems when appropriate,"[72] including expanding the definition of "original information" and treating internal reporting as a positive factor when determining monetary awards.[73] These provisions reflect the SEC's judgment that investor protection is best served by allowing, but not mandating, internal reporting.[74]

Section 301 of the Sarbanes-Oxley Act of 2002[75] (Sarbanes-Oxley or SOX) reflects a similar public policy judgment in favor of confidential reporting. That provision requires employers to implement channels for employees to report illegal conduct to a corporate board of directors anonymously, without the knowledge of their direct supervisors or managers.[76] In fact, the Department of Labor's (DOL) Administrative Review Board (ARB) has recognized that a company that publicly identifies a whistleblower may have committed an adverse action against the whistleblower and be liable under Sarbanes-Oxley's anti-retaliation provision.[77] In *Menendez v. Halliburton*, the ARB noted:

> The reason for requiring audit committees to create confidential and/or anonymous disclosure procedures is evident. Employee whistleblowers are one of the most effective sources of information concerning questionable accounting and auditing matters as well as fraud and corporate crime. Since employees are more willing to identify misconduct if they can do so anonymously, it stands to reason that anonymous and/or confidential reporting mechanisms encourage internal reporting of corporate misconduct. Furthermore, the confidentiality that Section 301 provides allows employees to report problems directly to the independent audit committee and thus effectively to their employer, while at the same time permitting the whistleblowing employee to avoid possible retaliation from supervisors or high-ranking company managers who may be defensive about wrongdoing

71. *Id.* at 105.

72. *Id*. at 5.

73. *See* 17 C.F.R. § 240.21F-6(4) (2013).

74. *See* Brief of the Sec. & Exch. Comm'n, Amicus Curiae in Support of the Appellant, Liu Meng-Ling v. Siemens AG, No. 13-4385, 2014 WL 663875, at *2 (2d Cir. Feb. 20, 2014). ("Throughout the rulemaking process, the Commission considered the 'significant issue' of how to ensure that the whistleblower program does not undermine the willingness of individuals to make whistleblower reports internally at their companies before they make reports to the Commission."); *see also* ADOPTING RELEASE, *supra* note 6, at 90–91 ("The objective of this provision is to support, not undermine, the effective functioning of company compliance and related systems by allowing employees to take their concerns about possible violations to appropriate company officials first while still preserving their rights under the Commission's whistleblower program.").

75. 15 U.S.C. § 78j-1(m)(1) (2012).

76. *See id.*

77. *See* Menendez v. Halliburton, Inc., ARB Nos. 09-002, 09-003, ALJ No. 2007-SOX-005, at 23-24 (ARB Sept. 13, 2011).

> in which they might be implicated. Congress well recognized the importance of encouraging the reporting of accounting irregularities and potential fraud by means of confidential disclosures.
>
> . . .
>
> Since the purpose of confidentiality is to encourage employees to come forward with information about SOX violations, permitting an employer to indiscriminately expose the identity of an employee who presents information concerning questionable accounting or auditing matters would most assuredly chill whistleblower-protected activity.[78]

In addition to implicating Dodd-Frank's anonymity provisions, agreements purporting to require internal reporting may also undercut the statute's anti-retaliation protections. Several courts, including the Fifth Circuit, have held that the Act does not protect internal whistleblowers because its statutory definition of "whistleblower" requires a report to the SEC.[79] This result is controversial, and several other courts have reached the opposite conclusion for a variety of reasons.[80] However, to the extent the Fifth Circuit's view prevails, it would be anomalous to permit an employer to require a whistleblower to report internally before reporting to the SEC because the employer would then have a defined window in which it could retaliate without facing any Dodd-Frank penalties.[81] This result seems likely to dissuade prospective whistleblowers from coming forward, particularly as reported retaliation rates remain strikingly high.[82]

The potentially profound effect of these "internal reporting" agreements on Dodd-Frank's anonymity and anti-retaliation protections—and the corresponding centrality of these dual protections to the statute's overall investor-protection scheme—indicates that they should, and very likely will, be found unenforceable under *Town of Newton*. An employer's desire to learn of potential problems cannot justify the risk that fewer whistleblowers will come forward if private con-

---

78. *See id.*

79. *See* Asadi v. G.E. Energy (USA), L.L.C., 720 F.3d 620, 630 (5th Cir. 2013); *see also* Banko v. Apple Inc., No. 13–02977, 2013 WL 7394596, at *1 (N.D. Cal. Sept. 27, 2013); Wagner v. Bank of Am. Corp., No. 12-CV-00381, 2013 WL 3786643, at *1 (D. Colo. July 19, 2013).

80. *See, e.g.*, Bussing v. COR Clearing, LLC., No. 8:12-CV-238, 2014 WL 2111207, at *12 (D. Neb. May 21, 2014); Rosenblum v. Thomson Reuters (Markets) LLC, No. 13 Civ. 2219, 2013 WL 5780775, at *3–5 (S.D.N.Y. Oct. 25, 2013); Ellington v. Giacoumakis, No. 13-11791, 2013 WL 5631046, at *2–3 (D. Mass. Oct. 16, 2013); Murray v. UBS Sec., LLC, No. 12 Civ. 5914, 2013 WL 2190084, at *3–7 (S.D.N.Y. May 21, 2013); Genberg v. Porter, 935 F. Supp. 2d 1094, 1106–07 (D. Colo. 2013); Kramer v. Trans-Lux Corp., No. 11 Civ. 1424, 2012 WL 4444820, at *3–5 (D. Conn. Sept. 25, 2012); Nollner v. S. Baptist Convention, Inc., 852 F. Supp. 2d 986, 993–95 (M.D. Tenn. 2012); Egan v. TradingScreen, Inc., No. 10 Civ. 8202, 2011 WL 1672066, at *5 (S.D.N.Y. May 4, 2011).

81. Sarbanes-Oxley clearly would protect this internal whistleblower from retaliation, but as mentioned above, its procedures and remedies are not as favorable to whistleblowers as Dodd-Frank's provisions.

82. *See* ETHICS RES. CTR., *supra* note 63, at 9.

tracts can dismantle these two pillars of Dodd-Frank's statutory scheme. Instead, public policy favors preserving the delicate balance that the SEC, after public comments and deliberation, struck with respect to internal reporting.[83]

This result would be consistent not only with congressional and administrative intent, but also with prior case law recognizing as unenforceable contractual provisions that burden, but do not completely bar, communications with the SEC.[84] For example, in *SEC v. Lipson*, an Illinois district court refused to enforce a provision that would have limited the extent to which employees could communicate with the SEC without a subpoena, reasoning that

> Neither the fact that [the] SEC remains free to subpoena the signatories to the agreement with Mr. Lipson, nor the possibility that the language of the agreement might be construed narrowly by the signatories to permit informal discussions with SEC personnel on certain topics, satisfies this court that the challenged provisions are harmless.[85]

As in *Lipson*, the question is not whether employees might still be able to communicate with the SEC despite their contractual restrictions, but instead whether those restrictions threaten material harm to the SEC's investigative abilities. Here, as in *Lipson*, the answer is that they do, and therefore should not be enforceable.

B. CONTRACTS REQUIRING RELINQUISHMENT OF A DODD-FRANK REWARD

Equally common, and equally troubling, are contractual provisions that preserve employees' right to report possible securities violations to the SEC, but mandate that the employee waive, decline, or agree not to seek a monetary award. Such a provision might state, for example, "[n]othing in this agreement is intended to prevent Employee from communicating or cooperating with a government agency, except Employee agrees that Employee will not be entitled to any individual monetary payment or relief resulting from any administrative claim or investigative proceeding."

Some employers may argue that such provisions are voluntary waivers of a statutory right, which courts typically permit unless expressly prohibited by statute. Thus, these employers would contend, the provision is exempt from analysis under *Town of Newton*.[86] Employers are likely to point to the fact that, while Dodd-Frank amended SOX to include such an express prohibition on statutory waivers, it

83. *See generally* ADOPTING RELEASE, *supra* note 6.

84. *See* SEC v. Lipson, No. 97 C 2661, 1997 WL 801712, at *2 (N.D. Ill. Oct. 28, 1997).

85. *Id*.

86. *See* United States v. Mezzanatto, 513 U.S. 196, 201 (1995) ("[A]bsent some affirmative indication of Congress' intent to preclude waiver, we have presumed that statutory provisions are subject to waiver by voluntary agreement of the parties.").

included no such prohibition with respect to Dodd-Frank's own whistleblower provisions.[87] In the face of the Sarbanes-Oxley amendment, employers may argue that congressional silence about waiver in Dodd-Frank whistleblower provisions implies that Congress intentionally permitted employees to waive their bounty right.

However, the Supreme Court has noted that the absence of an anti-waiver provision is not dispositive when "legislative policy would be thwarted by permitting" contractual waivers of statutory rights.[88] The Court has applied a similar public policy test as described in Part III.A, *supra*, by voiding a contractual waiver provision when it was "inconsistent with the provision creating the right sought to be secured."[89] Thus, whether an agreement to relinquish a Dodd-Frank award is viewed as a waiver of a statutory right or a standard contract under *Town of Newton*, the relevant question remains the same: would enforcement of the agreement impermissibly undercut the public policy goals of the relevant statute?

Employers are likely to contend that the answer is no because such provisions allow whistleblowers to communicate with the SEC on a voluntary and anonymous basis. The employee does not face any punishment or penalty for whistleblowing; the employee simply cannot receive an award for doing so. Employers are also likely to argue that the potential harm to the SEC is low because the Commission retains its traditional investigative tools, including the ability to speak to witnesses without a subpoena.

In support of this argument, employers may analogize agreements waiving Dodd-Frank awards to similar provisions used in employment severance or settlement agreements. These typically permit an employee to file a discrimination claim with the EEOC but not to obtain personal damages or other monetary relief. In other words, employees could notify the EEOC of possible discrimination, allowing the EEOC to investigate potentially systemic or continuing discrimination, but would release individual claims to relief.

Although certain EEOC offices are beginning to challenge such provisions,[90] they have so far been routinely enforced by

87. *See* 18 U.S.C. § 1514A(e)(1) (2012) ("The rights and remedies provided for in [SOX] may not be waived by any agreement, policy form, or condition of employment.").

88. Brooklyn Sav. Bank v. O'Neil, 324 U.S. 697, 713 (1945).

89. New York v. Hill, 528 U.S. 110, 116 (2000); *see also Brooklyn Sav. Bank*, 324 U.S. at 704 (in determining that the right to liquidated damages under the Fair Labor Standards Act is not waivable, the Court noted: "Where a private right is granted in the public interest to effectuate a legislative policy, waiver of a right so charged or colored with the public interest will not be allowed where it would thwart the legislative policy which it was designed to effectuate.").

90. *See, e.g.*, Complaint, EEOC v. CVS Pharmacy, Inc., No. 14-cv-863, 2014 WL 540344 (N.D. Ill. Feb. 7, 2014); Complaint, EEOC v. Baker & Taylor, Inc., No. 13-cv-03729 (N.D. Ill. May 20, 2013).

courts.[91] The Supreme Court considered a similar issue in *EEOC v. Waffle House*[92]—whether an arbitration agreement can prevent the EEOC from litigating on an employee's behalf in court—and concluded that the EEOC could bring claims in court despite the employee's arbitration agreement, but that "[the employee's] conduct may have the effect of limiting the relief that the EEOC may obtain."[93] Employers are likely to argue that the same rule should apply in the Dodd-Frank context; that is, that agreements may not validly waive employees' rights to make a Dodd-Frank disclosure, but they may waive employees' rights to benefit personally from that disclosure.

This comparison, while superficially appealing, ignores the substantial differences between the public policy goals of Title VII and Dodd-Frank, and the two statutes' enforcement schemes. The EEOC enforces antidiscrimination laws by investigating claims of alleged discrimination victims, who may prosecute their claims directly by intervening in an EEOC action or, when the EEOC declines to bring an action, by filing their own private lawsuits.[94] Damages obtained by an employee in an EEOC action are based primarily on the EEOC's vindication of the employee's own rights.[95] Therefore, failing to enforce the waiver in an EEOC action would typically result in a double recovery for the employee, who would receive both the consideration given for the waiver and the damages from the EEOC action.[96] As the Supreme Court has made clear, "courts can and should preclude double recovery by an individual."[97]

The same logic does not apply to Dodd-Frank's unique statutory scheme, in which the SEC is not seeking to vindicate the personal rights of a whistleblower—who may not have suffered any injury as a result of the reported securities violations—but is instead bringing

91. *See, e.g.*, EEOC v. Cosmair, Inc., L'Oreal Hair Care Div., 821 F.2d 1085, 1091 (5th Cir. 1987) ("[A]lthough an employee cannot waive the right to file a charge with the EEOC, the employee can waive not only the right to recover in his or her own lawsuit but also the right to recover in a suit brought by the EEOC on the employee's behalf."); EEOC v. Goodyear Aerospace Corp., 813 F.2d 1539, 1543 (9th Cir. 1987); EQUAL EMP'T OPPORTUNITY COMM'N, ENFORCEMENT GUIDANCE ON NON-WAIVABLE EMPLOYEE RIGHTS UNDER EQUAL EMPLOYMENT OPPORTUNITY COMM'N (EEOC) ENFORCED STATUTES (Apr. 10, 1997), *available at* http://www.eeoc.gov/policy/docs/waiver.html ("[T]he Commission notes that even though an individual who has signed a waiver agreement or otherwise settled a claim subsequently files a charge with the Commission based on the same claim, the employer will be shielded against any further recovery by the charging party . . . .").

92. 534 U.S. 279 (2002).

93. *Id.* at 296 (citations omitted).

94. *See generally* 42 U.S.C. § 2000e et al. (2012).

95. *Id.*

96. *See Waffle House*, 534 U.S. at 297; *Goodyear Aerospace Corp.*, 813 F.2d at 1543 (while injunctive relief against employer would serve the public good, any back pay awarded to EEOC would "go directly to [the employee]" and is therefore not recoverable if previously waived).

97. *Waffle House*, 534 U.S. at 297.

claims on behalf of the government, for the ultimate benefit of investors. Typically, the whistleblower only has the right to seek a Dodd-Frank award, which compensates the whistleblower for information, not injury. Therefore, a whistleblower award cannot be duplicative of the consideration that an employee may have received from the employer in exchange for a release of the claims that the employee could have brought directly against the employer.[98]

Given these distinctions, the enforceability of Dodd-Frank award waivers should not rest on EEOC precedent. Instead, a more apt, though still imperfect, analogy for the SEC whistleblower program is the *qui tam* regime of the False Claims Act[99] (FCA). The FCA resembles Dodd-Frank by providing a reward for whistleblowers who report employer misconduct[100] and by involving claims in which the injury being vindicated also belongs to the government rather than the whistleblower.[101] Unlike Dodd-Frank, though, FCA whistleblowers, or "relators," bring these claims by filing their own lawsuit against the company, in which the government may or may not intervene.[102] FCA waiver cases typically arise when an employee signs an agreement releasing all claims against an employer, and then subsequently files an FCA complaint.[103]

Consistent with *Town of Newton*[104] and *Lipson*,[105] courts assessing the enforceability of FCA waivers have sought to balance the "public interest in having information brought forward that the government could not otherwise obtain" with the public interest in "encouraging parties to settle disputes."[106] Significantly, courts have recognized

98. This rationale would also prevent an employer from suing a whistleblower under a more general release of claims against the employer. Because the SEC award is not based on any whistleblower claim against the employer, it should not be included in a general release.

99. 31 U.S.C. §§ 3729–3733 (2012).

100. *See id.* § 3730(d).

101. *See id.* §§ 3729–3733. *See also* Geoffrey Christopher Rapp, *Mutiny on the Bounties? The Attempt to Reform Wall Street by the New Whistleblower Provisions of the Dodd-Frank Act*, 2012 BYU L. REV. 73, 76–77 (2012) ("Dodd-Frank drew some of its inspiration from the False Claims Act," but Dodd-Frank is inferior because it does not adopt the *qui tam* aspect of the FCA that allows "whistleblowers to *litigate cases independently* from federal action") (emphasis added); *id.* at 132–43 (differences between the reward programs of the False Claims Act and Dodd-Frank).

102. 31 U.S.C. § 3730(b) (2012).

103. *See, e.g.*, United States *ex rel*. Radcliffe v. Purdue Pharma L.P., 600 F.3d 319, 329 (4th Cir. 2010); United States *ex rel*. Ritchie v. Lockheed Martin Corp., 558 F.3d 1161, 1168–69 (10th Cir. 2009); United States *ex rel*. Gebert v. Transp. Admin. Servs., 260 F.3d 909, 916 (8th Cir. 2001); United States *ex rel*. Hall v. Teledyne Wah Chang Albany, 104 F.3d 230, 231–33 (9th Cir. 1997); United States *ex rel*. Green v. Northrop Corp., 59 F.3d 953, 966 (9th Cir. 1995); United States *ex rel*. Nowak v. Medtronic, Inc., 806 F. Supp. 2d 310, 336–37 (D. Mass. 2011).

104. 480 U.S. 386 (1987).

105. No. 97 C 2661, 1997 WL 801712 (N.D. Ill. Oct. 28, 1997).

106. *Hall*, 104 F.3d at 233.

that the dispositive question here is not whether an employee could still have the right to blow the whistle if the damage waiver or release were enforced, but whether enforcement of the waiver would substantially reduce the efficacy of the statute's incentive structure.[107] As the Ninth Circuit noted in *United States ex rel. Green v. Northrop Corp.*:

> [A]lthough, as Appellees maintain, enforcing the Release at issue in this case would not *prohibit* a relator from coming forward with information concerning Appellees' alleged misconduct, our analysis of the structure and purposes of the Act demonstrates that this consideration is not dispositive. If the *qui tam* provisions *never* had been enacted, presumably whistleblowers still *could* come forward. The Act reflects Congress's judgment that *incentives to file suit* were necessary for the government to learn of the fraud or to spur government authorities into action; permitting a prefiling release when the government has neither been informed of, nor consented to, the release would undermine this incentive, and therefore, frustrate one of the central objectives of the Act.[108]

Under *Green* and its progeny, a waiver of an incentive award would be invalid if it frustrated a statute's central objectives.

As *Green* reflects, courts applying this reasoning in FCA waiver cases have typically refused to enforce prefiling releases when the government was unaware of the alleged misconduct until the relator filed the claim, on the theory that enforcing such releases would limit the government's ability to detect wrongdoing. On the other hand, some courts have agreed to enforce FCA waivers when the government was already aware of the alleged misconduct before the filing of the complaint because "the public interest in having information brought forward that the government could not otherwise obtain [was] not implicated."[109]

Applying this rationale to the Dodd-Frank context suggests that a similar, but not identical, outcome should prevail. First, given the centrality of monetary awards to the SEC Whistleblower Program, it seems clear that the "central objectives" of Dodd-Frank's whistleblower provisions would be substantially frustrated if courts enforced award waivers executed when the SEC did not already know the underlying information. As in the FCA context, enforcement of such waivers would decrease willingness to report misconduct and decrease the flow of potentially valuable information to the SEC. Indeed, one of the key concerns behind the statute was that the SEC was not receiving or generating sufficient information about possible securities viola-

107. *See* United States *ex rel*. Head v. Kane Co., 668 F. Supp. 2d 146, 152 (D.D.C. 2009); United States *ex rel*. Grandeau v. Cancer Treatment Ctrs. of Am., 350 F. Supp. 2d 765, 773 (N.D. Ill. 2004); X Corp. v. Doe, 805 F. Supp. 1298, 1310 n.24 (E.D. Va. 1992).

108. *Green*, 59 F.3d at 965.

109. United States *ex rel*. Radcliffe v. Purdue Pharma, L.P., 600 F.3d 319, 332 (4th Cir. 2010) (citing *Hall*, 104 F.3d at 233).

tions prior to Dodd-Frank.[110] Significantly, allowing the waiver of Dodd-Frank awards would not only dissuade employees subject to the waiver from coming forward, but also decrease the SEC's ability to use awards to build program awareness, encourage others to come forward,[111] and deter future securities violations,[112] all of which are crucial programmatic interests of Dodd-Frank and the SEC whistleblower rules.

Unlike the prevailing FCA rule, however, applying this rationale to the SEC Whistleblower Program suggests that Dodd-Frank waivers should not be enforced even if they are executed *after* the SEC has learned of the potential misconduct. First, there is a basic distinction between the mechanics of Dodd-Frank and the FCA. In an FCA case, the whistleblower brings a claim against the company in court and has an opportunity to receive a share of any resulting settlement or judgment. Thus, it makes more sense to allow for the private resolution of claims between the relator and the company, provided that it does not result in violations of law being concealed from the government. The SEC whistleblower, on the other hand, has no direct claim against the company and is not a party to enforcement actions. Likewise, the SEC whistleblower award is not paid by the company in any way, but instead is paid from a separate fund established by Congress.[113] Therefore, there is no actual dispute or claim between the employee and the employer with respect to the award, and the public interest in promoting settlement of disputes is simply not implicated. It makes little public policy sense to allow employers to insert themselves into this award scheme, regardless of whether the SEC is aware of the misconduct.

Moreover, a rule allowing the enforcement of waivers when the SEC has independently learned of the misconduct rests on the incorrect assumption that subsequent whistleblower assistance will not have significant investigative value to the SEC. In practice the SEC

110. *See* SEC. & EXCH. COMM'N, PROPOSED RULES FOR IMPLEMENTING THE WHISTLEBLOWER PROVISIONS OF SECTION 21F OF THE SECURITIES EXCHANGE ACT OF 1934, RELEASE NO. 34-63237 (Nov. 17, 2010) ("More frequent reporting of high-quality information promotes greater deterrence by enhancing the efficiency and effectiveness of the Commission's enforcement program.").

111. *See* 17 C.F.R. § 240.21F-6(a)(3)(ii) (2013) (a factor in any award amount determination is "[t]he degree to which an award encourages the submission of high quality information from whistleblowers by appropriately rewarding whistleblowers' submission of significant information and assistance").

112. *See* 15 U.S.C. § 78u-6(c)(1)(B)(III) (2012) (a factor in any award amount determination is "the programmatic interest of the Commission in deterring violations of the securities laws by making awards to whistleblowers who provide information that lead[s] to the successful enforcement of such laws"); 17 C.F.R. § 240.21F-6(a)(3) ("The Commission will assess its programmatic interest in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws.").

113. *See* U.S. SEC. & EXCH. COMM'N, 2013 ANNUAL REPORT, *supra* note 21, at 16.

often obtains valuable information and assistance from whistleblowers even after it has begun to investigate an alleged violation and the SEC actively solicits follow-up complaints from whistleblowers who have already filed complaints.[114] In fact, an important factor that may increase the amount of a whistleblower's award is the level of "[a]ssistance provided by the whistleblower."[115] Enforcing waivers when the SEC has already learned of the general misconduct would limit this flow of potentially useful information and assistance, impeding a federal interest. Accordingly, a balancing of public policy interests dictates that waivers of a Dodd-Frank whistleblower award should not be enforced, regardless of when and how the SEC learns of the underlying securities violation.

C. USING CONFIDENTIALITY AGREEMENTS TO IMPEDE DODD-FRANK WHISTLEBLOWING

In addition to contractual provisions that directly limit or condition an individual's ability to report misconduct to government agencies, or to receive personal benefits for doing so, many whistleblowers also face more general confidentiality agreements, which could arguably prohibit some communication with the SEC.[116] Employment, compliance, and separation agreements frequently include terms providing, for example, that "Employee shall not disclose, and represents that Employee has not disclosed, any confidential company information to any third party." These agreements often define confidential information broadly to encompass any information that employees learned during the course of their employment at the company. These provisions are particularly significant because they can be used by an employer to bring, or threaten to bring, a breach of contract claim against a whistleblower seeking damages beyond the compensation that the employee received in connection with the contract, a tactic now being used against FCA whistleblowers with increasing frequency.[117]

---

114. As chief of the SEC's Office of the Whistleblower, McKessy noted in an SEC video for prospective whistleblowers, "People often call us to ask if they should submit something, or submit an update, and we will almost always suggest that you submit it. As I often tell people, you never know what information may be the last piece of a puzzle for an investigation." SEC Office of the Whistleblower, *What Happens to Tips* (Transcript), *available at* http://www.sec.gov/about/offices/owb/owb-what-happens-to-tips.shtml (last visited Sept. 28, 2014).

115. *See* 15 U.S.C. § 78u-6(c)(1)(B)(i)(II) (2012); 17 C.F.R. § 240-21F-6(a)(2) (2013).

116. Another similar and troubling practice, beyond the scope of this Article, is the use of a broad confidentiality agreement that prevents employees from consulting independent legal counsel, effectively eliminating their ability to file whistleblower complaints anonymously in accordance with SEC rules.

117. *See, e.g.*, Walsh v. Amerisource Bergen Corp., Civ. No. 11-7548, slip op. at 13 (E.D. Pa. June 16, 2014); *see also* Marissel Descalzo, *Employers Fight Back Against Whistleblowers*, INSIDE COUNSEL (June 24, 2014), http://www.insidecounsel.com/2014/06/24/employers-fight-back-against-whistleblowers; Ben James, *5 Questions to Ask Before Suing over Whistleblower Theft*, LAW360 (May 21, 2014), https://www.law360.com/articles/533633/5-questions-to-ask-before-suing-over-whistleblower-theft; Jean F. Kuei & Michael

These commonplace confidentiality provisions implicate important interests on both sides. Employers have a strong interest in obtaining such agreements for legitimate employer concerns, such as promoting research and innovation, protecting trade secrets and corporate reputation, and facilitating communication between a principal and its agents.[118] For this reason, confidentiality agreements tailored to protect legitimate interests are enforceable when they are not contrary to public policy.[119]

It is equally clear that strictly enforcing such confidentiality agreements to prevent whistleblowers from reporting misconduct to the SEC would abridge important law enforcement interests. This would contravene Rule 21F-17, which expressly states that confidentiality agreements may not be used to impede individuals from communicating with SEC staff.[120] It would also be inconsistent with a long line of cases prohibiting secrecy agreements purporting to restrict individuals from reporting violations of law.[121] Courts have also held that information about wrongdoing cannot be a trade secret warranting confidentiality protection.[122]

A more difficult question arises when an employer accepts the whistleblower's right to report misconduct but argues that the whistle-

---

R. Kleinmann, *Health Care Employers Take Note: New Weapons Are Available When Defending False Claims Act Suits*, FORBES (June 20, 2014), *available at* http://www.forbes.com/sites/theemploymentbeat/2014/06/20/health-care-employers-take-note-new-weapons-are-available-when-defending-false-claims-act-suits/.

118. *See* O'Day v. McDonnell Douglas Helicopter Co., 79 F.3d 756, 763 (9th Cir. 1996) (employer had "strong interest" in preventing employees from improperly taking and disclosing to other co-workers confidential documents); Dworkin & Callahan, *supra* note 33, at 174.

119. *See, e.g.*, McGrane v. Reader's Digest Ass'n, Inc., 822 F. Supp. 1044, 1046 (S.D.N.Y. 1993) (confidentiality agreements involving "matters of substantial concern to the public" are distinct from "trade secrets or other legitimately confidential information").

120. Similarly, the Commission has stated "we wish to clarify that confidentiality agreements or protective orders entered into in [Self-Regulatory Organization] arbitration or adjudicatory proceedings may not be used to prevent a party from reporting a possible securities law violation." ADOPTING RELEASE, *supra* note 6, at 201 n.407.

121. *See* Chambers v. Capital Cities/ABC, 159 F.R.D. 441, 444 (S.D.N.Y. 1995) ("Absent possible extraordinary circumstances . . . , it is against public policy for parties to agree not to reveal, at least in the limited contexts of depositions or pre-deposition interviews concerning litigation arising under federal law, facts relating to alleged or potential violations of . . . law."); EEOC v. U.S. Steel Corp., 671 F. Supp. 351, 357 (E.D. Pa. 1987) (agreements restricting former employees revealing violations of law to EEOC will "hinder[]" implementation of the "Congressionally mandated duty to enforce the provisions" of federal statutes), *overturned on other grounds*, 921 F.2d 489 (3d Cir. 1990).

122. *McGrane*, 822 F. Supp. at 1051–52; *id.* at 1046 ("Courts are increasingly reluctant to enforce secrecy arrangements where matters of substantial concern to the public—as distinct from trade secrets or other legitimately confidential information—may be involved."); *id.* at 1052 ("Disclosures of wrongdoing do not constitute revelations of trade secrets which can be prohibited by agreements binding on former employees.").

blower cannot take or use company documents that might support the claim. In this situation, does the employee's right to communicate with the government justify the taking and sharing of these confidential documents, or does the employer have a superior interest in maintaining the confidentiality of its proprietary information? Courts have long grappled with these questions in the FCA context,[123] and are now beginning to face them in the SEC whistleblower context.

Employers are likely to argue that the federal interest in SEC whistleblowing cannot outweigh traditionally recognized property and intellectual property rights, and are likely to characterize employees' taking of documents for whistleblowing purposes as theft or conversion.[124] Employers may also note that, once the SEC is alerted to wrongdoing, it can request or subpoena documents, reducing the need for employees to take confidential documents.[125] This argument finds at least some support in existing case law, as some courts have taken an anti-whistleblower stance even when employees took documents to support a disclosure of illegality to the government. A prominent example is *JDS Uniphase Corp. v. Jennings*,[126] in which an employee defended his former employer's claim for a breach of a confidentiality agreement by claiming that the agreement was unenforceable in violation of the public policy in favor of whistleblowing.[127]

123. *See* Zahodnick v. Int'l Bus. Mach. Corp., 135 F.3d 911, 914–15 (4th Cir. 1997); Siebert v. Gene Sec. Network, No. 11-cv-01987-JST, slip op. at 11–13 (N.D. Cal. Oct. 16, 2013); United States *ex rel*. Wildhirt v. AARS Forever, Inc., No. 1:09-cv-01215, slip op. at 9 (N.D. Ill. Sept. 19, 2013); United States *ex rel*. Ruhe v. Masimo Corp., 929 F. Supp. 2d 1033, 1039 (C.D. Cal. 2012); Glynn v. Impact Sci. & Tech., Inc., 807 F. Supp. 2d 391, 423–24 (D. Md. 2011), *aff'd*, 710 F.3d 209, 214–18 (4th Cir. 2013); United States *ex rel*. Head v. Kane Co., 668 F. Supp. 2d 146, 152 (D.D.C. 2009); United States *ex rel*. Grandeau v. Cancer Treatment Ctrs. of Am., 350 F. Supp. 2d 765, 773 (N.D. Ill. 2004); X Corp. v. Doe, 805 F. Supp. 1298 n.24 (E.D. Va. 1992). For a good discussion of FCA case law examining the enforceability of confidentiality agreements, see Joel D. Hesch, *The False Claims Act Creates a "Zone of Protection" That Bars Suits Against Employees Who Report Fraud Against the Government*, 62 DRAKE L. REV. 361, 395–404 (2014).

124. *See, e.g.*, *Ruhe*, 929 F. Supp. 2d at 1038 (company claimed that the relator copied confidential documents and transmitted them to the government in violation of relator's nondisclosure agreement); *Head*, 668 F. Supp. 2d at 150 (D.D.C. 2009) (suit by former employer against a False Claims Act relator for fraud, libel, tortious interference with contract, and other associated claims arising from relator's disclosure of confidential employer documents to the government, in violation of the relator's nondisclosure agreement).

125. *See, e.g.*, Securities and Exchange Act of 1934, § 17(b), 15 U.S.C. § 78q-1(b) (2012).

126. 473 F. Supp. 2d 697 (E.D. Va. 2007).

127. *See id.* at 701–02. Pursuant to the agreement's choice of law provision, the court analyzed this claim under California law, which has a provision that asserts a "generalized declaration of public policy in favor of whistle-blowing." *Id.* at 701. However, the court also noted that "Sarbanes-Oxley is itself an embodiment of a federal policy encouraging whistleblowers to come forward, and the effect of the California declaration, if any, is to encourage liberal construction of whistleblower statutes by California courts or other courts applying California law." *Id.* at 701 n.5.

Specifically, the employee argued that he needed to take proprietary documents "to function as an effective Sarbanes-Oxley whistleblower."[128] In rejecting this argument, the court concluded that a pro-whistleblower public policy cannot "authorize disgruntled employees to pilfer a wheelbarrow full of an employer's proprietary documents in violation of their contract merely because it might help them blow the whistle on an employer's violations of law, real or imagined."[129] The court pointedly concluded that "Sarbanes-Oxley is not a license to steal documents and break contracts."[130]

Many other courts, however, take a more nuanced approach, focusing on the nexus between the confidential documents in question and the misconduct alleged by the whistleblower. These courts have often found that an employer can bring a breach-of-contract claim against the employee, or successfully repel a retaliation claim by the employee, based on a confidentiality agreement if the purportedly confidential documents or materials taken by the employee bear little relationship to the reported violation. For example, in *Cafasso, U.S. ex rel. v. General Dynamics C4 Sys., Inc.*,[131] an FCA relator argued that the court should adopt a public policy exception to enforcement of her confidentiality agreement.[132] The court determined that, even if it adopted such an exception, the exception would not protect the relator because of her "vast and indiscriminate appropriation" of the employer's files.[133] The relator had copied approximately "eleven gigabytes of data—tens of thousands of pages," with little understanding or limitation on her choice of documents to take:

> She decided which [employer] documents to copy by browsing through folders related to technology and technology development, and, she testified, "if I saw something that I thought actually could apply and should be investigated, *I just grabbed the whole folder*" (emphasis added). Further, she scanned only file names and "did not look at any individual documents at all." Swept up in this unselective taking of documents were attorney-client privileged communications, trade secrets belonging to [her employer] and other contractors, internal research and development information, sensitive government information, and at least one patent application that the Patent Office had placed under a secrecy order.[134]

The Ninth Circuit concluded that any employee asserting a public policy exception to a breach of confidentiality agreement claim must

128. *Id.* at 702.
129. *Id.*
130. *Id.* at 703.
131. 637 F.3d 1047 (9th Cir. 2011).
132. *See id.* at 1061–62.
133. *See id.* at 1062.
134. *Id.*

make a "particularized showing" that the "removal of the documents was reasonably necessary to pursue an FCA claim."[135]

When the relationship between the documents in dispute and the reported wrongdoing is close, courts typically will refuse to enforce the confidentiality provisions on public policy grounds.[136] For example, courts have repeatedly found that an FCA relator's taking of documents is not actionable if those documents could be used as evidence at trial or are "relevant to the alleged fraud" because the FCA reflects a "strong public policy in favor of protecting whistleblowers who report fraud against the government."[137] Otherwise, "[e]nforcing a private

---

135. *Id.* The Ninth Circuit did not rule out such an exception, but clearly limited its use:

> The need to facilitate valid claims does not justify the wholesale stripping of a company's confidential documents. Although courts perhaps should consider in particular instances for particular documents whether confidentiality policies must give way to the needs of FCA litigation for the public's interest, Cafasso's grabbing of tens of thousands of documents here is overbroad and unreasonable, and cannot be sustained by reference to a public policy exception.

Id.; *see also* Walsh v. Amerisource Bergen Corp., Civ. No. 11-7548, slip op. at 13 (E.D. Pa. June 16, 2014) (refusing to dismiss a counterclaim for breach of confidentiality agreement because it was too early to tell whether "the entirety" of the documents taken by the whistleblower were necessary for his FCA claim); Siebert v. Gene Sec. Network, Inc., 11-CV-01987-JST, slip op. at 13 (N.D. Cal. Oct. 16, 2013) ("The Court agrees that any alleged obligation by Siebert not to retain or disclose the confidential documents that form the basis of this action is unenforceable as a matter of public policy because it would frustrate Congress' purpose in enacting the False Claims Act. . . . But the Court cannot now conclude that the counterclaim in its entirety should be dismissed, because it is possible that Siebert also took confidential documents that bore no relation to his False Claims Act claim."); United States *ex rel*. Wildhirt v. AARS Forever, Inc., No. 1:09-cv-01215, slip op. at 6 (N.D. Ill. Sept. 19, 2013) (refusing to dismiss a counterclaim based on a confidentiality agreement when it was alleged that the relator took documents "with no intention of using" them in the qui tam suit and when the relator's disclosure went beyond what was necessary for the suit).

136. *See, e.g.*, *Siebert*, 2013 WL 5645309, slip op. at 13 ("[A]ny alleged obligation by Siebert not to retain or disclose the confidential documents that form the basis of this action is unenforceable as a matter of public policy because it would frustrate Congress' purpose in enacting the False Claims Act—namely, the public policy in favor of providing incentives for whistleblowers to come forward, file FCA suits, and aid the government in its investigation efforts," but holding that a breach of contract claim may still be appropriate if the relator took confidential documents that "bore no relation" to his FCA claim); United States *ex rel*. Ruhe v. Masimo Corp., 929 F. Supp. 2d 1033, 1039 (C.D. Cal. 2012) ("Relators sought to expose a fraud against the government and limited their taking to documents relevant to the alleged fraud. Thus, this taking and publication was not wrongful, even in light of nondisclosure agreements, given 'the strong public policy in favor of protecting whistleblowers who report fraud against the government.'") (quoting United States *ex rel*. Grandeau v. Cancer Treatment Ctrs. of Am., 350 F. Supp. 2d 765, 773 (N.D. Ill. 2004) (relator exempt from liability for breach of confidentiality agreement for disclosure to government of documents showing employer engaged in fraudulent healthcare billing)); United States *ex rel*. Head v. Kane Co., 668 F. Supp. 2d 146, 152 (D.D.C. 2009); X Corp. v. Doe, 805 F. Supp. 1298, 1310 n.24 (E.D. Va. 1992) (a confidentiality agreement would be void as against public policy if, when enforced, it would prevent "disclosure of evidence of a fraud on the government").

137. *Siebert*, 11-CV-01987-JST, slip op. at 12; *see also Ruhe*, 929 F. Supp. 2d at 1039; *Grandeau*, 350 F. Supp. 2d at 773.

agreement that requires a *qui tam* plaintiff to turn over his or her copy of a document, which is likely to be needed as evidence at trial, to the defendant who is under investigation would unduly frustrate the purpose" of the FCA.[138]

A similar rule prevails in the Sarbanes-Oxley context, in which courts also recognize that the federal interest in whistleblowing can trump employers' otherwise legitimate desire to protect confidential documents when there is a reasonable connection between the documents and the alleged securities violation.[139] For example, one court stated: "[T]he statute demonstrates the public policy in favor of allowing even current employees to assist in securities fraud investigations. It certainly does not establish a public policy in favor of allowing employers to muzzle their employees with overbroad confidentiality agreements."[140]

Even more specifically, the DOL's ARB, which hears appeals of Sarbanes-Oxley whistleblower retaliation claims, has indicated that employees should be able to take and share documents related to potential misconduct, despite the existence of a confidentiality agreement, if those documents represent "the kind of 'original information' that Congress intended be protected under either the Internal Revenue Service [(IRS)] or SEC whistleblower programs."[141] In *Vannoy v. Celanese Corp.*, an employee complained internally about his employer's financial practices, and then reported the practices to the IRS under the Agency's whistleblower reward program.[142] As part of the IRS complaint, the employee attached numerous proprietary and confidential company documents in violation of the company's general confidentiality agreement.[143] The employee filed a Sarbanes-Oxley retaliation claim after the employer terminated his employment.[144]

Initially, a DOL administrative law judge (ALJ) rejected the employee's claim, finding that the company properly discharged the employee for, among other things, copying confidential documents in violation of his confidentiality agreement.[145] The ALJ also rejected the employee's argument that he had an "informer's privilege" to use the company's confidential documents when reporting wrongdoing, asserting that "SOX allows for the reporting of violations but not for illegally obtaining documents."[146] On appeal, however, the ARB concluded

138. *Head*, 668 F. Supp. 2d at 152.
139. *In re* JDS Uniphase Corp. Secs. Litig., 238 F. Supp. 2d 1127, 1136 (N.D. Cal. 2002).
140. *Id.*
141. Vannoy v. Celanese Corp., ARB No. 09-118, slip op. at 17 (Sept. 28, 2011).
142. *See id.* at 4, 6.
143. *Id.* at 6.
144. *Id.* at 2.
145. *Id.* at 20–21.
146. *Id.* at 22 (citing JDS Uniphase Corp. v. Jennings, 473 F. Supp. 2d 697 (D. Va. 2007)).

that the confidentiality agreement did not necessarily prohibit the employee from providing documents to the government, even though they contained sensitive data such as social security numbers.[147]

The ARB noted the difficulty of resolving the "clear tension between a company's legitimate business policies protecting confidential information and the whistleblower bounty programs" and looked to the public policy supporting the bounty programs to resolve the tension.[148] The ARB asserted that Congress created the IRS and Dodd-Frank programs:

> to encourage whistleblowers to disclose confidential company information in furtherance of enforcement of tax and securities laws. Passage of these bounty provisions demonstrate that Congress intended to encourage federal agencies to seek out and investigate independently procured, non-public information from whistleblowers such as Vannoy to eliminate abuses in the tax realm under the IRS Whistleblower program and now in the securities realm with the SEC Whistleblower program . . . . [T]he Dodd-Frank Act established the SEC Investor Protection Fund, which is to be used to pay whistleblower claims and is funded with monetary sanctions that the SEC collects in a judicial or administrative action, or through certain disgorgements under the Sarbanes-Oxley Act of 2002. Similar to the IRS Whistleblower bounty program that Vannoy pursued, Section 21F(b) of the Dodd-Frank Act provides that the SEC "shall pay" a whistleblower who voluntarily provides original information to the SEC that leads to the successful enforcement of a covered judicial or administrative action and results in certain monetary sanctions.
>
> . . .
>
> . . . Under the terms of the SEC whistleblower bounty program, Congress anticipated that the whistleblower would provide independently garnered, insider information that would be valuable to the SEC in its investigation.[149]

Ultimately, the ARB remanded the case to the ALJ, noting that, in light of these public policy interests, "the crucial question for the ALJ to resolve . . . is whether the information [the employee] procured from the company is the kind of 'original information' that Congress intended be protected under either the IRS or SEC whistleblower programs, and whether . . . the transfer of information was protected activity."[150]

Vannoy offers a guiding principle that documents may be lawfully taken by an employee, notwithstanding a confidentiality agreement, if those documents reasonably support or relate to a whistleblower complaint that is required, protected, or encouraged by federal or state law because the government has a compelling interest in receiving the doc-

147. *See id*. at 8.
148. *Id.* at 16.
149. *Id.*
150. *Id.* at 17.

uments. Conversely, documents with no reasonably ascertainable relevance to a possible securities violation would be subject to the applicable confidentiality agreement.

As the ARB's discussion of Dodd-Frank in *Vannoy* suggests, there is good reason to extend this guiding principle to the SEC Whistleblower Program because it comports fully with the public policy aims of the statute. Relevant documents taken from an employer not only can provide potentially valuable evidence of a possible securities violation, but also can help the SEC confirm the veracity of the whistleblower's information and better distinguish between tips that warrant significant attention and those that do not. This is a critical function because the SEC received over 3,200 tips through the SEC Whistleblower Program in fiscal year 2013 alone,[151] and receives tens of thousands of other tips and referrals through other means, such as investor complaints.[152] Similarly, background documents such as organizational charts, compliance policies, and descriptions of relevant internal systems can save investigative time and resources by helping the SEC understand the facts of a case more quickly.[153] Indeed, the SEC expects whistleblowers to provide documentary support. The SEC's "Tips, Complaints and Referrals" form (Form TCR) specifically asks the whistleblower to "[d]escribe all supporting materials in the complainant's possession . . ." and to "[i]dentify with particularity any documents or other information in your submission that you believe could reasonably be expected to reveal your identity."[154] These questions would make little sense if the SEC did not expect whistleblowers to include relevant documents in their submissions.

Finally, while employers would obviously like to avoid SEC scrutiny, the disclosure of documents to the SEC poses relatively little risk of harm to employers who have not engaged in wrongdoing. SEC policy mandates that all investigations—and all documents produced therein—must be kept confidential and nonpublic until the filing of a complaint or administrative order, giving employers a high level of assurance that any confidential documents will not be leaked

151. U.S. SEC. & EXCH. COMM'N., 2013 ANNUAL REPORT, *supra* note 21.

152. As the SEC's Enforcement Manual indicates, the SEC cannot allocate the same level of resources to each tip and investigation, and instead must rank investigations based on a number of factors, including the scope of the misconduct and investor harm. U.S. SEC. & EXCH. COMM'N., ENFORCEMENT MANUAL § 2.1.1 (2013) ("Devoting appropriate resources to investigations that are more significant will help ensure high quality investigations and maximize desired program outcomes.").

153. The ability to gain early access to documents is particularly significant because the SEC cannot subpoena documents without a formal order of investigation, which itself typically requires investigating attorneys to have some evidence that a securities violation is occurring or has occurred. *See id.* § 2.3.4.

154. U.S. SEC. & EXCH. COMM'N, FORM TCR, *available at* http://www.sec.gov/about/forms/formtcr.pdf.

to the public or third parties.[155] In this way, SEC investigations offer greater confidentiality protections to employers than an FCA suit, in which relators may choose to attach supporting documents to public filings.[156]

A rule that allows whistleblowers to provide the SEC with documents relevant to understanding and investigating a possible securities violation strikes an appropriate balance between employers' legitimate interests in confidentiality and data security, while ensuring that the SEC retains access to potentially valuable sources of evidence and supporting background information. While employers and employees may disagree about whether certain documents are relevant to a possible securities violation, this rule also has the benefit of being relatively easy to understand and intuitive, reducing the risk that whistleblowers will inadvertently expose themselves to personal liability while making a good-faith effort to report possible misconduct.

IV. Practical Steps to Reduce the Risks Posed by Agreements Restricting Whistleblowing

This analysis of the three types of de facto gag clauses indicates that courts will, and should, refuse to enforce agreements that would significantly threaten the flow of potentially actionable information and documents about possible securities violations from whistleblowers to the SEC. If our prediction is correct, and courts do strike down such contractual clauses, they will become less common over time. In the meantime, even if courts refuse to enforce de facto gag clauses, the inclusion of such provisions in agreements continues to pose a danger to the SEC Whistleblower Program. Many individuals, particularly those who are unrepresented, may not understand that such provisions could be challenged, and may decide to forgo reporting as a result. Other potential whistleblowers may recognize that such provisions are likely unenforceable but decide that staying silent is preferable to acting as a "test case" and risking personal liability by blowing the whistle. Employees may also reasonably fear that challenging such provisions will flag them as a potential whistleblower, leading to retaliation. The widespread use of such agreements poses risks for employers, too, who may reflexively seek the broadest confidentiality and release provisions possible without recognizing the law's substantial limitations.

155. ADOPTING RELEASE, *supra* note 6, at 126. Additionally, employers producing documents to the SEC can request confidentiality for those documents under the SEC's Freedom of Information Act procedures. *See* 17 C.F.R. § 200.83 (2014).

156. The FCA provides that relators must first file their complaints under seal to give the government an opportunity to investigate. *See* 31 U.S.C. § 3730(b)(2) (2012). Unless the government seeks an extension, however, the complaint may be unsealed after sixty days. *Id*.

Accordingly, our analysis suggests that the key stakeholders—employers, employees, and the SEC—should each take steps now to reduce the risks associated with these agreements. First, employers and their counsel should be aware that agreements that impede employees from reporting misconduct to the SEC or other government authorities may backfire. Although such agreements may dissuade some employees from reporting misconduct, other employees may challenge these provisions, resulting in uncertainty and added employer litigation costs. In such cases, employers may find that bargained-for contractual provisions are unenforceable, upsetting settled expectations.[157]

In addition to losing the benefit of their bargain, employers and their counsel may face substantial liability or sanctions for drafting agreements that purport to limit or condition communications with the SEC. Such agreements may put employers and their counsel in the SEC's crosshairs for violating Rule 21F-17 or federal and state statutes prohibiting compounding and obstruction of justice.[158] Such agreements also may subject employers' counsel to professional sanctions under Rule 3.4(f) of the Model Rules of Professional Conduct, which, with limited exceptions, states that attorneys shall not "request a person other than a client to refrain from voluntarily giving relevant information to another party."[159]

Even if the SEC does not act, employees may be able to bring Sarbanes-Oxley or Dodd-Frank retaliation claims against employers based upon an employment-related agreement that purports to limit or condition their ability to communicate with the SEC, on the theory that they have suffered an adverse employment action as a result of trying to exercise or preserve statutory rights.[160] Courts have previously allowed similar retaliation claims under other statutes where (1) the employee engaged in protected whistleblowing conduct prior to receiving the problematic agreement[161] or (2) the employee did not engage in prior protected conduct, but the employer either "(i) attempt[ed] to

157. Employers should also be aware that anonymity provisions discussed above make it possible that employers may never learn when and if an employee has breached an agreement by, for example, accepting a whistleblower award.

158. As Professor Bauer points out in an article exploring the ethical implications of evidence-suppressing settlements, it is unlikely that a settlement prohibiting voluntary disclosures would be deemed criminal conduct, especially if it includes a carve-out for disclosures pursuant to subpoena or court order. *See* Jon Bauer, *Buying Witness Silence: Evidence-Suppressing Settlements and Lawyers' Ethics*, 87 OR. L. REV. 481, 506 (2008). Nevertheless, there is a risk that the SEC or a federal prosecutor might draw inferences from an agreement that aims to deter whistleblowing to the SEC. *See id.*

159. MODEL RULES OF PROF'L CONDUCT R. 3.4(f) (1983). For a detailed discussion of Model Rule 3.4(f), see Bauer, *supra* note 158, at 506.

160. *See* 18 U.S.C. § 1514A (2012) (Sarbanes-Oxley); 15 U.S.C. § 78u-6(h) (2012) (Dodd-Frank).

161. Conn. Light & Power Co. v. Sec'y of U.S. Dep't of Labor, 85 F.3d 89 (2d Cir. 1996).

enforce the agreement against an employee who signed the agreement but nevertheless files or participates in an EEOC charge, or (ii) with[e]ld benefits already promised or owed from an employee who refuses to sign the agreement."[162] An agreement that the employer intended to use as a shield from liability may become a sword in the hands of a sophisticated employee-side attorney. Thus, employers and their counsel should take proactive steps to ensure that their agreements do not directly or indirectly impede their employees' ability to report misconduct to the government.

For their part, employees and their counsel should educate themselves about the legal ramifications of these provisions and take a firm stand against their enforceability and legality. In particular, employee-side counsel should understand both the relevant law, including SEC rules, ethical rules, and case law, and the available legal tools at their disposal, including public policy arguments to defend a breach-of-contract claim or bring a retaliation claim against the employer. Counsel can then argue against the inclusion of such provisions during negotiations or, if necessary, challenge their enforceability later. Likewise, employees and their counsel should seriously consider advising the SEC if a company is using agreements to block individuals from reporting possible securities violations, especially if the company is under investigation by the SEC for other possible misconduct. The SEC has expressed interest in receiving such information,[163] and reports can be made anonymously. Employees' attorneys also should inform clients about the potential risks of taking and disclosing documents—including the risk of a claim against the employee—to ensure that employees do not expose themselves to personal liability by indiscriminately taking documents that bear no reasonable relationship to a possible securities violation.

Finally, and perhaps most importantly, we believe that government agencies should take meaningful action to counter the chilling effect of de facto gag clauses on whistleblowing. First, the SEC should use its enforcement authority to sanction companies that run afoul of Rule 21F-17, as Sean McKessy has already warned.[164] In addition, the

162. EEOC v. Nucletron Corp., 563 F. Supp. 2d 592, 594 (D. Md. 2008).

163. Mahoney, *supra* note 25 (quoting McKessy as stating that "we are actively looking for examples of confidentiality agreements, separat[ion] agreements, employee agreements that . . . in substance say 'as a prerequisite to get this benefit you agree you're not going to come to the Commission . . . .'").

164. John A. Goldmark, *SEC Warns In-House Counsel Against Using Incentives to Deter External Whistleblowing*, DAVIS WRIGHT TREMAINE LLP (Apr. 14, 2014), *available at* http://www.dwt.com/SEC-Warns-In-House-Counsel-Against-Using-Incentives-to-Deter-External-Whistleblowing-04-14-2014 (quoting McKessy as stating that companies should "[b]e aware that this is something we are very concerned about. If you're spending a lot of your time trying to come up with creative ways to get people out of our programs, I think you're spending a lot of wasted time and you run the risk of running afoul of our regulations.").

SEC could bring administrative actions against attorneys who require employees to enter into impermissibly restrictive agreements and could potentially suspend such attorneys from practicing before the SEC.[165]

Moreover, we believe the SEC should amend Rule 21F-17 to provide additional guidance on the type of contractual provisions that impede an individual from communicating with the SEC. Such guidance should clarify that an attempt to condition payment of severance or any other benefit on any limitation to an employee participating in the SEC's whistleblower reward program (such as losing the ability to make an anonymous report or receive an award) violates Rule 21F-17.[166] In addition, an amended Rule 21F-17 could provide examples of prohibited provisions, while also clarifying that the examples are not exclusive.[167] Likewise, OSHA, which already reviews certain settlement agreements in Sarbanes-Oxley cases to ensure that they do not contain explicit gag clauses,[168] should also modify its existing settlement review policies to clarify that any provision that bars or impedes participation in the SEC Whistleblower Program is invalid.[169]

---

165. Under Rule 102(e)(1)(iii) of the SEC's Rules of Practice, the SEC "may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found . . . to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder." SEC Rules of Practice, Rule 102(e)(1)(iii), 17 C.F.R. § 201.102(e)(1)(iii) (2013).

166. While this Article is focused on contractual provisions that deter SEC whistleblowing, such provisions also undermine the effectiveness of similar whistleblower reward programs. Accordingly, the CFTC and IRS should consider issuing guidance barring these types of provisions. Furthermore, the General Services Administration should consider amending the Federal Acquisition Regulations to bar these types of provisions in any agreement between a government contractor and an employee of the contractor.

167. For this reason, one of the authors of this Article, Jordan Thomas, along with the nonprofit whistleblower advocacy organization Government Accountability Project, has submitted a rule-making petition to the SEC seeking such an amendment to Rule 21F-17(a). *See* SEC File No. 4-676; SEC File No. 4-677 (July 18, 2014).

168. *See* Occupational Safety & Health Admin., Whistleblower Investigations Manual 6–11 (2011) ("OSHA will not approve a 'gag' provision that restricts the complainant's ability to participate in investigations or testify in proceedings relating to matters that arose during his or her employment. When such a provision is encountered, the parties should be asked to remove it or to replace it with the following: 'Nothing in this Agreement is intended to or must prevent, impede or interfere with Complainant's providing truthful testimony and information in the course of an investigation or proceeding authorized by law and conducted by a government agency.'").

169. For this reason, one of the authors of this Article, Jason Zuckerman, along with the Government Accountability Project, has submitted a rule-making petition to OSHA seeking such an amendment.

Such guidance from the SEC and OSHA would provide additional clarity for both employers and employees, and help protect the efficacy of the SEC Whistleblower Program. If the SEC Whistleblower Program is to fulfill its goal of better protecting investors, it must be allowed to function as Congress intended, without being constrained by private agreements. The public policy behind Dodd-Frank is too significant to allow for any other result.

BNA Daily Labor Report®

Reproduced with permission from Daily Labor Report, 196 DLR I-1 , 10/11/2011. Copyright © 2011 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

WHISTLEBLOWERS

The protections and incentives for whistleblowers provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act will result in a significant increase in whistleblower activity and, by extension, will have a huge impact on the workplace environment, attorneys Tammy Marzigliano of Outten & Golden and Jordan A. Thomas of Labaton Sucharow say in this BNA Insights article.

The authors examine the protections provided by the statute and offer practical guidance for plaintiffs' employment lawyers in identifying and counseling potential SEC whistleblowers.

Advocacy & Counsel for the SEC Whistleblower: A Primer for Employment Lawyers

BY TAMMY MARZIGLIANO AND JORDAN A. THOMAS

In the wake of multiple far-reaching corporate scandals and pervasive misconduct that have eroded public faith in the markets, Congress enacted the whistleblower provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] The provisions require the SEC to pay financial awards to whistleblowers who voluntarily provide original information leading to a judicial or administrative action in which the SEC obtains monetary sanctions over $1 million, subject to certain limitations. Whistleblowers who provide such information are eligible for an award of 10 percent to 30 percent of the monetary sanctions.[2]

Since the enactment of the whistleblower provisions, there has been undue emphasis on the financial incentives available to qualified SEC whistleblowers. However, the new robust anti-retaliation provisions contained in the guidelines are equally important. Employers are prohibited from retaliating against individuals who provide the SEC with information about possible federal securities law violations, and victims of retaliation are granted an independent cause of action with significant potential remedies. Providing additional protection, whistleblowers are also permitted to report securities violations anonymously if they are represented by counsel.

These protections and incentives will result in a significant increase in whistleblower activity and, by extension, will have a huge impact on the workplace environment. This article examines the protections provided by the statute and offers practical guidance for

[1] 17 C.F.R. § 240.21F-1, et seq.

Tammy Marzigliano, a partner at Outten & Golden LLP, represents employees in litigation and negotiation in all areas of employment law. She is co-chair of the firm's Financial Services Practice Group and its Whistleblower and Retaliation Practice Group. Jordan A. Thomas is a partner at Labaton Sucharow LLP and serves as chair of its Whistleblower Representation Practice. A former assistant director and assistant chief litigation counsel at the Securities and Exchange Commission, Jordan played a leadership role in the development of the agency's Whistleblower Program.

[2] This article focuses on how best to represent whistleblowers who have information about possible violations of the securities laws. However, Dodd-Frank also amended the Commodity Exchange Act to protect and encourage whistleblowers to report CFTC violations. Accordingly, since the CFTC whistleblower provisions and implementing rules closely mirror the SEC's, the guidance in this article also applies to the CFTC whistleblower program.

COPYRIGHT © 2011 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0418-2693

the plaintiff's employment lawyer in identifying and counseling potential SEC whistleblowers.

Identifying the SEC Whistleblower Client: What Violations Meet the Standard?

Any violation of the federal securities laws qualifies for protection under Dodd-Frank. The reported violation may have occurred anywhere in the world, involving public or private organizations and domestic or international violators. In most cases, securities fraud occurs when manipulative and deceptive practices are employed in connection with the purchase and sale of a security. Beyond stocks and bonds, the federal securities laws have interpreted ''security'' broadly to include investment contracts, notes, and other nontraditional investments.[3] Common securities violations that may lead to SEC investigations and whistleblower awards include misrepresentation or omission of important information about securities, manipulating the market prices of securities, stealing customers' funds or securities, violating broker-dealers' responsibility to treat customers fairly, insider trading, selling unregistered securities, and bribing foreign officials.

Employment lawyers should consider a new intake protocol to identify potential SEC whistleblowers and provide appropriate counsel.

This broad scope of eligibility has a direct impact on case evaluation. Traditionally, in evaluating cases, employment lawyers have focused on the conduct of the employer toward a specific employee, or towards a group of similarly situated employees. Although this approach may be effective in analyzing potential state and federal employment violations, it is inadequate for identifying possible securities violations and related eligibility as a whistleblower under Dodd-Frank. To this end, employment lawyers should consider a new intake protocol to identify potential SEC whistleblowers and provide appropriate counsel. Some easy to implement steps include:

- Ask whether the client or potential client knows, suspects, or has heard that their employer or any other individual or organization has or is engaged in misconduct. This inquiry should not be limited to securities violations insofar as many employees will not know what constitutes a securities violation. Moreover, many securities violations do not initially appear to involve securities. For instance, if a company systematically disposed of hazardous waste in violation of state and local laws, most clients would not associate the misconduct with a securities violation. However, this conduct could in fact constitute a federal securities law violation depending upon the seriousness of the violation, whether the company's stock traded on a U.S. exchange and how the violation impacted the company's financials, among other factors.

- If the client or potential client reports a possible violation, flesh out the details with open-ended questions and seek documents and potential witnesses to corroborate the report. In fraud actions, a plaintiff must plead scienter, which refers to ''a mental state embracing intent to deceive, manipulate or defraud.'' Accordingly, it is important to attempt to elicit facts about whether the violators knew or were reckless in their conduct.

- Where possible violations have been reported, determine whether investor funds are or were involved, if the violator is regulated by the SEC, and if stock traded or currently trades on any U.S. securities exchanges. Although these factors are not required to establish a securities violation, one or more of them are often present in SEC enforcement actions.

Who Is a Whistleblower? Qualifying for Retaliation Protections Under Dodd-Frank

Under Dodd-Frank, a whistleblower is any individual or group of individuals that possess a reasonable belief that the information reported to the SEC, pursuant to its procedures, involves a possible violation of the federal securities laws that has occurred, is ongoing, or is about to occur. Similar to the interpretation of other whistleblower statutes, ''reasonable belief'' requires the whistleblower to genuinely believe, as any similarly situated employee would, that the reported conduct constitutes a possible securities violation. In addition, the source of the whistleblower's information can come from independent knowledge or analysis. The SEC implementing rules authorize submissions of information that would otherwise constitute hearsay evidence.

Qualifying as a whistleblower under Dodd-Frank can be complicated—especially when seeking a whistleblower award. However, the anti-retaliation provisions under Dodd-Frank apply to a whistleblower regardless of whether the whistleblower is ultimately entitled to a financial award. To qualify for the anti-retaliation protections of Dodd-Frank, whistleblowers are only required to report possible securities violations online or by submitting a Form TCR in accordance with SEC rules.[4] It is critically important that employee advocates understand that despite the financial incentives offered by the SEC, internal reporting does not entitle an individual to the anti-retaliation protections of Dodd-Frank. Accordingly, based upon the unique facts and circumstances of each client's case, counsel should carefully consider whether and when a whistleblower submission would be advantageous for their client.

Does Dodd-Frank Provide the Best Protection?

Dodd-Frank not only provides robust whistleblower protection, but it has revived pre-existing whistleblower claims. The False Claims Act (FCA), once limited to individuals who were ''original sources'' with ''direct and independent knowledge,'' has been expanded to cover individuals with either information or analysis.

Section 1079(b) of Dodd-Frank amends the FCA by expanding the concept of protected activity to include ''lawful acts done by the employee, contractor, or agent or associated others in furtherance of an action under this section or other efforts to stop 1 or more violations

[3] See, e.g., 17 C.F.R. § 240.3a-10.

[4] See 17 C.F.R. § 240.21F-9(a).

 COPYRIGHT © 2011 BY THE BUREAU OF NATIONAL AFFAIRS, INC. DLR ISSN 0418-2693

of [the False Claims Act].'' As a result, the FCA now encompasses a more expansive range of activities that could further a potential qui tam action, including protections against associational discrimination.

Similarly, the Sarbanes-Oxley Act (SOX) now appears to have the teeth it was intended to have. Dodd-Frank expanded SOX by extending coverage beyond just public companies to employees of affiliates and subsidiaries of publicly traded companies ''whose financial information is included in the consolidated financial statements of such publicly traded company.''[5] Included in this measure are foreign subsidiaries and affiliates of U.S. public companies;[6] Dodd-Frank provides extraterritorial reach in actions brought by the SEC and the Justice Department.[7] Furthermore, Dodd-Frank took a short 90-day statute of limitation and expanded it to 180 days (and though while still short, doubles the allotted time). It also provides for independent jurisdiction of a jury trial for claims brought under SOX whistleblower protections.

Dodd-Frank grants a private right of action in federal court and, in contrast to SOX's previous requirements, the employee need not exhaust administrative remedies before filing in federal court.[8] To protect whistleblowing employees, the employee may remain anonymous until an award is made if she/he is represented by counsel. Under Dodd-Frank, an employer may not take retaliatory action against an employee who provides information to the SEC, initiates, testifies in, or assists in an investigation or judicial or administrative action, and makes disclosures that are required or protected under the law.[9] Retaliatory acts by employers include discharge, demotion, harassment, suspension, threats, and other discrimination as a result of any lawful act by the whistleblower.[10] Dodd-Frank expanded the statute of limitations to six years from the retaliatory conduct or three years upon discovery of the conduct.[11] Remedies were also expanded to include double back pay and litigation costs (including expert witness fees).[12]

Without the Dodd-Frank Act, these statutes would have remained lifeless. Dodd-Frank not only revived these familiar federal statutes, but it created additional whistleblower protections.

Dodd-Frank granted new protections for employees who report possible violations of the Securities Exchange Act and Commodity Exchange Act. Whistleblowers that bring violations to the SEC or the CFTC are granted a private right of action in federal court as long as they bring their claim within two years from the date of the retaliation.[13]

The Function and Scope of Bureau of Consumer Financial Protection

Congress also expanded coverage to financial service employees by creating a Bureau of Consumer Financial Protection to protect whistleblowing employees from retaliation. Employers covered as ''financial products or services'' include: any company that extends credit or service or broker loans; provides real estate settlement services or performs property appraisals; provides financial advisory services to consumers relating to proprietary financial products (including credit counseling); and collects, analyzes, maintains, or provides consumer report information or other account information in connection with any decision regarding the offering or provision of consumer financial product or service.[14]

The prohibited retaliatory conduct provided for by Dodd-Frank is broadly defined. Employees who work for such companies cannot be retaliated against for testifying or being willing to testify in a proceeding for administration or enforcement of Dodd-Frank; filing, instituting or causing to be filed or instituted, any proceeding under any federal consumer financial law; and objecting to, or refusing to participate in any activity, practice, or assigned task that the employee reasonably believes to be a violation of any law, rule, standard, or prohibition subject to the jurisdiction of the bureau.[15]

Filing a retaliation claim with the bureau only requires an employee to show (by a preponderance of the evidence) that the protected conduct was a ''contributing factor'' to the retaliation.[16] If shown, the burden shifts to the employer to show (by clear and convincing evidence) that it would have taken the same action in the absence of the employee's protected activity.[17] The process for filing claims follows the framework for retaliation claims brought under the Consumer Product Safety Improvement Act of 2008.[18]

Negotiating Settlements: Key Considerations

To effectively negotiate a claim covered by Dodd-Frank, employee advocates must be aware of the numerous changes made to existing whistleblowing laws in order to competently evaluate any offer and implement an effective strategy. Some important considerations:

- ***No Rush to Settle***: The urgency that once plagued advocates to either settle or file has been mitigated by Dodd-Frank's longer statute of limitations (three months under SOX but six years from the retaliatory conduct or three years upon discovery of the conduct under Dodd-Frank).

- ***Don't Sell Yourself Short***: These claims are now worth substantially more due to the expanded back pay awards of double damages. Make sure when you negotiate you understand the true value of the claims.

- ***Release of Rights***: Be aware that Dodd-Frank invalidates any ''agreement, policy form, or condition of employment, including a pre-dispute arbitration agreement'' that has the effect of waiving rights and remedies available to whistleblowers.[19] Make sure there is a carve-out in the settlement agreement for these claims.

- ***Confidentiality Provisions***: The SEC implementing rules expressly state that ''[n]o person may take any ac-

[5] Id. at Section 929(a).
[6] Id. at Section 929P(b).
[7] Id. at Section 929P(c).
[8] Id. at Section 922 (h)(1)(A)(i)-(iii).
[9] Id.
[10] Id. at Section 922 (h)(1)(A).
[11] Id. at Section 929(a); Section 922(h)(1)(B)(iii).
[12] Id. at Section 922(h)(1)(C)(i)-(iii).
[13] Id. at Section 748(h)(1)(C).
[14] Id. at Section 1002(15)(A).
[15] Id. at Section 1057(a)(1)-(4).
[16] Id. at Section 1057(c)(3)(c).
[17] Id.
[18] 15 U.S.C. § 2087 (claims filed with the Labor Department's Occupational safety and Health Administration within 180 days).
[19] Id. at Section 922(c).

tion to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement.''[20] This is another potential carve-out in a settlement agreement.

■ ***Nondisparagement Provision***: This provision becomes tricky in light of the Dodd-Frank provisions stated above, as an employer may believe it is ''disparaging'' for an ex-employee to allege that the company committed fraud, for example. It is important to insert carve-out language in this section too.

■ ***Cooperation Provisions***: These are rather typical in settlement agreements, but it is important to make sure that embedded in this section is a ''reasonable'' factor.

■ ***Indemnification***: This needs to be examined on a case-by-case basis, but if the employee had a hand in the wrongdoing, you should seek an indemnification provision.

Accordingly, any settlement agreement must be drafted and reviewed with Dodd-Frank in mind, including confidentiality agreements and nondisparagement clauses that expressly exclude the rights and remedies provided for by the act. Because Dodd-Frank provides additional retaliation causes of action, express language carving out the act is necessary to best protect employee interests.

When to Seek Help

Without question, the SEC whistleblower guidelines are complex, encompassing a broad scope of conduct undertaken by a broad range of violators. Understanding who is a whistleblower, where there are exceptions, and how best to advocate for their interests, is extremely nuanced. Further complicating the calculus, in establishing the Bureau of Consumer Financial Protection, Dodd-Frank added a new player to the whistleblower arena, requiring that advocates broaden their engagement to effectively represent clients. An additional minefield, though not addressed here, involves how to handle cases in which the client or potential client may have criminal or civil liability for the reported misconduct.

Given the complexity and variety of statutory whistleblower protections and incentives, employee advocates may wish to secure counsel or partner with experienced securities and employment attorneys who routinely litigate in this area. By tapping into the knowledge base of these legal specialists who are familiar with the claims processes, rewards, damages, statute of limitations, and defenses under the whistleblower program, employee advocates will position themselves—and their clients—for success.

A New Regulatory Framework, A New Workplace Environment

The Dodd-Frank Act harkened a new era in the government's fight against corporate malfeasance by greatly expanding whistleblower protections to include mandatory rewards, greater coverage for financial services workers and commodities violations, and expanding FCA protections. It is safe to assume that these new provisions will have a monumental impact on the global workplace. By understanding the remedies and protections available under the new SEC whistleblower program, attorney advocates will be better positioned to successfully guide their clients through this new, complex, and revolutionary terrain.

[20] 17 C.F.R. § 240.21F-17.

 COPYRIGHT © 2011 BY THE BUREAU OF NATIONAL AFFAIRS, INC. DLR ISSN 0418-2693

Labaton Sucharow

Reporting Without Regrets:

The SEC Whistleblower Handbook

prepared for
PIABA Mid-Year Meeting

April 4, 2019

Table of contents

Introduction 1

Anonymous reporting 2

Employment protections 3

Monetary awards 6

Common securities violations 11

Restrictive employment agreements 16

Early success of the SEC Whistleblower Program 17

Conclusion 18

Introduction

At Labaton Sucharow, we work to protect and empower SEC whistleblowers, so they can successfully report securities violations—without personal or professional regrets. As first-hand witnesses to wrongdoing, whistleblowers are a formidable opponent to corruption. Their courageous actions safeguard jobs and investors, ensure fair markets and facilitate capital formation. When courageous individuals speak out against wrongdoing, we stand up, we step closer and use every tool in our arsenal to make their voices heard.

This handbook is a guide to this revolutionary process.

The Birth of the SEC Whistleblower Program

By 2010, a long series of corporate scandals had harmed numerous companies and countless individuals. Investor confidence was devastated. As the country debated how to break the cycle of fraud and corruption, financial watchdogs agreed on two fundamental truths: the investor protection status quo was failing and law enforcement could not effectively and efficiently police the marketplace without the help of individuals with actionable intelligence.

In response, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, one of the most significant financial reforms since the Great Depression. Under the statute, the SEC developed a revolutionary bounty program through which eligible whistleblowers can receive significant monetary awards, employment protections, and the ability to report anonymously. To qualify, an individual or group of individuals must voluntarily provide the SEC with original information that results in a successful enforcement action in which the SEC collects over $1 million in sanctions. Depending on various factors, the individual or group would receive a financial reward between 10% – 30% of the sanctions collected.

Days before the final rules were implemented in 2011, we predicted that history would reveal that in crafting the whistleblower provisions of Dodd-Frank, Congress and the SEC created a potent system to fight misconduct. Today, we can say with absolutely certainty that the SEC Whistleblower Program is one of the most successful public-private partnerships in history. The Commission has reported consistent increases in the volume and quality of tips. And, as of this writing, the SEC has awarded more than $153 million to courageous whistleblowers and secured more than $1 billion in monetary sanctions for injured investors.[1]

The ability to report possible misconduct anonymously is one of the most important pillars of the SEC Whistleblower Program.

Anonymous Reporting

In the past, fear of retaliation and blacklisting prevented corporate whistleblowers from reporting wrongdoing in the workplace. Corporate cultures of silence and complicity developed writ large and intimidated those who would speak out against misconduct. As a result, law enforcement and regulatory authorities were often unable to detect and prosecute securities violations, especially in earlier stages. Too often, hidden fraud and misconduct would fester and grow until they were discovered in the midst of a complete corporate collapse—leaving employees and companies devastated. To minimize risk of retaliation, the SEC Whistleblower Program empowers whistleblowers by allowing anonymous reporting. The vast majority of Labaton Sucharow clients, who are often senior executives, elect this option.

The ability to report possible misconduct anonymously is one of the most important pillars of the SEC Whistleblower Program To anonymously report possible violations to the SEC, a whistleblower must be represented by an attorney and must provide counsel with a copy of the whistleblower submission signed under the penalty of perjury.[2] The attorney will verify the identity of the whistleblower before submitting any information to the SEC; serve as an intermediary between the SEC and whistleblower during any investigation and related enforcement action; and advocate for the highest potential monetary award if the submission results in a successful SEC enforcement action. Prior to receiving any monetary award, for eligibility, tax and other reasons, whistleblowers must disclose their identity to the SEC.

Over the years, the SEC has carefully guarded the anonymity of whistleblowers, and is required to make every effort to protect any sensitive identifying information. In Fiscal 2016, nearly 65% of SEC Whistleblower award recipients were company insiders and almost one quarter of the award recipients submitted their information anonymously through counsel.



$368M

BALANCE OF INVESTOR PROTECTION FUND FROM WHICH AWARDS ARE PAID (AS OF FY 2016)



$153M

SEC WHISTLEBLOWER AWARDS PAID TO DATE



4,218

NUMBER OF SEC WHISTLEBLOWER SUBMISSIONS IN FY 2016

Employment Protections

Dodd-Frank also established powerful anti-retaliation protections for whistleblowers, including a new private right of action for employees subjected to retaliation by their employer. The Act also significantly improved existing whistleblower-protection laws, most notably the related provisions of the Sarbanes-Oxley Act of 2002 (SOX). Many whistleblowers may also be eligible for other federal and state whistleblower protections.

Anti-Retaliation Protections for SEC Whistleblowers

Under the SEC Whistleblower Program, an employer may not discharge, demote, suspend, threaten, harass, or take any other retaliatory action against an employee who:

- provides information about his or her employer to the SEC in accordance with the whistleblower rules;
- initiates, testifies in, or assists in an investigation or judicial or administrative action; or
- makes disclosures that are required or protected under SOX, the Exchange Act, and any other law, rule, or regulation subject to the jurisdiction of the Commission.[3]

If retaliation occurs, the employee is granted an automatic private right of action in federal court, without the need to exhaust administrative remedies prior to filing.[4] In addition, some courts have held that the private right of action extends to disclosures even if an employee does not provide the information to the SEC. In February 2018, the Supreme Court of the United States ruled that Dodd Frank's anti-retaliation protections do not extend to individuals who report possible securities violations internally in the first instance. Instead, to be eligible for the tremendous protections of the SEC whistleblower program, employees must first report to the Commission. whistleblowers who suffer retaliation before they report to the SEC.

The SEC Whistleblower Program was specially designed to protect courageous whistleblowers and severely punish companies that retaliate against them.

The remedies available include reinstatement to the same seniority, double back pay, and litigation costs (including attorneys' fees and expert witness fees). An employee suing under this section must file the claim no later than six years from the retaliatory conduct or three years from when the employee knew, or reasonably should have known, of the retaliatory conduct, but in no event to exceed 10 years after the date of the violation.

To qualify for these anti-retaliatory protections, the whistleblower must possess a "reasonable belief" that the information provided relates to a possible securities violation. The SEC has explained that a "reasonable belief" is a subjectively genuine belief that the information demonstrates a possible violation, and that this belief is one that a similarly situated employee might reasonably possess.[5] Furthermore, the information must demonstrate a "possible violation," which eliminates frivolous submissions from eligibility.

In 2016, Labaton whisteblowers spurred a $415 million penalty against Merrill Lynch.

Enhancement of SOX Anti-Retaliation Protections

Dodd-Frank also enhanced anti-retaliation protections established by SOX, expanding coverage beyond public companies to employees of affiliates and subsidiaries of publicly traded companies.[6] This includes foreign subsidiaries and affiliates of U.S. public companies.[7]

One of the largest award in the history of the SEC Whistleblower Program—more than $30 million—was paid to an international whistleblower.

Through these enhancements, Dodd-Frank now provides broad extraterritorial reach in actions brought by the SEC and the Justice Department.[8] The SEC's whistleblower program was designed with an understanding of the nature of the global economy. Since the program's initiation, the SEC has received whistleblower tips from individuals in more than 100 countries outside the United States. Furthermore, Dodd-Frank expands SOX coverage to employees of nationally recognized statistical ratings organizations, such as Moody's Investors Service Inc., A.M. Best Company Inc., and Standard & Poor's Ratings Service.[9]

Finally, Dodd-Frank doubles the statute of limitations for SOX whistleblower claims from 90 to 180 days; provides for a jury trial for claims brought under SOX whistleblower protections; and declares void any "agreement, policy form, or condition of employment, including a predispute arbitration agreement" which waives the rights and remedies afforded to SOX whistleblowers.[10]

New Anti-Retaliation Protections for Financial Service Employees

Congress also created the Consumer Financial Protection Bureau through Dodd-Frank. Dodd-Frank extends whistleblower protection to employees of financial products or services companies. Some examples of such companies include those that conduct the following: extend credit or services or brokers loans; provide real estate settlement services or perform property appraisals; provide financial advisory services to consumers relating to proprietary financial products (including credit counseling); or collect, analyze, maintain, or provide consumer report information or other account information in connection with decisions regarding the offering or provision of a consumer financial product or service.[11]

Employees of such companies cannot be retaliated against for any of the following:

(i) testifying or expressing the willingness to testify in a proceeding for administration or enforcement of Dodd-Frank;

(ii) filing, instituting or causing to be filed or instituted, any proceeding under any federal consumer financial law; or

(iii) objecting to, or refusing to participate in any activity, practice, or assigned task that the employee reasonably believes to be a violation of any law, rule, standard, or prohibition subject to the jurisdiction of the Bureau.[12]

A financial services employee who experiences retaliation must file a complaint within 180 days of the retaliatory conduct with the Secretary of Labor, and may seek de novo review in federal district court within 120 days of the Secretary of Labor's determination (or 210 days after filing with the Secretary of Labor). The sole requirement for filing a claim is to demonstrate, by a preponderance of the evidence, that the protected conduct was a "contributing factor" to the retaliation.[13] Upon such a showing, the burden shifts to the employer to show, by clear and convincing evidence, that it would have taken the same action regardless of the employee's protected activity.[14]

New SEC Power to Enforce the Anti-Retaliation Provisions

To further protect SEC whistleblowers, Dodd Frank empowered the SEC to bring enforcement actions for wrongful retaliation.[15] Concerning this Rule, the SEC has stated:

> Rule 21F-2(b)(2) states that Section 21F(h)(1) of the Exchange Act, including any rules promulgated thereunder, shall be enforceable in an action or proceeding brought by the Commission. Because the anti-retaliation provisions are codified within the Exchange Act, we agree with commenters that we have enforcement authority for violations of Section 21F(h)(1) by employers who retaliate against employees for making reports in accordance with Section 21F.[16] A number of recent cases demonstrate the SEC's expansive view on whistleblower protections, and its determination to fight back against retaliation.

Knowing that the SEC has your back, makes doing the right thing a lot easier.

The SEC has recently begun to wield its anti-retaliation authority in earnest

The SEC is keenly aware that in order to protect and encourage whistleblowers, it must fight against measures designed to stymie transparency. A number of recent cases demonstrate the SEC's expansive view on whistleblower protections, and its determination to fight back against retaliation.

In the case of Paradigm Capital Management, Inc.,[17] the whistleblower was Paradigm's head trader and a Labaton Sucharow client. He reported to the SEC that the firm and its owner had engaged in principal transactions that created an undisclosed conflict of interest with a client. After the firm learned of the whistleblowing, it reassigned the head trader to full-time compliance assistant, stripped him of his supervisory responsibilities, and otherwise marginalized him. Paradigm agreed to settle this case for $2.2 million, and the whistleblower received the statutory maximum award.[18]

In another landmark case, the SEC brought a stand-alone enforcement action for retaliation against International Gaming Technology, even though IGT was not found to have violated any other securities laws—including those which were the subject of the whistleblower's reports.[19]

Most recently, the SEC settled charges, including a retaliation charge, brought against SandRidge Energy. This case was notable because it involved internal reporting only.[20] Office of the Whistleblower Chief Jane Norberg stated the following in the press release announcing the settlement: "Whistleblowers who step forward and raise concerns internally to their companies about potential securities law violations should be protected from retaliation regardless of whether they have filed a complaint with the SEC."[21]

Monetary Awards

In determining who qualifies for an SEC whistleblower award, there are four general criteria. It is important to note that certain threshold requirements are set forth in the Whistleblower Program and there are certain types of individuals that are either ineligible or are subject to additional procedural requirements before they can receive an SEC whistleblower award.[22]

Qualifying for a Reward as a Whistleblower

Typically, the Whistleblower Program provides for a monetary award to any eligible individual or group of individuals (a company or other entity is not eligible), regardless of citizenship, who:

- voluntarily provide the Commission;
- with original information about a possible violation of the federal securities laws;
- that leads to a successful enforcement action;
- resulting in monetary sanctions exceeding $1,000,000.[23]

Due to their importance, we examine each of these four main criteria for qualifying for a whistleblower award in greater detail.

Voluntarily Provide

To qualify for an award as a whistleblower, the first requirement is that the individual "voluntarily provide" the information to the SEC. Information is provided voluntarily if it is provided "before a request, inquiry, or demand" for such information: (i) by the SEC; (ii) by the Public Company Accounting Oversight Board or any self-regulatory organization in connection with an investigation, inspection or examination; or (iii) in connection with an investigation by Congress, the Federal Government, or a state attorney general or securities regulatory authority.[24] The submission also will not be considered voluntary if the whistleblower was required to provide the information to the SEC as a result of a pre-existing legal duty to the Commission, or a contractual duty owed to the Commission or to one of the other authorities enumerated in the previous sentence, or pursuant to a duty that arises out of a judicial or administrative order.[25] Only a request, inquiry, or demand made on an individual whistleblower will be considered in connection with the question of whether a submission is voluntary.

A request, inquiry or demand on the organization for which a whistleblower is employed, for example, will have no bearing. Thus, if an employee is aware that a demand for information was made to his or her employer or that the employer is being investigated, and that employee provides the SEC with information about a possible securities violation, the submission could still be deemed voluntary. But an issue could arise if the employee provides the same information to the Commission that the Commission received as part of its investigation of the company (or would have received even if the employee had not provided the information to her employer during the investigation). That could affect the determination of whether the employee's submission led to a successful enforcement action, another required element for an SEC whistleblower award.

Another important caveat is that a submission to the SEC may be deemed voluntary, even if made after receiving a request, inquiry, or demand from the SEC, if the information was voluntarily provided to another law enforcement or regulatory authority prior to the SEC's request or inquiry.

Original Information

The second requirement for receiving an award is that the individual provide original information. To be considered original, the information must be:

- derived from independent knowledge or independent analysis;
- not already known to the SEC from any other source;
- not exclusively derived from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the media, unless the whistleblower was the original source for the information; and
- provided to the SEC after July 21, 2010.[26]

Independent Knowledge and Independent Analysis. The Commission defines independent knowledge as factual information in the individual's possession that is not derived from publicly available sources.[27] Significantly, the information could be gained from experiences, communications, and observations in business or social interactions. In other words, the individual need not have first-hand knowledge of the possible violation, but could have learned of the facts from a third party.

Independent analysis is defined as an individual's own examination and evaluation of information that may be publicly available, such as financial reports, but which reveals information that is not generally known or available to the public.[28]

There are a number of important circumstances in which the SEC will not consider information to be derived from independent knowledge or analysis. These exclusions generally apply to narrow categories of individuals, such as lawyers, consultants, and other third parties who acquire information as part of their work on behalf of a client, or company insiders who learn of the information in connection with their role in an internal investigation into wrongdoing, as well as information acquired illegally. Specifically, information is excluded in the following circumstances:

- when the information is subject to the attorney-client privilege, unless disclosure of that information would otherwise be permitted by an attorney pursuant to § 205.3(d)(2), the applicable state attorney conduct rules, or otherwise;
- the information was obtained in connection with the legal representation of a client, and the lawyer seeks to make a whistleblower submission for his or her own benefit, unless disclosure of that information would otherwise be permitted by an attorney pursuant to § 205.3(d)(2), the applicable state attorney conduct rules, or otherwise;
- the information was obtained because the individual was (a) an officer, director, trustee, or partner of an entity and was informed of the allegations by another person, or learned of the allegations in connection with the entities internal process for identifying and reporting violations of law; (b) an employee whose duties involve compliance or internal audits, or an employee of a firm retained to perform compliance or internal audit; (c) employed by a firm retained to conduct an internal investigation; or (d) an employee of a public accounting firm and the information was obtained during an engagement; or
- the information was obtained by means determined by a United States court to violate federal or state criminal law.[29]

There are a few important exceptions to the third category of exclusions—individuals who are insiders and third parties retained to perform legal, audit, or investigative work. This exclusion will not apply if the whistleblower has a reasonable basis to believe disclosure is necessary to prevent the entity from engaging in conduct that will cause substantial injury to the entity or the investing public, or that the relevant entity is engaging in conduct that will impede an investigation. In addition, the exclusion will not apply if more than 120 days have elapsed since the whistleblower provided the information to the entity's audit committee, chief legal or compliance officer, or his or her supervisor.[30]

Original Source. As stated above, for information to be considered original, it cannot already be known to the SEC from any other source. There are two exceptions to this rule. First, the SEC will consider a whistleblower the original source of information that was previously received by the SEC from another source if that source obtained the information from the whistleblower or the whistleblower's representative in the first place (and the information otherwise satisfies the definition of original). Second, the SEC will consider a whistleblower to be the original source of information if that information derives from the whistleblower's independent knowledge or analysis and materially adds to the information already known to the Commission.[31]

Successful Enforcement Action

The third requirement is that the whistleblower's voluntarily provided, original information must lead to a successful enforcement action. The applicable rules set forth three circumstances constituting a successful enforcement action:

- The information provided to the Commission caused the Commission to commence an examination, open an investigation, reopen a previously closed investigation, or inquire about different conduct as part of a current investigation, and the Commission brings a successful action based in whole or in part on the original information provided;
- The original information relates to a conduct that is already under investigation by the Commission (or other federal authority) and significantly contributes to the success of an enforcement action based on that conduct; or
- The information is provided by an employee through his or her employer's internal reporting procedures before or at the same time the employee submits the information to the Commission, and the employer then provides the employee's information (or the results of an internal investigation) to the SEC, which leads to a successful enforcement action (the employee will get the full credit for providing the information to the SEC).[32]

This last category was not in the original rules proposed by the SEC, and many comments expressed the concern that whistleblowers would completely bypass organizations' internal reporting mechanisms.[33] This provision was therefore added, along with other procedural incentives to encourage individuals to utilize internal compliance programs, and further encourage the use of these programs in facilitating compliance with the securities laws.

In addition, the SEC will pay an award based on sanctions collected in a related proceeding brought by the Attorney General of the United States, a regulatory authority or self-regulatory organization, or a state attorney general, that is based on the same information that led to the Commission's successful enforcement action.[34]

TOP WHISTLEBLOWER TIPS RECEIVED IN FY 2016



Monetary Sanctions Exceeding $1,000,000

Generally, the monetary sanctions must exceed $1 million in a single judicial or administrative action. In some circumstances, however, the SEC will aggregate the sanctions collected in two or more proceedings if the proceedings arise out of a common nucleus of operative facts.[35] In such cases, once this threshold is met, a whistleblower is eligible for a monetary award based upon all monetary sanctions collected in related enforcement actions—regardless of amount.

Procedures for Filing an SEC Whistleblower Submission

Regulation 21F provides two methods for submitting information to the SEC: (1) online using the Commission's Tip, Complaint or Referral Portal (http://www.sec.gov), or (2) by mailing or faxing a Form TCR to the SEC Office of the Whistleblower.[36] The whistleblower must declare under penalty of perjury that the information contained in the submission is true and correct to best of his or her knowledge.[37] Additionally, if the whistleblower wishes to remain anonymous, his or her submission must be made by an attorney in accordance with the same procedures just described.[38]

While the procedures for making a whistleblower submission to the SEC are relatively simple, it is essential that they be followed correctly, or a potential whistleblower might be disqualified from receiving an award or be ineligible for the anti-retaliation protections provided by Dodd-Frank.[39] Moreover, due to the SEC's limited resources and the high-volume of tips it receives, successful SEC whistleblowers often file sophisticated and detailed submissions. On behalf of its own SEC whistleblowers clients, Labaton Sucharow regularly files 100 page legal and factual whistleblower submissions with supporting exhibits.

Procedures for Filing an SEC Application for Award

After a successful enforcement action where the monetary sanctions exceed $1 million is announced, the SEC will post a Notice of Covered Action on its website. To claim an award, SEC whistleblowers and their legal counsel are required to mail or fax a completed application for award, SEC Form WB-APP, to the SEC Office of the Whistleblower, within 90 calendar days of the notice date. If the whistleblower provided his or her original submission anonymously, the whistleblower must disclose his or her identity on the Form WB-APP.[40]

As a courtesy, the SEC Staff often notifies known SEC whistleblowers or their legal counsel about the successful enforcement action and the opportunity to apply for an award. That being said, SEC whistleblowers are solely responsible for monitoring the SEC's Notices of Covered Actions, so they do not miss the deadline for filing an application for award. On behalf of our SEC Whistleblower Program clients, Labaton Sucharow regularly monitors these notices and files lengthy applications for awards that address the governing law and highlight their many significant contributions during the SEC investigation and any related prosecution.

Determining the Amount of the Award

If all conditions are met and a whistleblower is entitled to an award, the amount of that award will be between 10 and 30 percent of the sanctions collected by the SEC or other prosecuting authority.[41] Even if there are multiple whistleblowers, the total amount awarded to all whistleblowers will still range between 10 and 30 percent of the sanctions, with the amount of the award for each whistleblower determined on an individual basis. The determination of the specific percentage within the range that will be used to calculate a reward is in the sole discretion of the SEC. There is no ceiling for an SEC whistleblower award.

In reaching its determination of specific award, the SEC considers several factors unique to the circumstances of each case. The factors that may increase a whistleblower's award include:

- the significance of the provided information to the success of the action or related action, including how the information related to the action and the degree to which the information supported one or more successful claims;
- the degree of assistance provided by the whistleblower to the Commission in the action or related action, including, among other things, the extent to which the whistleblower explained complex transactions and interpreted key evidence, and assisted the authorities in the recovery of the fruits and instrumentalities of the violation;
- law enforcement interest in prosecuting and deterring the type of securities violation involved in the submission; and
- whether the whistleblower reported the potential violation internally using organizational compliance procedures.[42]

Conversely, factors that could reduce the size of a whistleblower's award are:

- the culpability or involvement of the whistleblower in the securities violation, including the whistleblower's role in and the extent he or she benefited from the violation;
- whether the whistleblower unreasonably delayed reporting the potential violation; and
- if the whistleblower internally reported the potential violation in accordance with his or her employer's compliance program, and whether, and the extent which, the whistleblower interfered with or undermined that program.[43]

As the above indicates, an individual will not automatically be precluded from receiving an award as a whistleblower if he or she had some culpability in the underlying violation. Generally, the extent of the culpability would merely be a factor considered by the SEC in determining the size of the award.

Due to the SEC's limited resources, the probability of a successful enforcement action and the size of monetary award are dramatically enhanced when whistleblower tips are supported by expert analysis and assistance.

Common Securities Violations

With the prospect of large financial awards and robust employee protections provided by Dodd-Frank and the SEC Whistleblower Program, it is important that individuals are aware of what constitutes a qualifying violation for the program.

A whistleblower may report any possible violation of the federal securities laws that has occurred, is ongoing, or is about to occur. However, for the SEC to obtain a monetary civil penalty, the relevant securities violation(s) must have occurred, or have remained ongoing, within the past five years, even if the whistleblower did not discover the possible violation until a later date.[44]

WHISTLEBLOWER TIPS BY ALLEGATION TYPE (AVERAGE)



19%	CORPORATE DISCLOSURES AND FINANCIALS
16%	OFFERING FRAUD
14%	MARKET MANIPULATION
7%	INSIDER TRADING
5%	TRADING AND PRICING
5%	FCPA
3%	UNREGISTERED OFFERINGS
3%	MARKET EVENT
2%	MUNICIPAL SECURITIES AND PUBLIC PENSION
24%	OTHER
3%	NOT REPORTED

Corporate Disclosures and Financials

Corporate disclosures and financial violations often relate to false or misleading financial statements that have been filed with the SEC in either a company's registration statement, prospectus, or as part of any other of the company's required filings under the Exchange Act.

Failures to make required filings would also fall under this category. This type of fraud often occurs when a company uses accounting tricks to increase the reported earnings and revenues for a particular reporting period.

Another common scenario is when companies engage in manipulative business transactions that have the effect of altering revenues, expenses, earnings, and/or losses for a reporting period. Sometimes these transactions might even be legal, but they are used unlawfully.

A violation under this category could also occur when a company fails to speak truthfully when discussing its financial results e.g., in press releases or analyst or investor presentations. Additional examples include undisclosed conflicts of interest, corporate governance/legal matters, or revenue impact of one-time events.

SEC enforcement cases don't get better with age.
Tips that are over 5 years old are pretty much dead on arrival.

Offering Fraud

Offering fraud generally occurs when an individual (or group of individuals) makes misrepresentations and/or omissions of material fact to potential investors in a new company.

One example of this type of fraud is individuals contacting potential investors to induce them into investing in a new, unknown company, by making false claims about the company. Another common type of offering fraud is a Ponzi scheme, where investors are paid returns from their own money or from the money invested by subsequent investors, rather than from any actual earned profit. The operator of the scheme induces new investors by paying unusually consistent or abnormally high returns to older investors. Pyramid schemes are also an example of offering fraud.

Market Manipulation

Market manipulation is the interference with the free and fair operation of the market by engaging in conduct that creates an artificial price or maintains an artificial price for a security. Examples of market manipulation include:

- **Pump and Dump:** Where owners of a security spread false information so that the price of the security will increase (the pump). When the price of the security does increase based on these false rumors, the owners who spread the false information sell off their shares, making a profit (the dump).
- **Bear Raid:** Attempt by investors to move the price of a stock opportunistically by selling large numbers of shares short. The investors pocket the difference between the initial price and the new, lower price after this maneuver. This technique is illegal under SEC rules, which stipulate that every short sale must be on an uptick.
- **Wash Trading:** Wash trading involves the simultaneous or near-simultaneous selling and repurchase of the same security for the purpose of generating activity and increasing the price.
- **Matched Orders:** Orders to buy or sell securities that are entered with knowledge that a matching order on the opposite side has been or will be entered.
- **Painting the Tape:** Placing successive orders in small amounts at increasing or decreasing prices.
- **Spoofing/Layering:** A tactic that has been used by high frequency traders to manipulate prices, spoofing is the placing of a bid or offer with the intent to cancel before execution. "Layering" is a form of spoofing in which the trader places multiple orders on one side of the book, in order to create a false impression of heavy buying or selling pressure.

Insider Trading

Insider Trading is the buying or selling of a corporate security while in possession of material information that is not known to the public at the time, but which later becomes public and causes the price of the security to rise or fall significantly. Often, this information is obtained by corporate insiders who have access to this material information based on their position inside the organization. That insider then buys or sells the securities based on that information.

Insider trading may also occur when a corporate insider "tips" the nonpublic information to someone outside of the organization, who then buys or sells securities. In that case both the provider and the recipient of the information are liable for illegal insider trading. Insider trading is unlawful because trading while having special knowledge is unfair to other

investors who don't have access to such knowledge. An example of illegal insider trading is when an executive at Company A learned, prior to a public announcement, that Company A will be taken over, and bought shares in Company A knowing that the share price would likely rise.

Trading and Pricing

Trading and pricing violations include any number of trading techniques that are illegal under the securities laws. For example:

- **Market Timing/Late Trading:** This occurs when a mutual fund permits certain customers to purchase shares in the fund after trading has closed for the day. Because mutual fund prices are set once a day, a customer that purchases after trading is closed can do so at that day's price and not at the following day's price.
- **Marking the Close:** Buying or selling a security near the close of the day's trading in order to affect the closing price.
- **Front Running:** The buying or selling of securities while knowing that another investor is about to make a trade that will influence the price of the security. An example would be buying stock in Company A knowing that another investor is about to make a very large purchase of the same stock, causing its price to increase.
- **Pooling:** An agreement among a group of people delegating authority to a single manager to trade in a specific stock, for a specific period of time, and then to share the resulting profits or losses.
- **Freeriding:** Buying a stock in a cash account and selling before paying for it.
- **Stock Parking/Kiting:** Forms of collusion between trading parties in which a trade is entered into with a side agreement that the seller will buy back the stock from the buyer at a later time (done to meet/avoid disclosure obligations), or that they will disregard settlement obligations so that one party can exploit the delay and continue to trade based on a position that should no longer be available.
- **Naked Shorting:** Shares are sold short without arrangements made to borrow them to deliver, then seller intentionally fails to deliver within the standard three-day settlement period.
- **Churning:** When a broker engages in excessive buying and selling of securities in a customer's account chiefly to generate commissions that benefit the broker.
- **Cherry-Picking:** Where an investment professional with both proprietary and management operations delays trade allocations until after results are in, and then allocates in an unfair manner (i.e., takes more successful trades in the proprietary account and sticks the managed accounts with most of the losers).

The Foreign Corrupt Practices Act (FCPA)

The FCPA prohibits the offer, payment, or promise to pay money or anything of value—i.e., a bribe—to any foreign official in an effort to win or retail business from that foreign official's government.

It is not a violation of the FCPA, however, if (i) the payments are legal under the written laws of the country in which the payments are made; or (ii) the payment is a reasonable expenditure directly related to the conducting of business with a foreign government.

Unregistered Offerings

With limited exception, offerings of securities in the U.S. must be registered with the SEC. An offering that is not registered, or that fails to meet or adhere to the requirements for exemption, constitutes a violation (and sales, or attempted sales, are a serious crime).

Non-public offerings are among the more common exceptions to the registration requirement. This exemption, sometimes referred to as the "private placement" exemption, is established by Section 4(a)(2) of the Securities Act, and generally applies to offerings in which purchasers are informed, "sophisticated investors" who have agreed not to resell the securities to the public.

Notwithstanding these general parameters, however, this exemption leaves much to interpretation, and thus a safe harbor is included in Rule 506 of Regulation D. In addition, in Rules 504-504, Regulation D sets forth some other common exceptions to registration, which generally turn on one or more of the following:

- the size/duration of the offering (e.g., an offering of $1 million or less over a 12-month time period faces the least restrictions in qualifying for exemption);
- the means of solicitation (public advertising is often a hitch);
- the level of disclosure provided; and
- the characteristics of the investors and/or the securities.

The JOBS Act (discussed in Section I.H., supra) required certain amendments to existing exemptions and creation of new ones to make it easier, particularly for smaller companies, to raise capital without SEC registration.

Cybersecurity

Cybersecurity is critical to the successful operation of companies and our financial markets. Companies increasingly rely on and are exposed to digital technology. The SEC has recognized that "cybersecurity risks pose grave threats to investors, our capital markets, and our country." As companies' exposure to and reliance on networked systems and the internet have increased, the corresponding risks and frequency of cybersecurity incidents have also increased dramatically. Cybersecurity incidents can result from unintentional events or deliberate attacks by insiders or third parties, including cybercriminals, competitors, or foreign states.

There are a number of cyberattacks that can paralyze a company or an entire market. These include:

- Stolen access credentials
- Malware
- Ransomware
- Phishing
- Structured query language injection attacks
- Distributed denial-of-service attacks

The objectives of cyber-attacks vary broadly but often include the theft or destruction of financial assets, intellectual property, or other sensitive information belonging to companies, their customers or their business partners.

The SEC has issued guidance regarding disclosure obligations of publicly traded companies related to cybersecurity risks and incidents. The SEC believes that it is critical that public companies take all required actions to inform investors about material cybersecurity risks and incidents in a timely fashion. Companies must have disclosure controls and procedures that provide an appropriate method of determining the impact that cybersecurity risks may have on the company, its financial condition and its operations as well as a protocol to determine the potential materiality of such risks and incidents. Additionally, directors, officers and other corporate insiders must not trade a public company's securities while in possession of material nonpublic information which may include knowledge regarding a significant cybersecurity incident experienced by the company.

Market Events

Market events refer to disruptions or aberrations in the securities markets, such as an unexpected interruption in trading on a securities exchange, a liquidity crisis or a flash crash. While not all such market events represent securities violations, the SEC has brought enforcement actions against exchanges and related entities where the market event was caused or exacerbated by the exchange's failure to follow relevant SEC or internal rules. The SEC and other federal agencies conduct surveillance of trends and dealer and investor positions to help determine whether market events are indicative of fraudulent activities.

Municipal Securities and Public Pensions

Municipal securities are debt securities issued by state and local governments in the United States and its territories, and are generally used to fund items such as infrastructure, schools, libraries, and other general municipal expenditures. Dealers in municipal securities are required to disclose material information about the securities to investors and, as with any security, securities laws prohibit any person from making a false or misleading statement of material fact, or omitting any material fact in connection with the offer, purchase, or sale of any municipal security. Thus, a failure to comply with these laws in connection with the purchase or sale of municipal securities would be an actionable securities violation subject to SEC enforcement.

Restrictive Employment Agreements

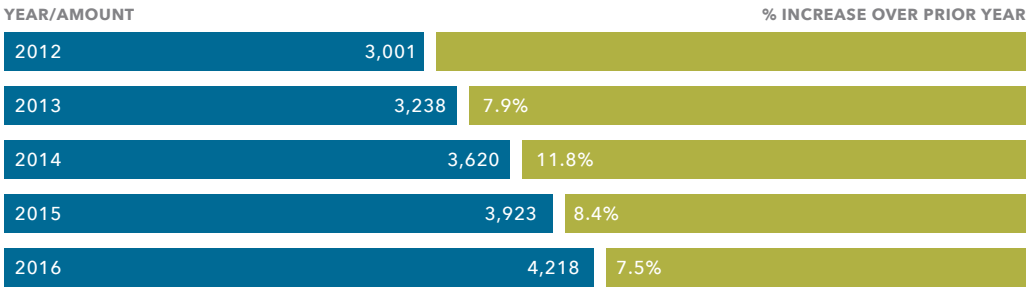
In addition to its new authority to bring enforcement actions based on retaliation against employee whistleblowers, the SEC can also pursue companies under Regulation 21F-17 for impermissible secrecy agreements that discourage employees from reporting possible securities violations to the SEC. This has been a particular point of emphasis for the regulator.

The first case brought was the Matter of KBR, Inc., which established that merely failing to make clear that a confidentiality provisions does not restrict reporting to the SEC can run afoul of the law. In that case, KBR required employees participating in an internal investigation to sign a broad confidentiality agreement which prohibited discussing particulars of an interview without the prior authorization of KBR's legal department upon threat of disciplinary action, including termination of employment. KBR agreed to pay a $130,000 fine and change its confidentiality agreement language going forward.[45]

Since the KBR case, the SEC has made clear that this is an area of continuing, keen focus. The issue also arose in the SEC's case against Merrill Lynch, which involved a group of SEC whistleblowers represented by Labaton Sucharow and settled in June 2016 for $415 million. The SEC found that Merrill Lynch had used "improper confidentiality provisions" in severance agreements for departing employees that prohibited them from disclosing confidential information to any outside entity without prior approval from the firm.[46]

In addition to the KBR and Merrill Lynch cases, there have been no less than seven other recently settled cases involving this issue, including BlueLinx Holdings Inc.,[47] Health Net, Inc.,[48] InBev,[49] NeuStar Inc.,[50] the above-discussed Sandridge Energy,[51] BlackRock Inc.,[52] and HomeStreet Inc.[53]

WHISTLEBLOWER TIPS RECEIVED BY THE SEC



Early Success of the SEC Whistleblower Program

Although the Whistleblower Program has been in effect for less than six years at the time of this writing, and SEC investigations typically take two to four years to complete, it has already had a tremendous impact on the enforcement of securities violations. Each year, the SEC receives more than 20,000 tips, complaints and referrals. Of these, more than 4,000 tips are received through the SEC Whistleblower Program. At any one time, the SEC actively conducts about 2,000 investigations. The SEC has made clear it has no patience for impeding whistleblowing in any form and has warned companies that it will sanction those that step out of line.

The SEC's Investor Protection Fund, exclusively dedicated to paying whistleblower awards, is richly endowed to continue this important work—with over $368 million in funds, as illustrated in the following chart:

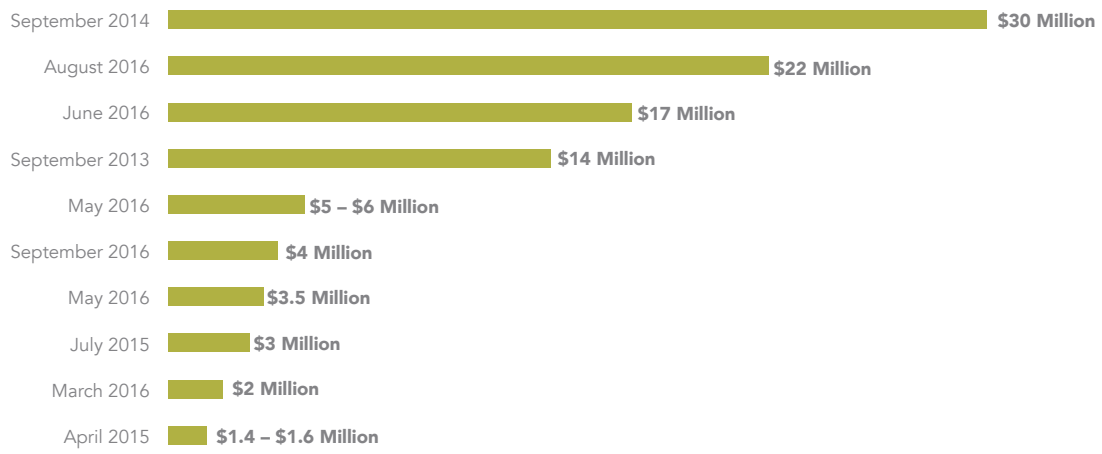
FY 2016

Balance of Fund at beginning of fiscal year	$	400,693,089.56
Amounts deposited into or credited to Fund during fiscal year	$	0.00*
Amount of earnings on investments during fiscal year	$	2,412,788.41
Amount paid from Fund during fiscal year to whistleblowers	$	(34,945,648.43)
Amount disbursed to Office of the Inspector General during fiscal year	$	(44,222.10)
Balance of Fund at end of the fiscal year	$	368,116,007.44

* Section 4D(a) of the Exchange Act, id. § 78d-4(a).

In addition, the following chart gives a sense of how whistleblower awards have been distributed so far:

TOP 10 SEC WHISTLEBLOWER AWARDS



The SEC has made clear it has no patience for discouraging whistleblowing in any way.

To provide a sense of how significant SEC enforcement actions can be, in recent years, the SEC has secured more than $4 billion annually in monetary sanctions, with a number of individual actions exceeding $100 million. For example, some of our clients tipped the SEC about securities violations at Merrill Lynch that recently resulted in a staggering $415 million in sanctions!

The information provided by SEC whistleblowers has led to over $584 million in sanctions for violations or alleged violations.[54] These sanctions are commonly used to reimburse victimized investors, and can therefore literally be life-changing for individuals and their families. The program also provides immeasurable societal benefits by fostering orderly markets protecting employees and other vulnerable individuals.

Thus, we have it on good and abundant authority that participation in the whistleblower program by those situated to do so also leads to better sleep at night.

Our partners have had the pleasure of serving—for decades—in senior positions at the SEC and DOJ during both Republican and Democratic administrations. In our experience, unlike financial regulation, white collar law enforcement has been a bipartisan priority for most administrations. Given the program's early success, long-term potential and relatively low operation cost, we fully expect that the SEC Whistleblower Program will remain substantially unchanged in the years ahead.

Conclusion

The passage of Dodd-Frank and the enactment of the SEC Whistleblower Program were watershed moments in financial regulation and investor protection. Going forward, it is likely that many of the SEC's most significant enforcement actions will result from whistleblower tips, changing the landscape of securities enforcement for generations. Responsible organizations must carefully and continually evaluate their internal reporting systems and maintain cultures of integrity. However, bad actors may persist. It is vital to the safety and integrity of our markets that potential whistleblowers and their counsel familiarize themselves with the relevant statutory provisions and the rules adopted by the SEC so whistleblowers can properly and safely report and maximize their awards.

WORK WITH US

An ultra-selective practice. A team with a century of federal law enforcement experience, led by a principal architect of the SEC Whistleblower Program. Exclusively partners working exclusively for SEC whistleblowers. World-class in-house investigators, accountants and analysts. Precedent-setting whistleblower awards.

A practice like no other.

ENDNOTES

1 See https://www.sec.gov/page/whistleblower-100million.

2 As set forth in Regulation 21F-7(b), a whistleblower who wishes to submit information to the Commission anonymously must do the following: (1) . . . have an attorney represent [them] in connection with both [their] submission of information and . . . claim for an award, and [the] attorney's name and contact information must be provided to the Commission at the time [of] submi[ssion]; (2) . . . follow . . . procedures set forth in [Regulation] 21F-9 [involving, inter alia, attorney certification of certain information about the submission]; and (3) . . . disclose [their] identity to the Commission [which] must be verified [prior to payment of any award].

3 Exchange Act § 21F(h)(1)(A)(i)-(iii).

4 *Id.* at § 21F(h)(1)(B)(i). Victims of wrongful termination are commonly required to bring their claims, in the first instance, to an employment agency such as the Occupational Safety and Health Administration, the Equal Employment Opportunity Commission or their state Employment Agency. Section 21F(h) dispenses with that requirement.

5 Implementation Release at 16 (emphasis in original) (citing ***Livingston v. Wyeth, Inc.***, 520 F.3d 344, 352 (4th Cir. 2008); ***Clover v. Total Sys. Servs., Inc.***, 176 F.3d 1346, 1351 (11th Cir.1999)).

6 Pub. L. 111-203, § 929A.

7 *Id.* at § 929P(b).

8 *Id.* at § 929P(c).

9 *Id.* at § 922(b).

10 *Id.* at § 922(c).

11 *Id.* at § 1002(15)(A).

12 Pub. L. 111-203, § 1057(a)(1)-(4).

13 *Id.* at § 1057(c)(3)(c).

14 *Id.*

15 17 C.F.R. § 240.21F-2(b)(2).

16 Implementation Release at 18.

17 Release No. 2014-118 (June 16, 2014), available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542096307#.VAndkPldXxp.

18 *Id.*; *see also* Release No. 2015-75 (April 28, 2015), available at https://www.sec.gov/news/pressrelease/2015-75.html.

19 Release No. 2016-204 (Sept. 29, 2016), available at https://www.sec.gov/news/pressrelease/2016-204.html.

20 *See* Order, Release No. 79607 (Dec. 20, 2016), available at https://www.sec.gov/litigation/admin/2016/34-79607.pdf.

21 Release No. 2016-270 (Dec. 20, 2016), available at https://www.sec.gov/news/pressrelease/2016-270.html.

22 As set forth in Regulation 21F-8(c), the whistleblower cannot: (1) have been a member, officer, or employee of the Commission, the Department of Justice, an appropriate regulatory agency, a self-regulatory organization, the Public Company Accounting Oversight Board, or any law enforcement organization at the time they acquired the original information provided to the Commission; (2) have been a member, officer, or employee of a foreign government, any political subdivision, department, agency, or instrumentality of a foreign government, or any other foreign financial regulatory authority as that term is defined in . . . the Exchange Act (15 U.S.C. 78c(a)(52)) at the time they acquired the original information provided to the Commission; (3) be convicted of a criminal violation that is related to the Commission action or to a related action; (4) have obtained the original information through an audit of a company's financial statements, such that making a whistleblower submission would be contrary to requirements of Section 10A of the Exchange Act (15 U.S.C. 78j-a); (5) be the spouse, parent, child, or sibling of a member or employee of the Commission, or reside in the same household as a member or employee of the Commission; (6) have acquired the original information from a person or persons (i) who would be restricted under #4, above, unless the information is not excluded from their use or is about possible violations by them, or (ii) with intent to evade any provision of these rules; or (7) knowingly and willfully make any false, fictitious, or fraudulent statement or representation, or use any false writing or document knowing that it contains any false, fictitious, or fraudulent statement or entry with intent to mislead or otherwise hinder the Commission or another authority.

23 17 C.F.R. § 240.21F-3.

24 *Id.* at § 240.21F-4(a)(1).

25 *Id.* at § 240.21F-4(a)(3).

26 *Id.* at § 240.21F-4(b).

27 *Id.* at § 240.21F-4(b)(2).

28 *Id.* at § 240.21F-4(b)(3).

29 17 C.F.R. § 240.21F-4(b)(4)(i)-(iv).

30 *Id.* at § 240.21F-4(b)(4)(v).

31 *Id.* at § 240.21F-4(b)(5)-(6).

32 *Id.* at § 240.21F-4(c).

33 Implementing Release at 101-07.

34 17 C.F.R. § 240.21F-3(b).

35 *Id.* at § 240.21F-4(d).

36 *Id.* at § 240.21F-9(a). "TCR" stands for Tips, Complaints and Referrals.

37 *Id.* at § 240.21F-9(b).

38 *Id.* at § 240.21F-4(c).

39 Id. at § 240.21F-8(a).

40 17 C.F.R. § 240.21F-10(c).

41 17 C.F.R. § 240.21F-5(b).

42 *Id.* at § 240.21F-6(a).

43 *Id.* at § 240.21F-6(b).

44 *See* 28 U.S.C. § 2462; ***Gabelli v. SEC,*** 133 S.Ct. 1216 (2013).

45 Release No. 2015-54 (April 1, 2015), available at https://www.sec.gov/news/pressrelease/2015-54.html.

46 Release No. 2016-128 (June 23, 2016), available at https://www.sec.gov/news/pressrelease/2016-128.html.

47 Release 2016-157 (Aug. 10, 2016) available at https://www.sec.gov/news/pressrelease/2016-157.html.

48 Release No. 2016-164 (Aug. 16, 2016), available at https://www.sec.gov/news/pressrelease/2016-164.html.

49 Release No. 2016-196 (Sept. 28, 2016), available at https://www.sec.gov/news/pressrelease/2016-196.html.

50 Release No. 2016-268 (Dec. 19, 2016), available at https://www.sec.gov/news/pressrelease/2016-268.html.

51 Release No. 2016-270 (Dec. 20, 2016), available at https://www.sec.gov/news/pressrelease/2016-270.html.

52 Release No. 2017-14 (Jan. 17, 2017), available at https://www.sec.gov/news/pressrelease/2017-14.html.

53 Release No. 2017-24 (Jan. 19, 2017), available at https://www.sec.gov/news/pressrelease/2017-24.html.

54 2016 Annual Report to Congress on the Dodd Frank Whistleblower Program, at 1, available at https://www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2016.pdf.

In addition to the information contained in this Handbook, we encourage readers to visit our website https://www.secwhistlebloweradvocate.com/ to review Frequently Asked Questions about the program, the reporting process and our Firm.

Labaton Sucharow

140 Broadway
New York, NY 10005

New York
Washington DC
Delaware

© 2019 Labaton Sucharow LLP

New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 258—NO. 14
FRIDAY, JULY 21, 2017

Outside Counsel

Expert Analysis

Happy Anniversary, Dodd-Frank

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. Seven years is prophetic in import and impact. Heck, it's biblical. From Genesis right on through Deuteronomy, we can read about seven years of famine, seven years of plenty, seven years of fire, having to cancel all debts after seven years, seven years until Armageddon …

Maybe that last one is prescient. Today, seven years into Dodd-Frank, repeal is on the table. Even Barney Frank has acknowledged some weak spots in the legislation. But there was more to the 2,000 plus pages than onerous reporting requirements and liquidity standards. In response to the serial misconduct in the financial marketplace, Dodd-Frank charged the SEC with the creation of a revolutionary program to provide meaningful protections and financial incentives to whistleblowers. I was privileged to serve as one of the principal architects

By **Jordan A. Thomas**



of that program during my tenure at the Commission. In its formation and now its fruition, it has proven to be one of the greatest public-private partnerships in American history.

We don't say this often, and we haven't heard it lately, but with the SEC Whistleblower Program, the United States government got it right. *Really right.*

Success by the Numbers

The reach of the SEC whistleblower program is significant: Since its launch, submissions have been received from all 50 states and over 100 countries. Taking on goliath financial institutions and seemingly untouchable corporations with intelligence from whistleblowers, the SEC has already levied sanctions of more than $1 billion—the majority of which has been returned to injured investors. And the tips keep coming.

Not only has the number of tips soared year over year, SEC leadership has consistently praised their high quality. Former SEC Chair Mary Jo White called the program a "game changer" and Andrew Ceresney, the former Director of Enforcement, has described the program as a powerful tool for "the detection of illegal conduct and moving investigations forward quicker and through the use of fewer resources."

Perhaps equally compelling is the award activity—more than $150 million paid to date—which is astonishing in light of the fact that this is a new program and SEC investigations take two to four years to complete. Anyone who thinks the pace of awards signals a weak program ought to think again. The number and size of enforcement actions initiated by whistleblowers will continue to grow as awareness of the program increases and the cases in the enforcement pipeline mature.

> Contrary to Corporate America's initial concerns, the program has actually strengthened, not weakened, compliance and integrity programs in a number of important ways.

JORDAN A. THOMAS *chairs the whistleblower representation practice at Labaton Sucharow. A former Assistant Director in the SEC's Enforcement Division, he played a leadership role in the development of the SEC Whistleblower Program.*

Initial Concerns Unrealized

Early on, opponents of the program heralded the death to corporate compliance. By incentivizing the reporting of misconduct, naysayers argued, SEC whistleblowers would bypass internal reporting systems leaving companies at a disadvantage to detect and cure wrongdoing. They argued that the Commission should, at a minimum, require whistleblowers to report possible securities violations internally to be eligible for a monetary award.

The SEC refused to do so. In the program rules, the Commission struck the right balance by incentivizing, rather than requiring, internal reporting by whistleblowers. History proved the wisdom of this position. According to the SEC's most recent annual report to Congress, some 80 percent of whistleblowers were current or former employees of the organization at issue and raised their concerns internally or understood that the entity was already aware of the misconduct before turning to the SEC.

A Boost to Compliance

Contrary to Corporate America's initial concerns, the program has actually strengthened, not weakened, compliance and integrity programs in a number of important ways. First, after the establishment of the program, many companies invested more time and resources in strengthening their internal reporting and compliance programs—to encourage their employees to report internally, rather than externally. Second, attorneys, accountants, compliance professionals and other gatekeepers are meaningfully empowered because they can now argue that failure to do the right thing or invest more in the company's compliance and integrity systems will likely result in external reporting. Third, with the help of whistleblowers, SEC investigations commence in a far more targeted and informed manner—reducing the time and costs associated with responding to such inquiries.

Taking on an 'Omerta' Culture

Not all employers play nicely. The proliferation of secrecy agreements that bar employees from reporting misconduct to the government is perhaps one of the more nefarious workplace developments of recent years. In a 2015 study of financial services professionals we conducted with the University of Notre Dame, a full 25 percent of respondents earning $500,000 or more annually reported they have signed or have been asked to sign an agreement that prohibits reporting potentially illegal or unethical activities directly to law enforcement.

Here, too, the SEC whistleblower program has served up a sobering tonic to such assaults on American values. Without a doubt, one of the program's key accomplishments has been to affirm an individual's unwaivable right to engage with law enforcement. To date, the agency has brought nine enforcement actions involving improper efforts by employers to restrict whistleblowers.

The program has also taken aim at workplace retaliation, which is a scourge on corporate culture and democracy itself. With its new enforcement authority established by Dodd-Frank, the SEC has already brought three enforcement actions arising out of retaliation against a whistleblower. Interestingly, in one such action announced last year, the entity was sanctioned for retaliation even though the Commission found no underlying securities violation.

A Bright Future?

Having worked in the trenches prosecuting wrongdoing at the SEC and DOJ, I know firsthand how desperately law enforcement needs insiders to provide early, actionable intelligence. To get this information, we need to continue to incentivize and protect courageous witnesses. The whistleblower program the SEC has established under Dodd-Frank does this. And then some. And it does so in spite of constant budgetary restraints that pinch staffing; and it pays awards through a replenishing fund that does not dip into taxpayers' pockets. Ultimate economy, doing ultimate good.

Would it be nice to expedite the pace of whistleblower award payments? Of course. There is no doubt that the length of time the SEC takes to pay a whistleblower claim can discourage whistleblowers, particularly those who have suffered retaliatory termination and face dire financial circumstances. As the program becomes more established, we are hopeful that it will become more efficient in this critical area.

For now, when our public institutions face unprecedented challenges, we can all take pride in this shining example of what *is* possible when citizens and their government band together to clean up the street. These successful partnerships uphold the finest elements of a thriving American democracy.

Reprinted with permission from the July 21, 2017 edition of the NEW YORK LAW JOURNAL © 2017 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-07-17-33

New York Law Journal
Compliance
An ALM Publication
WWW.NYLJ.COM
MONDAY, NOVEMBER 7, 2011

The **Limitations** of Corporate Compliance

Establish an ethical culture in an era of scandal.

BY JORDAN A. THOMAS

AFTER MORE than 15 years in federal law enforcement, first as a Trial Attorney at the Department of Justice and later as an Assistant Director in the Enforcement Division of the U.S. Securities and Exchange Commission (SEC), one thing has become certain about corporate compliance: Many programs, well wrought, thoughtful and expensive as they may be, only address half of the equation. They focus largely on the mechanics of compliance and the practical response to misconduct. A more important and preemptory issue—establishing an ethical culture that deters misconduct—is often absent from the calculus.

Without a robust ethical platform, corporate compliance is a post-facto and tactical exercise. In a post-Dodd-Frank environment, the stakes are too high for tactics. Companies need ethical strategists. Any corporate leader who disagrees need only consider that, with the new SEC whistleblower provisions enacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the federal government has deputized virtually every company employee, vendor, customer (and their second cousins) to serve as their eyes and ears. The scrutiny is, and will grow far more, intense.

It's time to develop a new paradigm for corporate character. This is particularly important in an economic downturn, when executives send messages about profit-or-else and fears about job security can supersede ethical decision-making. It's time for corporate leaders, in-house and outside counsel included, to make principles like doing the right thing and fulfilling responsibilities to investors, customers, and employees a fundamental part of doing business. Given the unprecedented attention the whistleblower provisions of Dodd-Frank have generated, this is a moment of real opportunity.

Beyond Cops and Robbers

Over the years, the field of corporate compliance has undergone a major and positive transformation. A long series of scandals beginning with Enron, regulatory reform under Sarbanes-Oxley, and favorable dispensation under the sentencing guidelines have all contributed to the growth of strong and independent compliance functions, often separate from an in-house law department, with direct reporting to the top. These functions, an important first line of defense, often have impressive arsenals: strong leadership; assorted corporate bodies like governance committees and peer review boards; and solid training programs. There are sophisticated internal controls and monitoring systems; ombudsmen, hotlines and investigation teams; and, voluminous employee manuals, policy statements and memoranda about conduct. Of course, these tools are a vital part of any company's fight against malfeasance. But do they work?

In 2007, surveying various indicia of misconduct, the Compliance and Ethics Leadership Council determined that, of 45 variables tested, the fear of speaking up is the strongest indicator of misconduct. The study found that "companies in which employees are uncomfortable speaking up or fear retaliation have significantly elevated levels of misconduct."[1] Recent related studies are equally troubling. Consider these findings from KPMG's 2008-2009 Integrity Survey:

- 74 percent of employees surveyed reported that they had personally observed or had first-hand knowledge of wrongdoing *during the previous 12 months*;[2]
- Only 57 percent of employees surveyed would feel comfortable using a hotline to report misconduct;[3] and
- Only 53 percent of employees believed they would be protected from retaliation.[4]

In light of such statistics, we need to accept as a given that conventional reporting mechanisms are not working. Indeed, the best evidence of the inadequacy of traditional compliance programs is the long list of distinguished companies that have been the subject of significant SEC enforcement actions, from "white shoe" financial services firms such as Goldman Sachs and Bear Stearns, to corporate giants like Tyco, Siemens and General Electric. Surely these organizations had vigilant compliance officers and sufficient resources to establish state-of-the-art compliance programs. However, during the relevant times, what many of these organizations and others like them have lacked was a strong ethical culture.

With a **strong ethical culture**, an organization is able to instill in its employees a sense of **stewardship** and **personal accountability** that looks beyond the next quarter's earnings.

Too many organizations ignore this fundamental area and focus their energies and resources on the latest compliance trends. With such a limited focus, we're doomed to a reactive Whack-a-Mole mentality: racing to respond to fraud only after it emerges, with no ability to prevent its occurrence. Apply this scenario to a large compliance department with oversight responsibility for tens of thousands of employees and it isn't hard to imagine how fraud escapes detection. In the end, policies and procedures may create a standard for conduct, and outline penalties for wrongdoing, but they do not adequately prevent it.

Creating a Strong Ethical Culture

Big misconduct often results from long chains of little mistakes; one breakdown in judgment cascades to another breakdown, and then another. It could be smoothing out revenue figures one financial quarter, and then creating nonexistent clients to cover up the prior misconduct the next. In time, isolated and seemingly random bad choices snowball into front-page scandals.

Former SEC Chairman Richard Breeden remarked that "it is not an adequate ethical standard to aspire to get through the day without being indicted."[5] We can take this a step further. It's not an adequate standard to have good compliance initiatives in place. We need to prevent or deter misconduct, with a better grounding in operational ethics, rendering compliance less necessary. With a strong ethical culture, an organization is able to instill in its employees a sense of stewardship and personal accountability that looks beyond the next quarter's earnings.

For some, the tricky part is determining who is responsible for creating and maintaining an ethical culture. Time after time, we have heard congressional and trial testimony of CEOs who, without apology, have shirked responsibility for misconduct in their organizations because they couldn't possibly know what their employees were doing all of the time. Similarly, many GCs and chief compliance officers believe that the realm of ethos is best reserved for parents, priests and professors. If an organization receives a Wells Notice from the SEC, will the organization be harmed and who will be held responsible? This is, intellectually and practically, a broad and shared responsibility. Oftentimes, disaster—from SEC fines and shareholder actions to public censure and reputational harm—could have been avoided if the company had operated within a culture where doing the right thing was the only standard.

A New Paradigm

Successful strategies for promoting ethical conduct involve creating a culture that maximizes an employee's ethical potential. The details will differ from company to company; some will take a more formal approach to training than others. However, at the end of the day, organizations with a strong ethical culture tend to have the following characteristics:

A Sense of Community. Ethics is a natural outgrowth of a healthy work environment where employees have a sense of belonging and are concerned about the well-being of their colleagues, customers, and the organization as a whole. Organizations can foster employee engagement in the workplace and

JORDAN A. THOMAS *is a partner at Labaton Sucharow and chairs its whistleblower representation practice.*

studies have shown that "trust" and "integrity" were key drivers of employee engagement.[6] If employees do not have this emotional or intellectual connection to their work, they are more likely to engage in unethical behavior because they are not constrained by the potential impact of their misconduct on others. To more effectively promote ethical conduct, invest more time in laying the brick and mortar of the corporate community.

A Compelling Vision. Ethical organizations are driven by a common ethical vision that is clear, understandable and viable. Employees need a set of values, with a related body of rules or Code of Ethics, which they can buy into. This vision should appeal to each employee's own sense of reason and moral judgment. It will guide employees in making day-to-day decisions and assist them in managing the conflicting interests of multiple constituencies. Successful organizations earn employees' trust by convincing them that the company's ethical vision will help them to do the right thing and, at the same time, allow them to succeed in the workplace. Since all potential problems cannot be anticipated or prevented by internal policies and procedures, an organization's ethical vision is the best compass for employees to navigate the complex and dynamic corporate landscape.

Shared Responsibility. An organization's ethical vision must apply, and be important, to everyone. Although there is no such thing as top-down ethics, leaders have the added responsibility of ensuring that their organization lives up to its ethical vision in everything it does. They must lead by example and be devoted cheerleaders of this vision, regularly and clearly communicating its principles to employees.

Empowered Employees. In order for employees to accept an organization's ethical vision, they must be trusted to make decisions consistent with the company's Code of Ethics. Leaders must allow for, and entertain, questions and challenges by employees to earn their moral trust. Studies show that ethics systems which are perceived to be just "window dressing" do no good and actually may be harmful.[7] Of course, at every juncture, encourage employees to report possible misconduct and assure them that they will not be subjected to retaliation of any kind. Make such assurances credible with meaningful follow-up with employees who report misconduct.

Integrated Values. Doing the right thing has to be embedded in an organization's DNA through a deep integration of what it says and does. This ethical vision cannot be a remote, abstract thing that sits bound and dusty on a cubicle shelf. It must be a factor as important to daily decision making as other strategic priorities set by senior leadership. Organizations should develop values-based manuals, compensation structures and performance goals that establish and reinforce these principles within the workplace. All employees need to regularly incorporate this vision into their daily activities—everything from hiring to 360 evaluations to promotions to strategic partnerships.

Accountability. Since trust is an important factor in establishing employee engagement, organizations must endeavor to be fair and consistent regarding all ethical matters. Leaders should look for innovative ways to encourage employees to report possible unethical conduct—including public recognition and financial incentives. Organizations should be prepared to investigate, in a timely manner, reports of misconduct. When legal or ethical violations are discovered, violators should be held accountable, regardless of their position in the organization and in a manner consistent with others similarly situated. Any potential benefits for employees that report possible violations should also be dispensed in an equitable fashion.

Transparency. If "sunshine is the best disinfectant," in an organization, more transparency will generate more credibility and trust. To this end, it is critical that organizations communicate more often and more effectively. Too often companies bury in the corporate vault how they dealt with reports of misconduct. This practice significantly undermines employees' confidence in their organization's commitment to ethics, leads to unnecessary whistleblower submissions, and misses a crucial opportunity to stand against and deter misconduct. A key driver of ethical conduct is the perception of what is acceptable behavior—so shaping the normative view of conduct is important to establishing a powerful and lasting ethical culture. One powerful way to establish an organization's commitment to creating an ethical culture (and to earn cooperation credit) is to self-report significant violations to the SEC and other law enforcement organizations.

Ethics Training and Support Programs. Like any other skill set, an employee's ability to make ethical decisions is enhanced with ongoing training and support programs. Beyond avoiding corporate scandals, studies have shown that ethics training can lead to a boost in workforce morale, an increased work ethic, and a higher quality product or service. Savvy organizations make long-term investments in ethics training and support programs. For well-regarded training and other practice resources, consult the Ethics Resource Center or the Ethics and Compliance Officer Association.

Commitment to Continuous Improvement. Ethical organizations continuously seek ways to improve the manner in which they do business. Leaders challenge employees and themselves by asking: What more can be done to empower employees to make good decisions? Do we encourage employees to speak up and out against wrongdoing? Do the businesses we associate with operate with the highest ethical standards? Do we hold individuals and entities accountable when unethical conduct is discovered? What more can we do to protect investors? Equally important, and often overlooked, removing obstacles to desired behaviors—by modifying internal protocols—can be more effective than developing newer and more complex policies and procedures.

Some great examples of innovative and effective initiatives that build upon these common characteristics include:

- The standards handbook and training programs of the AeroSpace Corporation;
- Employee empowerment strategies at the Ford Motor Company;
- The mandatory ethics component in annual performance appraisals at United Technology Corporation;
- The Talent Sustainability and the "Internal Audit methodology" at the Pepsi Company;
- The ethical partnership strategies at Starbucks;
- The Best Buy ethics blog that is open to employees and the public; and
- The monthly ethical surveys and Tone from the Top strategies at Xerox;

Read up on them. Mirror them. Become a model organization.

Ambivalence Has a New Price Tag

Never doubt that 10 years of financial scandals can ignite a crusade. From federal and state law enforcement to potential whistleblowers and the ordinary citizens who are disgusted by the greed and misconduct pervading the commercial marketplace, there are new and formidable armies poised and ready to root out bad behavior. Some are protesting on Wall Street and others are sitting in board rooms or working in offices down the hall. This new reality presents organizations and their leaders with a critical and urgent question: How committed are they to establishing an ethical culture?

History will show that, with respect to the whistleblower provisions of Dodd-Frank, Congress and the SEC got it right. The genius of Dodd-Frank is that it recognized that law enforcement authorities cannot effectively and efficiently police the marketplace without the assistance of private individuals and entities. Now, for the first time, individuals have significant protections to come forward and report violations of the federal securities laws. In the coming years, whistleblowers will revolutionize securities enforcement and strengthen investor confidence in our markets. It would not be farfetched to predict that many of the SEC's most significant cases will be the direct result of whistleblowers.

Sophisticated organizations will embrace this change and look for innovative ways to recognize employees for exposing unethical behavior. Since the probability of detection has dramatically increased, legal and compliance officers will now have a compelling argument for increased resources and support in establishing strong ethical cultures and state-of-the-art compliance programs. As a result, their organizations will receive tips that they would not have otherwise received. More securities violations will be detected and stopped earlier. Investors will be protected. And their organizations' invaluable reputations will be preserved.

Unsophisticated organizations will remain steadfast to a flawed status quo and treat employees who expose unethical behavior as disloyal or opportunistic, a costly mistake that will result in future SEC whistleblower submissions.

1. The Compliance and Ethics Leadership Council Identifies Leading Indicators of Misconduct at Large Organizations (Aug. 8, 2007), executiveboard.com.
2. Significantly, 46 percent of these employees reported that what they observed could cause a significant loss of public trust if discovered—with that number growing to 60 percent for employees working in the banking and financial services industries.
3. In practice, only 3 percent of reports of misconduct are made to hotline telephone numbers. Ethics Resource Center, 2009 National Business Ethics Survey.
4. Disturbingly, 15 percent of employees who observed and reported misconduct perceived retaliation as a result. Ethics Resource Center, 2009 National Business Ethics Survey.
5. "Managing for Organizational Integrity," Harvard Business Review, L.S. Paine, March-April 1994.
6. Employee Engagement: A Review of Current Research and Its Implications, John Gibbons, The Conference Board, Inc. (November 2006).
7. "Ethical Culture Building: A Modern Business Imperative," Ethics Resource Center (2009).

Reprinted with permission from the November 9, 2011 edition of the NEW YORK LAW JOURNAL © 2011 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-11-11-16

The New York Times

Once an S.E.C. Regulator, Now Thriving as a Lawyer for Whistle-Blowers

By Randall Smith

March 20, 2018

When Jordan A. Thomas left the Securities and Exchange Commission in 2011, he could have landed a job at a top law firm, likely earning $500,000 or more a year to defend corporations and Wall Street firms in government investigations.

But Mr. Thomas had another plan: He wanted to build a law practice representing whistle-blowers seeking to expose corporate wrongdoing.

“People thought I was crazy not to go into a big corporate defense practice where I could make a lot of money,” Mr. Thomas said.

Seven years later, his bet is paying off. He has built one of the top legal practices in the country representing corporate whistle-blowers. And because of a program that Mr. Thomas helped create at the S.E.C., in which whistle-blowers can receive a cut of penalties the agency imposes as a result of information they provide, the money is starting to pour into Mr. Thomas’s firm.

On Monday, the S.E.C. announced two awards totaling $83 million, with the money coming from a fund established by Congress that is financed by the fines paid by violators. Mr. Thomas said three clients of his firm, Labaton Sucharow, would collect the awards for alerting the agency to wrongdoing at Bank of America’s Merrill Lynch unit, which led to Merrill’s paying $415 million to settle the case in June 2016.

Mr. Thomas’s firm could pocket more than $25 million, with him personally reaping a significant slice of that.

The awards disclosed Monday were the largest ever paid under the S.E.C. whistle-blower program. The previous record was a $30 million payout in 2014 to a client of Mr. Thomas’s biggest rival, the law firm of Phillips & Cohen.

Michael J. Osnato Jr., who was a senior S.E.C. enforcement attorney until last year, said Mr. Thomas has been successful at finding whistle-blowers with valuable information and then “packaging that for consumption by teams at the S.E.C., making it much easier to investigate.”

Equally important, Mr. Osnato said, is Mr. Thomas’s ability to make his clients comfortable with the whistle-blowing process.

It was only last year, after seeing several cases pay out, that Mr. Thomas recouped the costs of getting his practice up and running. After a client received an $8.8 million award in a New York State tax-fraud case last April, Mr. Thomas recruited three additional partners to join him, two of them alumni of the S.E.C.

Aside from expanding his practice, Mr. Thomas has made one concession to his improved fortunes: He traded in his 16-year old Toyota Avalon for a Tesla Model S — sticker price $68,000.

Mr. Thomas, 47, doesn't have the traditional pedigree of a Wall Street lawyer.

He describes his childhood as traumatic. His parents divorced when he was young, and he grew up with his mother, a teacher, and stepfather in mobile home parks in California and Yakima, Wash. He and his stepfather battled, and at 15, Mr. Thomas became an emancipated minor.

Later, while studying at the University of California, Los Angeles, he was inspired by a performance by the Alvin Ailey American Dance Theater and transferred to Bennington College in Vermont, known for its contemporary dance program. Seeking to create some distance from his past, he changed his name to Jordan Thomas. (He declined to give his parents' names or the name on his own birth certificate.)

"He said he felt basically broken. He had a lot of wounds in his life," said Susan Sgorbati, who mentored Mr. Thomas in dance improvisation at Bennington. "I remember a lot of anger, uncertainty and restlessness in him but also real ambition." His classmates included the future Hollywood star Peter Dinklage.

Mr. Thomas went to law school and then entered the United States Navy Judge Advocate General's Corps. In 1999, he joined the Justice Department. There, he described himself as "a poor boy trying to fit in with all the Ivy League guys."

Mr. Thomas eventually migrated to the S.E.C., working in the enforcement division before helping to develop the whistle-blower program, which was created in response to criticism that the agency failed to heed warnings about Bernard Madoff's Ponzi scheme.

Mr. Thomas left the commission just before its whistle-blower office opened in 2011. He decorated his new office in downtown Manhattan with posters of movies about the legal system, including "All the President's Men," "Twelve Angry Men" and "Anatomy of a Murder."

So far, his clients have filed 57 whistle-blower submissions to the agency. Three of those submissions have generated rewards. Another 10 cases either have awards pending or are in the application process after the S.E.C. took action based on their tips. The agency is still investigating another 27 submissions of Mr. Thomas's clients.

Including the Merrill awards, the agency has paid a total of more than $262 million to whistle-blowers. Awards range from 10 percent to 30 percent of the penalty paid by wrongdoers.

Many whistle-blowers seek to remain anonymous, to avoid being blacklisted in their fields. Mr. Thomas arranged for one of his clients in the Merrill case to speak with S.E.C. investigators while using an electronic device to disguise his voice. The Merrill whistle-blowers helped the S.E.C. build a case that accused the Wall Street firm of improperly risking customer assets in order to generate trading profits from 2009 through 2012.

In a telephone interview with Mr. Thomas on the line, one of the anonymous Merrill whistle-blowers said the experience had been “lonely” and “pretty stressful.”

“The one person I could talk to was Jordan,” he said.

A version of this article appears in print on March 21, 2018, on Page B1 of the New York edition with the headline: After the S.E.C., Still Blowing Whistles, and Thriving at It

The New York Times DealB%k WITH FOUNDER ANDREW ROSS SORKIN

Wall Street's New Enforcers Aim to Muzzle Whistle-Blowers

By JORDAN THOMAS and TOM DEVINE
July 21, 2014 7:38 am

Jordan Thomas is chairman of the whistle-blower representation practice at Labaton Sucharow and was a former assistant director in the enforcement division of the Securities and Exchange Commission. Tom Devine is legal director of the Government Accountability Project and co-author of "The Corporate Whistleblower's Survival Guide: A Handbook for Committing the Truth."

Welcome to Wall Street, where the unwritten rule has always been that you don't talk about illegal or unethical activities with law enforcement or regulatory authorities. Of course, this type of code of silence is not new. What is new is that this corporate omerta is being enforced by lawyers wielding gag orders.

In the wake of the economic crisis, our country debated how to break the cycle of corporate scandals that have plagued financial markets. Our financial watchdogs landed on two simple, fundamental truths: the investor protection status quo wasn't working; and those responsible for law enforcement could not effectively and efficiently police the marketplace without help from private individuals.

Consequently, four years ago this Monday, the Dodd-Frank financial overhaul was signed into law. Among its many provisions, the statute established the Securities and Exchange Commission's whistle-blower program, which offers eligible whistle-blowers significant employment protections, monetary awards and the ability to report possible securities violations anonymously. Potential monetary awards can be substantial because the agency secures over $3 billion a year in monetary sanctions and whistle-blowers are entitled to 10 to 30 percent of the sanctions collected as a result of their tips.

Although public debate on Dodd-Frank continues, few have questioned the whistle-blower program's early success and potential to protect investors. The $8.9 billion settlement with BNP Paribas, although not reported through the S.E.C. program, is the latest example of how whistle-blowers can help law enforcement detect, investigate and prosecute corporate wrongdoing.

Mary Jo White, the S.E.C. chairwoman, said last year that the program "has rapidly become a tremendously effective force-multiplier, generating high quality tips and, in some cases, virtual blueprints laying out an entire enterprise, directing us to the heart of an alleged fraud."

As Dodd-Frank has steadily increased the probability of detection, companies have become more sophisticated and aggressive in their efforts to discourage employees from reporting possible

violations to the S.E.C. and other authorities. The legal countermeasures being deployed include a variety of employment, severance and settlement agreements that weaken both new and existing whistle-blower programs.

It was no isolated aberration that KBR, one of the nation's largest government contractors, required employees seeking to report fraud to sign internal confidentiality agreements prohibiting them from reporting violations to law enforcement authorities. Rather, it reflects a growing trend of companies trying to silence whistle-blowers, at the same time Congress strengthens their rights.

Examples include: failing to educate employees about the S.E.C. whistle-blower program and their rights, unlike other corporate, state and federal programs; preventing employees from consulting legal counsel through the use of nondisclosure agreements, effectively eliminating their ability to file anonymously in accordance with S.E.C. rules; exploiting corporate whistle-blowers' fear of retaliation and blacklisting by requiring notice of external reporting, in violation of their right under Dodd-Frank and S.E.C. rules to report anonymously; de-incentivizing tips by making employees sign agreements waiving any future monetary awards for blowing the whistle; and intimidating potential whistle-blowers with lawsuits to enforce secrecy agreements, a battle few whistle-blower have the desire and resources to fight.

To be sure, the vast majority of companies want to do the right thing. Many need guidance on lawful boundaries for standard employment agreements. Others appear to be intentionally crossing the line and using gag orders to chill external reporting. While no court has issued an opinion on the legality of these agreements in light of Dodd-Frank, many of them are clearly at odds with public policy, not justified by a legitimate corporate interest and inconsistent with principles of employment, contract and securities law. Because of the systemic nature and continuing harm, we have just filed a petition with the S.E.C. that will provide companies clear direction regarding these troubling agreements.

We are joined by a broad and growing coalition, representing more than 250 organizations and nearly two million citizens, including Americans for Financial Reform, the National Employment Lawyers Association, the International Brotherhood of Teamsters and other prominent groups. This coalition has also submitted a petition, urging the S.E.C. to hold a series of hearings around the country to discuss the problem of workplace retaliation and explore new ways to increase reporting, internally and externally. It also asks the agency to create an advisory committee on whistle-blower reporting and protection to recommend program improvements and best practices; and engage in appropriate rule-making to clarify and strengthen whistle-blower protections.

With whistle-blowers beginning to break Wall Street's code of silence, it would be a historic mistake if the S.E.C. and other authorities allowed corporations to systematically dismantle this landmark investor protection reform through private agreements and legal bullying. If their rights are protected, in the coming years, enforcement records will be broken and many of the S.E.C.'s most significant cases will come from courageous whistle-blowers. More important, whistle-blowers will become the enforcers of a new culture of integrity on Wall Street that deters future violations and restores the public's trust in our financial system.

NATIONAL EXAM PROGRAM
RISK ALERT

In this Alert:

Topic: *Examinations of investment advisers' and broker-dealers' compliance with Whistleblower Rules.*

Key Takeaways: *OCIE is including in certain examinations a review of registrants' compliance with rules impacting whistleblowers and potential whistleblowers that arose out of the Dodd-Frank Act.*

By the Office of Compliance Inspections and Examinations[1]

□□□□ME □I□I□□□E □ □□T□BE□ □□□□□□□

EX□MI□I□G □ HI□T□EB□□□ E□ □□□E □□M□□I□□□E

Staff in the Office of Compliance Inspections and Examinations (the "Staff") is examining registrants' compliance with key whistleblower provisions arising out of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Commission has brought several enforcement actions recently charging violations of Rule 21F-17 of the Commission's whistleblower regulations.[2] The Staff is examining registered investment advisers and registered broker-dealers, reviewing, among other things, compliance manuals, codes of ethics, employment agreements, and severance agreements to determine whether provisions in those documents pertaining to confidentiality of information and reporting of possible securities law violations may raise concerns under Rule 21F-17. This review is included in examinations as staff deem appropriate.

I□ B□□□G□□□□D

The Dodd-Frank Act amended the Securities Exchange Act of 1934 ("Exchange Act") by adding Section 21F, entitled "Securities Whistleblower Incentives and Protection." To implement Section 21F, among other things, the Commission adopted Rule 21F-17[3] under the Exchange Act, which provides that "no person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications." Rule 21F-17 became effective on August 12, 2011.

Recent Enforcement actions have identified certain provisions of confidentiality or other agreements required by employers as contributing to violations of Rule 21F-17 because they contained language that, by itself or under the circumstances in which the agreements were used, impeded employees and former employees from

1 The views expressed herein are those of the staff of OCIE, in coordination with other staff of the Securities and Exchange Commission ("SEC" or "Commission"), including staff of the Division of Investment Management and the Division of Enforcement. The Commission has expressed no view on the contents of this Risk Alert. This document was prepared by the SEC staff and is not legal advice.

2 *See, e.g., In the Matter of KBR, Inc.*, Release No. 34-74619 (April 1, 2015), https://www.sec.gov/litigation/admin/2015/34-74619.pdf; *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated et al*, Release No 78141, (June 23, 2016), https://www.sec.gov/litigation/admin/2016/34-78141.pdf; *In the Matter of Health Net, Inc*. Release No 78590 (Aug. 16, 2016), https://www.sec.gov/litigation/admin/2016/34-78590.pdf; *In the Matter of BlueLinx Holdings Inc.*, Release No. 78528 (Aug. 10, 2016), https://www.sec.gov/litigation/admin/2016/34-78528.pdf; *In the Matter of Anheuser-Busch*, Release No. 78957 (Sept. 28, 2016), https://www.sec.gov/litigation/admin/2016/34-78957.pdf.

3 "Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934," Release No. 34-64545, http://www.sec.gov/rules/final/2011/34-64545.pdf.

communicating with the Commission concerning possible securities law violations.[4] This potential chilling effect can be especially pronounced when such documents (*e.g.*, severance agreements) provide that an employee may forfeit all benefits if he or she violates any terms of the agreement.

Remedial actions taken in recent Enforcement actions have included:

- revising documents on a going-forward basis to make it clear that nothing contained in those documents prohibits employees or former employees from voluntarily communicating with the Commission or other authorities regarding possible violations of law or from recovering a Commission whistleblower award;[5]

- providing general notice to employees, or notice to employees who signed restrictive agreements, of their right to contact the Commission or other authorities;[6] and

- contacting former employees who signed severance agreements to inform them that the company does not prohibit them from communicating with the Commission or seeking a whistleblower award.[7]

II□ EX□MI□□TI□□□

In examinations where the Staff includes a review of registrants' compliance with Rule 21F-17, the Staff is analyzing a variety of documents, including:

- Compliance Manuals;
- Codes of Ethics;
- Employment Agreements; and
- Severance Agreements.

In this review, the Staff assesses whether these documents contain provisions similar to those in agreements that the Commission has found to violate Rule 21F-17, including provisions that: (a) purport to limit the types of information that an employee may convey to the Commission or other authorities;[8] and (b) require departing employees to waive their rights to any individual monetary recovery in connection with reporting information to the government.[9]

4 *See In the Matter of Health Net, Inc.* (respondent's severance agreements included language requiring the signatory to waive his or her right to any monetary recovery pursuant to Section 21F of the Exchange Act); *In the Matter of BlueLinx Holdings Inc.* (respondent's severance agreements included language requiring the signatory to waive his or her right to any monetary recovery related to any government investigation); *In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated et. al.* (language found in Respondent's form severance agreement limited the types of disclosures that the employees could make to the Commission or government authorities); *In the Matter of KBR, Inc.* (before interviewing employees in internal investigations into possible securities law violations, Respondent required witnesses to sign a confidentiality statement agreeing that they would not discuss the subject matter of the interview without prior approval of the Law Department); *In the Matter of Anheuser-Busch* (respondent's separation agreement contained language that impeded an employee of respondent's wholly owned subsidiary from communicating directly with Commission staff).

5 *See, e.g., In the Matter of BlueLinx Holdings Inc.*; *In the Matter of KBR, Inc.*; *see also In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated et al.*

6 *See, e.g., In the Matter of KBR, Inc.*; *see also In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated et al.*

7 *See, e.g., In the Matter of Health Net, Inc.*; *In the Matter of BlueLinx Holdings Inc.*

8 *See, e.g., In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated et al.*

9 *See, e.g., In the Matter of Health Net, Inc.*; *In the Matter of BlueLinx Holdings Inc.*

The Staff also assesses whether these documents contain other provisions that may contribute to violations of Rule 21F-17 in circumstances where their use impedes employees or former employees from communicating with the Commission, such as provisions that:

(a) require an employee to represent that he or she has not assisted in any investigation involving the registrant;

(b) prohibit any and all disclosures of confidential information, without any exception for voluntary communications with the Commission concerning possible securities laws violations;

(c) require an employee to notify and/or obtain consent from the registrant prior to disclosing confidential information, without any exception for voluntary communications with the Commission concerning possible securities laws violations; or

(d) purport to permit disclosures of confidential information only as required by law, without any exception for voluntary communications with the Commission concerning possible securities laws violations.[10]

When examining registrants' compliance with Rule 21F-17, the Staff is citing deficiencies and making referrals to the Division of Enforcement where appropriate.

III □ □□□□□□□□□

Registrants are encouraged to consider the issues identified in this Risk Alert to evaluate whether their compliance manuals, codes of ethics, employment agreements, severance agreements, and other documents contain language that may be inconsistent with Rule 21F-17.

The Staff welcomes comments and suggestions about how the Commission's examination program can better fulfill its mission to promote compliance, prevent fraud, monitor risk, and inform Commission policy. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify us at http://www.sec.gov/complaint/info_tipscomplaint.shtml.

This Risk Alert is intended to highlight for firms risks and issues that the staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some may not be applicable to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

[10] *See, e.g., In the Matter of KBR, Inc.*; *see also In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated et al.*

Labaton Sucharow

The Street, The Bull and The Crisis:

A Survey of the US & UK Financial Services Industry

Presented by
The University of Notre Dame
and Labaton Sucharow LLP

May 2015

UNIVERSITY OF NOTRE DAME
Mendoza College of Business

From the Authors

In the aftermath of the financial crisis, as we struggled to understand the key drivers of the fallout, our work—albeit in very different trenches—brought us together. As sweeping financial reforms honed in on the wounded market, we turned our focus from the industry to the individual, to better understand the character of, and on, Wall Street.

In this report, we present the findings of our collaborative study—the most detailed and expansive of its kind—to measure workplace ethics in the financial services industry. We surveyed more than 1200 professionals working in the United States and the United Kingdom. Respondents represented a broad spectrum of the industry, from young professionals to senior executives, investment bankers and investment managers, from San Francisco to Scotland.

Our findings are particularly compelling when compared to data from Labaton Sucharow's 2012 benchmark study, **Wall Street, Fleet Street and Main Street: Integrity at a Crossroads**. In the three years since that report, regulations have taken hold in both the US and UK, and authorities have successfully investigated and levied record fines against numerous global banking giants. Various indicia of market health suggest that investors' faith in the markets has somewhat returned. Against this backdrop, we wonder if that faith is rightly placed. Has the industry truly reformed or has the public grown complacent? Has enforcement deterred wrongdoing or are perpetrators finding new ways to evade the law? Are we just as, or perhaps even more, vulnerable to another financial disaster? What does the future hold?

The answers are not pretty. Despite the headline-making consequences of corporate misconduct, our survey reveals that attitudes toward corruption within the industry have not changed for the better. To be sure, there are some encouraging statistics such as increased faith in law enforcement and in colleagues. Nevertheless, there is no way to overlook the marked decline in ethics and the enormous dangers we face as a result, especially when considering the views of the most junior professionals in the business. **Most concerning, is the proliferation of secrecy policies and agreements that attempt to silence reports of wrongdoing and obstruct an individual's fundamental right to freely engage with her government**.

We hope this report will serve as a useful tool for those who wish to understand and remedy the current state of ethics within the industry. As an educator and an advocate, we each believe it is imperative to tackle the issue from all sides. Greed and corruption are not endemic to financial services nor are they critical to its success. Allowing the status quo to persist is an open invitation to the next, perhaps more devastating, financial crisis.



Ann Tenbrunsel
University of Notre Dame



Jordan Thomas
Labaton Sucharow LLP

Key Findings

State of Play: Unethical Behavior Continues to Persist

Nearly seven years after the global financial crisis rocked investors' confidence in the markets and financial services in general, our survey clearly shows that a culture of integrity has failed to take hold. Numerous individuals continue to believe that engaging in illegal or unethical activity is part and parcel of succeeding in this highly competitive field. With legal and regulatory sanctions coming out on almost a daily basis, the industry has a long way to go to regain the confidence of the public.

- 47% of respondents find it likely that their competitors have engaged in unethical or illegal activity in order to gain an edge in the market. This represents a spike from the 39% who reported as such when surveyed in 2012. **This figure jumps to 51% for individuals earning $500,000 or more per year.**

- More than one-third (34%) of those earning $500,000 or more annually have witnessed or have first hand knowledge of wrongdoing in the workplace.

- 23% of respondents believe it is likely that fellow employees have engaged in illegal or unethical activity in order to gain an edge, **nearly double the 12% that reported as such in 2012.**

- 25% would likely use non-public information to make a guaranteed $10 million if there was no chance of getting arrested for insider trading. Employees with less than 10 years' experience are more than two times as likely as those with over 20 years' experience, reporting 32% and 14% respectively.

- In the UK, 32% of individuals said they would likely engage in insider trading to earn $10 million if there was no chance of getting arrested, compared to 24% of respondents from the US.

- Nearly one in five respondents feel financial services professionals must at least sometimes engage in illegal or unethical activity to be successful.

- 27% of those surveyed disagree that the financial services industry puts the best interests of clients first. This figure rises to 38% for those earning $500,000 or more per year.

- Nearly one-third of respondents (32%) believe compensation structures or bonus plans in place at their company could incentivize employees to compromise ethics or violate the law.

- 33% of financial services professionals feel the industry hasn't changed for the better since the financial crisis.

Whistleblowing: Hope and Challenges

There is hope. The marked increase in whistleblower activity along with the strengthening of internal compliance procedures serve as a powerful deterrent to wrongdoers. Still, an alarming number of people report being subject to corporate policies and confidentiality agreements that they believe prevent them from reporting wrongdoing to outside authorities. These troubling policies and agreements can silence the reporting of *all* local, state, and federal violations. We applaud recent efforts by Congress and the SEC to address these questionable secrecy policies and agreements.

- While the majority of industry professionals (89%) would report misconduct given the incentives and protections such as those offered by the SEC whistleblower program, 37% of respondents are still not aware of the SEC's program.

- 28% of respondents earning $500,000 or more per year (16% for all employees) say their company's confidentiality policies and procedures bar the reporting of potential illegal or unethical activities directly to law enforcement or regulatory authorities. In the UK, this rises to 21% for all employees.

- 25% of respondents earning $500,000 or more annually have signed or been asked to sign a confidentiality agreement that would prohibit reporting illegal or unethical activities to the authorities.

- 19% of respondents find it likely that their employer would retaliate if they were to report wrongdoing in the workplace. This jumps to 24% for respondents from the UK.

The Professional in Crisis

We uncovered some of our most astounding results when we examined the ethos of the financial services professional, and the key influencers of bad behavior. Despite three years of significant reforms and high-profile prosecutions since Labaton Sucharow's 2012 survey, this year, many figures are unchanged and many more have changed for the worse. Our evidence reveals a large number of individuals in the midst of–and losing–an ethical battle of the highest order.

When looking at their own companies, 23% of all respondents believe it is likely that fellow employees have engaged in illegal or unethical activity in order to gain an advantage over competitors or others at the company, **nearly double the 12% that reported as such in 2012**.

- This rises to 28% for respondents in the UK, *a full 6 points higher than the US*.

- With no small amount of dismay, we note that individuals with the fewest years in the industry have the least confidence in their colleagues' ethical conduct. Nearly one out of every four respondents with less than 10 years, compared to one out of five respondents with more than 21 years, indicate that they believe it is likely that colleagues have made ethical or illegal compromises in order to get ahead.

What would you do if no one was watching? This year, we again ask individuals how likely they would be to utilize nonpublic information to make a quick $10 million if there was no chance of being arrested for insider trading. **Consistent with prior years**, 25% admit they would likely do so.

- We are particularly dismayed by the ethical standards of the most junior employees in the industry. Looking at the total sample, 32% of employees with less than a decade in the financial services industry said they would likely engage in insider trading to make $10 million if there was no chance of being arrested. This compares to 14% of employees with more than 21 years in the industry.

- Respondents from the UK are either more willing to commit a crime they could get away with, or are more frank about it. A full 32% of individuals from the UK say they would likely engage in insider trading to make $10 million if there was no chance of being arrested, compared to 24% of respondents from the US.

- Testing the total sample, there is a 5-point spread, with 27% of males saying they would likely engage in insider trading to make $10 million if there was no chance of being arrested, against 22% of females. In the UK, the gender spread is even more remarkable; 34% of male respondents say they would engage in this insider trading scenario, compared to 23% of females.

Nearly one third of employees with less than two decades in the industry say they would likely engage in insider trading to make $10 million if there was no chance of being arrested. That's more than two times the figure for employees with more than two decades in the financial services sector.

With the effects of the financial crisis still in our midst, it is shocking that nearly one-third of those surveyed (32%) believe there are compensation structures/bonus plans at their company that could incentivize employees to compromise ethical standards or violate the law.

Not surprisingly, when we ask a more pointed question—*have you ever felt pressure at your company to compromise ethical standards or violate the law*—only 10% of all respondents admit to feeling such pressure.

- There is a 6-point spread based on geography, with 14% of respondents from the UK affirming such pressure, compared to 8% of their US counterparts.

- Most disconcerting is the evidence that individuals at the top face more ethical dilemmas. 23% of those earning $500,000 or more per year report experiencing pressure to compromise, compared with 9% of those earning less than $50,000 year.

The sliver of good news is a modest decline in the witnessing of misconduct: 22% of respondents have personally observed or have first-hand knowledge of wrongdoing in the workplace, down from 26% in 2012.

- Our data indicates a correlation between income level and the likelihood of witnessing misconduct. More than one-third (34%) of those earning $500,000 or more annually have witnessed or have first-hand knowledge of wrongdoing in the workplace, compared to 21% of those earning less than $50,000 per annum.

- Years in the industry factors similarly into the calculus. 29% of individuals with more than 21 years in the industry say they have witnessed or have first-hand knowledge of wrongdoing, compared to 18% of those with less than a decade in the business.

- While the number of individuals who say they have observed or have first-hand knowledge of wrongdoing in the workplace did not change for US respondents since our prior survey, individuals in the UK reveal a decline—dropping to 25% this year from 30% in 2012.

A change coming? In April 2015, the SEC announced a landmark enforcement action against KBR, Inc., a Texas-based technology and engineering firm, for using restrictive language in confidentiality agreements that could stifle whistleblowers.

An Industry on the Edge

We recognize that respondents may sometimes be unwilling to reckon with and divulge personal truths–especially negative ones–and it is probable that respondents' views about their own companies are understated. Therefore, we believe respondents' views of their competitors may represent the most accurate snapshot of industry reality. So we are alarmed to report that nearly half (47%) of all respondents find it likely that their competitors have engaged in illegal or unethical activity in order to gain an edge in the market. This represents a spike from 39% in 2012. This figure jumps to 51% for individuals earning $500,000 or more per year.

Customer focused? With trillions of dollars in customer assets under management, 27% of those surveyed disagree that the financial services industry puts the best interests of clients first.

- This figure rises to 38% for those earning $500,000 or more per year.
- Remarkably, in the UK, professionals with fewer than 10 years in the industry are the least confident in a client-first culture. Indeed, 42% disagree that clients come first in the industry.

Despite numerous reform efforts and severe fines levied against industry Goliaths, one-third of those surveyed do not believe the financial services industry has changed for the better since the financial crisis.

- We detect a significant variation based on gender. Across the total sample, 35% of males, compared to 28% of females, do not feel the industry has changed for the better.
- Across the sample, we find the highest degree of skepticism among high wage earners, with 38% of those making $500,000 or more per year feeling the industry has not changed for the better.

To what extent, in the current environment, do industry professionals have to engage in illegal or unethical activity in order to be successful? Nearly one in five respondents—19%—feel misconduct is part of the recipe for success, nearly double the 11% who remarked as such in 2012.

33% of financial services professionals do not feel the industry has changed for the better since the financial crisis and 27% disagree that the financial services industry puts the interests of clients first.

The Employers, The Enforcers: Are Safeguards Working?

Given the tremendous responsibility shouldered by the financial services professional, employers *should* take every step to foster a culture of integrity. To the contrary, our findings reveal an alarming tendency on the part of industry employers to construct an 'omerta culture,' characterized by policies that demand silence and complicity. Even more egregious, is the growing preponderance of explicit, and often targeted, confidentiality agreements crafted in large part to deter specific employees from reporting wrongdoing to the appropriate authorities.

One in 10 respondents has signed or been asked to sign a confidentiality agreement that would prohibit reporting illegal or unethical activities to the authorities.

- This figure surges to 25% for those respondents earning $500,000 or more annually.

- Surprisingly, more junior employees report being issued these gag orders than the most senior statesmen, with 13% of those with fewer than 10 years in the industry, compared to 7% of those with more than 21 years.

- Respondents from the UK note a higher exposure to gag orders, at 14%, a full five points higher than US respondents.

As troubling as formal agreements that silence employee reporting is the cultivation of a culture where policies and procedures enforce the same code of silence.

- 16% of those surveyed report their company's confidentiality policies and procedures prohibit the reporting of potential illegal or unethical activities directly to law enforcement or regulatory authorities.

- In the UK, this figure surges to 21%, a full six points higher than US respondents.

- 28% of respondents earning $500,000 or more per year say their company's confidentiality policies and procedures bar the reporting of potential illegal or unethical activities directly to law enforcement or regulatory authorities.

What is the 'tone from the top'? We ask if respondents believe company leaders would ignore suspicions that a top performer was earning large profits from insider trading. A disheartening 15% feel it is likely that leaders would look the other way.

- This rises to 21% for respondents earning $500,000 or more per year.

- Respondents from the UK have slightly less faith in company leaders, with 18% believing it is likely that leaders would ignore a profitable problem.

Taking the examination a step deeper, we ask respondents a slightly different question: If company leaders learned a top performer had engaged in insider trading, how likely or unlikely is it that leadership would report the matter to the law enforcement or regulatory authorities?

- An astonishing 17% of all respondents find it unlikely that company leaders would report misconduct to law enforcement.

- Respondents with more years in the industry have more confidence in the brass; 13% feel that leaders would be unlikely to report the misconduct, as compared to 19% of those with fewer than 10 years in the industry.

- This question stands as one of a few with a notable gender disparity; 20% of females find it unlikely that company leaders would report the crime, against 16% of males.

Employers simply cannot stand in the way of an individual's unwaivable right to report possible violations of law to the government.

Given the proportion of respondents who feel that leaders are inclined to 'look the other way' when a top performer engages in wrongdoing, how might leaders handle those who report misconduct?

- 19% find it likely that their employer would retaliate if they were to report wrongdoing in the workplace.
- This figure jumps to 24% of respondents from the UK.
- Tenure appears to factor into fear of retaliation with 21% of respondents working less than 10 years fearing retaliation as opposed to only 13% of respondents with over 20 years in the industry.

One in five females in the financial services industry doubt that company leaders would report a top performer's insider trading to the authorities.

Despite the role of corporate malfeasance in bringing on the financial crisis, our survey suggests that more corporate reform is necessary. Against the backdrop of a culture that effectively ignores–and perhaps even encourages–misconduct, enforcement may be the only way to create meaningful change and safeguard against another crisis.

- 39% of respondents think law enforcement and regulatory authorities in their country are ineffective in detecting, investigating and prosecuting securities violations.
- This rises to 46% for professionals earning $500,000 or more per year.
- We note a 5-point spread when looking at gender, with 41% of males finding the authorities to be ineffective, compared to 36% of females.

With perception of authorities' efficacy in the balance, we ask if respondents would report misconduct in their workplace if they could do so anonymously, with protection from retaliation, and if they had the potential to receive a monetary award.

Affirming the core components of the SEC whistleblower program—anonymity, employment protections and the potential for a monetary award—89% of industry professionals say they would report misconduct, a figure that has remained consistent since the 2012 survey of the industry.

- Respondents in the US are more inclined to report misconduct with these protections and incentives at 90% versus 83% of those in the UK.

Some of the doubt regarding the government's ability to affect change may be the result of limited knowledge of the SEC whistleblower program and its successes. Astonishingly, while the lion's share of industry professionals would report misconduct given the incentives and protections such as those offered by the SEC whistleblower program, 37% of respondents are still unaware of the agency's program.

- This is a significant improvement over the 2012 survey, when 56% of the sample was unfamiliar with the program. However, more industry and public worldwide education is warranted. Any investment in this area is likely to yield a substantial increase in high-quality tips and assistance.
- While there is greater awareness among US respondents–63% are aware of the SEC program, against 56% of UK professionals—due to the significant law enforcement potential of the program, the SEC should attempt to raise awareness through a more sophisticated and robust education campaign.

Conclusion

In examining our results, we return to the same question: Are we destined for another financial crisis? Given the troubling attitudes toward corruption in the financial services industry, we fear that the industry has not learned its lesson. Our concerns are further exacerbated by new evidence of employers actively seeking to suppress employee truth-telling through the widespread use of restrictive, and often illegal, confidentiality agreements.

Without an aggressive plan to stamp out misconduct, we are simply sitting and waiting for another financial disaster to strike. We needn't be so powerless. We can formulate and initiate such a recovery plan, but it must start with an implicit partnership between employees and employers to speak up about possible wrongdoing in the workplace.

The SEC Whistleblower Program is a powerful investor protection tool that is quietly revolutionizing the way securities laws are enforced. However, this tool cannot be fully utilized without empowered individuals. Both the government and corporate leadership must educate employees of their right *and their responsibility* to report misconduct, internally or externally, whenever and wherever it occurs.

We also must encourage an honest dialogue among the industry's most junior employees who are demonstrating a surprising and disturbing cynicism regarding corporate ethics. Educating a generation of young professionals—early and often—on the importance of ethics, transparency and honesty is crucial if we wish to affect real change in the industry and avert another, perhaps more destructive, financial crisis.

"SEC rules prohibit employers from taking measures through confidentiality, employment, severance, or other type of agreements that may silence potential whistleblowers before they can reach out to the SEC. We will vigorously enforce this provision."

Andrew J. Ceresney, Director of the SEC's Division of Enforcement

Methodology

This report presents the findings of 1223 participants who were surveyed using an email-based online panel. Respondents were employed in the financial services/banking industry in the US (925) and UK (298), worked more than 35 hours per week, were employed at firms with 10 employees or more and were employed as account executives, financial/investment/wealth advisors, financial analysts, investment bankers, branch/operations management, and portfolio managers. This survey was conducted December 22, 2014 – January 23, 2015.

In this report, we occasionally make comparisons with figures in the 2012 survey. In those cases, we have made the appropriate adjustments for differences in question structure, including a varying number of answer options.

The majority of UK respondents were from England, but the survey included professionals from Northern Ireland, Scotland and Wales. Within the US, respondents were generally well distributed among the four census bureau divisions of Northeast, Midwest, South, and West.

Greed and corruption are not endemic to the financial services industry, nor are they critical to its success.

About Us

The **University of Notre Dame** provides a distinctive voice in higher education that is at once rigorously intellectual, unapologetically moral in orientation, and firmly embracing of a service ethos. Founded in 1842 by a priest of the Congregation of Holy Cross, Notre Dame is an independent, national Catholic research university located adjacent to the city of South Bend, Indiana. The University is home to **The Mendoza College of Business**, which, as evident by its motto "Ask More of Business," fosters academic excellence, professional effectiveness and personal accountability in a context that strives to be faithful to the ideals of community, human development and individual integrity.

For more than 50 years, **Labaton Sucharow** has been one of the country's premier law firms comprehensively representing businesses, institutional investors and consumers in complex securities and business litigation. It was the first law firm in the country to establish a practice exclusively focused on protecting and advocating for whistleblowers who report possible securities violations to the SEC. The Whistleblower Representation Practice leverages a world-class in-house team of investigators, financial analysts and forensic accountants with federal and state law enforcement experience to provide unparalleled representation for whistleblowers. Labaton Sucharow is consistently among the top plaintiff litigation firms based upon its rankings in *Chambers & Partners*, *The Legal 500*, *The National Law Journal's Plaintiffs' Hot List* and *Benchmark Litigation*. More information about the firm and its Whistleblower Representation Practice is available at **www.labaton.com.**

140 Broadway
New York, NY 10005
jthomas@labaton.com
T: (212) 907-0836
C: (202) 746-9314

Column: How Wall Street creates criminals

USA Today: By Lynn Stout and Jordan Thomas

It is time to admit that Wall Street has lost its moral compass. Each day brings a new story of banks misleading clients, hedge funds' insider trading or investment banks manipulating prices. In one breathtakingly brazen scandal, Barclays and many of the largest banks in the U.S. and the U.K.— including Bank of America, Citigroup, HSBC, JPMorgan Chase and Royal Bank of Scotland— are being investigated for possibly rigging the Libor interbank lending interest rate that determines the interest charged on countless credit cards and bank loans.

The tsunami of scandals cannot be explained away as the work of a few "bad apples." Our financial services industry is in ethical crisis. To assess the depth of the problem, Labaton Sucharow, a law firm where one of us works, commissioned an anonymous survey of 500 financial services professionals in the United States and United Kingdom. The results are alarming.

More than a quarter of respondents reported they had personally observed or had firsthand knowledge of wrongdoing in the workplace. (Given the human tendency to underreport bad behavior, the true figure is likely higher.) Nearly 40% believed their competitors had engaged in illegal or unethical behavior; 24% thought you have to break rules to be successful. An astonishing 16% admitted that they'd engage in illegal insider trading if they would not be caught.

Waiting for a chance

When 16% of people working in financial services readily admit they would commit a crime if they could get away with it, alarm bells should be going off at the Securities and Exchange Commission and other financial regulators. True, Wall Street might attract more than its share of Gordon Gekko-like criminal personalities. But behavioral science suggests more is at work. The financial services industry has become a "criminogenic"environment that tempts otherwise ethical, conscientious people into criminal conduct they would never indulge in outside the workplace. Consider the tragic case of Rajat Gupta, a Goldman Sachs director and noted philanthropist who seemed a pillar of the community until he was recently convicted of insider trading.

How does the financial service industry transform otherwise ethical individuals into criminals? The modern infatuation with "incentives" has played a role — 30% of survey respondents reported that their bonus or compensation plans created pressure to engage in unethical or illegal behavior. (The dirty underbelly of pay for performance, rarely acknowledged by economists or compensation experts, is that it is almost impossible to design a compensation metric that can't be met through illegal behavior.)

Why stay silent?

But a more disturbing part of the story lies in the question of why financial services professionals who observe illegal behavior and don't stand to personally profit from it nevertheless remain silent. Like bank robberies, corporate scandals are rarely one-man jobs, and there are almost always witnesses. It is highly unlikely that more than $1 billion of client funds could disappear at MF Global, or that Libor could be manipulated by Barclays, without many people knowing about it. If more than a quarter of the individuals in the financial industry have firsthand knowledge of illegal or unethical activity, as the survey found, why aren't they reporting this? Where are the whistle-blowers?

Answering this question could be essential to figuring out how to cure the ethical rot that's eating away at many financial services firms. Even in the best of environments, some people will engage in misconduct when the opportunity for personal gain becomes too great to resist. But when a substantial percentage of financial services professionals tolerates misconduct by others, that speaks to a deeper problem. In the language of social science, the financial world is a "social context" that tolerates and encourages illegal or unethical behavior. In lay terms, the problem is Wall Street's culture.

Culture — the mélange of social signals we receive about what our superiors expect, what our peers are doing and how our acts harm or help others in our "in-group" — can be hard to change. But though changing culture is hard, it's by no means impossible. Obvious first steps include giving the SEC and other regulators greater resources; making sure that whistle-blowers are rewarded and protected from retaliation, and that potential whistle-blowers are aware of those rewards and protection; and examining pay-for-performance plans with a skeptical eye to make sure they aren't really pay-for-misconduct schemes.

But as we recently passed the second anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, it's time to recognize that regulation won't work alone. The first step the financial services industry needs to take toward recovery is to admit it has a corporate ethics problem. Otherwise, we should brace ourselves for the next scandal.

CONFIDENTIALITY AGREEMENTS IN FINRA ARBITRATION – DO BROKER-DEALERS' DOCUMENTS WARRANT CONFIDENTIAL TREATMENT?

Jeffrey B. Kaplan, Esq.

Introduction

In virtually every FINRA arbitration proceeding involving a customer dispute, broker-dealers object to producing certain documents based on assertions that the documents are confidential, contain trade secrets, or would violate non-party individual's privacy rights. When raising those objections, respondents often refuse to produce documents unless and until claimants enter into onerous confidentiality agreements. In doing so, broker-dealers incorrectly presuppose that their business records (which were not created for use in any particular arbitration proceeding, and therefore, are not privileged work product) are confidential. They ignore FINRA's edict and long-standing legal authority that documents produced in discovery, including internal business records, generally are not afforded confidential treatment unless the producing party meets its burden of demonstrating that documents contain trade secrets or protected personal information. Broker-dealers generally cannot make such a showing, however.

In attempting to impose confidentiality over documents they produce, broker-dealers seek to shroud cases in secrecy. But the purpose of arbitration, like all legal and equitable proceedings, is to seek and determine the truth. The law is clear that counsel have the right to compare documents among cases they are handling and to compare discovery they receive with other attorneys prosecuting similar cases. Such collaboration improves the truth-seeking process and keeps broker-dealer respondents honest, so to speak, because they will be forced to be consistent in the documents that they produce to different counsel regarding the same type of case. In contrast, broker-dealers' confidentiality demands hinders the truth-seeking process and is contrary to the law.

The real reason that broker-dealers seek confidentiality likely is so lawyers handling similar cases against the broker-dealer cannot assist each other. While it is understandable that broker-dealers would hope to force each claimant to prosecute their claims in the dark, the law does not support and actually prohibits broker-dealers' desire for such a tactical advantage. Arbitration panels should put a stop to broker-dealers' obstructive conduct and order broker-dealers to produce documents without a confidentiality agreement unless the broker-dealers can meet the high burden of demonstrating that confidentiality is warranted.

Courts Disfavor Confidentiality

Confidentiality agreements demanded by parties as part of discovery are disfavored, such that only a very limited type of documents warrant confidential treatment.[1] "[L]itigants and their lawyers have a First Amendment interest in disseminating information procured through discovery."[2] If Respondents, or for that matter any other corporate defendant, were to appear in court and ask for confidentiality protection as to documents that are not legitimately "trade secrets," their request would be summarily denied, except perhaps for truly private material (*e.g*.

[1] *See Koster v. Chase Manhattan Bank*, 93 F.R.D. 471, 475 (S.D.N.Y. 1982).

[2] *Koster*, 93 F.R.D. at 475.

like Social Security numbers).[3] At least one court even noted that it "knows of no rule or principle which generally restricts the use of discovery to the case in which it is provided."[4]

The United States Supreme Court declared in *U.S. v. Nixon*, "The very integrity of the judicial system and public confidence in the system depend on full disclosure of all the facts, within the framework of the rules of evidence. . . . '[T]he public ... has a right to every man's evidence,' except for those persons protected by a constitutional, common-law, or statutory privilege.'"[5] It reiterated the principle in *Jaffee v. Redmond*, stating "For more than three centuries it has now been recognized as a fundamental maxim that the public ... has a right to every man's evidence. When we come to examine the various claims of exemption, we start with the primary assumption that there is a general duty to give what testimony one is capable of giving, and that any exemptions which may exist are distinctly exceptional, being so many derogations from a positive general rule."[6]

Courts have recognized that there are only limited circumstances in which a party should be required to maintain the confidentiality of documents produced in discovery. Some courts have held that confidentiality only can be imposed after a "close scrutiny of its impact on protected First Amendment expression."[7] Other courts follow a more liberal "good cause" standard.[8]

The Party Seeking Confidentiality Must Prove Confidentiality is Warranted

Even under the liberal "good cause" standard, the party seeking confidentiality must show that a "clearly defined and very serious injury" would result if confidentiality is not required.[9] The party also must provide the tribunal with "information from which it can reasonably conclude that the nature and magnitude of the moving party's interests are such that a protective intervention . . . is justified."[10] The Panel then must consider "whether [confidentiality] will prevent threatened harm, whether there are less restrictive means to preventing the threatened harm, the interests of the party opposing the motion, and the interests of the public."[11]

Many broker-dealers do not even attempt to demonstrate, nor can they demonstrate, that documents deserve confidential treatment. Indeed, it is rare that a broker-respondent's documents contain trade secrets and broker-dealers are generally free to redact private personal information of non-party customers, such as the customers' names, Social Security numbers, and all but the last four digits of account numbers.

---

[3]*Dahdal v. Thorn Americas, Inc.*, No. 97–2119, 1997 WL 599614 *1 (D. Kan. Sep. 15, 1997).

[4]*Dahdal,* 1997 WL at *1.

[5]418 U.S. at 709, 94 S.Ct. at 3108.

[6]*Jaffee v. Redmond*, 518 U.S. 1, 9, 116 S.Ct. 1923, 1928 (1996).

[7]*In re Halkin*, 598 F.2d 176, 183 (D.C. Cir 1979).

[8]*Koster* at 478.

[9]*Id.* at 479.

[10]*Id.*

[11]*Id*.

Broker-dealers appear to recognize that they cannot meet their burden to demonstrate that documents warrant confidentiality. As a result, they routinely propose confidentiality agreements that have terms that would shift the burden to claimants to prove that documents are not confidential. But because of the mountain of authority holding that parties seeking confidentiality must demonstrate the need for confidentiality, claimants have little pressure to agree to broker-dealers' attempt to shift the burden to claimants.

The *Dahdal* court addressed whether business records are confidential. The defendants, like many broker-dealers, sought to restrict the disclosure of certain business manuals, arguing that its manuals contained proprietary and confidential business information. The court noted that while certain business documents may be confidential, a conclusory statement that documents deserve special protection does not suffice.[12] The court went on to hold that, "[b]usiness documents as a category do not qualify as intrinsically confidential and personal."[13] The *Dahdal* court set forth the standard that, "[t]he party seeking a protective order has the burden to show good cause for it."[14]

FINRA also recognizes this standard. The FINRA Discovery Guide states that, "[t]he party asserting confidentiality has the burden of establishing that the documents in question require confidential treatment."[15] Broker-dealers' frequent effort to place the burden on the party receiving documents turns the law and FINRA's edict on its head. There is no compelling reason for claimants to bear a burden that FINRA and courts throughout this country have deemed is to be borne by broker-dealers.

Demonstrating a Need for Confidentiality is a Steep Burden

To meet its burden, a broker-dealer must submit "a particular and specific demonstration of fact, as distinguished from stereotyped and conclusory statements" that documents deserve confidential treatment.[16] To limit the dissemination of items and information received in discovery, the movant must show "that disclosure of the information will result in a 'clearly defined and very serious injury.'"[17]

After articulating the applicable standard, the *Dahdal* court denied the requested protective order. The court concluded that the defendant did not meet its burden of showing "good cause" for keeping the documents secret and did not present adequate evidence that disclosure would result in "a clearly defined and serious injury."[18]

---

[12]*Dahdal* at *2.

[13]*Id.* (Emphasis added.)

[14]*Id.* (Emphasis added.)

[15]Discovery Guide at p. 4.

[16]*Id.* at *1.

[17]*Dahdal* at *1. (citing *Zapata v. IBP, Inc.*, 160 F.R.D. 625, 627 (D. Kan. 1995) (quoting *Koster v. Chase Manhattan Bank*, 93 F.R.D. 471, 480 (S.D.N.Y. 1982).

[18]*Dahdal* at *2.

Through its Discovery Guide, FINRA also recognizes the narrow circumstances under which a party could meet its burden that their documents warrant confidential treatment. Specifically, the Discovery Guide states that arbitrators should consider factors such as:

> 1. Whether the disclosure would constitute an unwarranted invasion of personal privacy (*e.g.*, an individual's Social Security number, or medical information).
>
> 2. Whether there is a threat of harm attendant to disclosure of the information.
>
> 3. Whether the information contains proprietary confidential business plans and procedures or trade secrets.
>
> . . .
>
> 5. Whether an excessively broad confidentiality order could be against the public interest or could otherwise impede the interests of justice.
>
> 6. Whether there are legal or ethical issues which might be raised by excessive restrictions on the parties.[19]

Most documents that broker-dealers produce in typical customer disputes do not come close to meeting the above-articulated standard. For example, broker-dealers' compliance and supervisory manuals and other business records do not even come close to meeting the definition of a trade secret. Nor do they fall within any of the other categories itemized in the Discovery Guide.

If broker-dealers have legitimate reasons for confidentiality, *i.e.*, trade secrets, they should be required to make such arguments for panels' consideration. But if the motivation for confidentiality is simply to keep counsel from using documents against that broker-dealer in other cases (without a legitimate accompanying basis for confidentiality), then panels should summarily deny such requests for confidentiality.

Demonstrating a Trade Secret is a Strict Standard

Consistent with the above discussed authority, many documents that broker-dealers produce do not involve trade secrets that warrant confidential treatment.

The *Uniform Trade Secrets Act* (the "Act") defines a trade secret as:

> . . . information, including a formula, pattern, compilation, program, device, method, technique, or process, that:
>
> (i) derives *independent economic value*, actual or potential, from not being generally known to, and *not being readily ascertainable by proper means* by, other persons who can obtain economic value from its disclosure or use, and

[19]Discovery Guide at p. 4.

(ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[20]

Regulatory rules require brokerage firms to maintain supervisory and compliance systems governing numerous specified issues. As such, broker-dealers cannot demonstrate any independent economic value to their internal documents that are mandated by securities regulators.[21]

Moreover, broker-dealers' manuals and other internal supervisory and compliance documents often are in the public domain already and readily ascertainable by proper means. The court in *Miller v. Smith Barney Harris Upham*, No. 84-4307, 1986 WL 2762, (S.D.N.Y. Feb. 27, 1986) determined that brokerage compliance manuals are not confidential. In reaching that conclusion, the court noted that the manuals had been produced in prior litigation matters. Not surprisingly, the Discovery Guide states that when reviewing a party's request that documents be kept confidential, arbitrators should consider, "[w]hether the information has previously been published or produced without confidentiality or is already in the public domain.

The *Miller* court reasoned that it was "hard-pressed to see how compliance manuals, previously disclosed in other litigations, can be considered confidential."[22] The court also stated that the SEC, NASD n/k/a FINRA and New York Stock Exchange require brokerage firms to develop and maintain compliance manuals and that such manuals are routinely inspected by those regulatory bodies. The court stated that given "these external requirements to compile and make available internal regulations*"* the documents cannot be regarded as confidential or privileged.[23]

Notwithstanding the foregoing, in virtually every customer dispute broker-dealers argue that their compliance and supervisory manuals (and even the tables of contents to the manuals) are confidential. Such arguments do not hold water, however.

Documents Produced to Regulators Are Not Confidential

In many customer disputes, claimants seek the production of documents that a broker-dealer has produced to a securities regulator as part of the regulator's investigation into the broker-dealer's or an associated person's conduct. Broker-dealers routinely argue that such documents are protected by an "SEC privilege," a "FINRA privilege," or a "regulatory privilege." In other words, broker-dealers have argued that such documents are shrouded in confidentiality by virtue of the fact that the documents have been provided to a regulator. This simply is not true.

While regulators, including FINRA and the SEC may protect their own investigative files from disclosure, the fact that a broker-dealer has provided documents to a regulator does not cast a cloak of confidentiality over those otherwise non-confidential documents.[24]

---

[20]Uniform Trade Secrets Act, Section 1 (4). (Emphasis added.)

[21]*See* SEC Rule 17a.

[22]*Miller,* 1986 WL 2762 at *6.

[23]*Id.*

[24]*See Mallinckrodt Chemical Works v. Goldman, Sachs & Co*., 58 F.R.D. 348, 351-52 (S.D.N.Y. 1973) (citing *Zients v. LaMorte*, 319 F. Supp. 956 (S.D.N.Y. 1970) (where defendant claimed SEC regulations

Counsel Have the Right to Share Discovery Materials

In raising many confidentiality objections, broker-dealers do not seek to preserve trade secrets that would put them at a competitive disadvantage within the industry, nor do they seek to protect any individual's privacy. Rather, they seek confidentiality to improperly prevent various claimant counsel from "comparing notes" to determine if documents produced are complete and contain all relevant information. But that simply is not a recognized basis for imposing confidentiality. The fact is that when a broker-dealer has wronged numerous investors in the same way, multiple claimant lawyers naturally will work together to benefit their respective clients. But absent a clearly articulated trade secret or other compelling and recognized exception, broker-dealers should not be permitted to prevent that from happening by imposing an improper confidentiality agreement on each claimant lawyer.

As the court stated in *Garcia v. Peeples*, "[s]hared discovery is an effective means to ensure full and fair disclosure."[25] The *Garcia* court explained that, "[p]arties subject to a number of suits concerning the same subject matter are forced to be consistent in their responses by the knowledge that their opponents can compare those responses."[26] Broker-dealers often attempt to avoid any checks and balances that would require them to be consistent with their document production among cases. But, again, that is not a recognized basis for confidentiality.

Broker-dealers' proposed confidentiality agreements that prohibit the sharing of information would permit broker-dealers to improperly engage in inconsistent document production among cases and among various claimants counsel. By way of example, in one product-failure case, the broker-dealer was not consistent in its production of documents from case to case. It produced different supervisory and compliance materials in different cases notwithstanding that the cases all involved the same alleged wrongdoing, the same securities, and the same time period. That inconsistent document production only came to light by comparing documents among counsel and among cases. But for the ability to compare discovery, which is supported by courts throughout the country, the broker-dealer would have been successful in its attempt to "hide the ball."

It is this type of discovery gamesmanship and inconsistent document production that some broker-dealers seek to preserve through their draconian proposed confidentiality agreements. Absent a compelling reason for confidentiality, such agreements would prevent the type of document comparison from taking place that prevents inconsistent document production. With their proposed confidentiality agreements in place, broker-dealers would be able to obscure relevant documents in various cases. That is, broker-dealers would be able to impose restrictions on claimants and counsel that are contrary to the law and that would hinder this truth-seeking process. Panels should not permit such conduct.

---

prohibited disclosure, district court concluded it was the SEC's privilege, not defendant's).

[25] *Garcia v. Peeples*, 734 S.W.2d, 343, 347 (Texas 1987).

[26] *Id.*

Discovery in Arbitration is Not Confidential

Many broker-dealers have argued that arbitration is private and, therefore, documents produced in arbitration automatically are deemed confidential. There is no support for that position. Indeed, if what broker-dealers claim were supported by the law, then there would not be any need for a confidentiality agreement.

Broker-dealers often confuse and conflate the issues of the *privacy* of the arbitration process and the *confidentiality*, or lack thereof, of documents produced in arbitration. Arbitration does provide certain aspects of privacy. Pleadings are not filed in the public domain and the general public cannot attend an arbitration hearing.[27] But there is no rule of law or FINRA rule that prohibits parties to an arbitration from publishing or disseminating to others information gained or learned in a proceeding. While the public generally cannot pry into an arbitration proceeding, a party to an arbitration proceeding can unilaterally publish such information or disseminate it in any way they choose.

FINRA has directly provided guidance to arbitrators on this issue. Specifically, in its April 2004 *Neutral Corner* publication titled "Arbitrators and Orders of Confidentiality," the NASD n/k/a FINRA addressed this issue. The NASD stated, in pertinent part

> 'Arbitrators must consider all aspects of an arbitration to be confidential.' This is the instruction given to arbitrators in The Arbitrator's Manual . . . While the statement is certainly true, it is important that arbitrators not misinterpret its intended meaning. Its purpose is to encourage arbitrators to respect the privacy of the parties before whom they serve, being careful not to casually divulge information obtained during the course of the proceeding. . . . The instruction is designed to remind arbitrators of their ethical responsibility not to personally disclose the details of arbitration proceedings.
>
> There have been instances, however, where arbitrators have misinterpreted the above instruction and have ordered that all matters pertaining to the dispute be kept confidential by everyone involved - including the parties. While blanket orders of confidentiality in arbitration might be acceptable if all parties agree, they should be the exception, not the rule. The NASD staff, and the arbitrators on its Roster, are ethically obligated to keep confidential information obtained in an arbitration. However, ***parties are generally free to disclose details of their own proceeding as they see fit***.[28]

[27]But even the privacy of arbitration is limited. Arbitration awards, motions to vacate, motions to confirm, and orders regarding the same are publicly available and often disclose significant details about the particular arbitration proceeding.

[28]April 2004 Neutral Corner. (Emphasis added.).

The NASD went on to say that, "confidentiality orders should not be granted without a serious and case-by-case consideration of the issues," and that "[a]rbitrators should not routinely designate all discovery as confidential. Where confidentiality is appropriate, bear in mind that it should generally be accomplished in the least restrictive manner."[29]

In short, FINRA long has recognized that confidentiality is the exception, not the rule. FINRA also recognizes that the fact that arbitration is a private forum does not make all documents produced in the forum confidential.

Two other prominent arbitration forums and also provide guidance on the issue. The American Arbitration Association ("AAA"), one of the preeminent arbitration forums in world, has published its *Statement of Ethical Principles for the American Arbitration Association*, which state, in pertinent part:

> **Confidentiality**
>
> An Arbitration proceeding is a private process. . . . staff and its neutrals have an ethical obligation to keep information confidential. However, the AAA takes no position on whether parties should or should not agree to keep the proceeding and award confidential between themselves. ***The parties always have a right to disclose details of the proceeding, unless they have a separate confidentiality agreement*.**[30]

Similarly, the Administrative Dispute Resolution Act of 1996 (the "ADR Act"), which applies to all federal administrative agencies, also addresses the issue. The section that governs the confidentiality of arbitration proceedings held under the ADR Act states, in pertinent part:

> **§ 574. Confidentiality**
>
> **(f) Nothing in this section shall prevent the discovery or admissibility of any evidence that is otherwise discoverable, merely because the evidence was presented in the course of a dispute resolution proceeding.[31]**

Simply, there is nothing unique about arbitration as opposed to court that renders otherwise non-confidential documents confidential. Absent either an agreement between the parties to keep documents confidential or a party meeting its significant burden of demonstrating good cause for confidentiality, documents produced in discovery are not confidential.

Many Confidentiality Agreements May Be Unethical

Finally, agreeing to or creating unwarranted confidential protection over documents produced in discovery has significant ethical implications for the attorney that is bound by the confidentiality agreement. Indeed, lawyers have an ethical duty to zealously represent their clients and not to

---

[29] *Id.*

[30] AAA *Statement of Ethical Principles for the American Arbitration Association*, at p. 3.

[31] Administrative Dispute Resolution Act of 1996, §574(f).

keep relevant information from their client. Agreeing not to use documents and information obtained in one case for the benefit of a client in another similar case arguably would cause the lawyer to violate their obligations owed to their client. As such, entering into unwarranted confidentiality agreements could be a direct violation of that lawyer's ethical obligations.

Moreover, bar rules nationwide generally prohibit lawyers from entering into agreements that would restrict a lawyer's right to practice law. Unwarranted confidentiality agreements would improperly restrict a lawyer's ability to practice law because that lawyer would not be permitted to use all discovery materials obtained in prior cases.[32] At bottom, unwarranted confidentiality agreements place lawyers at risk of violating ethics rules that govern their licenses to practice law.

Conclusion

Certain documents deserve to be protected by confidentiality agreements. But broker-dealers have the burden of demonstrating that particular documents contain *bona fide* trade secrets or proprietary or personal information. Absent such a showing confidentiality of discovery materials is not justified. Arbitration is a truth-seeking process, and arbitrators should not countenance broker-dealers' attempts to shelter themselves from this truth through the use of unwarranted confidentiality agreements.

[32]*See Hu-Friedy Mfg. Co., Inc. v. General Elec. Co*., 1999 WL 528545, *4 (N.D.Ill.1999). Defendants sought to bar plaintiff's counsel because he was aware of relevant material that had been disclosed in another case that settled under a confidentiality agreement. The court declared, "[Defendant's] interpretation of the protective order and cooperation agreement is contrary to the policy of Rule 5.6(b).") The Agreement would violate ABA Model Rule 5.6, which forbids a lawyer from entering into agreements that restrict a lawyer's right to practice. While those rules pertain to employment-related agreements and settlement agreements, the spirit of the rule is clear that agreements that restrict a lawyer's practice are unethical. Here, if counsel is not permitted to use documents in any other cases, counsel would be restricted from ensuring that discovery is complete and that broker-dealers have produced the same internal documents in each case.

HOW LAWS ARE MADE

Compilation of Materials
by Robin S. Ringo

Introduction[1]

This online resource provides a basic outline of the numerous steps of our federal law-making process from the source of an idea for a legislative proposal through its publication as a statute. The legislative process is a matter about which every person should be well informed in order to understand and appreciate the work of Congress. It is hoped that this guide will enable readers to gain a greater understanding of the federal legislative process and its role as one of the foundations of our representative system. One of the most practical safeguards of the American democratic way of life is this legislative process with its emphasis on the protection of the minority, allowing ample opportunity to all sides to be heard and make their views known. The fact that a proposal cannot become a law without consideration and approval by both Houses of Congress is an outstanding virtue of our bicameral legislative system. The open and full discussion provided under the Constitution often results in the notable improvement of a bill by amendment before it becomes law or in the eventual defeat of an inadvisable proposal. As the majority of laws originate in the House of Representatives, this discussion will focus principally on the procedure in that body.

The Congress[2]

Article I, Section 1, of the United States Constitution, provides that:

All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.

The Senate is composed of 100 Members—two from each state, regardless of population or area—elected by the people in accordance with the 17th Amendment to the Constitution. The 17th Amendment changed the former constitutional method under which Senators were chosen by the respective state legislatures. A Senator must be at least 30 years of age, have been a citizen of the United States for nine years, and, when elected, be an inhabitant of the state for which the Senator is chosen. The term of office is six years and one-third of the total membership of the Senate is elected every second year. The terms of both Senators from a particular state are arranged so that they do not terminate at the same time. Of the two Senators from a state serving at the same time the one who was elected first—or if both were elected at the same time, the one elected for a full term—is referred to as the ''senior'' Senator from that state. The other is referred to as the ''junior'' Senator. If a Senator dies or resigns during the term, the governor of the state must call a special election unless the state legislature has authorized the governor to appoint a successor until the next election, at which time a successor is elected for the balance of the term. Most of the state legislatures have granted their governors the power of appointment.

Each Senator has one vote.

---

[1] *How Our Laws Are Made – Learn About the Legislative Process.* https://www.congress.gov/resources/display/content/How+Our+Laws+Are+Made+-+Learn+About+the+Legislative+Process

[2] *Id*.

As constituted in the 110th Congress, the House of Representatives is composed of 435 Members elected every two years from among the 50 states, apportioned to their total populations. The permanent number of 435 was established by federal law following the Thirteenth Decennial Census in 1910, in accordance with Article I, Section 2, of the Constitution. This number was increased temporarily to 437 for the 87th Congress to provide for one Representative each for Alaska and Hawaii. The Constitution limits the number of representatives to not more than one for every 30,000 of population. Under a former apportionment in one state, a particular Representative represented more than 900,000 constituents, while another in the same state was elected from a district having a population of only 175,000. The Supreme Court has since held unconstitutional a Missouri statute permitting a maximum population variance of 3.1 percent from mathematical equality. The Court ruled in *Kirkpatrick v. Preisler*, 394 U.S. 526 (1969), that the variances among the districts were not unavoidable and, therefore, were invalid. That decision was an interpretation of the Court's earlier ruling in *Wesberry v. Sanders*, 376 U.S. 1 (1964), that the Constitution requires that ''as nearly as is practicable one man's vote in a congressional election is to be worth as much as another's.'

A law enacted in 1967 abolished all ''at-large'' elections except in those less populous states entitled to only one Representative. An ''at-large'' election is one in which a Representative is elected by the voters of the entire state rather than by the voters in a congressional district within the state.

A Representative must be at least 25 years of age, have been a citizen of the United States for seven years, and, when elected, be an inhabitant of the state in which the Representative is chosen. Unlike the Senate where a successor may be appointed by a governor when a vacancy occurs during a term, if a Representative dies or resigns during the term, the executive authority of the state must call a special election pursuant to state law for the choosing of a successor to serve for the unexpired portion of the term.

Each Representative has one vote.

In addition to the Representatives from each of the States, a Resident Commissioner from the Commonwealth of Puerto Rico and Delegates from the District of Columbia, American Samoa, Guam, and the Virgin Islands are elected pursuant to federal law. The Resident Commissioner, elected for a four-year term, and the Delegates, elected for two-year terms, have most of the prerogatives of Representatives including the right to vote in committee to which they are elected, the right to vote in the Committee of the Whole (subject to an automatic revote in the House whenever a recorded vote has been decided by a margin within which the votes cast by the Delegates and the Resident Commissioner have been decisive), and the right to preside over the Committee of the Whole. However, the Resident Commissioner and the Delegates do not have the right to vote on matters before the House. Under the provisions of Section 2 of the 20th Amendment to the Constitution, Congress must assemble at least once every year, at noon on the third day of January, unless by law they appoint a different day.

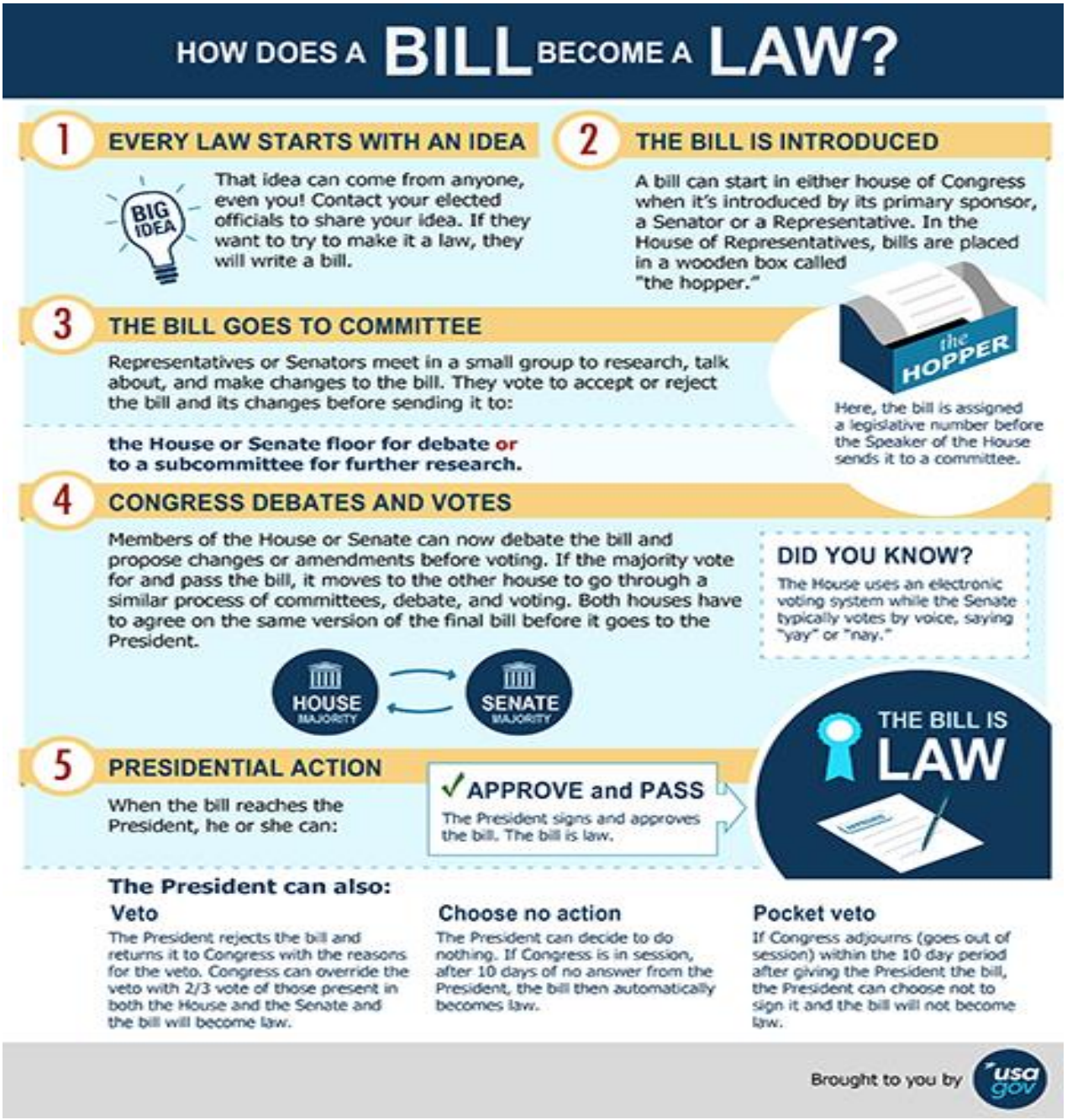
A Congress lasts for two years, commencing in January of the year following the biennial election of Members. A Congress is divided into two regular sessions.

The Constitution authorizes each House to determine the rules of its proceedings. Pursuant to that authority, the House of Representatives adopts its rules anew each Congress, ordinarily on the opening day of the first session. The Senate considers itself a continuing body and operates under continuous standing rules that it amends from time to time. Unlike some other parliamentary bodies, both the Senate and the House of Representatives have equal legislative functions and powers with certain exceptions. For example, the Constitution provides that only the House of Representatives may originate revenue bills. By tradition, the House also originates appropriation bills. As both bodies

have equal legislative powers, the designation of one as the ‘‘upper’’ House and the other as the ‘‘lower’’ House is not applicable.

The chief function of Congress is the making of laws. In addition, the Senate has the function of advising and consenting to treaties and to certain nominations by the President. Under the 25th Amendment to the Constitution, a vote in each House is required to confirm the President’s nomination for Vice-President when there is a vacancy in that office. In the matter of impeachments, the House of Representatives presents the charges—a function similar to that of a grand jury—and the Senate sits as a court to try the impeachment. No impeached person may be removed without a two-thirds vote of those Senators voting, a quorum being present. The Congress under the Constitution and by statute also plays a role in presidential elections. Both Houses meet in joint session on the sixth day of January following a presidential election, unless by law they appoint a different day, to count the electoral votes. If no candidate receives a majority of the total electoral votes, the House of Representatives, each state delegation having one vote, chooses the President from among the three candidates having the largest number of electoral votes. The Senate, each Senator having one vote, chooses the Vice President from the two candidates having the largest number of votes for that office.

How Does A Bill Become A Law? [3]



[3] *How A Bill Becomes A Law. Infographic,* https://app_usa_prod_eqffnyamdzrb.s3.amazonaws.com/How_Bill_Becomes_Law_0.pdf.

How Federal Laws Are Made [4]

The U.S. Congress is the legislative branch of the federal government and makes laws for the nation. Congress has two legislative bodies or chambers: the U.S. Senate and the U.S. House of Representatives. Anyone elected to either body can propose a new law. A proposal for a new law is called a bill.

Steps in Making a Law

A bill can be introduced in either chamber of Congress by a Senator or Representative who sponsors it.

Once a bill is introduced, it is assigned to a committee whose members will research, discuss, and make changes to the bill.

The bill is then put before that chamber to be voted on.

If the bill passes one body of Congress, it is then presented to the other body to go through a similar process of research, discussion, changes, and voting.

Once both bodies vote to accept a bill, they must work out any differences between the two versions. Then both chambers vote on the same exact bill and, if it passes, they present it to the president.

The president then considers the bill. The president can approve the bill and sign it into law or not approve (veto) a bill.

> Article I, section 7 of the Constitution grants the President the authority to veto legislation passed by Congress. This authority is one of the most significant tools the President can employ to prevent the passage of legislation. Even the threat of a veto can bring about changes in the content of legislation long before the bill is ever presented to the President. The Constitution provides the President 10 days (excluding Sundays) to act on legislation or the legislation automatically becomes law. There are two types of vetoes: the “regular veto” and the “pocket veto.”
>
> The regular veto is a qualified negative veto. The President returns the unsigned legislation to the originating house of Congress within a 10-day period usually with a memorandum of disapproval or a “veto message.” Congress can override the President’s decision if it musters the necessary two–thirds vote of each house. President George Washington issued the first regular veto on April 5, 1792. The first successful congressional override occurred on March 3, 1845, when Congress overrode President John Tyler’s veto of S. 66.
>
> The pocket veto is an absolute veto that cannot be overridden. The veto becomes effective when the President fails to sign a bill after Congress has adjourned and is unable to override the veto. The authority of the pocket veto is derived from the Constitution’s Article I, section 7, “the Congress by their adjournment prevent its return, in which case, it shall not be law.” Over time, Congress and the President have clashed over the use of the pocket veto, debating the term “adjournment.” The President has attempted to use the pocket veto during

[4] *How a Bill Becomes A Law*, https://www.usa.gov/how-laws-are-made#item-35837. Except where otherwise cited, the entirety of this article is reprinted from usa.gov, and is provided for educational purposes only.

intra- and inter- session adjournments and Congress has denied this use of the veto. The Legislative Branch, backed by modern court rulings, asserts that the Executive Branch may only pocket veto legislation when Congress has adjourned sine die from a session. President James Madison was the first President to use the pocket veto in 1812.[5]

Differences Between the House and Senate Procedures

The Senate and the House have some procedural differences between them.

How a bill becomes law when it originates in the House of Representatives[6]

Making and enacting laws is Congress's greatest responsibility. The U.S. House of Representatives and the U.S. Senate consider legislation in four forms:

Bills: There are two types of bills, public and private. Public bills affect the general public while private bills affect a specific individual or group. In order to become law, bills must be approved by both Chambers and the President.

Joint resolution: Similar to a bill, joint resolutions originate in either the U.S. House of Representatives or the U.S. Senate, but—opposite of what the name suggests—never jointly in both Chambers. Also like bills, joint resolutions require the President's approval to become law.

Concurrent resolution: Legislation addressing a matter affecting the operations of both the U.S. House of Representatives and the U.S. Senate, concurrent resolutions are voted on by both Chambers of Congress and do not need the President's signature to pass.

Simple resolution: Legislation addressing a matter affecting the operations of either the U.S. House of Representatives or the U.S. Senate, simple resolutions only need to pass in the Chamber it effects.

Bills are the most common form of legislation. While most bills can originate in either Chamber, bills regarding revenue always begin in the U.S. House of Representatives.

Beginning of the Bill

Although ideas for bills can come from anywhere, the two most common sources are Members and their constituents. For example, a bill may be inspired by campaign promises made by Members. Or constituents with ideas for laws may contact their Representatives. The Constitution guarantees a constituent's right to submit ideas for legislation to his or her Representative in Congress.

Introduction to the Bill

In the U.S. House of Representatives, any Member, Delegate, or Resident Commissioner may introduce a bill any time the House is in session. In order to officially introduce the bill,

[5] https://history.house.gov/Institution/Presidential-Vetoes/Presidential-Vetoes/.

[6] *How a Bill Becomes A Law*, https://kids-clerk.house.gov/middle-school/lesson.html?intID=17.

the Member places it in the “hopper,” a wooden box on the side of the Clerk’s desk. The Member introducing the bill is known as its primary sponsor, and an unlimited number of Members can cosponsor a bill.

When a bill is introduced, the title of the bill is entered in the House Journal and printed in the Congressional Record. The Clerk assigns the bill a legislative number and the Speaker of the House assigns the bill to the appropriate committee.

The Bill Goes to Committee

When the Chairman of the committee receives a copy of a bill, the clerk of the committee places the bill on the committee’s legislative calendar. While the bill is in committee, the committee members will seek expert input, hold “mark-up” sessions to make any changes or updates deemed important, and, if necessary, send the bill to a subcommittee for further analysis through research and hearings.

When the committee is satisfied with the content of the bill, it is sent back to the House for debate. It is also possible for a bill to die in committee if the legislation is deemed unnecessary.

Consideration and Debate

By tradition, all bills must be given consideration by the entire membership of the House, with adequate opportunity for the Members to debate and propose amendments. The rules of debate are decided during the first day of each new Congress, including the amount of time allocated for debate on the bill. Typically, the bill is read section by section and Members are given the opportunity to propose amendments and debate the bill’s content.

Voting

When debate is over, the Speaker asks “shall the bill be engrossed and read a third time?” If the Members agree, the bill is read by title only.

If deemed necessary by the Speaker, voting on a bill may be delayed up to two days. There are three methods for voting:

- Viva voce (voice vote): The Speaker asks the Members who support the bill to say “aye” and those who oppose to say “no.”
- Division: The Speaker says “those in favor, rise and stand to be counted,” and then again for those who oppose to stand and be counted.
- Recorded: The most common way to collect votes, Members either slide their electronic voting cards into the electronic voting machine and select “yea,” “nay,” or “present,” or complete a paper ballot which is handed to the tally clerk to be recorded.

The votes are tallied and, if a majority of the House has voted in favor of the legislation, it passes and is sent to the U.S. Senate. If the bill fails, yet the Speaker feels the bill should become a law, it may be sent back to committee for further research and updates. Otherwise, the bill dies.

Senate Action

If a bill passes in the U.S. House of Representatives, an exact copy is sent to the U.S. Senate. The bill is sent to a Senate committee for review and discussion before proceeding to the Senate floor for a vote. The Senate, like the House, considers each amendment separately before the bill is voted on. Unlike the House, the Senate typically votes by voice.

The Bill Returns to the House

If the bill is passed by the Senate, both the House and Senate bills are returned to the House with a note indicating any changes. If the Senate has made amendments, the House must vote on the bill again as both Chambers of Congress must agree to identical legislation in order for it to become law. If the Speaker of the House decides the Senate amendments require further research, the bill can be sent back to committee before the House votes again.

The Bill Is Enrolled

When both Chambers have passed identical legislation, the enrolling clerk prepares the final document for presentation to the President of the United States. The enrolled bill is printed on parchment paper and certified by the Clerk of the House. The Clerk reviews the bill to ensure it is accurate and sends it to the Speaker to be signed. The Speaker then passes the document to the President of the Senate for signature.

Presidential Action

Once the leaders of both Chambers have signed-off, the Clerk of the House delivers the bill to a clerk at the White House and obtains a receipt. When the President receives the bill, he has three options:

- Pass: If the President approves the bill he signs it and, usually, writes “approved” and the date, although the Constitution only requires his signature.
- Veto: If the President does not approve the bill, he must return it to its Chamber of origin with his objections within 10 days.
- Pocket Veto: If the President receives the bill and does not sign or return it to Congress with objections within 10 days—excluding Sundays—it becomes law as long as Congress remains in session. If Congress recesses before the 10 days have passed, the bill dies.

Back to Congress

If the President vetoes the bill, it is sent back to the U.S. House of Representatives. From here, the Speaker may decide not to pursue the bill further, send it back to committee for further consideration, or return to the bill to the House floor for a vote. In order to override the President’s veto, the bill will need to pass by two-thirds majority in both Chambers of Congress.

How a bill becomes law when it originates in the Senate[7]

1. Have an Idea

The first step in creating a new law -- or revising an existing law -- is to have an idea of how we can make our country stronger or better. This idea can come from anywhere, including from you!

2. Write a Bill

After identifying the problem, Members of Congress work to create a law that provides a solution. Sometimes, they will work together to jointly introduce legislation with other Senators. Senators can also collaborate with members of the House of Representatives on legislation so that identical or very similar bills are introduced in both the House and the Senate. The Senator or Senators who introduce the bill are known as sponsors and they are the primary champions of the legislation. Other Senators, who did not introduce the legislation themselves but who also want to express strong support for the bill, can sign on as a cosponsor. After being introduced, the bill is sent to the Senate Parliamentarian who assigns it to a specific committee or committees for further deliberation.

3. Debate in Committee

When a bill is introduced, the Senate Parliamentarian is responsible for deciding which Committee should review the legislation. The chair of the committee may decide to hold a hearing in order to examine the legislation. During a hearing, committee members invite policy experts, agency representatives, and other stakeholders to testify on how the bill will affect the country. After holding a hearing or hearings, the chair of the committee can decide to hold a "markup" during which committee members debate, modify, and ultimately vote for or against the bill. If the majority of the committee members vote favorably for the bill, it is advanced to the Senate floor, where every Senator has an opportunity to review and debate the legislation. Sometimes, less controversial pieces of legislation will be included in related larger bills as amendments in order to help speed up the legislative process.

4. Debate on the Senate Floor

After being voted upon favorably by a committee, the bill is referred to the full Senate for a vote. Here, the Majority Leader of the Senate is responsible for deciding when to bring up a piece of legislation for a vote and what type of vote it needs. Sometimes, a non-controversial bill will be “hotlined”, which means the Majority Leader and Minority Leader -- after consulting with their Senate colleagues -- agree to pass the legislation by unanimous consent and without a roll-call vote in order to save time by moving legislation more quickly. Often times, though, legislation requires more debate and must be discussed in-depth on the Senate floor. During the floor debate, every Senator is given the opportunity to speak for or against a bill and multiple votes are taken to move the bill through the legislative process. After much debate and consideration, the Majority leader may schedule a vote with all the Senators. If this route is taken, a series of votes must be taken in order for a bill to pass the Senate. First,

[7]*How A Bill Becomes A Law*, Tom Carper, U.S. Senator for Delaware. https://www.carper.senate.gov/public/index.cfm/how-a-bill-becomes-a-law#B3576BA3-BFB9-4320-96ED-57E4CFFE7892

the Senate must agree to consider the legislation by voting on a "Motion to Proceed" which indicates the start of debate. After all Senators have had the opportunity to discuss the legislation, a “Motion to End Debate” or a "Cloture Vote" is made, which then brings the Senate to one final vote on the legislation.

5. Work with House Colleagues

Meanwhile, the House of Representatives is responsible for introducing and voting on a companion bill of its own. Just like in the Senate, when a bill is introduced in the House, the House Parliamentarian is responsible for assigning that legislation to a specific House committee or committees for further deliberation. Sometimes the House authors will give the bill a different title and sometimes the House Parliamentarian will give the legislation a different bill number than its Senate companion. Ultimately, a law can only be passed if both the Senate and the House of Representatives introduce, debate, and vote on similar pieces of legislation.

6. Negotiate Compromises in Conference

Often times, the Senate bill and the House bill will have minor differences in their respective bills that have to be worked out before each chamber can approve the final legislative text and then send it to the President to be signed into law. When this happens, a special conference committee made up of members from both the Senate and the House will work together to come to consensus about the different provisions in the bill.

7. Send it to the President for a signature

After the conference committee resolves any differences between the House and Senate versions of the bill, each chamber must vote again to approve the final bill text. Once each chamber has approved the bill, the legislation is sent to the President. The President then makes the decision of whether to sign the bill into law or not. If the President signs the bill, it becomes a law. If the President refuses to sign it, the bill does not become a law. When the President refuses to sign the bill, the result is called a veto. Congress can try to overrule a veto. To do this, both the Senate and the House must vote to overrule the President’s veto by a two-thirds majority. If that happens, the President's veto is overruled and the bill becomes a law.

8. Reauthorization

Some laws, especially laws that appropriate funding to new programs, include provisions that require Congress to decide, after a set period of time, whether the legislation is effective and should be renewed, or “reauthorized”. To do this, a new bill must be introduced that renews the provisions of the law, makes any necessary changes to the original law, and offers a new timeline for how long it is active.

Congress creates and passes bills. The president then signs those bills into law. Federal courts may review these laws and strike them down if they think they do not agree with the U.S. Constitution.

Find Federal Laws

The United States Code contains the general and permanent federal laws of the United States. It does not include regulations, decisions, or laws issued by:

- Federal agencies
- Federal courts
- Treaties
- State and local governments

New public and private laws are published in each edition of the United States Statutes at Large.

Federal Regulations

Regulations are issued by federal agencies, boards, or commissions. They explain how agencies intend to carry out laws. Regulations are published yearly in The Code of Federal Regulations.

The Rulemaking Process

Federal regulations are created through a process known as rulemaking. If an agency wants to make, change, or delete a rule, the agency will publish the proposal in the Federal Register and seek public comments.

After the agency considers the public's comments and changes the rule if necessary, it publishes the rule's final version in the Federal Register, along with a description of the comments received, the agency's response to those comments, and the date the rule goes into effect.

Federal Court Decisions

Although federal courts do not write or pass laws, they may establish individual "rights" under federal law through their interpretations of federal and state laws and the U.S. Constitution. For example, the U.S. Supreme Court's decision in *Brown v. Board of Education of Topeka* held that state laws which segregated public school students by race were unconstitutional, because they violated the 14th Amendment to the Constitution. In striking down those state laws, the Supreme Court determined that "separate but equal" educational facilities instilled a sense of inferiority in minority children that undermined their educational opportunities.

State Laws and Regulations

State legislatures make the laws in each state. State courts may review these laws and remove them if they think they do not agree with the state's constitution.

Executive Orders and Other Presidential Actions

The president creates many documents to issue orders and make announcements. These executive or presidential actions can include:

- Executive orders
- Presidential memoranda
- Proclamations

Executive Orders

An executive order has the power of federal law. Presidents can use executive orders to create committees and organizations. For example, President John F. Kennedy used one to create the Peace Corps. More often, presidents use executive orders to manage federal operations.

Congress may try to overturn an executive order by passing a bill that blocks it. But the president can veto that bill. Congress would then need to override that veto to pass the bill. Also, the Supreme Court can declare an executive order unconstitutional.

Presidential Memoranda

Presidential memoranda are like executive orders. The president can use memos to direct government operations. But executive orders are numbered and published in the Federal Register. Presidential memos are not.

Presidential Proclamations

Presidential proclamations are statements that address the public on policy matters. They are mainly symbolic and are usually not enforced as laws.

Find Presidential Actions

The White House posts presidential actions issued by the current president. The National Archives and Records Administration (NARA) maintains older executive orders. These date back to 1937.

There are potentially 10 steps a bill can go through before becoming a law. Below is a description of each step in the process, using the Genetic Information Non-Discrimination Act of 2003 (S. 1053), as an example.

Steps to a Bill Becoming a Law[8]

There are potentially 10 steps a bill can go through before becoming a law. Below is a description of each step in the process, using the Genetic Information Non-Discrimination Act of 2003 (S. 1053), as an example.

Step 1: A Bill Is Born
Anyone may draft a bill; however, only members of Congress can introduce legislation, and, by doing so, become the sponsor(s). The president, a member of the cabinet or the head of a federal agency can also propose legislation, although a member of Congress must introduce it.



On May 13, 2003, Senator Olympia Snowe (R-Maine) introduced the Genetic Information Non-Discrimination Act of 2003 (S. 1053).

S. 1053 was referred to the Senate Committee on Health, Education, Labor and Pensions (HELP).

Step 2: Committee Action
As soon as a bill is introduced, it is referred to a committee. At this point the bill is examined carefully and its chances for passage are first determined. If the committee does not act on a bill, the bill is effectively "dead."

Step 3: Subcommittee Review
Often, bills are referred to a subcommittee for study and hearings. Hearings provide the opportunity to put on the record the views of the executive branch, experts, other public officials and supporters, and opponents of the legislation.

On May 21, 2003, the Senate HELP Committee held a mark up of S. 1053. Senator Judd Gregg (R-N.H.), chair of the HELP Committee, offered an amendment to the bill.

Step 4: Mark up
When the hearings are completed, the subcommittee may meet to "mark up" the bill; that is, make changes and amendments prior to recommending the bill to the full committee. If a subcommittee votes not to report legislation to

[8]*How A Bill Becomes Law, example*. (2012, March 12). National Human Genome Research Institute. https://www.genome.gov/12513982/.

the full committee, the bill dies. If the committee votes for the bill, it is sent to the floor.



On July 2, 2003, Senator Gregg presented a dynamic argument for the protection of genetic privacy. "In the years since Crick and Watson's discovery ... there have been reservations with what we will do with this new information we are uncovering. Unlocking our genetic code unleashes new power. And power produces new responsibilities in protecting the privacy of our genetic information."

Step 5: Committee Action to Report a Bill
After receiving a subcommittee's report on a bill the full committee votes on its recommendation to the House or Senate. This procedure is called "ordering a bill reported."

The Senate voted on S. 1053 on Oct. 14, 2003. It passed by a vote of 95 to 0.

Step 6: Voting
After the debate and the approval of any amendments, the bill is passed or defeated by the members voting.

Step 7: Referral to Other Chamber
When the House or Senate passes a bill, it is referred to the other chamber, where it usually follows the same route through committee and floor action. This chamber may approve the bill as received, reject it, ignore it, or change it.

S. 1053 was referred to the House of Representatives where it now waits for action.

Step 8: Conference Committee Action



When the actions of the other chamber significantly alter the bill, a conference committee is formed to reconcile the differences between the House and Senate versions. If the conferees are unable to reach agreement, the legislation dies. If agreement is reached, a conference report is prepared describing the committee members' recommendations for changes. Both the House and Senate must approve the conference report.

Step 9: Final Action

After both the House and Senate have approved a bill in identical form, it is sent to the president. If the president approves of the legislation, he signs it and it becomes law. Or, if the president takes no action for ten days, while Congress is in session, it automatically becomes law.If the president opposes the bill he can veto it; or if he takes no action after the Congress has adjourned its second session, it is a "pocket veto" and the legislation dies.



Step 10: Overriding a Veto

If the president vetoes a bill, Congress may attempt to "override the veto." If both the Senate and the House pass the bill by a two-thirds majority, the president's veto is overruled and the bill becomes a law.

Glossary

The definitions provided in this glossary relate to words as used on Ben's Guide to the U.S. Government.[9] There may be other definitions for these words.

Act: Legislation that has passed both Houses of Congress and has been either approved by the President or passed over his veto, thus becoming law. Also used technically for a bill that has been passed by one House of Congress.

Amend: To change the wording or meaning of a motion, bill, Constitution, etc. by formal procedure. For example, Congress may amend the Constitution.

Amendment: A proposal by a Member (in committee or floor session of the respective Chamber) to alter the language or provisions of a bill or act. It is voted on in the same manner as a bill. The Constitution of the United States, as provided in Article 5, may be amended when two-thirds of each House of Congress approves a proposed amendment and three-fourths of the states thereafter ratify it.

Bicameral: The quality of having two branches, chambers, or houses, such as the United States Congress, which is made up of the Senate and the House of Representatives.

Bill: Formally introduced legislation. Most legislative proposals are in the form of bills and are designated as H.R. (House of Representatives) or S. (Senate), depending on the House in which they are introduced. They are numbered in the order in which they are introduced during each Congress. Public Bills deal with general questions and become Public Laws, or Acts, if they approved by Congress and signed by the President. Private Bills deal with individual matters such as claims against the Federal Government, immigration and naturalization cases, land titles, and so on, and become Private Laws if approved and signed.

Bill of Rights: The first ten amendments to the United States Constitution.

Calendar: A list of bills, resolutions, or other matters to be considered before committees or on the floor of either House of Congress.

Committee: A group of Members of Congress appointed to investigate, debate, and report on legislation.

Congress: The seat of legislative power. There are 535 members of the U.S. Congress: 435 in the House of Representatives and 100 in the Senate. See also House of Representatives and Senate.

Congressional District: A division or part of a state based on population; each district elects one person to Congress.

Constituent: A person who is part of a larger group. In politics, a constituent is represented by an elected official.

Elastic Clause: A statement in the U.S. Constitution granting Congress the power to pass all laws necessary and proper for carrying out the list of powers it was granted (Article I, Section 8).

---

[9] *Ben's Guide*. https://bensguide.gpo.gov/glossary.

Hearing: A meeting or session of a committee of Congress, usually open to the public, to gather information and opinions on proposed legislation, conduct an investigation, or oversee a program.

Hopper: A box attached to the side of the Clerk's desk in the House of Representatives into which a proposed legislative bill is dropped and in so doing is officially introduced.

House of Representatives: Along with the Senate, it is one of the two Houses of the U.S. Congress. Members are granted to each state based upon population and each representative serves a two-year term. There are currently 435 members in the House of Representatives.

Initiative: A process by which a particular number of voters may propose a statute, constitutional amendment, or ordinance, and compel a vote on its adoption.

Law: A system of rules of conduct established and enforced by the authority, legislation, or custom of a given community, state, or nation. Used in the singular to mean a specific law (a law protecting free speech) or in the plural to refer to a set of laws (the law of the land).

Legislative Day: A formal meeting of a House of Congress which begins with the call to order and opening of business and ends with adjournment. A legislative day may cover a period of several calendar days, with the House recessing at the end of each calendar day, rather than adjourning.

Legislation: A law or a body (set) of laws.

Line-item Veto: The power of an executive to disapprove or reject parts of a bill without having to reject the entire bill.

Motion: A formal suggestion or proposal that an action be taken related to the process of making a law.

Pocket Veto: The disapproval of a bill brought about by an indirect rejection by the President. According to the Constitution, the President is granted 10 days, Sundays excepted, to review a piece of legislation passed by Congress. If the President has not signed the bill after 10 days, it becomes law without his signature. But if Congress adjourns during the 10 day period, the bill does not become law.

Preamble: An introduction to a document.

Public Law: A bill or joint resolution (other than for amendments to the Constitution) passed by both Houses of Congress and approved by the President. Bills and joint resolutions vetoed by the President, but then overridden by the Congress also become Public Law. Public Laws affect society as a whole, and most laws passed by Congress are Public Laws. Public Law citations include the abbreviation, Pub.L., the Congress number (e.g. 107), and the number of the law. For example: Pub.L. 107-006.

Private Law: A law that affects an individual, family, or small group and is enacted to help citizens that have been injured by government programs or who are appealing an executive agency ruling such as deportation. Private Laws citations include the abbreviation, Pvt.L., the Congress number (e.g. 107), and the number of the law. For example: Pvt.L. 107-006.

Ratify: To sign or officially approve an agreement, treaty, contract, amendment, or similar document.

Ratification: In U.S. Government, this can be the act of approval of a proposed constitutional amendment by the legislatures of the States; it can also refer to the Senate process of advice and consent to treaties negotiated by the President.

Referendum: A general or direct vote by the people on a political issue.

Report: The printed record of a committee's actions, including its votes, recommendations, and views on a bill or question of public policy or its findings and conclusions based on oversight inquiry, investigation, or other study. Senate committees usually publish a committee report to accompany the legislation they have voted out; these are numbered consecutively in the order in which they are filed in the Senate. Committee reports discuss and explain the purpose of measures and contain other, related information. The term can also refer to the action taken by a committee ("report the legislation") to submit its recommendations to the Senate.

Representative: A person appointed, chosen, or elected to act on another's behalf. In Congress, Representatives are granted to each state based upon population and each Representative serves a two-year term. There are currently 435 members in the House of Representatives.

Resolution: A proposal approved by either or both Houses of Congress which, except for joint resolutions signed by the President, does not have the force of law.

Senate: Along with the House of Representatives, it is one of the two Houses of the U.S. Congress. There are two Senators granted to each state and each Senator serves a six-year term. There are currently 100 members in the Senate.

Senator: The Constitution requires that a Senator be at least 30 years old, a citizen of the United States for at least nine years, and an inhabitant of the state from which he or she is elected. A person elected or appointed to the Senate and duly sworn is a Senator. There are currently 100 members in the Senate.

Separation of Powers: The system of dividing power and authority; in the United States, it is divided among the legislative, executive, and judicial branches of the Government.

Tabling Motion: A motion to stop action on a pending proposal and to lay it aside until further notice. When the Senate or House agrees to a tabling motion, the measure which has been tabled is effectively defeated.

Unanimous Consent: An agreement among members of Congress to set aside a specified rule of procedure to expedite proceedings.

Veto: The procedure, as allowed by the Constitution, by which the President refuses to approve a bill or joint resolution and thus prevents its enactment into law. A regular veto occurs when the President returns the legislation to the originating House without approval. It can be overridden only by a two-thirds vote in each House. A pocket veto occurs after Congress has adjourned and is unable to override the President's action.

"A LAWYER SHALL MAKE REASONABLE EFFORTS TO EXPEDITE LITIGATION CONSISTENT WITH THE INTERESTS OF THE CLIENT."[1]

As a Claimant's or Plaintiff's attorney our first obligation is to zealously and lawfully pursue a recovery of client's specific personal losses. But we also have an obligation to work toward passing legislation that addresses the issues that caused or enabled our clients' losses. Rule 3.2 of the ABA's Model Rules for Professional Conduct ("Expediting Litigation") is quite blunt about this aspect of our professional responsibilities: "A lawyer shall make reasonable efforts to expedite litigation consistent with the interests of the client." Most often, this means lobbying. Every serious organized group is out there trying to influence litigation. Here are some tips on how to do that in the most effective and efficient manner.

Lobbying for a cause is an important part of the political process and a key way all citizens can impact government decisions. There are many ways to advocate for a cause. Here are seven important points to consider when regarding how to lobby for a cause important to you[2].

1. **Know background information.** Having a holistic picture of an issue and understanding all sides will allow you to have more effective and productive conversations.

2. **Have a clear objective.** No matter how broad your cause may be, have specific points to address and keep the focus on a clear goal, such as signing a bill. Refer to bills and pieces of legislation by their specific name and number, and remain up to date on events that could affect your objectives.

3. **Be persistent and personal.** A crucial part of lobbying for a cause is building a relationship with members of Congress and their staff. Introduce yourself and tell a story that explains your personal connection to a cause. Bring photos or documents relevant to your story if you have them. These personal touches can make an issue significant for a politician. Similarly, persistence reiterates the importance you place on a cause and is vital for building relationships with your representatives.

4. **Listen.** Try and have a conversation with others about your cause rather than doing all of the talking yourself. Pay attention to what questions are asked regarding the cause and your objectives as well as common themes in differing viewpoints. Listening will allow you to better formulate your argument in a way that addresses concerns and dispels misconceptions.

[1]Rule 3.2 of the ABA's Model Rules for Professional Conduct ("Expediting Litigation").

[2]Excerpted from The Borgen Project. "The Borgen Project is an incredible nonprofit organization that is addressing poverty and hunger and working towards ending them." – The Huffington Post. Similar methods are employed and espoused by groups as politically diverse as the NRA and the advocates – and opponents – of abortion rights.

5. **Find allies.** Being part of a group not only provides a strong support network that will help you learn how to effectively lobby for a cause, but also shows a Congress member the cause is important and personal to many constituents. Spreading awareness and advocating for a cause is more effective in a group. Beyond other supporters of a cause, also remember the important role staffers play in pushing a cause through. Do not underestimate the importance of your relationships with staffers, and know that they can advocate for you and your cause as well.

6. **Remember the power of positive reinforcement.** Do not forget to say thank you and acknowledge tiny positive actions. Whether it is for signing a piece of legislation related to your cause or just taking the time to meet with you, using positive reinforcement in your interactions paves the way for building strong relationships. Collect business cards and contact information from staffers and be sure to follow-up interactions with thank you messages.

7. **Don’t get discouraged.** Even if your Congressional offices do not support your cause, remain polite and persistent. There are a myriad of factors influencing political decisions, so do not be discouraged if your objective is not supported immediately or even after years of work. There is no recipe for how to lobby for a cause with 100 percent success. It is important to remain focused on the personal connection you have with this cause and continue to build relationships and find allies to support your work.