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DUTIES OF BROKER DEALERS AS TO TRANSFERRED-IN SECURITIES: DEFEATING THE "SOME OTHER DUDE DID IT" DEFENSE

Thomas D. Mauriello[1]

I. INTRODUCTION

At some point, the claimants' securities arbitration practitioner will likely encounter a case where the client's broker moves from one broker/dealer to another, bringing the client's account – and the securities portfolio in it – to the new firm. The new firm has an obvious financial incentive for the arriving broker to maintain as many of his existing accounts as possible. As noted in a 2007 FINRA Notice to Members:

> It is not uncommon for an individual registered representative or a group of representatives with an established customer base to terminate their association with one firm in favor of another. In such instances, one of the principal interests of the acquiring firm is ensuring that the newly associated representatives retain as much as possible of the customer base they serviced.[2]

But in its zeal to obtain those precious new accounts, the firm may not realize – or may overlook – the fact that the new account contains: securities that are not suitable for the client (or perhaps for almost any client), a portfolio that is grossly over-concentrated, or other issues that give rise to potential liability for breach of fiduciary duty, fraud, negligence, or violations of industry rules and standards. This article examines the issue of the new firm's potential liability for misconduct associated with securities that were purchased at a prior firm and transferred in to the second firm.

The practitioner can bet that any brokerage firm inevitably will disavow responsibility for securities that were purchased at the previous brokerage firm. Essentially the argument goes like this, usually yelled at high volume in an offended tone of voice: "It wasn't me! Some other dude did it!" But the

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1. Thomas D. Mauriello is a San Diego-based securities and investment dispute attorney. He is a member of the Board of Directors of the Public Investors Advocate Bar Association (PIABA). He is admitted to practice law in California, New Jersey, and Pennsylvania. He holds a JD degree from the University of San Diego School of Law and a BA degree from Brown University.

2. NASD Notice to Members 07-06 (2007).

issue is hardly as in favor of the brokerage firm as they would make you believe.

To the contrary, a "toolkit" of common law legal principles and securities industry rules establishes that – under the right fact and sometimes depending on the applicable State law -- the second firm may be liable for the suitability, or lack thereof, of securities purchased in the prior account. These legal resources include: common law on fiduciary duties of financial advisors and brokerage firms; common law on liability for "hold" recommendations; FINRA Rules, Notices to Members, and Regulatory Notices that have broadened the concept of "investment advice" to include recommendations to maintain a portfolio or not to sell any securities; and firms' own policies and procedures regarding the review of new brokers and their new accounts.

This article discusses authorities and arguments that practitioners can use to surmount the "Some Other Dude" defense and persuade opposing counsel and arbitration panels that the new firm does indeed bear responsibility for transferred-in securities.

II. COMMON LAW THEORIES SUPPORTING LIABILITY FOR TRANSFERRED-IN SECURITIES

A. *Fiduciary Duties Owed by Brokerage Firms Under Common Law*

A good starting point in analyzing this issue is the concept of fiduciary duty.

Under certain States' laws, brokerage firms have a fiduciary duty to their customers. For example, a series of California appellate decisions dating at least back to the 1960's have long established the fiduciary duty of stock brokers.

> With respect to stockbrokers it is recognized, "The duties of the broker, being fiduciary in character, must be exercised with the utmost good faith and integrity." (Meyer, The Law of Stockbrokers and Stock Exchanges (1931) p. 253. *See also id.*, §§ 39-40, pp. 249-253; and *Walsh v. Hooker Fay* (1963) 212 Cal.App.2d 450, 452 [28 Cal.Rptr. 16].)[3]

3. *Twomey v. Mitchum, Jones Templeton, Inc.*, 69 Cal. Rptr. 222, 236 (Ct. App. 1968).

"[T]he relationship between a stockbroker and his or her customer is fiduciary in nature."[4] "California imposes a fiduciary duty on every broker-customer relationship."[5]

> [S]ecurities brokers who have assisted a fiduciary or a trustee in speculating with trust funds and deceiving the beneficiaries of an investment trust as to the financial stability of the trust are directly liable to the beneficiaries themselves both for breach of the ***brokers'*** fiduciary duties, and for aiding and abetting the trustee's breach in order to further the brokers' own economic interests. (*Duffy* v. *Cavalier* (1989) 215 Cal.App.3d 1517, 1533; Rest.2d Trusts, § 326, pp. 124-125; 4 Scott on Trusts, *supra,* § 326.2, pp. 296-298; Bogert on Trusts, *supra,* § 901, pp. 315-318; cf. *Pierce* v. *Lyman, supra,*1 Cal.App.4th at pp. 1103-1106.)[6]

Federal courts applying State law similarly have recognized that stockbrokers and brokerage firms hold fiduciary duties to their customers. As the Eleventh Circuit Court of Appeals noted:

> The law is clear that a broker owes a fiduciary duty of care and loyalty to a securities investor. *Thompson v. Smith Barney, Harris Upham Co., Inc.,*709 F.2d 1413, 1418 (11th Cir. 1983); *Dupuy v. Dupuy,* 551 F.2d 1005, 1015 (5th Cir. 1977). *See also* RESTATEMENT (2d) of Agency § 425 (agents employed to make, manage, or advise on investments have fiduciary obligation).[7]

The Eighth Circuit Court of Appeals similarly held that brokers are fiduciaries to their clients:

> Securities brokers . . . at Merrill Lynch are licensed professionals holding themselves out as trained and experienced to render a specialized service. Like the clients of real estate agents, securities customers rely on the agent's expertise and expect the agent to act in their best interests. Because we see no significant difference between real estate brokers and securities brokers, we believe that if confronted

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4. *Duffy v. Cavalier*, 264 Cal. Rptr. 740, 751 (Ct. App. 1989).

5. *Petro-Diamond Inc. v. SCB & Associates, LLC*, 122 F. Supp. 3d 949, 959 (C.D. Cal. 2015).

6. City of Atascadero v. Merrill Lynch, 80 Cal. Rptr. 329, 355 (Ct. App. 1998) (Emphasis in original.)

7. Gochnauer v. A.G. Edwards Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987). The *Gochnauer* court was applying Florida common law. But its conclusion references the Restatement of Agency, which is designed to be a distillation of general common law.

> with the question, the South Dakota Supreme Court would find that securities brokers are fiduciaries that owe their customers a duty of utmost good faith, integrity, and loyalty.[8]

The Eighth Circuit was interpreting South Dakota law. It expressly relied on the reasoning contained is two South Dakota state court cases, one of them dating back to 1910, holding that real estate agents and brokers are fiduciaries.[9]

As in California, Florida, and South Dakota, financial advisors and broker/dealers are also fiduciaries as a matter of law in Missouri. As one Missouri court concluded:

> This fiduciary duty includes at least these obligations: to manage the account as directed by the customer's needs and objectives, to inform of risks in particular investments, to refrain from self-dealing, to follow order instructions, to disclose any self-interest, to stay abreast of market changes, and to explain strategies.[10]

Not surprisingly, none of these cases differentiate between securities recommended by the current firm versus securities recommended by the customer's prior brokerage firm. Indeed, such a distinction appears antithetical to the very concept of a fiduciary duty. Thus, to the extent that a firm that accepts a customer's new account and the securities transferred in has a fiduciary duty, it cannot evade that duty simply because the securities were purchased in a prior account.

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8. Davis v. Merrill Lynch*,* 906 F.2d 1206, 1215 (8th Cir. 1990).

9. *See* Durand v. Preston, 128 N.W. 129, 131 (1910) (holding that real estate agents and brokers are fiduciaries); Hurney v. Locke, 308 N.W.2d 764, 768 (1981) (confirming the reasoning in *Durand*, and holding real estate brokers are "licensed professionals holding themselves out as trained and experienced to render a specialized service . . . clients rely on the agent's expertise and expect the agent to act in their best interests").

10. A.G. Edwards & Sons, Inc. v. Drew, 978 S.W.2d 386 (Mo. Ct. App. 1998). *See also* State ex rel. PaineWebber, Inc. Voorhees, 891 S.W.2d 126 (Mo. 1995); *Edwards & Sons, Inc.* 801 S.W.2d 746 (Mo. Ct. App. 1990); Leuzinger v. Merrill Lynch, 396 S.W. 570 (Mo. 1965) (ruling that as part of this fiduciary duty, if a broker "knows of facts and circumstances" that would lead "an ordinary careful and diligent person" to believe harm was going to befall his customer, then "a duty to inform would arise.").

B. *Duties Attaching to "Hold" Recommendations Under Common Law*

Another body of common law that practitioners should consider are cases establishing the new firm's responsibility for recommending that a customer "hold" securities that were recommended by and purchased through a prior brokerage firm.

A good starting point here is the general tort law regarding misrepresentations that induce the recipient to ***refrain from*** acting in reliance on the misrepresentations. The Restatement of Torts notes as follows:

> ***One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to*** act or to ***refrain from action in reliance upon it***, is subject to liability to the other in deceit for the pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.[11]

Numerous cases have applied these principles to the securities industry to hold that brokerage firms have a legal duty to their customers for "hold" recommendations made by the firm. This includes California common law:

> California law should allow a holder's action for fraud or negligent misrepresentation. California has long acknowledged that if the effect of a misrepresentation is to induce forbearance-to induce persons not to take action- and those persons are damaged as a result, they have a cause of action for fraud or negligent misrepresentation. We are not persuaded to create an exception to this rule when the forbearance is to refrain from selling stock. This conclusion does not expand the tort of common law fraud, but simply applies long-established legal principles to the factual setting of misrepresentations that induce stockholders to hold on to their stock.[12]

This also includes Florida common law:

> The federal and Florida securities laws only apply to the purchase or sale of securities and not to representations intended to induce a stockholder to retain their securities. *Riley v. Merrill Lynch, Pierce, Fenner Smith, Inc.*, 292 F.3d 1334, 1343 (11th Cir. 2002) ("[W]hile 'holding' claims are not actionable under federal securities laws, they may well be actionable under

11. Restatement (Second) Torts § 525 (1977) (emphasis added). *See also* Restatement (Second) Torts § 531 (1977); 37 Am. Jur.2d Fraud and Deceit § 243 ("A person is entitled to damages resulting ***from inaction*** where an untrue statement is made with the intent to induce that person ***to refrain from acting***, so long as it can be demonstrated that the false statement produced the inaction.") (Citation omitted, emphasis added.)

12. Small v. Fritz Cos., 132 Cal. Rptr. 2d 490, 492 (2003).

state laws."); *Ward v. Atlantic Sec. Bank*, 777 So.2d 1144, 1147 (Fla. 3d DCA 2001) (assuming that Florida Securities Investors Protection Act, § 517.011, *et. seq*., Florida Statutes, like analogous federal securities laws, would not cover holding claims because they are not "in connection with the offer, sale, or purchase of any investment or security."). ***State common law recognizes such a claim, in fraud and negligent misrepresentation, called a "holding claim."*** (Emphasis added.)[13]

To the extent that a brokerage firm has liability for "hold" recommendations, there is no rational principle for limiting liability to the firm in which the securities were purchased. Put another way, a firm should not be absolved from liability for a hold recommendation merely because that recommendation relates to securities that were purchased at a prior broker dealer.[14]

III. RELEVANT FINRA NOTICES TO MEMBERS, RULES, AND REGULATORY NOTICES

In addition to the common law addressing brokerage firms' fiduciary duties and their duties attaching to "hold" recommendations, FINRA rules and notices also provide authority for firms' legal responsibilities for hold recommendations as to securities purchased at a customer's prior firm.

13. Rogers v. Cisco Systems, Inc., 268 F.Supp.2d 1305, 1311, n.13 (N.D. Fla. 2003).

14. Be aware, however, that the United States Supreme Court in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), held that "holders" of securities were not entitled to sue under Section 10(b) of the Exchange Act. *Id*. at 749. The Court described several policy reasons that it concluded weighed against a claim that would rely largely on a plaintiff's "oral version of a series of occurrences." *Id.* at 742. Because a "holder" claim is not "verifiable by documentation" and depends entirely on "oral recollection," the Court concluded that a "holder" cause of action may encourage frivolous and "vexatious litigation" that is difficult to resolve on the merits without a trial. *Id*. at 742-43. Permitting "holder" claims would "throw open to the trier of fact many rather hazy issues of historical fact the proof of which depended almost entirely on oral testimony" about largely conjectural and speculative damages. *Id*.

A. *NASD Notice to Members 07-06: Firm's Duty to "Learn the Nature of the New Representative's Business"*

A good starting point for FINRA guidance on this issue is NASD Notice to Members 07-06, which addresses firms' duties when taking on new brokers and the new brokers' existing customers.

Notice To Members 07-06 specifically addresses new customers whose accounts contain proprietary or other securities products, including mutual funds or variable products, which may be difficult to service at the new firm, for a variety of reasons:

> Registered representatives with an established customer base may, from time to time, change their association from one firm to another and may wish to bring with them customer assets, including mutual funds and variable products. In some cases these mutual funds or variable products may be held directly with the product issuer or they may be proprietary to the representative's prior firm and the sponsor may not permit them to be transferred into the customer's account at the new firm. Even nonproprietary products may not be freely transferable if the sponsor does not have a dealer or servicing agreement with the new firm.[15]

Although Notice To Members 07-06 focuses on a firm's duty to review proprietary products contained in a new broker's accounts, by its own terms it applies the new firms' due diligence requirements more broadly. Notice To Members 07-06 reaffirms firms' duty to investigate a newly hired broker's book of business, noting: "When conducting due diligence concerning a prospective new registered representative, the new firm should seek to learn the nature of the representative's business."[16]

Similarly, FINRA Rule 2090 provides: "Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer."[17]

These rules contain no product-based limitation on the duty to understand a new representative's book of business. Thus, Notice To Members 07-06 and Rule 2090 provide a robust avenue to introduce a firm's obligations to carefully review a new client's incoming portfolio. Further, these resources

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15. NASD Notice to Members 07-06 (2007).

16. *Id* at 3.

17. FINRA Rule 2090 (2012).

"set the table" for additional FINRA rules and regulatory notices, discussed below, which address hold recommendations more specifically.

B. *FINRA Rule 2111(a): "Investment Strategy" Includes Explicit Recommendations to Hold a Security*

FINRA Rule 2111(a), the current "suitability" rule, requires firms and registered representatives to carefully consider their recommendations not merely in terms of specific transactions, but also in terms of "investment strategies."

> A member or an associated person ***must have a reasonable basis to believe that a recommended*** transaction or ***investment strategy involving a security or securities is suitable for the customer***, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile.[18]

The Supplementary Material to Rule 2111 expressly states that the term "investment strategy" "is to be interpreted broadly" and includes "an explicit recommendation to hold a security or securities":

> .03 Recommended Strategies. ***The phrase "investment strategy involving a security or securities"*** used in this Rule is to be interpreted broadly and ***would include, among other things, an explicit recommendation to hold a security or securities***.[19]

Taken together, these components of Rule 2111 establish that "an explicit recommendation to hold a security or securities" is an "investment strategy" for which a firm "must have a reasonable basis to believe . . . is suitable for the customer."

C. *FINRA Regulatory Notice 12-25: "Overly Concentrated Positions"*

The further implications of FINRA Rule 2111 are discussed in FINRA Regulatory Notice 12-25:

> The new rule [FINRA Rule 2111], moreover, imposes broader obligations on firms and associated persons regarding recommendations of investment strategies involving a security or

18. FINRA Rule 2111(a) (2012) (Emphasis added).

19. Supplementary Material to Rule 2111 (2012) at Section .03 (Emphasis added).

> securities. Not only does the new rule now explicitly cover recommended investment strategies involving a security or securities, but it also states that the term "investment strategy" is to be interpreted "broadly" and includes recommendations to "hold" a security or securities.[20]

The backup materials to Regulatory Notice 12-25 elaborate on the firm's duties with respect to hold recommendations. They expressly address the situation of a hold recommendation that is given with respect to securities purchased at a prior firm and transferred into the account, and particularly the circumstances of an over-concentrated position(s):

> Where a broker did not recommend the original purchase of a security but explicitly recommends that the customer subsequently hold that security, the new suitability rule would apply. However, as stated above and discussed in greater detail below, a firm may take a risk-based approach to evidencing compliance with the rule. A hold recommendation involving shares of a blue chip stock ordinarily would not present the type of risk, absent unusual facts, that would require a detailed analysis or documentation. ***Where the hold recommendation involves an overly concentrated position in a security, however, documentation usually would be necessary, even if the broker did not originally recommend the purchase of the security***.[21]

As is clear from the discussion in Regulatory Notice 12-25, FINRA rules and guidance have evolved to conclude without ambiguity that firms have express obligations for securities transferred into an account, even though the firm had no role in recommending the purchase of the securities.

Finally, at the risk of stating the obvious but lest the point escape the attention of the arbitration panel, the practitioner should be sure to drive home the point that the "documentation" referred to above -- in the phrase "documentation usually would be necessary" – means meaningful analysis of a customer's portfolio, and not merely paper generation confirming that the firm has reviewed the incoming portfolio.

20. FINRA Regulatory Notice 12-25 (2012).

21. FINRA Regulatory Notice 12-25 (2012), Response to Question 11 (Emphasis added).

D. *FINRA Regulatory Notice 12-55: "Investment Advice" Includes Advice Not to "Sell Any Securities" or "Make Any Changes to the Account"*

Like NASD Notice to Members 07-06 and FINRA Rule 2111(a), FINRA Regulatory Notice 12-55 and its backup materials also discuss the term "investment strategy":

> [T]he term ["investment strategy"] would capture ***an explicit recommendation to hold a security or securities or to continue to use an investment strategy involving a security or securities***. The rule would apply, for example, when a registered representative meets (or otherwise communicates) with a customer during a quarterly or annual investment review and ***explicitly advises the customer not to sell any securities in or make any changes to the account or portfolio*** or to continue to use an investment strategy.[22]

The Response to Question 7 in Notice 12-55 is significant because it defines "investment strategy" as including when the broker or firm "***continues to use an investment strategy*** involving a security or securities" (emphasis added) or "***advises the customer not to sell any securities in or make any changes to the account or portfolio*** . . . ." (Emphasis added.) This discussion makes clear that the "investment strategy" concept – i.e., the "know your customer" suitability duty -- applies not only to a recommendation to hold a ***specific security***. Rather, the firm has a suitability duty for an implicit approval of transferred-in securities as part of ongoing portfolio advice, even where the firm or broker did not provide an explicit "hold" recommendation as to a specific security or securities.

The thread running through these FINRA authorities appears to be that the transferred-in securities may not be legally isolated but rather become part of the portfolio for which the firm and the broker are responsible to provide reasonable and suitable advice.

IV. INTERNAL FIRM DOCUMENTS (ACCOUNT INTAKE FORMS AND POLICIES AND PROCEDURES MANUALS)

Firm policies and procedures manuals also are likely to contain provisions of the firm's/broker's duties with respect to transferred-in securities, including the firm's review of new account and the firm's supervision of the broker with

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22. Regulatory Notice 12-55 (2012), Response to Question 7 (Emphasis added).

respect to new accounts. Under the law, internal policies and procedures can be used as evidence of the duty element under negligence claims.[23]

Brokerage firms have policies and procedures for evaluating new accounts to assess the new customer, the customer's existing securities, and whether those securities are appropriate for the customer and the new firm. The standards and obligations reflected in these documents provide an additional layer of responsibility and scrutiny that firms must undertake in evaluating a new customer, including his or her transferred-in securities. An example of this would be transfer of a portfolio of securities concentrated in a single sector (e.g., energy) which remains so concentrated in the new account that it would generate activity reports or otherwise raise "red flags" in the normal course under that firm's policies.

V. FINAL THOUGHTS

To summarize Key points as to brokerage firm liability for transferred-in securities:

1. Under certain states' common law, brokerage firms and their registered representatives have a fiduciary duty to their customers.
2. Under certain states' common law, brokerage firms and their registered representatives may be held liable for "hold" recommendations.
3. FINRA Rule 2111(a) requires a broker to have "a reasonable basis to believe that a recommended transaction ***or investment strategy*** involving a security or securities is suitable for the customer." (Emphasis added.)
4. The "Supplementary Material" to Rule 2111, at Section .03, provides that the term "investment strategy" includes "***an explicit recommendation to hold a security or securities.***" (Emphasis added.)
5. The response to Question 7 in Notice 12-55 indicates that Rule 2111 would apply even where the transferred-in securities are not specifically discussed or mentioned by the broker (i.e., where the broker ***"advises the customer not to sell any securities in or make any changes to the account or portfolio . . . ."***) (Emphasis added.)

Based on these principles and authorities, to the extent that a Claimant can credibly convince an arbitration panel that the new broker recommended that

23. *See, e.g.* Throop v. Bache Halsey Stuart Sheilds, Inc., 650 F.2d 817, 820 (6th.Cir. 1981); Miller v. Smith Barney, Harris Upham & Co., 84 Civ. 4307, 1986 U.S. Dist LEXIS 28787*14-15 (S.D.N.Y. Feb. 27, 1986).

the client hold a transferred-in security, the Claimant may successfully establish the firm's liability relating to that security.

What constitutes a "recommendation to hold" a security? This certainly gives parties another issue to argue over at an arbitration hearing. But even without an express hold recommendation specific to that security, the firm may still be liable for the transferred-in securities where they effectively became part of the broker's recommended "investment strategy" where the broker advises the customer to make no changes in the account or to not sell any securities.

The practitioner should be prepared for the argument that the firm should not be penalized for an "investment strategy" (i.e., advice to "hold" or "do not sell") that, under most circumstances, would not be expected to generate any income for the firm. Do not discount the rhetorical power of this argument. But be prepared to argue that the issue of what is an appropriate portfolio or investment strategy is separate from whether the firm profits from it. In other words, the absence of commission or other income is not a license for the firm to not scrutinize new accounts. This is contrary to the law, contrary to the firms' policies and procedures, and if allowed would be an invitation for firms to breach their fiduciary duties to their new customers.

Finally, the argument for liability on the part of the second firm for transferred-in securities may inevitably be more persuasive where the customer follows the broker to the new firm than where the customer parts ways with the broker and moves to a new firm. From a standpoint of "optics" or perceived equities, the argument may have some weight, similar to the argument that the firm made no money from the purchase of the securities at issue. But legally the duty to review new accounts is that of the firm and cannot be evaded merely because the recommending broker is not affiliated with the new firm. Thus, the argument is a "red herring" and the practitioner needs to push back hard against it.

By using the "toolkit" of common law fiduciary duty and "holders" principles, FINRA rules and other guidance, and the firm's policies and procedures, the claimants' securities practitioner can establish liability for transferred-in securities that are unsuitable, over-concentrated, or otherwise inappropriate for the customer. When the new firm argues that "Some other dude" is at fault, use these tools to tell the firm: "***You're*** the dude, dude!"

PRODUCTION OF REGULATORY INVESTIGATION DOCUMENTS IN FINRA ARBITRATION

Stefan Apotheker[1]

Introduction

FINRA arbitration cases frequently involve issues and parties that have been the subject of a recent regulatory investigation and/or settlement with regulators. Claimants involved in such cases would be remiss not to seek discovery of the documents and transcripts of testimony provided to the regulatory investigators.[2] Broker-dealer respondents in FINRA arbitrations have developed a litany of objections to the production of such records, and for good reason. When a securities regulator concludes that a broker-dealer violated securities laws or SRO rules, the regulator's findings are often based (at least in part) upon the documents and testimony the broker-dealer and its employees provided to the regulatory investigators. In other words, the documents provided to the regulatory investigators often provide a roadmap for investors to prove claims based upon the same or similar misconduct that was the subject of the regulatory settlement. At a minimum, these documents may include useful gems that can be used during cross-examination of the respondent broker-dealer's witnesses at trial.

Successfully overcoming broker-dealers' objections to the production of regulatory investigation documents is essential to successfully discovering the truth. This article will address several of the most common objections asserted by broker-dealers on this issue, and explore some of most compelling case law and other authorities that claimants' counsel can use to address these objections when moving to compel the production of such records.

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1. Stefan Apotheker is an "AV" rated trial attorney with the law firm of Erez Law, PLLC in Miami, Florida. Since 2005, Stefan has represented hundreds of investors in FINRA arbitration proceedings in claims against broker-dealers and other financial institutions.

2. Testimony provided to FINRA and other securities regulators in connection with a pending investigation often comes in the form of an "on-the-record" interview ("OTR"), which may not be "testimony" *per se*, but nonetheless often contains extremely relevant statements and admissions which may pull back the curtain on a variety of highly sensitive issues which ultimately led the regulators to conclude that securities law violations may have occurred.

i. Documents provided to regulators and transcripts of statements provided to regulators are discoverable in subsequent civil proceedings involving the same or similar issues

As a threshold matter, the law is well settled that the documents and transcripts of statements provided to securities regulators in connection with an investigation related to the same or similar misconduct at issue, are discoverable in subsequent civil litigation proceedings. For example, in *Kirkland v. Superior Court of Los Angeles County,*[3] a corporation brought an action for fraud and unfair competition against a competitor.[4] The corporation issued a discovery request to the competitor seeking documents and transcripts of testimony given to the SEC related to an SEC investigation into the competitor.[5] The trial court granted the corporation's motion to compel and the competitor appealed.[6] On appeal the court held:

> Testimony and documents presented to the SEC about transactions involving PLB, Western, and Pacific, and about similar transactions involving Kirkland, are all relevant to Guess's claim that Kirkland orchestrated those transactions in an effort to enhance PLB's financial appearance… The SEC materials are discoverable for this reason, and we therefore disregard Kirkland's screed about the perils of overreaching discovery arising out of Guess's incidental unfair competition claims.[7]

Similarly, in *Mallinckrodt Chemical Works v. Goldman Sachs & Co.* a party sought to compel the production of all documents submitted to S.E.C. investigators in connection with an S.E.C. investigation.[8] When ordering the documents to be produced, the court noted that the S.E.C. investigation focused on the same or similar conduct and practices at issue in the pending civil litigation, and held:

3. 115 Cal. Rptr. 2d 279 (Cal. Ct. App. 2002).

4. *Id*.

5. *Id*.

6. *Id.* at 280-81.

7. *Id.* at 284.

8. 58 F.R.D. 348 (S.D.N.Y. 1973).

> **[i]t is apparent that the SEC investigation focused on the practices used by defendant**...
> **The substantive issues raised by plaintiffs in this action are intimately related to these practices. Even if some items are irrelevant, plaintiffs' demand for this group of documents certainly complies with the requirement of relevance**. (Emphasis added.)[9]

In fact, courts addressing this issue throughout the country have similarly held that documents provided to the regulatory investors are discoverable in subsequent civil litigations involving the same or similar practices, conduct or issues.[10]

As illustrated above, courts addressing this issue have consistently held that documents a party has previously provided to securities regulators in an investigation and transcripts of statements it provided to investigators, are discoverable in subsequent litigation involving the same or related issues.

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9. *Id*. at 354.

10. *See also, Tavoulareas v. Washington Post Co.*, 93 F.R.D. 24 at 31 (D.D.C. 1981) ("The Court finds Mobil's objections unpersuasive. The SEC investigation of Mobil concerned events and transactions that are directly relevant to the issues raised by this lawsuit... Request 11 is focused on a particular SEC investigation of the particular allegation... at issue in this suit. Consequently, the Court will order production of the documents requested."); *In re Home Unity S'holder Litig.*, No. 87-5609, 1988 WL 52014, at *2 (E.D. Pa. 1988) ("There is no dispute that these documents are highly relevant to this litigation... Because the SEC documents are plainly relevant to this litigation... I will grant the portion of plaintiffs' motion seeking the production of documents.); *In re Tyco Int'l*, MDL Docket No. 02-1335-B, 2004 WL 556715, at *4 (D.N.H. 2004) ("For the reasons set forth in this Memorandum and Order, I grant Belnick's motion to compel... Tyco is ordered to produce documents that it previously provided to the SEC...").

ii. There is no privilege or policy consideration that protects the documents and statements a broker-dealer has provided to securities regulators from discovery in subsequent civil proceedings

One of the more common objections asserted by broker-dealers seeking to avoid producing regulatory investigation documents is that documents provided to regulatory investigators are somehow deemed to be confidential, privileged, or otherwise protected from discovery as a matter of public policy.

Broker-dealers often seek to mislead FINRA arbitration panels by improperly seeking to claim a privilege that belongs solely and exclusively to the regulator, not the broker-dealer. Courts addressing this issue have consistently held that there is no privilege or other policy consideration that protects the documents and statements provided to investigators from discovery in subsequent proceedings involving the same or similar issues.

One common tactic used to assert this objection is to cite to statutes such as 17 C.F.R. § 203.2 and § 203.6 as a basis for an objection that any documents or transcripts of statements they provided to the Securities and Exchange Commission (SEC) in connection with an investigation are deemed to be "non-public" and therefore protected from discovery. 17 C.F.R. § 203.2 and § 203.6 provide in relevant part:

> **§ 203.2 Information obtained in investigations and examinations**
> **Information or documents obtained by the Commission in the course of any investigation or examination, unless made a matter of public record, shall be deemed non-public**…
> **§ 203.6 Transcripts**
> … A person who has submitted documentary evidence or testimony in a formal investigative proceeding shall be entitled, upon written request, to procure a copy of his documentary evidence or a transcript of his testimony on payment of the appropriate fees: Provided, however, That **in a nonpublic formal investigative proceeding the Commission may for good cause deny such request**. **In any event, any witness, upon proper identification, shall have the right to inspect the official transcript of the witness' own testimony**. (Emphasis added.)

Efforts to rely on 17 C.F.R. § 203.2 and similar statutes as a basis for avoiding production of documents it previously provided to the SEC are misplaced. For example, 17 C.F.R. § 203.2 merely provides that the SEC's internal investigation files are deemed to be "non-public", however this provision has no applicability to the production of documents from a party. In other words, 17 C.F.R. § 203.2 could be an impediment to a litigant obtaining the SEC's internal investigation files from the SEC. However, this statute should never be an impediment to a litigant obtaining many of those same documents directly from the party who provided the records to the SEC in the first place.

For example, in *D'Addario v. Geller*, a shareholder brought suit against several corporate officers and directors for, amongst other things, fraud and breach of fiduciary duty.[11] The trial court dismissed the shareholder's action and the shareholder appealed on the grounds that, amongst other things, the trial court erred by refusing to compel the corporate officers and directors to produce documents they submitted to the SEC in connection with an investigation.[12] On appeal, the Fourth Circuit Court of Appeals vacated the trial court's summary judgment and held:

> D'Addario next argues that the district court erred by refusing to compel Geller and Couture to produce (on behalf of RMST) documents and materials that RMST had submitted to the SEC in a separate investigation. **The district court found, and Geller and Couture now argue, that there exists a privilege (an SEC privilege) as to documents that are involuntarily submitted to the SEC in response to an investigative subpoena**.
>
> **The district court erred because there is no such thing as an SEC privilege**. Geller and Couture cite to *In re Steinhardt Partners, L.P.*, 9 F.3d 230 (2nd Cir.1993), *In re Subpoenas Duces Tecum*, 738 F.2d 1367 (D.C.Cir.1984), and 17 C.F.R. § 203.2 (2004) to support their argument for this privilege. **These sources do not establish or support an independent SEC privilege**…
>
> **Further, the regulation cited by Geller and Couture, 17 C.F.R. § 203.2, provides only that information and documents obtained by the SEC in the course of an investigation are deemed non-public. The regulation does not provide that documents and materials submitted to the SEC are not discoverable in a later civil proceeding. Because there is no SEC privilege, the district court erred in refusing to compel discovery of the documents and materials submitted by RMST to the SEC**.[13]

This issue was also addressed in detail in *Kirkland v. Superior Court of Los Angeles County*, where a corporation attempted to avoid production of documents and testimony provide to regulators on the grounds that federal

11. 129 F. App'x 1 (4th Cir. 2005).

12. *Id*. at 5.

13. *Id*. (emphasis added).

laws and S.E.C. regulations required that the documents and transcripts be treated as private and confidential.[14] When rejecting this argument, the court held:

> **We conclude that transcripts of testimony given before the SEC in the course of an investigation are discoverable in civil litigation where, as here, the party from whom discovery is sought has possession of or ready access to the documents and transcripts**… **[t]here is no law to support Kirkland's claim that the SEC testimony and documents should as a matter of policy be treated as private or confidential, and the law that does exist supports the opposite conclusion**. Witnesses who testify or produce documents to the SEC usually have the right to obtain copies of the transcripts of their testimony and documents (17 C.F.R. § 203.6 (2001)), and where they have done so (as has Kirkland) there is no cognizable claim of confidentiality or privacy in those documents or transcripts.[15]

Once a party has been provided with a copy of the transcripts of its employees' statement to the regulatory investigators, absent some explicit restriction from the regulator, those transcripts are discoverable the same as any other document in the party's possession.

Perhaps the seminal case addressing this issue is *LaMorte v. Mansfield*, wherein the Second Circuit Court of Appeals rejected a defendant's attempt to avoid production of his prior testimony to the S.E.C. in connection with an S.E.C. investigation involving the same and/or similar issues.[16] Specifically, in *Zients v. LaMorte*, a group of corporate stockholders brought an action alleging violation of federal securities laws against several corporate officers and directors, including the corporation's president. In discovery, the stockholders sought to compel the production of the corporate president's prior testimony to S.E.C. investigators involving some of the same matters that gave rise to the stockholders' claims.[17] The corporate president sought to avoid production of the transcript on the grounds that federal statutes and S.E.C. regulations provide that documents and transcripts obtained in S.E.C. investigative proceedings are to be deemed confidential.[18] When rejecting the

14. 115 Cal. Rptr. 2d 279 (Cal. Ct. App. 2002).

15. *Id.* at 281, 284.

16. 438 F.2d 448 (2d Cir. 1971).

17. 319 F. Supp. 956, 957 (S.D.N.Y. 1970).

18. *Id.* at 957-58.

corporate president's arguments, the United States District Court for the Southern District of New York held:

> [i]t is left to the administrative agency, the SEC, to determine whether the cloak of confidentiality is essential to the conduct of a particular investigation being conducted by it or whether public disclosure of the contents of documents and testimony would not be contrary to the public interest. **In this investigation the SEC does not believe that Mr. LaMorte's testimony must remain confidential, since it has permitted him to obtain a complete transcript without any injunction against his disclosure of it to third persons**…
>
> Under such circumstances we fail to see any sound purpose to be served in barring plaintiffs here from access to the transcript of La Morte's SEC testimony…
>
> Here the SEC, by releasing the testimony to LaMorte, does not consider confidentiality as being any longer essential to the investigation. (Emphasis added.)[19]

In *LaMorte v. Mansfield*, the corporate president then petitioned the Second Circuit Court of Appeals for a writ of mandamus seeking to vacate the trial court's order on the grounds that federal statutes and S.E.C. regulations require that the transcripts be treated as confidential.[20] When rejecting the corporation's president's argument, the Second Circuit Court of Appeals held:

> Petitioner relies principally on federal statutes and SEC regulations designed to preserve the secrecy of administrative investigations when this is necessary for proper discharge of the agency's functions. The thrust of his argument is that by availing himself of the opportunity, provided both by statute, 5 U.S.C. § 555(c), and regulation, 17 C.F.R. § 203.6, to obtain under some circumstances a transcript of his testimony before the SEC in a nonpublic investigation, he did not thereby forfeit his alleged privilege to maintain the confidentiality of this testimony…
>
> Petitioner's assertion is that the grant to agencies of a limited power to maintain the secrecy of nonpublic investigatory records that was made by what is now 5 U.S.C. § 555(c) and by 5 U.S.C. § 552(b)(7), along with the SEC's regulations to the same effect, provides a witness who has obtained copies of his own testimony pursuant thereto with a comparable right of nondisclosure. **This would stand these statutes and regulations on their heads**… The attendant limited grants to

19. *Id.*

20. *Mansfield*, at 449-50.

> agencies of the right to inhibit access to testimony in nonpublic investigatory proceedings were in recognition that such investigations, 'like those of a grand jury, might be thwarted in certain cases if not kept secret, and that if witnesses were given a copy of their transcript, suspected violators would be in a better position to tailor their own testimony to that of the previous testimony, and to threaten witness about to testify with economic or other reprisals…
> **To the extent that a privilege exists, it is the agency's, not the witness'**. **The agency is free to withdraw the veil of secrecy, and once the witness has been allowed to obtain the transcript of his testimony, it is no more privileged or confidential in his hands-absent any restriction placed by the agency on disclosure of its contents-than any other record of a previous statement would be**. (Emphasis added.)[21]

As set forth above, the courts addressing this issue have consistently held that there is no privilege or public policy consideration that protects the documents and transcripts of statements provided to regulatory investigators from discovery.

iii. Requests for documents exchanged with regulators and transcripts of statements provided to regulators are not "overly broad"

Another common objection asserted by broker-dealers is to argue that the discovery requests calling for documents provided to securities regulators are "overly broad" or somehow lacking sufficient specificity for the respondent broker-dealer to identify the documents being requested. This objection has

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21. *Id.* at 449-51. *See also, Marshall v. Galvanoni*, No. 17-cv-00820, 2019 WL 803895, at *2 (E.D. Cal. Feb. 21, 2019) ("The court is persuaded by these authorities and by the text of the regulations themselves that any privilege to prevent the public's access to investigatory records is held by the SEC, and not by defendants. Defendants thus do not have standing to seek sealing of the one new document they now present."); *Maryville Acad. v. Loeb Rhoades & Co.*, No.77-C-1206, 1978 WL 114, at *2 (N.D. Ill Dec. 5, 1978) ("The confidentiality rules, employed by the SEC in non-public investigations, are for the benefit of the Commission… Accordingly, plaintiff's motion to compel is granted. Defendants are directed to request any non-defendant officer, director, employee, agent, attorney or other representative who testified before the Securities and Exchange Commission to obtain transcripts and to deliver them to plaintiff.").

also been rejected by the courts. For example, in *Mallinckrodt*, the court addressed this exact issue and held:

> Plaintiffs have moved... for an order compelling defendant, Dun & Bradstreet, Inc. (Dun & Bradstreet or D&B) to produce for plaintiffs' inspection **'all documents submitted to the Securities and Exchange Commission (SEC) in connection with the SEC's investigation of the financial collapse of the Penn Central Company.'**
>
> **The designation is limited both spatially and temporally to the SEC inquiry**...
>
> Defendant states that its production to the SEC does not necessarily bring plaintiffs' demand within the ambit of Rule 34(b), which requires that a designation of documents be reasonably specific.
>
> The leading commentators view the designation requirement as going to identification. Professor Moore believes the appropriate question 'is whether a reasonable man would know what documents or things are called for.' 4A J. Moore, Federal Practice, ¶34.07, at 34–57 & n. 18. Under this standard **it is clear that defendant can identify the documents demanded by plaintiffs. Defendant has already produced these documents to the SEC**.[22]

Id. at 353.

Similarly, in *In re Home Unity Shareholder Litigation*, the United States District Court for the Eastern District of Pennsylvania addressed this issue and ordered the production of documents responsive to exactly such discovery requests. When issuing its decision, the court held:

> **Request number 4 seeks:**
>
> **All documents referring to, relating to, or reflecting any lawsuit, investigation or proceeding by:**
>
> **(a) the Securities and Exchange Commission (SEC),**
>
> **(b) the Federal Savings and Loan Insurance Corporation and**
>
> **(c) the Federal Home Loan Bank Board.**
>
> **Request number 5 seeks:**
>
> All documents referring or relating to examination or supervision of the conditions or performance of Home Unity by FSLIC and any other federal, state, or local agency including without limitation, **all documents referring or relating to any consent supervisory agreements entered into with FSLIC**…

22. 58 F.R.D. 348, 353 (S.D.N.Y. 1973) (emphasis added).

> **Because the SEC documents plaintiffs seek are relevant to this litigation and defendants have failed to demonstrate that the documents are privileged, I will grant that portion of plaintiffs' motion seeking the production of documents sought in plaintiffs' request number five (5)**…
> **That part of plaintiffs' motion which seeks the production of documents relating to "any lawsuit, investigation or proceeding" by the SEC is GRANTED. Defendants shall provide plaintiffs with these documents within 10 days of the date of this order.**[23]

As clearly illustrated above, courts routinely order the production of discovery requests containing broadly worded language calling for the production of documents related to a regulatory investigation.

iv. Documents broker-dealers provide to securities regulators are not protected by the attorney-client privilege

Another common objection asserted by broker-dealers seeking to avoid production of regulatory investigation records is that the documents it provided to regulatory investigators are protected by the attorney-client and/or work product privilege. Regulatory investigations often include communications back and forth between regulatory investigators and the broker-dealer's counsel. These communications may include document and information requests and responses, among other things.

Courts addressing this issue have held that documents exchanged with securities regulators, including correspondence and other documents prepared by the broker-dealer's counsel, are discoverable. In *In re Kidder Peabody*, 168 F.R.D. 459 (S.D.N.Y. 1996), shareholders brought a derivative suit against their brokerage firm for fraud in connection with misstated earnings.[24] The shareholders filed a motion to compel seeking, inter alia, correspondence and memoranda prepared and provided by the brokerage firm's attorneys to the

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23. 1988 WL 52014, at *1-3 (E.D. Pa. 1988) (emphasis added); *see also, In re WorldCom Sec. Litig.*, 234 F. Supp. 2d 301, 306 (S.D.N.Y. 2002) ("Defendants argue that plaintiffs' discovery request is not sufficiently 'particularized' to justify a partial lifting of the stay. Yet plaintiffs' request has already been pared down to address the concerns of the U.S. Attorney and involves a clearly defined universe of documents, specifically certain documents which WorldCom has already produced in connection with other identified proceedings.").

24. 168 F.R.D. at 461.

SEC.[25] The brokerage firm objected on the grounds that the documents were protected by the attorney work product privileges.[26] When rejecting this argument, the court held:

> **The submission of the draft report to the SEC at a time when the Commission was considering the question of who was responsible for the scandal suffices to waive any privilege for the underlying documents**…
>
> **The fact that the documents here are sought by plaintiffs and not by the SEC is inconsequential. Kidder cannot "pick and choose" when to waive the privilege, allowing some to see the privileged documents and others not to**... If the privilege was effectively waived vis-a-vis the SEC, it was waived as well for the parties in this litigation.[27]

Similarly, in *In re: Steinhardt Partners L.P.*, 9 F.3d 230 (2d Cir. 1993), investors filed a class action lawsuit alleging market manipulation of U.S. treasury notes, which had previously been the subject of an S.E.C. investigation.[28] In discovery, a group of co-defendants sought to avoid production of a memorandum that had previously been provided to the S.E.C. in connection with its investigation.[29] The plaintiffs filed a motion to compel production of the memorandum and the co-defendants objected on the grounds that the memorandum had been prepared by their attorney and was protected by work product privilege.[30] The trial court granted the motion to compel on the grounds that prior disclosure of the memorandum to the S.E.C. waived the claim for work product protection, and the co-defendants filed a petition for writ of mandamus seeking to vacate the trial court's order.[31] When rejecting the co-defendant's argument, the Second Circuit Court of Appeals held:

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25. *Id.* at 461-62.

26. *Id.*

27. *Id.* at 473 (emphasis added).

28. 9 F.3d at 230.

29. *Id.*

30. *Id.*

31. *Id.*

Conclusion

> **At the time of the submission of the memorandum to the Enforcement Division, the SEC and Steinhardt stood in an adversarial position. Steinhardt's voluntary submission of the memorandum to the Enforcement Division waived the protections of the work product doctrine as to subsequent civil litigants seeking the memorandum from Steinhardt**.[32]

As illustrated above, courts throughout the country have consistently held that parties who have previously produced a document to regulatory investigators are deemed to have waived their right to claim the documents are privileged when seeking to avoid production of those records in subsequent civil litigation.

v. It is not unduly burdensome for a broker-dealer to produce the documents and transcripts of statements it previously provided to regulators

Broker-dealers routinely argue that the production of documents it previously provided to regulatory investigators would be "unduly burdensome." Again, the courts addressing this issue have rejected this argument. In *Ryan v. Gifford*, a plaintiff filed a motion to compel seeking all correspondence between the defendants and the SEC.[33] The defendants objected on the grounds that the requests were burdensome, irrelevant and

32. *Id.* at 236 (emphasis added). *See also, In re Leslie Fay Cos., Inc. Sec. Litig.*, 161 F.R.D. 274, 283 (S.D.N.Y. 1995) ("[t]he Audit Committee's production of the ACR [Audit Committee Report] to the SEC waived any work-product immunity and attorney-client and self-critical analysis privileges... BDO is entitled to its requested discovery..."); *Bank of America v. Terra Nova Ins. Co.,* 212 F.R.D. 166 (S.D.N.Y. 2002) ("[t]he Court finds that Terra Nova waived its work product protection through the disclosures it made to the NYSID, the U.S. Attorney's Office and the United States Postal Inspector. Therefore the Court grants Bank of America's motion to compel."); *McKesson HBOC v. Adler*, 562 S.E.2d 809, 814 (Ga. Ct. App. 2002) ("[t]he trial court ordered McKesson to produce 'any and all materials sent out to the Securities and Exchange Commission'... The trial court correctly determined that the attorney-client privilege did not apply to the documents at issue here.").

33. 2007 WL 4259557, at *1 (Del. Ch. 2007).

called for privileged documents. When rejecting the defendants' objections, the court held:

> Plaintiffs seek an order compelling... all defendants (and Maxim) to provide copies of communications between any defendant and the Securities and Exchange Commission (the "SEC")... including transcripts of testimony provided to the SEC... defendants contend the requests are burdensome, irrelevant, privileged or not in the possession of the individual defendants.
>
> **For the following reasons, I grant plaintiffs' motion to compel**...
>
> **[t]he most equitable solution to plaintiffs' request for communications between all defendants (including Maxim) and the SEC, is for Maxim to scan and produce on CD or DVD a complete and unaltered set of all documents (including cover letters and "MXIM-SEC" Bates numbers) actually produced to the SEC, which Maxim has in its possession**...
>
> **This will obviate any purported burden** from such production because Maxim must have those documents organized in MXIM-SEC Bates number order in its files. Thus, production in the manner described above should not be difficult...
>
> Accordingly, consistent with the above-described parameters, I grant plaintiffs' July 3, 2007 motion to compel...[34]

Courts addressing this issue have repeatedly held that where the documents being requested have previously been produced, there is virtually no burden to produce those same documents in a subsequent civil litigation. For example, in *In re New Century*, 2009 WL 9568860 (C.D. Cal. 2009), a defendant objected to producing documents it had previously provided to government investigators, on the grounds that production would be unduly burdensome.[35] When rejecting this argument, the court held:

> **Indeed, there is virtually no burden that will be placed on defendant since the requested documents have already been found, compiled, and indexed.[36]**

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34. *Id.* at *2 (emphasis added).

35. 2009 WL 9568860, at *6.

36. *Id. See also, In re Delphi Corp.*, 2007 WL 518626 (E.D. Mich. 2007) ("[u]nlike cases rejecting virtually unlimited discovery requests, the motion at issue here describes a 'clearly defined universe of documents,' and the burden of producing the materials should be slight, considering that the defendants have previously produced them to other entities…"); *In re: Initial Pub. Offering Sec. Litig.*, 2004 WL 60290, at *5 (S.D.N.Y. Oct. 13, 2004) ("[d]iscovery of the Wells submissions at issue here poses neither undue burden nor a risk of embarrassment or annoyance... Indeed,

The modern reality is that broker-dealers typically maintain electronic copies of documents they provided to the regulatory investigators. As such, it can hardly be said to be a "burden" to copy the electronic files to an external hard drive and produce them.

vi. Financial privacy statutes do not prohibit broker-dealers from producing documents related to a regulatory investigation

An objection that has been asserted with increasing frequency in recent years is that financial privacy statutes preclude the broker-dealer from producing responsive documents. While it is true that documents provided to regulators often contain records related to non-party customers, the applicable financial privacy statutes do not prohibit the production of these documents in a subsequent litigation.

The applicable federal statute that governs financial privacy is the Gramm-Leach-Bliley Act, which generally prohibits financial institutions from disclosing non-public information about its customers. However, the Gramm-Leach Bliley Act explicitly authorizes the production of documents in legal proceedings such as arbitration. Specifically, the Gramm-Leach-Bliley Act states:

> (e) General Exceptions
> Subsections (a) and (b) of this section shall not prohibit the disclosure of nonpublic personal information—
> (8) **to comply with Federal, State, or local laws, rules, and other applicable legal requirements; to comply with a properly authorized civil, criminal, or regulatory investigation or subpoena or summons by Federal, State, or local authorities; or to respond to judicial process** or government regulatory authorities having jurisdiction over the financial institution for examination, compliance, or other purposes as authorized by law.[37]

In fact, state financial privacy statutes typically contain similar carveout language that specifically authorizes the production of non-party customer

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production of the Wells submissions would be absolutely no burden...."); *White v. Jaegerman*, 51 F.R.D. 161 at 163 (S.D.N.Y. 1970) ("We find that under the circumstances he will not assume an undue burden by producing documents copies of which may also be in the files of the Securities and Exchange Commission. We recognize the Commission practice of requiring litigants in private lawsuits to obtain materials from the person who furnished them to the Commission.").

37. *See* 15 U.S.C. § 6802 (2019) (emphasis added).

account information in response to “judicial process”, such as a litigation or arbitration proceeding.[38]

Objections that financial privacy statutes somehow prohibit the broker-dealer from producing documents related to non-party customers are often belied by the very financial privacy statute being cited.

vii. A broker/dealer’s settlement with the regulator is not an acceptable substitute for the documents which formed the basis for the regulatory investigator’s findings

Some claimants’ counsel may be tempted to forego pursuit of the regulatory documents and testimony under the assumption that as long they have the regulatory settlement, they do not need the underlying regulatory documents and testimony. In fact, a common tactic employed by broker-dealers seeking to avoid the production of regulatory documents and transcripts is to argue that the underlying documents are somehow unnecessary because the broker-dealer’s settlement with the regulator (e.g. FINRA Letter of Acceptance, Waiver and Consent, etc.) is already publicly available. This proposition is a trap.

First and foremost, the regulatory documents and testimony provided to regulators often form the foundation upon which the regulators’ factual findings are based. These documents often provide a rich source of useful material which can be used to cross examine the broker-dealer’s employees at the final hearing.

Claimants’ counsel foregoing the pursuit of the regulatory documents and transcripts under the assumption that they can simply introduce the regulatory settlement into evidence at the final hearing may be in for a rude awakening.

There is no guarantee that the regulatory settlement itself will be admissible at the final hearing. Broker-dealers routinely file motions in limine seeking to exclude AWC’s and other regulatory settlements from evidence in FINRA arbitration hearings.

Broker-dealers also regularly seek to exclude AWC’s and similar regulatory settlements on a variety of grounds[39] including, but not limited to:

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38. *See Regions Bank v. Lynch*, 2009 WL 395780, at *2 (M.D. Fla. 2009) (“Additionally, the financial privacy statutes cited by Defendants (also not presented to the Magistrate) have specific exclusions for subpoenas and appropriate court orders. See 15 U.S.C. § 6802(e)(8) and Fla. Stat. § 655.059(1)(e)”).

39. While there is a wealth of FINRA and legal authority firmly establishing the admissibility of factual findings contained in regulatory settlements, counsel must

(i) the settlement agreement does not contain an admission of liability; (ii) the factual findings in the settlement agreement were not adjudicated on the merits; (iii) federal rules of evidence limit the purposes for which a settlement agreement may be admissible[40]; and (iv) there are public policy arguments against the introduction of settlement agreements for the purpose of proving liability.

In the event that a panel were to grant such a motion in limine, a claimants' counsel who did not successfully obtain the underlying regulatory documents and transcripts in discovery could find themselves in the highly unenviable position of being precluded from cross examining the broker-dealer's witnesses about the settlement agreement, and also unable to cross examine the broker-dealer's witnesses about the underlying documents and testimony which gave rise to the settlement.

It is for precisely this reason that claimants' counsel should aggressively pursue discovery of the underlying regulatory documents and testimony. Once these records have been obtained in discovery, an adverse ruling regarding the admissibility of the actual settlement agreement will have a substantially less harmful impact on the presentation of the claims.

Conclusion

In cases involving a respondent that has been the subject of a regulatory investigation or settlement for the same or similar misconduct, the regulatory documents and transcripts have consistently proven to be one of the more important categories of discovery a claimant can obtain. As set forth above, there is extensive case law throughout the country supporting a litigant's right to discover this important category of evidence, and these records should be pursued aggressively in every case where responsive documents exist.

always be prepared to fully present their claims even in the face of an adverse or incorrect ruling regarding admissibility of an AWC or regulatory settlement.

40. It should be noted here that the FINRA Arbitrator Guide explicitly states that the Federal Rules of Evidence do not apply in FINRA arbitrations and that FINRA policy supports more liberal introduction of evidence than would otherwise be allowed in a court proceeding.

RIA STATE STANDARDS OF CONDUCT AND THE PRIVATE RIGHT OF ACTION SURVEYING CALIFORNIA, FLORIDA, ILLINOIS AND TEXAS

Michael S. Edmiston[1] and Maria E. Vaz Ferreira[2]

What distinguishes the obligations of investment advisers from stockbrokers is that they have a fiduciary duty to always act in their clients' best interests [3] when recommending or making investment decisions and, most importantly, many state statutes provide a private cause of action for the violation of that fiduciary duty.

The regulation of Registered Investment Advisers ("RIAs") starts with the Investment Advisers Act of 1940 ("IAA").[4] The details are left to the states, and while most states have adopted at least part of the IAA addressing the regulation of RIAs in their Blue-Sky laws, there are key state-by-state differences with regard to standards of conduct and available remedies.

This article focuses on the Blue Sky laws of California, Florida, Illinois, and Texas and the remedies available to investors related to RIA Standards of Conduct.[5]

- California does not provide a direct remedy for a violation of its rules and regulations governing the activities of RIAs, but leaves room for creativity and thoughtful pleading.
- Florida is the most aggressive in protecting its citizens by giving them an across-the-board private cause of action for investment adviser abuses.

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1. Michael S. Edmiston is an attorney with Jonathan W. Evans & Associates. Michael is grateful to Professor Christine Lazaro and Joe Wojciechowski for their research and contributions to this article.

2. Maria E. Vaz Ferreira is a St. John's University School of Law student. She is expected to graduate from law school in 2021.

3. *See generally* J. Tyler Kirk, *A Federal Fiduciary Standard under The Investment Advisers Act of 1940: A Refinement for the Protection of Private Funds*, 7 HARV. BUS. L. REV. ONLINE 19 (2016), https://www.hblr.org//wp-content/uploads/sites/18/2016/12/T.-Kirk_Private-Funds-FD-Published-2.pdf.

4. 15 U.S.C. § 80b-1 et seq.

5. The Appendix provides a cross-reference of issues and applicable California, Florida, Illinois and Texas rules.

- Illinois and Texas also give broad private causes of action, but their laws and regulations governing RIAs are less comprehensive than those of California and Florida.

I. Standard of Conduct Under California's Antifraud Provision and Related Regulations

A. California Antifraud Statute in Relation to The Investment Adviser Act of 1940

California Corporations Code § 25235 adopts the four anti-fraud provisions of § 206(1)-(4) and also § 208(c) of the Investment Advisers Act of 1940. From there, the California Code of Regulations defines the type of conduct which is considered fraudulent and/or deceptive practice.

The four anti-fraud prohibitions of Cal. Corp. Code § 25235 makes it unlawful for any investment adviser:

(a) To employ any device, scheme, or artifice to defraud any client or prospective client.

(b) To engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon any client or prospective client.

(c) Acting as principal for his own account, knowingly to sell any security to or purchase any security from a client for whom he is acting as investment adviser, or, acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of the transaction the capacity in which he is acting and obtaining the written consent of the client to such transaction.[6]

(d) To engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The commissioner shall, for the purpose of this subdivision, by rule define and prescribe means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

The "truth-in-title" section of § 25235 makes it unlawful for an investment adviser:

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6. Most states remove this provision, which was not included in the Uniform Act. Robert N. Rapp, 2 Blue Sky Regulation, Ch. 13, § 13.02 (Matthew Bender, 2019).

> (e) To represent that he is an investment counsel or to use the name "investment counsel" as descriptive of his business unless his principal business consists of acting as investment adviser and a substantial part of his business consists of rendering investment advisory services on the basis of the individual needs of his clients.

The California Code of Regulations brings certain conduct within the meaning of fraudulent and deceptive practices proscribed by its anti-fraud statute.

Cal. Code Regs. tit. 10, § 260.235[7] details the kinds of advertisements that are considered fraudulent, deceptive or manipulative, and are therefore a violation of investment adviser's duties. The advertising prohibitions broadly include testimonials; past recommendations; charts and graphs; promises of free analysis of service unless actually free; and, untrue statements of material act. For each type of advertising prohibition, the Regulation provides exceptions and safe harbors.

Failure to disclose compensation schemes and conflicts of interests is also considered "fraudulent, deceptive or manipulative act" within the meaning of Section 25235 of the Code, as per Cal. Code Regs. tit. 10, § 260.235.2.[8]

Cal. Code Regs. tit. 10, § 260.235.3(c) requires written disclosure and consent requirements for cross-agency transactions.[9] The lack of disclosure is considered a "fraudulent, deceptive or manipulative act." The cross-agency transaction rule is notable since it expressly does not relieve the adviser "from acting in the best interest of the advisory client" (or from any other disclosure obligations under California laws or regulations).[10]

Finally, Cal. Code Regs. tit. 10, § 260.235.4 attaches liability for the failure to disclose material facts with respect to the financial condition or disciplinary history of the adviser that is likely to impact the ability of the adviser to meet the client's obligations.[11]

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7. Cal. Code Regs. tit. 10, § 260.235 (2019).

8. *Id.* § 260.235.2.

9. *Id.* § 260.235.3.

10. *Id.* § 260.235.3(c).

11. *Id.* § 260.235.4.

B. California Statutes and Regulations Establishing Ethical Principles of Conduct

The California Corporations Code § 25238 gives the State Commissioner authority to prescribe rules designed to promote fair, equitable, and ethical principles.[12] Accordingly, Cal. Code Regs. tit. 10, § 260.238 establishes the standards of conduct for investment advisers.[13] The prohibited practices are:

(a) Unsuitable investment recommendations;
(b) Unauthorized trading;
(c) Trading on the instruction of a third-party without a written grant of authority;
(d) Discretionary trading without a written grant of authority;
(e) Excessive trading (size and/or frequency);
(f) Borrowing money from a client;
(g) Loaning money to a client;
(h) Misrepresenting the qualifications of the adviser, the scope of services to be provided, or the fees to be charged for the services provided;
(i) Providing third-party research or recommendations to the client without disclosing the source (exception for using research for providing advice, or ordering a report in normal course of business);
(j) Charging an unreasonable advisory fee in light of services to be provided, adviser's expertise, bargaining power of client, or that lower fees may be available from other sources;
(k) Failing to disclose conflicts of interest, including commissions received from transactions executed pursuant to advisory service (e.g., 12b-1 fee sharing or kickbacks from dealers);
(l) Guaranteeing results;
(m) Failing to maintain client confidentiality;
(n) Entering into a client-specific advisory contract unless, among other things, it is in writing and defines the services to be rendered, fees to be charged, and whether discretionary trading authority is given to the adviser; and,
(o) Making untrue statements of material fact, or omitting a statement of material fact.

12. Cal. Corp. Code § 25238 (West 2019).

13. Cal. Code Regs. tit. 10, § 260.238 (2019).

C. Cases Dealing With Private Right of Action for Investment Adviser Misconduct

The California Securities Laws includes a private right of action for consumers defrauded under the investment adviser portion of the Act at Cal. Corp. Code 25401.[14] California permits civil actions by anyone who received a material misrepresentation or omission in a securities transaction, whether the person is a buyer or seller.[15] There are no scienter, reliance, or loss causation requirements in the statute (unlike federal securities laws). The scope of the private right of action can include control persons and officers who provided "material" support.[16] The remedy is rescission if the injured party still holds the securities. Otherwise, the remedy is damages. For misconduct by an adviser, a plaintiff or claimant pursuing a California Securities Law cause of action or claim has to bring it under § 25401.

There is no implied civil liability under the Corporate Securities Law and outside of § 25401 and 25501, there is no stated private remedy for a violation of Cal. Corp. Code § 25235 or 25238.[17] Conversely, there is no prohibition against using Cal. Evid. Code § 669 *negligence per se* presumption linked to §25238 and the statute's underlying regulations in a negligence claim for damages.[18]

In July 2018, a magistrate judge in the Northern District of California recognized a private cause of action under Sections 25230 and 25235 of the California Corporations Code in *Yokell v. Draper*.[19] The *Yokell* facts are unique in that the plaintiff alleged that the defendant had acted as an unlicensed investment adviser.[20] Two of the many causes of action asserted by the

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14. THOMPSON, MAUREEN, STOWELL-RITTER, ANITA, AARP PUB. POLICY INST, SURVEY OF STATE INVESTMENT ADVISER LAWS: A CHARTBOOK 31 (1999), https://assets.aarp.org/rgcenter/consume/d15130_invest.pdf.

15. Cal. Corp. Code § 25401 (West 2019); Rapp, *supra* note 6, § 13.03.

16. Cal. Corp. Code § 25504 (West 2019).

17. Cal. Corp. Code § 25510 (West 2019).

18. *See* Cal. Serv. Station Etc. Ass'n v. Am. Home Assurance Co., 73 Cal. Rptr. 2d 182, 191–92 (Ct. App. 1998).

19. Yokell v. Draper, No. 18-CV-02124-JSC, 2018 WL 3417514, at *10 (N.D. Cal. July 13, 2018).

20. Allen Matkins, *Implied Private Right of Action and the Corporate Securities Law of 1968*, JD Supra, July 25, 2018, https://www.jdsupra.com/legalnews/implied-private-right-of-action-and-the-50551/.

Plaintiff were that: (1) the defendant was an unlicensed investment advisor as defined in Cal. Corp. Code § 25230 and (2) the defendant violated the anti-fraud provision of Cal. Corp. Code § 25235.

The Court found that a private cause of action for a violation of section 25230 (acting as an investment adviser without a license) *was* warranted by section 1029.8 of the California Code of Civil Procedure, which provides a right of action for persons harmed by *unlicensed* persons causing injury or damage. The Court dismissed the Cal. Corp. Code § 25230 claim, however, holding that the plaintiff failed to allege that defendant provided investment advice for compensation and failed to allege that defendant met the definition of investment adviser provided by the statute in Cal. Corp. Code § 25009.[21]

Analyzing the section 25235 claim, the Court held that plaintiffs' cause of action under Cal. Corp. Code § 25235 failed because it was "grounded in fraud," and plaintiff failed to plead it with sufficient particularity as required by the heightened pleading standard of Rule 9(b) of the Fed. R. Civ. Proc.[22] As a side note, the Court also dismissed the section 25401 claim, finding that the plaintiff failed to meet the heightened pleading requirements of identifying the false/misleading statement and providing an explanation of why the statement was false/misleading.

The key distinguishing feature of the *Yokell* decision comes from the fact the defendant was unlicensed to provide investment advice.[23] Since the 2018 *Yokell* decision, it does not appear an implied cause of action has been recognized by any other California courts.

II. Standard of Conduct Under Florida's Antifraud Provision and Related Regulations

A. Florida Antifraud Statute in Relation to The Investment Adviser Act of 1940

The Florida Investors Protection Act's antifraud provision adopts the language of only Sections 206(1) and 206(2) of the Investment Advisers Act of 1940.

Florida Statute Section 517.301(1)(a)1 states that it is unlawful for a person offering investment advice to "employ any device, scheme, or artifice

21. *Yokell*, 2018 WL 3417514 at *11.

22. *Id.*

23. Allen Matkins, *supra* note 20.

to defraud"[24] and "[t]o engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon a person."[25] The antifraud provision also prohibits obtaining "money or property 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."[26]

B. Florida Statutes and Rules Establishing Additional Standards of Conduct

In terms of establishing unethical conduct, Florida incorporated the provisions of NASAA Model Rule 102(a)(4)-1 in Florida Statute Section 517.1215, titled "Requirements, rules of conduct, and prohibited business practices for investment advisers and their associated persons."[27] In Section 517.1215, the Florida legislature granted the Financial Services Commission (the "FSC") the authority to: (1) specify requirements for investment advisers who have custody of the funds and (2) establish rules of conduct and prohibited business practices for investment advisers and their associated persons. Notably, the statute directs the FSC to:

> …consider general industry standards as expressed in the rules and regulations of the various federal and self-regulatory agencies and regulatory associations, including, but not limited to, the United States Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the North American Securities Administrators Association.[28]

The FSC followed the directive and incorporated many of the standards of conduct established by these entities. Rule 69W-600.0131 defines prohibited business practices for investment advisers and their associated persons and it provides a *non-exhaustive* list of actions falling within the "demonstrations of unworthiness" by an investment adviser or associated person under Section

24. Fla. Stat. Ann. § 517.301(1)(a)1 (West 2019).

25. *Id.* § 517.301(1)(a)3.

26. *Id.* § 517.301(1)(a)2. The language in 517.301(1)(a)1-3 is modeled after SEC regulation 17 C.F.R. § 240.10b-5.

27. *Id.* § 517.1215.

28. *Id.*

517.161(1)(h), Florida Statutes.[29] The rule applies to investment advisers and associated persons with respect to customers, transactions of business "in, to or from" the state, and brings within its scope investment advisers not registered or not required to register under the IAA.[30] Highlights from the list of prohibited activities are:

- The anti-fraud provisions of the Investment Advisers Act of 1940;
- Borrowing money from customers;
- Loaning money to customers;
- Making unsuitable recommendations;
- Exercising discretionary trading authority without prior written authorization;
- Excessive trading;
- Misrepresenting the title(s) or qualifications of the adviser;
- Charging unreasonable fees;
- Failing to disclose conflicts of interest;
- Guaranteeing results;
- Recommending a specific securities dealer with which the adviser receives a fee;
- Breaching client confidentiality;
- Giving false information to a regulator;
- Using hedge clauses in an advisory agreement; and,
- Failing to have and execute reasonable written supervisory procedures (unlike California)[31]

29. Fla. Admin. Code Ann. r. 69W-600.0131 (2019).

30. *Id.* r. 69W-600.0131(1)(a) (2019).

31. *Id.* r. 69W-600.0131 (2019).

1. References to SEC Standards of Conduct

Florida Rule 69W-600.012(d)(3) imposes net capital and debt requirements for investment advisers.[32] Subsection (b)(4) imposes on investment advisers a duty to provide clients with copies of any and all contracts between them.

2. Florida Regulations Incorporate Other Industry Standards of Conduct by Reference in Rule 69W-200.002.

Some of the SEC regulations incorporated by reference in Florida rule 69W-600.012 only tangentially mention investment advisers.[33] The most relevant are addressed below, but it is also important to note that in mid-2019, the FSC introduced proposed amendments to many of these regulations.[34]

Regulation 69W-200.002 subsection (50) and (53) incorporate the Investment Advisers Act by reference.[35] The regulation specifically incorporates investment adviser contract requirements through § 80b-5 and the antifraud provisions of § 80b-5 (§206). It also incorporates § 80b-6, prohibited

32. *Id.* r. 69W-600.012.

33. *See, e.g.,* 17 C.F.R. § 230.501 (2019) (definitions and terms used in Regulation D); *id.* § 275.206(4)-3 (cash payments for client solicitations); *id.* § 230.144A (private resales of securities to institutions); 15 U.S.C. § 77e (prohibitions relating to interstate commerce and the mails); 17 C.F.R. § 240.17a-3 (records to be made by certain exchange members, brokers and dealers); 15 U.S.C. § 78o (registration and regulation of brokers and dealers);17 C.F.R. § 230.135a (generic advertising); 15 U.S.C. § 78o-4 (municipal securities); *id.* § 80b-4 (reports by investment advisers); *id.* § 80b-4a (prevention of misuse of nonpublic information); 17 C.F.R. § 275.206(3)-1 (exemption of investment advisers registered as broker-dealers in connection with the provision of certain investment advisory services); *id.* § 240.17a-3 (records to be made by certain exchange members, brokers and dealers); *id.* § 275.204-2 (books and records to be maintained by investment advisers); *id.* § 240.15a-6 (exemption of certain foreign brokers or dealers).

34. Notices of Changes/Withdrawal, Fla. Admin. Code Ann. r. 69W-200.002 (proposed amendments as of Sep. 19, 2019); http://www.flrules.org/gateway/ruleno.asp?id=69W-200.002&PDate=9/19/2019&Section=3.

35. Subsection (50) incorporates 15 U.S.C. §§ 80b-1 through 80b-21; subsection (53) incorporates 15 U.S.C. §§ 80a-1 through 80a-64.

transactions by investment advisers;[36] § 80b-7, material misstatements;[37] and § 80b-8, general prohibitions.[38]

From the Code of Federal Regulations, the Florida statute incorporates § 275.204-3 (brochure delivery requirements);[39] § 275.206(3)-2 (requirements of agency cross transactions for advisory clients;[40] § 275.206(4)-1 (advertisement requirements for investment advisers);[41] and, § 275.206(4)-3 (restrictions on cash payments for client solicitations).[42]

The regulation also incorporates by reference § 78j (manipulative and deceptive devices) setting the standard for pleading investment adviser fraud.[43]

Rule 69W-600.0133 prohibits the use of self-conferred, marketing-related, and/or non-existent accrediting agency senior-specific designations.

C. Cases Dealing With Private Right of Action for Investment Adviser Misconduct

Florida's law includes a private right of action for consumers defrauded under the investment adviser portion of the Act.[44] For example, in *Eaton v. Coal Par*, the federal court held that sections 517.241 and 517.211 are the remedial provisions of the Florida Statute and that they are "inclusive of all the remedies available to private parties under Chapter 517, unless the legislature expressly provides otherwise."[45]

The Court identified Section 517.241 as the general remedies provision of the Act, allowing any person to bring any statutory or common-law action in any court for any act involved in the sale of securities.[46] The Court held that

36. 15 U.S.C. § 80b-6 (2019).

37. *Id.* § 80b-7.

38. *Id.* § 80b-8.

39. 17 C.F.R. § 275.204-3 (2019).

40. *Id.* § 275.206(3)-2.

41. *Id.* § 275.206(4)-1.

42. *Id.* § 275.206(4)-3.

43. 15 U.S.C. § 78j (2019).

44. THOMPSON, *supra* note 14.

45. Eaton v. Coal Par of W. Va., Inc., 580 F. Supp. 572, 579-80 (S.D. Fla. 1984).

46. *Id.*

517.211 also provides purchasers and sellers covered by the Act with a cause of action for rescission or damages.[47]

In *Eaton*, Plaintiff charged defendants with fraud under Florida law and sought rescission under section 517.211(2) of the Florida statute for defendants' alleged violations of the anti-fraud provisions of section 517.301. Plaintiff also brought an action under section 517.03(1), which requires that all broker/dealers establish and keep current a set of written supervisory procedures and a system for implementing such procedures which may reasonably be expected to prevent and detect violations of the Florida Securities Act and related rules.[48] However, the Court did not recognize a private right of action under 517.03(1) because it found that private parties have no remedies outside of 517.211 and 517.241.

In *Rushing v. Wells Fargo Bank*, a District Court for the Middle District of Florida held that there was no private right of action for a "holder" of securities under 517.211. The Court ruled that even if the holding was in connection with investment advice, the remedies provided by 517.211 only applied in connection with the purchase or sale of securities. In so doing, the Court rejected the decision of the Florida District Court of Appeal in *Ward*,[49] where that court distinguished the state standard for civil remedies under 517.211 from the federal standard based on section 517.301's prohibition of fraud "in connection with the rendering of any investment advice."[50]

In *Hillard*, the Court expanded the definition of "seller" to include those who solicit sales of securities and held that the buyer/seller privity requirement for state-law securities claim was satisfied.[51] The Court also defined "solicits" to include one who is "motivated at least in part by a desire to serve his own financial interests or those of the securities owner."[52]

In *J.P. Morgan v. Geveran*, the District Court of Appeal of Florida stated that the FSIPA provides for a remedy of rescission for all violations of section

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47. *Id.*

48. *Id.* at 577.

49. Ward v. Atl. Sec. Bank, 777 So. 2d 1144 (Fla. Dist. Ct. App. 2001).

50. Rushing v. Wells Fargo Bank, N.A., 752 F. Supp. 2d 1254, 1263 (M.D. Fla. 2010).

51. Hilliard v. Black, 125 F. Supp. 2d 1071, 1083 (N.D. Fla. 2000) (holding that sports agent qualified as "seller" under Florida securities statutes). Based on agent's allegedly self-motivated false statements to athletes concerning safety and lucrative nature of investment offer and concerning agent's lack of financial interest, agent's alleged actions constituted solicitation.

52. *Id.*

517.301 if the plaintiff still owns the security.[53] In terms of scope of liability, it stated that it extended to any "director, officer, partner or agent of the seller who has personally participated or aided in making the purchase."[54]

The *J.P. Morgan* court interpreted the decision of the Florida Supreme court in *Rouseff*[55] and held that 517.211 does not require privity of contract between parties, but that the "director, officer, partner or agent" in question are "directly involved" in the sale of the security. In other words, 517.211 is narrower than other Florida statutory provisions or common law actions in that it is "transaction-specific."[56]

In the words of the J.P. Morgan court, "[t]he Court was distinguishing liability under section 517.211 from liability under federal rule 10b–5, which extends to fraud more generally, whether conducted during the sale of securities or not. The Court used 'privity' as a short-hand for a direct sale of securities distinct from general corporate malfeasance."[57]

In *Rousseff*, the Florida Supreme Court analogized claims under section 517.211(3) seeking rescission to claims under section 12 of the Securities Act of 1933, which is codified at 15 U.S.C. § 77(l) (2016), as well as common law claims for rescission. Section 517.211(2) limits liability to persons involved directly in the sale of the security and damages are limited to the consideration paid.[58] A claim for rescission under section 517.211 includes a misrepresentation or omission of a material fact on which the buyer relied.[59] The remedial statute imposes both a materiality requirement and a reliance requirement.[60]

Lastly, a note on the scope of liability: In *Carran*,[61] the plaintiff sought a ruling that there is no aiding and abetting liability under Chapter 517 of the

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53. *Id.* at 324.

54. J.P. Morgan Sec., LLC v. Geveran Invs. Ltd., 224 So. 3d 316, 328 (Fla. Dist. Ct. App. 2017).

55. E. F. Hutton & Co. v. Rousseff, 537 So. 2d 978, 979 (Fla. 1989).

56. *J.P. Morgan*, 224 So. 3d at 328.

57. *Id.*

58. *Id.* at 324 (citing *Rousseff*, 537 So. 2d at 981).

59. *Id.*

60. *Id.* at 326-27.

61. Carran v. Morgan, No. 06-80608-CIV, 2007 WL 3520480 (S.D. Fla. Nov. 14, 2007).

Florida Statutes as a matter of law, but the Court declined to reach that question under the facts.[62]

III. Standard of Conduct Under Illinois' Antifraud Provision and Related Regulations

A. Illinois Antifraud Statute in Relation to The Investment Adviser Act of 1940

The Illinois Securities Law of 1953 (as amended through August 5, 2013) adopts three of the four anti-fraud provisions of § 206(1), (2) and (4) of the Investment Adviser Act of 1940.[63]

Section 12(J) prohibits an investment adviser, investment adviser representative or federal covered investment adviser by any means or instrumentality, directly or indirectly:

> (1) To employ any device, scheme or artifice to defraud any client or prospective client;
> (2) To engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; or,
> (3) To engage in any act, practice, or course of business which is fraudulent, deceptive or manipulative. The Secretary of State shall for the purposes of this paragraph (3), by rules and regulations, define and prescribe means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.[64]

Illinois' Administrative Code provides additional guidance on fraudulent practices by investment advisers related to sales practices, advertising, disclosure of the adviser's financial wherewithal and past legal and disciplinary history.

For sales practices, Illinois defines as fraudulent "…effecting transactions which are excessive in size or frequency or unsuitable in view of the financial resources and character of the account as fraudulent, deceptive or manipulative."[65]

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62. *Id.* at *4 n.3.

63. 815 Ill. Comp. Stat. Ann. 5/13 (West 2019).

64. *Id.* at 5/12.

65. Ill. Admin. Code tit. 14, § 130.853 (2019).

Addressing advertising, Illinois defines as fraudulent the following types of advertisements:

(1) testimonials about the investment adviser or any advice, analysis, report, or other service provided by the adviser;

(2) references to past recommendations which were or would have been profitable unless made in the immediate last year coupled with specific data and disclaimers;

(3) provision of charts, graphs and formulas which alone can be used to determine which securities to purchase;

(4) promising any report, analysis or service will be provided free of charge unless it actually is; and,

(5) any statement that contains any untrue statement of a material fact, or that is otherwise false or misleading.[66]

In addition, Illinois regulates the use of certifications related to senior citizens and professional designations.[67]

Clients facing disclosures about the adviser's financial condition along with past and current legal issues are a focal point of Illinois' regulatory scheme. Illinois holds that it is a fraudulent, deceptive, or manipulative act for an investment adviser to fail to disclose to any client or prospective client all material facts with respect to (1) the financial condition of the investment adviser that impairs the ability of the investment adviser to meet contractual commitments to clients or (2) a legal or disciplinary event that is material to an evaluation of the investment adviser's integrity or ability to meet contractual commitments.[68]

Illinois defines, as a rebuttable presumption, material "legal or disciplinary" events in the preceding 10 years as:

(1) Criminal or civil actions in which the adviser was convicted, pleaded guilty or *nolo contendere* to a felony or misdemeanor;[69]

(2) The adviser being named in a pending criminal proceeding related to investment business, fraud, false statements or omissions; wrongful taking of property; or, bribery, forgery, counterfeiting or extortion;[70]

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66. *Id.* § 130.848.

67. *Id.* § 130.855.

68. *Id.* § 130.847(a).

69. *Id.* § 130.847(b)(1)(A).

70. *Id*.

(3) The adviser having been found to have violated or caused the violation of an investment related statute or regulation;[71]
(4) Being the subject of any order, judgment or decree permanently or temporarily enjoining the person from, or otherwise limiting the person from, engaging in any investment related activity;[72]
(5) Administrative proceedings before the SEC or any other federal or state agency in which the person was found to have caused an investment-related business to lose its authorization to do business;[73]
(6) A finding from an administrative proceeding that the adviser violated or caused the violation of an investment-related statute or regulation and was the subject of an order by the agency denying, suspending or revoking the authorization of the person to act in, or barring or suspending the person's association with, an investment related business;[74]
(7) Proceedings before a self-regulatory organization in which the person was found to have caused an investment related business to lose its authorization to do business;[75] and/or,
(8) A finding by a self-regulatory organization of having violated or caused the violation of an investment-related statute or regulation and was the subject of an order by the agency denying, suspending or revoking the authorization of the person to act in, or barring or suspending the person's association with, an investment-related business.[76]

B. Illinois Statutes and Regulations Establishing Principles of Conduct

Unlike California and Florida, Illinois takes a light hand in establishing state-level principles of conduct. In part, this is due to Illinois specifically defining so many adviser conduct issues as "fraudulent" and in part is a reflection of a more relaxed regulatory approach. Conduct required of the adviser in Illinois:

71. *Id.* § 130.847(b)(1)(B).

72. *Id.* § 130.847(b)(1)(C).

73. *Id.* § 130.847(b)(2)(A).

74. *Id.* § 130.847(b)(2)(B).

75. *Id.* § 130.847(b)(3)(A).

76. *Id.* § 130.847(b)(3)(B).

1) Record-keeping;[77]
2) Maintaining client privacy;[78]
3) Brochure (Form ADV) delivery;[79]
4) Charging or receiving fair and reasonable compensation and not charging or receiving compensation based on the capital gains or capital appreciation of the funds with limited exception; [80] and,
5) Not using the term "Investment Counsel."[81]

C. The Private Right of Action for Investment Adviser Misconduct in Illinois

Section 13 of the Illinois Securities Law of 1953 sets forth a broad private right of action for any violation of the Act. "Every sale of a security made in violation of the provisions of this Act shall be voidable at the election of the purchaser…"[82] The right of action includes control persons and individuals who "aided in any way in making the sale."[83] There is a short, six month time period (after the purchaser gains knowledge that the transaction is voidable) to give notice of a claim.[84] However, discovery of the voidability of the transaction expands out to gaining such information from counsel.[85] Section 13 provides for a three-year statute of limitations but also includes a built-in discovery provision.[86]

Damages under Section 13 may be either rescission (including any promised interest or dividends or if none was specified 10% per annum, less

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77. 815 Ill. Comp. Stat. Ann. 5/8 (West 2019); Ill. Admin. Code tit. 14, § 130.845 (2019).

78. Ill. Admin. Code tit. 14, § 130.846 (2019).

79. *Id.* § 130.849.

80. *Id.* § 130.852(b)(3)(B).

81. *Id.* § 130.854.

82. 815 Ill. Comp. Stat. Ann. 5/13 (West 2019).

83. *Id*.

84. *Id.* at 5/13B.

85. Branch-Hess Vending Servs. Emps.' Pension Tr. v. Guebert, 751 F. Supp. 1333, 1342 (C.D. Ill. 1990).

86. 815 Ill. Comp. Stat. Ann. 5/13D (West 2019).

income received), or, if the security is no longer in possession of the harmed party, damages plus interest less income or amounts received by the purchaser.[87] A successful action under Section 13 also requires an award of costs, attorney's fees and expenses.[88]

A Section 13 claim may include violations related to adviser misconduct under the Act. This includes violations of Section 12 of the Act.

Section 12(F) of the Illinois Securities Law provides liability for any person who "…engage[d] in any transaction, practice or course of business in connection with the sale or purchase of securities which works or tends to work a fraud or deceit upon the purchaser or seller thereof."[89]

Section 12(J) holds investment advisers liable for using any means or instrumentality, directly or indirectly:

(1) To employ any device, scheme or artifice to defraud any client or prospective client;
(2) To engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; or,
(3) To engage in any act, practice, or course of business which is fraudulent, deceptive or manipulative. The Secretary of State shall for the purposes of this paragraph (3) - by rules and regulations - define and prescribe means reasonably designed to prevent such acts, practices and courses of business as are fraudulent, deceptive or manipulative.[90]

While there is no case addressing Section 12J claims brought by investors, on March 21, 2019, the Illinois Supreme Court issued its opinion in *Van Dyke v. White*.[91] *Van Dyke* addressed the issue of a dually-registered investment adviser and insurance producer who sold equity indexed annuities to his clients. Following a complaint by an heir of Van Dyke's client, an investigation by the Secretary of State Securities Department investigators, and a hearing, the Securities Department revoked Van Dyke's registration, barred him from the securities industry in Illinois, fined him, and assessed costs of the investigation and expert fees.

Van Dyke sought administrative review and lost at the Circuit Court level. Van Dyke then successfully appealed, arguing that equity indexed annuities

87. *Id.* at 5/13A(1), (2).

88. *Id.* at 5/13A(2).

89. *Id.* at 5/12.

90. *Id*.

91. Van Dyke v. White, 2019 IL 121452.

were not securities as defined by Illinois and, as a result, he could not have violated Section 12(J) of the Illinois Securities Act as: (1) Section 130.853 of the Illinois Administrative Code had nothing to do with the sale of insurance annuities and (2) the Securities Department failed to present evidence of any suitability analysis for the individual clients who purchased and/or replaced the insurance annuities.

The *Van Dyke* court upheld the appellate court's decision. Looking solely at the Section 12(J) argument, the *Van Dyke* Court found that while the Secretary of State was correct when it argued that the anti-fraud provision extended beyond just securities, the Secretary of State's decision was arbitrary and capricious as it relied on inaccurate damages and replacement analyses in concluding Van Dyke's customers were harmed and failed to present evidence of individual customers' suitability analyses.[92]

The take-away from *Van Dyke* is that any claim alleging an unsuitable transaction initiated by an investment adviser, even one not involving securities, must be supported by an individualized suitability analysis showing the adviser's recommendation was unsuitable for the specific client's needs, risk tolerance, and financial wherewithal.

IV. Standard of Conduct Under Texas's Antifraud Provision and Related Regulations

A. Texas Antifraud Statute in Relation to The Investment Adviser Act of 1940

Texas's Blue Sky law does not contain a section equivalent to the antifraud provisions of the Investment Adviser Act of 1940. Instead, it defines fraud rather broadly, encompassing several categories of conduct:

- Any misrepresentations, in any manner, of a relevant fact;
- Any promise or representation or predication as to the future not made honestly and in good faith or an intentional failure to disclose a material fact;
- The gaining, directly or indirectly, through the sale of any security, of an underwriting or promotion fee or profit, selling or managing commission or profit, so gross or exorbitant as to be unconscionable; and,

92. *Id.* at ¶ 86.

- Any scheme, device or other artifice to obtain such profit, fee or commission.[93]

However, Texas recognizes that its definition is not intended to "limit or diminish the full meaning of the terms "fraud," "fraudulent" and "fraudulent practice" as applied or accepted in courts of law or equity."[94]

B. Texas Statutes and Regulations Establishing Additional Standards of Conduct

Texas, like Illinois, takes a light hand in establishing state-level principles of conduct. Key conduct required of RIAs and their representatives in Texas are:

1) Record keeping;[95]
2) Cooperation with the Texas Securities Commissioner in any inspection;[96]
3) Reasonably supervise the activities of its Investment Adviser Representatives;[97]
4) Maintain written supervisory procedures;[98]
5) Maintain written supervisory procedures to address suspected financial exploitation of vulnerable adults;[99]
6) Brochure (Form ADV) delivery;[100]
7) Seek written consent of the client before assigning the advisory contract;[101] and,
8) If charging an advisory fee above 3.0% of assets under management, make a written disclosure to the client that such a fee "is in excess of

93. Tex. Rev. Civ. Stat. Ann. art. 581-4(F) (West 2019).

94. *Id.*

95. 7 Tex. Admin. Code §116.5 (2019).

96. *Id.* §116.7.

97. *Id.* §116.10.

98. *Id.* §116.14.

99. *Id.* §116.21.

100. *Id.* §116.11.

101. *Id.* §116.12.

> the industry norm and that similar advisory services can be obtained for less.[102]

Texas also restricts the type of advertising that investment advisers may make. Prohibited are: (1) testimonials about the investment adviser or any advice, analysis, report, or other service provided by the adviser; (2) references to past recommendations which were or would have been profitable unless made in the immediate last year coupled with specific data and disclaimers; (3) provision of charts, graphs and formulas which alone can be used to determine which securities to purchase; (4) promising any report, analysis or service will be provided free of charge unless it actually is; and, (5) any statement that contains any untrue statement of a material fact, or that is otherwise false or misleading.[103]

Texas draws a finer line for the use of unearned, phony or self-created senior-specific designations or certifications and holds that the use of such designations and/or certifications is an inequitable practice under the Texas Securities Laws.[104]

C. Private Right of Action for Investment Adviser Misconduct

Texas's law includes a private right of action for investors who engage the services of an investment adviser who is not registered and not eligible for an exemption from registration.[105] Damages include any consideration paid for the services.[106] There is a three-year statute of limitations for such actions.[107]

Additionally, investors have a private right of action against any investment adviser who has committed fraud or engaged in a fraudulent practice in rendering services as an investment adviser.[108] Damages include: (i) any consideration paid for the services, less any income the investor received from acting on the services; (ii) any loss incurred by acting on the advice; (iii) interest at the legal rate for judgments accruing from the date of

102. *Id.* §116.13.

103. *Id.* §116.15.

104. *Id.* §116.16.

105. Tex. Rev. Civ. Stat. Ann. art. 581-33-1(A)(1) (West 2019).

106. *Id.*

107. *Id.* art. 581-33-1(D)(1).

108. *Id.* art. 581-33-1(A)(2).

the payment of consideration; and, (iv) to the extent the court considers equitable, court costs and reasonable attorney's fees.[109] The statute of limitations for fraud claims is five years after the violation occurs or three years after the person knew or should have known, by the exercise of reasonable diligence, of the occurrence of the violation.[110]

The statute provides for control person liability. Control persons are jointly and severally liable "unless the controlling person sustains the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which liability is alleged to exist."[111] The statute also contemplates joint and several liability for anyone who "directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law" materially aids an investment adviser who violates the Blue Sky law.[112]

CONCLUSION

The Investment Adviser Act of 1940 is a cornerstone for state-based RIA regulation. Generally, it is fair to assume a state's statute will track close to the IAA in intent, if not format. However, it is equally fair to assume each state will put its own emphasis on what it believes to be the most critical activities to require regulation.

For the purpose of investor protection and private causes of action, the heart of the issue is whether there is an available private cause of action. Of the four states surveyed, California requires creativity in bringing actions or claims for violations related to the statute and related administrative codes for adviser misconduct beyond outright fraud. Florida, Illinois, and Texas are the most generous in protecting its citizens from unscrupulous advisers, but each state has its own statute of limitations and notice provisions (Illinois) which sometimes requires quick action by victims of adviser misconduct.

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109. *Id.* art. 581-33-1(B).

110. *Id.* art. 581-33-1(D)(2).

111. *Id.* art. 581-33-1(E)(1).

112. *Id.* art. 581-33-1(E)(2).

APPENDIX

PROVISIONS REGULATING INVESTMENT ADVISER CONDUCT IN CALIFORNIA AND FLORIDA

CONDUCT ADDRESSED	CALIFORNIA	FLORIDA	ILLINOIS	TEXAS
FRAUD AND MISREPRE-SENTATION	Cal. Corp. Code § 25235 (West 2019); Cal. Code Regs. tit. 10, § 260.235.1 (2019); *id.* § 260.235.2; *id.* § 260.235.3; *id.* § 260.235.4.	Fla. Stat. Ann. § 517.301 (West 2019); Fla. Admin. Code Ann. r. 69W-200.002 (2019); *id.* r. 69W-600.012; *id.* r. 69W-600.013.	815 Ill. Comp. Stat. Ann. 5/12 (West 2019); Ill. Admin. Code tit. 14, § 130.847 (2019); *id.* § 130.848; *id.* § 130.853; *id.* § 130.855.	Tex. Rev. Civ. Stat. Ann. art. 581-4 (West 2019); *id.* art. 581-14; *id.* art. 581-23; *id.* art. 581-23-1; *id.* art. 581-23-2; *id.* art. 581-32.
STANDARD OF CONDUCT AND ETHICAL BEHAVIOR	Cal. Corp. Code § 25238 (West 2019); Cal. Code Regs. tit. 10, § 260.238 (2019).	Fla. Stat. Ann. § 517.1215 (West 2019); Fla. Admin. Code Ann. r. 69W-600.0131 (2019); *id.* r. 69W-600.012; *id.* r. 69W-200.002; *id.* r. 69W-600.014.	Ill. Admin. Code tit. 14, § 130.845 (2019); *id.* § 130.846; *id.* § 130.849; *id.* § 130.852; *id.* § 130.854.	N/A
DECEPTIVE ADVERTISING	Cal. Code Regs. tit. 10, § 260.235 (2019)	17 C.F.R. § 275.206(4)-1 (2019); *id.* § 275.204-3 (incorporated through Fla. Admin. Code Ann. r. 69W-600.002 (2019)).	Ill. Admin. Code tit. 14, § 130.848 (2019).	7 Tex. Admin. Code § 116.15 (2019).

FAILURE TO REGISTER (NOT EXEMPT)	Cal. Corp. Code § 25230 (West 2019); *id.* § 25230.1.	Fla. Stat. Ann. § 517.12 (West 2019); *id.* § 517.1205.	815 Ill. Comp. Stat. Ann. 5/8 (West 2019); Ill. Admin. Code tit. 14, § 130.805 (2019); *id.* § 130.839; *id.* § 130.840.	7 Tex. Admin. Code § 116.1 (2019).
RESTRICTIONS ON ADVISORY CONTRACTS	Cal. Corp. Code § 25234 (West 2019).	15 U.S.C. § 80b-5 (2019); 17 C.F.R. § 275.205-3 (2019) (incorporated through Fla. Admin. Code Ann. r. 69W-600.002 (2019)).	Ill. Admin. Code tit. 14, § 130.852 (2019).	7 Tex. Admin. Code § 116.12 (2019).
RESTRICTIONS ON CUSTODY OF FUNDS	Cal. Corp. Code § 25237 (West 2019); Cal. Code Regs. tit. 10, §260.237.	Fla. Admin. Code Ann. r. 69W-600.0132 (2019).	Ill. Admin. Code tit. 14, § 130.844 (2019).	7 Tex. Admin. Code § 116.17 (2019).
FAILURE TO MEET QUALIFICATION STANDARDS	Cal. Corp. Code § 25236 (West 2019).	N/A	N/A	7 Tex. Admin. Code § 116.3 (2019).
USE OF SENIOR-SPECIFIC DESIGNATION	Cal. Corp. Code § 25243.5 (West 2019).	Fla. Admin. Code Ann. r. 69W-600.0133 (2019).	Ill. Admin. Code tit. 14, § 130.855 (2019).	7 Tex. Admin. Code § 116.16 (2019).
REMEDIAL PROVISIONS	Cal. Corp. Code §§ 25401, 25501 (West 2019).	Fla. Stat. Ann. § 517.211 (West 2019).	815 Ill. Comp. Stat. Ann. 5/13 (West 2019).	Tex. Rev. Civ. Stat. Ann. art. 581-33-1 (West 2019).

CURRENT REGULATORS OVERSEEING CRYPTOCURRENCIES ARE RESTRICTING ACCESS TO THIS INNOVATIVE NEW TECHNOLOGY

Matthew Barrack, J.D.[1]

I. INTRODUCTION

Cryptocurrencies are virtual tokens which can be sent and received all over the world just as easily as sending an email.[2] As they have become more widespread, some cryptocurrencies have become more and more valuable.[3] Some act as investments, while others act more like regular currencies.[4] These "coins" or "tokens" have raised issues about the future of financial transactions and whether a cryptocurrency will replace the dollar.[5] In order to avoid a lawless, wild west scenario, State and Federal governments have taken steps to regulate and tax cryptocurrency use.[6] This paper examines how current cryptocurrency regulation is ineffective in protecting cryptocurrency users.

As of March 10, 2019, there were 2,130 cryptocurrencies being traded with a market cap over $134 billion.[7] While it is unlikely that the United States will adopt a virtual currency in place of the dollar, there is demand and

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1. Candidate at St. John's University School of Law Class of 2020 and the PIABA James E. Beckley 2019 Student Writing Competition Winner.

2. *Cryptocurrency*, INVESTOPEDIA, https://www.investopedia.com/terms/c/cryptocurrency.asp (last visited Apr. 24, 2019).

3. *Global Charts - Total Market Capitalization*, COINMARKETCAP, https://coinmarketcap.com/charts/ (last visited Apr. 24, 2019).

4. *See, e.g.*, Philipp Maume & Mathias Fromberger, *Regulation of Initial Coin Offering: Reconciling U.S. and E.U. Securities Laws*, 19 CHI. J. INT'L L. 548, 558 (2019).

5. Ilias Louis Hatzis, *Blockchain Front Page: Can a Cryptocurrency replace the U.S. Dollar to Become the World's Reserve* Currency, DAILY FINTECH (Mar. 25 2019), https://dailyfintech.com/2019/03/25/can-a-cryptocurrency-replace-the-us-dollar-to-become-the-worlds-reserve-currency/.

6. *See generally* Stephen T. Middlebrook & Sarah Jane Hughes, *Regulating Cryptocurrencies in the United States: Current Issues and Future Directions*, 40 WM. MITCHELL L. REV. 813 (2014).

7. COINMARKETCAP, https://coinmarketcap.com/ (last visited Apr. 24, 2019).

acceptance among consumers and businesses for cryptocurrencies for their potential uses and benefits. There is currently no federal regulation specifically designed to regulate cryptocurrencies, although states have begun to make their own attempts. It is necessary to ensure that cryptocurrency use by individuals and organizations is regulated properly. The effect of such regulation should make cryptocurrencies more accessible, protect both consumer and market interests, and it should not limit the functionality of cryptocurrencies. Current regulations fail to achieve these goals, and reforms to current laws or entirely new laws are needed to fill the gaps.

The current approach for regulating cryptocurrencies has been to apply current law and regulations.[8] Generally, the coin's function(s) has been used to determine which regulators' jurisdiction the coin falls under.[9] Not all cryptocurrencies have the same function, so not all cryptocurrencies are regulated by the same law.[10] This requires regulators to review, on a case-by-case basis the function of a coin in order to determine the authority to regulate it.[11] Some cryptocurrencies will be regulated by one or multiple authorities including the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), Internal Revenue Service (IRS), state Blue Sky Laws, and others.[12] For cryptocurrency users, the protection of their virtual assets, as well as their compliance with regulations will depend on which jurisdiction(s) their coin falls under, and the circumstances surrounding the transaction.

Cryptocurrencies require either reform of current legislation, or new legislation, to provide clear regulations for cryptocurrencies. These reforms or new regulations should have four goals in mind. First, the new regulations should deter fraud, money laundering, and other criminal activity by requiring exchanges and issuers to regularly file public reports and financial statements. Second, the regulations should increase the accessibility of cryptocurrencies by making information about these coins more available and easy to understand for consumers. Third, they should make compliance a simple and straight forward process. This will help the first and second goals as well.

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8. *See* Maume & Fromberger, *supra* note 4, at 2.

9. *See CFTC v. McDonnell*, 287 F. Supp. 3d 213, 220 (E.D.N.Y. 2018).

10. *Id.*

11. *See, e.g.* Edmund Mokhtarian & Alexander Lindgren, *Rise of the Cryptocurrency Hedge Fund: Operational Issues and Best Practices for an Emergent Investment Industry*, 23 STAND. J.L BUS. & FIN. 112, 112 (2018).

12. *Id.*

Finally, compliance should not limit the functionality of the tokens to the extent that their utility is significantly diminished for legitimate purposes.

II. BACKGROUND

A. What is a cryptocurrency?

Cryptocurrencies are a form of virtual currency. "According to the Government Accountability Office (GAO), '[a] virtual currency is, generally, a digital unit of exchange that is not backed by a government-issued legal tender. Virtual currencies can be used entirely within a [video game world], or can be used in lieu of a government-issued currency to purchase goods and services in the real economy."[13] According to the United States Financial Crimes Enforcement Network (FinCEN), a virtual currency operates like a currency, but does not have legal tender status in any jurisdiction.[14] In the United States people already use cryptocurrencies in lieu of cash to purchase securities.[15] The SEC has determined that cryptocurrencies may be securities as defined under § 2 of the Securities Act of 1933 (the 33 Act), giving the SEC authority to regulate them under certain circumstances.[16]

Being labeled a virtual currency does not mean the U.S. government recognizes cryptocurrencies as it does foreign currencies such as Yen.[17] If it did, the IRS could regulate and tax them as such.[18] While not a foreign currency, there may not be much to differentiate cryptocurrencies from other

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13. Juliya Ziskina, Content: *The Other Side of the Coin: The FEC's Move to Approve Cryptocurrency's Use and Deny its Viability*, 10 WASH. J.L. TECH. & ARTS 305, 310 (2015) (brackets original).

14. *See* Tiffany L. Minks, *Ethereum and the SEC: Why Most Distributed Autonomous Organizations are Subject to the Registration Requirements of the Securities Act of 1993 and a Proposal for New Regulation*, 5 TEX. A&M L. REV. 405, 405 (2018).

15. *See e.g.* Sec. & Exch. Comm'n, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207, at 2-3 (July 25, 2017) [hereinafter *Release 81207*].

16. *See generally id.*

17. *See* Allison M. Lovell, *Avoiding Liability: Changing the Regulatory Structure of Cryptocurrencies to Better Ensure Legal Use*, 104 IOWA L. REV. 928, 935 (2019).

18. *Id.* at 928.

currencies. What separates cryptocurrencies from other currencies is blockchain technology and a lack of central authority overseeing transactions.[19]

1. Blockchain Provides Flexibility and Security to Cryptocurrencies.

Blockchain is the technology that underlies many cryptocurrencies.[20] A Cryptocurrency uses blockchain to verify transactions within its individual network of users.[21] "At its core, blockchain is a system for solving complex problems. More specifically, blockchain is a ledger of transactions with each 'block' representing a single piece of data that is recorded chronologically in a 'chain.'"[22] Each verified transaction is recorded and added to the blockchain.[23] This collective chain is commonly referred to as a "ledger."[24] The form of blockchain may vary among cryptocurrencies. For example, some ledgers, like the one Bitcoin uses, are open to the public.[25] Anyone in the network can view the ledger regardless of whether they participated in the transaction.[26] Others offer more limited access, "[p]rivate ledger systems allow a network of known participants to share transaction information between themselves more efficiently."[27] In either case, this technology is used to verify each transaction within a respective network.[28]

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19. *Cryptocurrency*, INVESTOPEDIA, https://www.investopedia.com/terms/c/cryptocurrency.asp, (last visited Apr. 24, 2019).

20. *Id.*

21. *See, e.g.*, Scott D. Hughes, *Cryptocurrency Regulations and Enforcement in the U.S.*, 45 W. ST. L. REV. 1, 6-7 (2017).

22. Averle Brookes, *U.S. Regulation of Blockchain Currencies: A Policy Overview*, 9 AM. U. INTELL. PROP. BR. 75, 78 (2018).

23. *See, e.g.*, Deidre A. Liedel, *The Taxation of Bitcoin: How the IRS Views Cryptocurrencies*, 66 DRAKE L. REV. 107, 111 (2018).

24. *See, e.g.*, Nathan J. Hochman, Feature: *Policing the Wild West of Cryptocurrency*, 41 LOS ANGELES LAW. 14, 16 (2018).

25. Lovell, *supra* note 17, at 933.

26. *Id.*

27. *McDonnell*, 287 F. Supp. 3d at 239.

28. *See, e.g.*, Lovell, *supra* note 17 at 933.

Generally, the ledgers are neither kept in a central location or server, nor are they maintained by a single individual or entity.[29] Utilization of blockchain eliminates the need for such a central authority or a particular third party, perhaps a bank, to verify each transaction.[30] The ledgers are decentralized, meaning each user has the ledger on their computer.[31] When a transaction occurs, it must follow specific steps in order to be verified by the other users.[32] Having access to the ledger, the other users can see new transactions that have been added. They verify the transactions through review, ensuring that the proper conditions have been fulfilled.[33] If the conditions are met, the transaction will be verified and added to the ledger.[34] If the conditions are *not* met, the users will not verify the transaction.[35]

Two of the key benefits of this form of peer verification are that it makes counterfeiting and double spending extremely difficult.[36] Counterfeit coins would be identified the because they would not appear on peer ledgers.[37] Double spending is prevented by the users, as they can see on their ledgers that the coins have already been transferred and that the individual trying to trade them no longer has ownership.[38]

Blockchain is a vital part of what makes many cryptocurrencies different from other currencies.[39] Not only does it provide security, but it also provides flexibility, allowing the coin to take on multiple functions.[40]

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29. *See, e.g.*, Mohktarian & Lindgren, *supra* note 11, at 119.

30. *See, e.g.*, Nareg Essaghoolian, *Initial Coin Offerings: Emerging Technology's Fundraising Innovation,* 66 UCLA L. REV. 294, 302 (2019).

31. Hughes, *supra* note 21.

32. Mohktarian & Lindgren, *supra* note 11, at 119.

33. *Id.*

34. *See, e.g.*, Minks, *supra* note 14, at 412.

35. Mohktarian & Lindgren, *supra* note 11, at 143.

36. *See* François R. Velde, *Bitcoin: A Primer*, CHI. FED LETTER (Dec. 2013).

37. *Id.*

38. *Id.*

39. *Cryptocurrency*, INVESTOPEDIA, https://www.investopedia.com/terms/c/cryptocurrency.asp, (last visited Apr. 24, 2019).

40. *See, e.g.*, Essaghoolian, *supra* note 30, at 308.

2. What Functions Can Cryptocurrencies Perform?

The majority of cryptocurrencies take advantage of blockchain technology, but they do not all function the same way. There are three categories of cryptocurrencies: currency tokens, investment tokens, and utility tokens.[41] "Token" and "coin" are used interchangeably in the cryptocurrency setting, each describes an individual unit of a cryptocurrency.[42] Each category is defined by the function of the specific coin.[43] However, these categories are not legal categories.[44] When courts consider who can regulate a coin, they do not just call it an investment token and allow the SEC to regulate it.[45] Titles are not dispositive.[46] The function(s) of the coin determine what agency can regulate it.[47]

Bitcoin, the most well-known cryptocurrency, is a currency token.[48] These tokens may be used as payment if people are willing to accept them.[49] In the United States, there are many online and brick-and-mortar stores that accept Bitcoin as payment.[50] Because Bitcoin is not backed by the dollar or the government, there is no guarantee that those who accept Bitcoin as payment will ever get to exchange it for any fiat currency.[51] They can only do so only as long as there is a market for Bitcoin.[52] But if the market declines, those who accept Bitcoin as payment get less value for their goods or services than if they had solely accepted fiat currency as payment.[53] Those who accepted Bitcoin

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41. *See* Maume & Fromberger, *supra* note 4.

42. *See, e.g.*, Mohktarian & Lindgren, *supra* note 11, at 145.

43. *See, e.g.*, Maume & Fromberger, *supra* note 4.

44. *Id.*

45. *Id.*

46. *See McDonnell,* 287 F. Supp. 3d at 220.

47. *Id.*

48. *See, e.g.*, Maume & Fromberger, *supra* note 4, at 559.

49. *Id*

50. *See e.g.*, Ziskina, *supra* note 13, at 316.

51. *See* Sagar Raich, *Cryptocurrencies: The Basics and the Law*, 26 NEV. LAW. 18, 19 (2018).

52. *Id.*

53. *Id.*

when it was valued at $10,000.00 took a risk, hoping its value would rise, or at least stay the same.[54] However, if they held on to it too long, they likely suffered a significant loss in value. Bitcoin is currently valued at $5,473.89.[55]

Some tokens may have a fixed value, pegged to a fiat currency, like J.P. Morgan's new JPM Coin.[56] People or businesses who accept JPM Coin as payment can exchange their coins for U.S. dollars at a 1:1 ratio with J.P. Morgan. A person could give $1,000.00 to J.P. Morgan in exchange for 1,000 JPM Coins and take or send the tokens anywhere in the world and use them anywhere accepted.[57] Merchants have an incentive to accept them because the coins are backed by J.P. Morgan, and they trust that J.P. Morgan will exchange $1 for 1 JMP Coin.[58]

Investment tokens are used in a way similar to stock in a company, but instead of receiving a stock to represent the buyer's share in the company, users receive a token.[59] "Investment tokens give the owner a right to participate in the issuer's future returns."[60] Like, stock in a company, these tokens may come with voting or other participation rights.[61] Initial Coin Offerings (ICOs) are when an organization issues tokens for consideration in order to raise funds for a new project, business, or other venture.[62] If the token gives the purchasers a right to the future returns of the organization, then it is likely an investment token.[63]

Utility tokens "offer a wide variety of benefits to the owner. The most common provide access to particular services offered by the company, such as

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54. *Id.*

55. COINMARKETCAP, https://coinmarketcap.com/ (last visited Apr. 24, 2019).

56. Chris Isidore, *J.P. Morgan is Creating its Own Cryptocurrency,* CNN (Feb. 14, 2019, 2:25 PM), https://www.cnn.com/2019/02/14/investing/jpmorgan-jpm-coin-cryptocurrency/index.html.

57. *Id.*

58. *Id.*

59. *See* Maume & Fromberger, *supra* note 4, at 559.

60. *Id.*

61. *Id.*

62. *ICO*, INVESTOPEDIA, https://www.investopedia.com/terms/i/initial-coin-offering-ico.asp (last visited Apr. 24, 2019).

63. *See* Maume & Fromberger, *supra* note 4, at 559.

the use of storage space (Filecoin)."[64] The value of these tokens is necessarily linked to the value of the services an owner would be entitled to.[65]

These categories are not exclusive. A token can have many features or functions, which may put it in multiple categories.[66] This would be a hybrid token,[67] which may be used as payment, while at the same time give the owner access to services of the coin's company.[68] This would be a currency-utility token.[69]

B. How are Cryptocurrencies Traded?

Cryptocurrencies can be traded in a variety of ways. They can be distributed by organizations as ICOs for fundraising.[70] They can be bought and sold online at exchanges or markets.[71] Some financial institutions offer cryptocurrency futures and other derivatives.[72] They can also be traded privately. Bitcoin in particular can be mined or created by verifying transactions within its network.[73]

How a coin is traded also dictates the regulations the transaction must accord with. For example, the Commodities Futures Trading Commission (CFTC) can regulate some cryptocurrency transactions if they involve the commodity (in this case the coin) being delivered at some future date.[74] This means cryptocurrency futures will likely be regulated by the CFTC. However,

64. *Id.* at 560, (parenthesis original).

65. *See* Nate Crosser, *Initial Coin Offerings as Investment Contracts: Are Blockchain Utility Tokens Securities?*, 67 KAN. L. REV. 379, 393 (2018).

66. *See* Maume & Fromberger, *supra* note 4, at 560.

67. *Id.*

68. *Id.*

69. *Id.*

70. *See e.g.*, Jay B. Sykes, CONG. RESEARCH SERV., R45201, 1 (Aug. 2018).

71. *See e.g.*, Dennis Chu, *Broker-Dealers for Virtual Currency: Regulating Cryptocurrency Wallets and Exchanges,* 118 COLUM. L. REV. 2323, 2330 (2018).

72. *See e.g.*, Lawrence J. Trautman, *Bitcoin, Virtual Currencies, and the Struggle of Law and Regulation to Keep Pace,* 102 MARQ. L. REV. 449, 460 (2018).

73. *See, e.g.,* Lovell, *supra* note 17, at 933.

74. *See generally McDonnell,* 287 F. Supp. 3d at 213.

spot transactions, transactions that involve immediate delivery, are not subject to CFTC regulations.[75]

Alternatively, a coin distributed in an ICO by a company looking to raise funds, will likely be regulated by the SEC.[76] Coins distributed as part of ICOs typically qualify as investment contracts under the *Howey* investment contract test.[77] Investment contracts fall under the definition of a 'security' in the Securities Act of 1933.[78] This gives the SEC authority to regulate the transaction and in effect, the coins.[79]

C. A Brief Overview of the Current State of Cryptocurrency Regulation.

Current law regulating cryptocurrencies is unclear at best. The current approach allows government agencies to regulate cryptocurrencies if they interpret their regulations to apply to cryptocurrencies.[80] The result of this is a blurry line and a patchy regulatory structure which causes more confusion than answers. If users fear violating some vague regulation, cryptocurrencies will be under-utilized as a result of that fear, despite that they may have great utility.

There is no singular statute, law, rule, or case, etc., that regulates all cryptocurrencies. Cryptocurrency users have no one source to look to for guidance when trying to comply with the law. Part of this is because cryptocurrencies and blockchain are relatively new technology and their application has yet to be fully explored. Even so, users seeking to comply with the law face many difficulties with no single concrete body of law or guidelines governing this technology. States have their own laws as well and a few, including New York and California, have implemented fairly complete laws regulating cryptocurrencies.[81] New York's laws in particular were mainly

75. *Id.*

76. *See Release 81207*, *supra* note 16.

77. *Id.*

78. 15 U.S.C. § 78c(a)(10).

79. *Id.*

80. *See e.g.*, *Release 81207*, *supra* note 16.

81. *See e.g.*, Hughes, *supra* note 21, at 21-22.

implemented to protect consumers from fraud and prevent money laundering.[82]

The federal government has opted to apply current regulatory structures to govern cryptocurrencies.[83] This leaves many agencies, including the SEC, CFTC, FinCEN, IRS, DOJ, and even the Secretary of Treasury with overlapping jurisdictions.[84] While cryptocurrencies may have some things in common with the items these bodies were intended to regulate, there are many differences that distinguish them. Some cryptocurrencies may not clearly fall under any jurisdiction leaving them unregulated and leaving users with no protection from bad actors.

One of the other main concerns with this patchy regulatory regime, is that it was not made for cryptocurrencies. This structure cannot adequately facilitate the innovation of this new technology because these laws were not intended to do that.[85] Some advocates believe regulation on a federal level would give the currencies room to reach their full potential.[86]

D. The Risk of Fraud.

Some risks are systemic, or inherent in the system in which they exist, and cannot be mitigated. Others can be reduced or even eliminated by effective regulations. If cryptocurrency regulations were effective, they would significantly reduce the risks of fraud, money laundering, and other criminal activity. However, because current regulations are ill suited with respect to cryptocurrencies, they do not adequately address the risks present in the cryptocurrency market.

Cryptocurrency users face a variety of risks. Some, like a decline in value of a particular coin, are shared by other financial instruments like stocks. Other risks however, are much more prevalent in the context of cryptocurrencies. For example, in December 2018 the founder of a cryptocurrency exchange died

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82. *Id.*

83. *See e.g.*, Jackson Heald, *VI: Regulating Virtual Currency Risk*, 37 REV. BANKING & FIN. L. 567, 576 (2018).

84. *See e.g.,* Middlebrooks & Hughes, *supra* note 6.

85. *See* Heald, *supra* note 83, at 571.

86. *Id.*

from complications due to Crohn's disease.[87] The matter was made complicated because he was holding his customers' coins in an offline file.[88] It is standard storage protocol to protect virtual assets from hackers by keeping them offline. This file was encrypted, and when the founder died it was determined he was the only person with the password.[89] This left roughly C$190 million in cryptocurrencies inaccessible to the actual owners. There is no regulatory regime in place that mandated the assets be kept in storage where more than one person had access. This problem might have been avoided with proper regulation. Settlement of this dispute will be left up to the Canadian court system.

Fraud is not unique to cryptocurrencies, however without proper regulation cryptocurrency users are more vulnerable than under other circumstances. ICOs have presented major risks of fraud to investors.[90] "Ernst & Young has reported that over 10 percent of all funds raised by ICOs have been stolen . . . ."[91] Criminals offer their coins on the basis that the funds raised will be used to develop a business or product. After they raise enough money they disappear leaving investors with worthless coins. They prey on investors looking to make a lot of money quickly, afraid of missing out on the next Bitcoin. The SEC has addressed this risk, determining that under the *Howey* test, some ICOs are investment contracts and can be regulated because they are securities.[92] However, the SEC did not say that all ICOs are securities, which means that if the ICO does not qualify under the *Howey* test, then investors can seek no protection from the SEC.[93]

Given that the majority of cryptocurrency transactions take place on the internet, hacking is a major risk to cryptocurrency exchanges, consumers, and

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87. Doug Alexander, *Crypto Exchange Founder Filed Will 12 Days Before He Died,* BLOOMBERG (Feb. 5, 2019), https://www.bloomberg.com/news/articles/2019-02-05/crypto-exchange-founder-filed-last-will-12-days-before-he-died.

88. *Id.*

89. *Id.*

90. *See* Essaghoolian, *supra* note 30, at 297.

91. *Id.*

92. *See e.g.*, *Release 81207*, *supra* note 16.

93. *See* Essahooglian, *supra* note 30, at 297.

issuers.[94] The blockchain itself is extremely difficult to alter or fabricate. However, exchanges where the assets are held are not impenetrable. "There have been instances of large Bitcoin exchanges and wallet providers suspending services and being liquidated due to hacking activity where thousands of Bitcoins (worth millions of USD) have been stolen."[95] With proper regulation these exchanges would be held to a higher standard, similar to those of regular exchanges, and would be liable for incidents like this. Instead, the customers bore the losses.[96] There are over 17,000 individual online markets where users can exchange cryptocurrencies.[97] All of them are susceptible to hacking, however the ones with fewer resources are even more susceptible to security breaches, and there is little user protection from third party fault.[98]

User anonymity, enabled by blockchain, also presents a risk. Users and issuers may not know who they are trading with. Anonymity is partially what allowed Bitcoin to fund the Silk Road, which facilitated illegal online activity.[99] Any regulation reformed or enacted would necessarily have to weigh the costs and benefits of allowing transactions to be conducted anonymously. For example, if a trusted third party was introduced, it could keep a database of user identities. If these identities were securely kept, they could be used to prevent cryptocurrencies from being used for illegal activities.

III. WHO IS REGULATING CRYPTOCURRENCIES?

Many of these risks can be addressed if the problems of who should regulate cryptocurrencies and how they should do it are solved. There are many actors trying to regulate cryptocurrencies. A coin's, function may give an agency jurisdiction to regulate the coin. This has lead the SEC, CFTC, FinCEN, and IRS among others, to take action involving cryptocurrencies. Some agencies have made changes to their regulations specifically to address

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94. *See* Jared Cotton, *Sending a Bit More Coin Home? An Analysis of Retail User Protection in Bitcoin Remittance Markets,* 49 VICT. U. WELLINGTON L. REV. 107, 117 (2018).

95. *Id.* (parenthesis original).

96. *Id.*

97. COINMARKETCAP, www.coinmarketcap.com (last visited Apr. 24, 2019).

98. Cotton, *supra* note 94.

99. *See e.g.,* Middlebrook & Hughes, *supra* note 6, at 818.

cryptocurrencies. Others have tried to fit cryptocurrencies into their existing regulations. Those which are adapting to address cryptocurrencies are doing a better job effectively regulating them.

A. The SEC's Authority to Regulate Securities.

The SEC has not created any new regulations specifically designed for cryptocurrencies. They have applied their old tests to this new technology. However, they can only regulate those cryptocurrencies which sufficiently fit under the definition of "security."[100] While the SEC has been consistent in its approach toward cryptocurrencies, it has been unable to fully protect cryptocurrency users from all of the potential risks they face.

The SEC was created by the Securities Exchange Act of 1934 (the 34 Act) to enforce the 33 Act and the protections it provided investors.[101] This gave the SEC authority to regulate securities by requiring securities and particular transactions to be registered with the SEC.[102] Securities are defined broadly under the 33 Act to include many instruments such as any note, stock, security future, transferable share, or investment contract.[103] If an investment or a transaction falls into one of these categories, it must be registered with the SEC unless exempt.[104] Cryptocurrencies, in the abstract, do not fall neatly into any of these categories. There is no bright line rule which allows the SEC to regulate any and all cryptocurrencies. Courts must make a factual determination in a case-by-case approach. Compliance with SEC regulations would be difficult without certainty that the SEC has the authority to regulate in the first place. Users are not going to go through the process of compliance, which can be expensive, if they are initially unsure of the SEC's authority. They do so at the risk of violating the 33 Act, if a court determines that the SEC does in fact have authority.

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100. 15 U.S.C. § 78c(a)(10).

101. 15 U.S.C. § 78d.

102. 15 U.S.C. §78l.

103. 15 U.S.C. § 78c(a)(10).

104. 15 U.S.C. §78l(a).

1. The DAO Report.

In July 2017, the SEC released its findings from an investigation into Slock.It UG, a German Corporation.[105] Slock.it created a Decentralized Autonomous Organization (DAO) and the report is known as the "DAO Report." A decentralized autonomous organization is a virtual organization that is embodied and executed on a distributed ledger or blockchain.[106] The DAO was to operate as a for-profit entity.[107] In order to raise funds, the DAO issued DAO tokens in exchange for another cryptocurrency called Ethereum.

The DAO tokens used smart contracts[108] to give the investors voting rights.[109] Investors were promised a share in the DAO's returns in exchange for their investment.[110] Before the DAO could begin funding projects, a hacker stole the DAO's assets by exploiting a hole in its code.[111] This is what lead to the initial investigation. The SEC needed to investigate the nature of the DAO tokens to determine if they were securities under the 33 Act.

The SEC applied the *Howey* investment contract test in order to determine if the DAO tokens were an investment contract and fell under the definition of security.[112] This test comes from *SEC v. W.J. Howey Co.*[113] In that case, the Supreme Court had to determine whether the investment in a citrus grove, offered by Howey, qualified as a security under the 33 Act.[114] After determining that the investment did not qualify as any of the other defined investment types, such as a note or bond, the Court explored investment

105. *See e.g. Release 81207*, *supra* note 16.

106. *Id.*

107. *Id.*

108. "Smart Contracts are self-executing contacts with the terms of agreement between buyer and seller being directly written into lines of code. Once a smart contract has been created, computer transaction protocols will execute the terms of a contract automatically based on a set of conditions." *Rensel v. Centra Tech, Inc.*, 2018 U.S. Dist. LEXIS 100720, 1, 26 (S.D. Fla. June 14, 2018).

109. *See e.g. Release 81207*, *supra* note 16.

110. *Id.*

111. *Id.*

112. *Id.*

113. *See SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

114. *Id.*

contracts. The Court came up with a four-prong test to determine the existence of an investment contract. These factors are: 1) the investment of money, 2) in a common enterprise, 3) with the expectation of profits, 4) based primarily on the work of others.

Using this test the SEC found in its DAO Report that the investment of Ethereum qualified as an investment of money. This determination was based on *SEC v. Shavers*, where the court determined that investment of Bitcoin qualified as an investment of money under this test[115] and Ethereum would also qualify. The common enterprise prong was satisfied. The funds raised by investors were pooled and utilized in the furtherance of the same enterprise, the DAO. The investors were promised a share of the profits, which satisfied the expectation of profits prong. The also SEC determined that the profits would be made primarily by the efforts of others. Despite the fact that the investors were given voting rights, "The DAO investors relied on the managerial and entrepreneurial efforts of Slock.It and its co-founders . . . ."[116] The SEC determined that, despite the voting rights, the investors lacked any *meaningful* control.[117]

The DAO ICO qualified as a security under the *Howey* investment contract test, meaning that the directors and managers violated the 33 Act when they failed to register it with the SEC or seek an exemption from registration. Registration is designed to give investors the information they need to make reasonable investment decisions. By not registering, Slock.It deprived investors of material information and protections that they were entitled to. However, the SEC limited this report by not extending the determination to all ICOs.[118] The determination is now made on a case-by-case basis.

The definition of security under the 33 Act is read broadly because the purpose of the act is to protect investors. The idea of an investment contract "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[119] This flexibility requires consideration of surrounding circumstances.[120]

115. *See SEC v. Shavers and Bitcoin Savings and Trust,* 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013).

116. *See e.g. Release 81207*, *supra* note 16.

117. *Id.* at 14.

118. Essaghoolian, *supra* note 30, at 297.

119. *Howey*, 328 U.S. at 299.

120. *Id.* at 301.

Despite this broad approach, not all transactions involving cryptocurrencies qualify as investment contracts, or any other security, excluding them from the mandatory registration requirement. For example, someone purchasing Bitcoin on an exchange fails the *Howey* test. There is an investment of money. There is an expectation of profits. However, the last two prongs would be difficult to satisfy. There is no common enterprise. The investor's money goes to the exchange and the exchange uses that money to execute other transactions. There is no pooling of investor assets. Funds that they invest could be used for many different purposes. But even if it was a common enterprise, the profits are not derived from the efforts of others. Bitcoin's value is based on speculation. There are no managerial or entrepreneurial efforts required to generate profits from Bitcoin. The only way the investor actually profits on this investment is to sell at the right time, which is solely up to the investor. Under the *Howey* test, investors certainly have the type of meaningful control which precludes them from claiming any profits were derived primarily from the effort of others.

2. The Hinman Token Standard.

As the cryptocurrency economy continued to develop the SEC has since followed up the DAO Report, issuing guidance to help market participants determine if they are dealing with a security or not.[121] The Commission has publicly acknowledged that Bitcoin and Ethereum are not securities.[122] In June 2018, William Hinman, Director of the Division of Corporate Finance of the SEC, spoke regarding the SEC's perspective on digital asset transactions.[123] Hinman stated that when promoters sell tokens to raise funds with expectations that investors can earn a return, the economic substance is the same as a conventional securities offering, and the *Howey* test can be easily applied.[124] He continued, that a secondary sale of a token acquired from an ICO may also

121. William Hinman, *Digital Asset Transaction: When Howey Met Gary (Plastic),* Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418.

122. Block Chain Association, *Understanding the SEC's Guidance on Digital Tokens: The Hinman Standard*, Medium (Jan. 10, 2019), https://medium.com/@BlockchainAssoc/understanding-the-secs-guidance-on-digital-tokens-the-hinman-token-standard-dd51c6105e2a.

123. *See* Hinman, *supra* note 121.

124. *Id.*

be the sale of a security based on the circumstances.[125] Hinman rejected the idea that the token itself is the main factor in determining if it is a security.[126] He also rejected the idea that labels such as "utility token" preclude an asset from being a security.[127] "Central to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers."[128] Often, promoters use the funds raised from selling tokens to investors to develop enterprises.[129] Under these circumstances, information asymmetry exists and securities regulations are designed to mitigate that advantage in knowledge a promoter has over investors.[130]

Hinman explained how promoters factor in to the *Howey* test. "If the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts, – the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede."[131] This means that a sale of a token may be an investment contract when it is initially offered, but later may not satisfy the *Howey* test, if the network becomes sufficiently decentralized.[132] Hinman stated that Bitcoin and Ethereum are sufficiently decentralized and lack a promoter whose efforts are needed to make a profit. There are circumstances where a promoter could package Bitcoin, such as into a fund, and sell interests in the fund to investors, and that interest sold would constitute a security.[133] The investments in such a fund would be pooled for a common enterprise, and the profits would be derived primarily from the efforts of others, satisfying the *Howey* test.

Hinman encouraged promoters to work with counsel and the SEC, in determining if the product is a security through formal guidance or no-action

125. *Id.*

126. *Id.*

127. *Id*

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.*

133. *Id.*

letters.[134] The SEC is not necessarily looking at the function of the token, but more to the circumstances surrounding its sale.

The SEC's authority to regulate cryptocurrencies is fairly limited by the *Howey* test. The SEC can only take action if certain conditions are satisfied. The SEC will be most effective in regulating ICOs, because they satisfy the *Howey* test.[135] Before the DAO Report, many investors had been defrauded by scam ICOs and registration requirements will protect investors by requiring disclosure of the issuer's material information. This will give investors the opportunity to make more prudent investment decisions. Where the asset and transaction fall outside of the *Howey* test, the SEC will lack regulatory authority. Users must look elsewhere for protection if the digital asset does not qualify as a security.

B. The CFTC and Cryptocurrencies as Commodities.

The CFTC has also tried to regulate cryptocurrencies using its old framework and definitions.[136] The Eastern District of New York has agreed with the CFTC, supporting its argument that under certain circumstances, cryptocurrencies qualify as commodities and can be regulated by the CFTC as such.[137] While this provides some regulatory guidance, the circumstances which result in CFTC authority are very fact sensitive and are not clear to users.[138] This has a chilling effect on virtual commodity markets as consumers abstain from participating out of fear that they will not be in compliance with CFTC, among other regulations.

Similar to the SEC, the CFTC is a government agency whose authority is derived from federal statute.[139] The Commodity Exchange Act (CEA) was enacted in 1936, establishing the CFTC.[140] The purpose of the act was to

134. *Id.*

135. *Id.*

136. *See McDonnell,* 287 F. Supp. 3d at 213.

137. *Id.*

138. *Id.*

139. *Commodity Exchange Act & Regulations,* U.S. COMMODITY FUTURES TRADING COMMISSION, https://www.cftc.gov/LawRegulation/CommodityExchangeAct/index.htm (last visited Apr. 25, 2019).

140. *Id.*

protect the public interest, market participants, and market professionals by preventing and deterring price manipulation, disruptions to market integrity, abusive sales practices, and promoting innovation and fair competition.[141] The CFTC is the agency tasked with achieving this goal.

Recently, the CFTC regulated cryptocurrencies "through enforcement actions, rather than rule making."[142] A key case regarding the CFTC and cryptocurrencies, *CFTC v. McDonnell,* was decided on March 6, 2018.[143] There the CFTC sued Patrick K. McDonnell and Coin Drop Markets for operating "'a deceptive and fraudulent virtual currency scheme . . . for purported virtual currency trading advice' and 'for virtual currency purchases and trading . . . and simply misappropriating [investor] funds.'"[144] The issue in this case was whether the CFTC had standing to bring claims against McDonnell for violating the CEA.[145] If the CFTC could regulate virtual currencies as "commodities," as defined under the act, then it may have standing.

The relevant part of the act defines commodity as "all other goods and articles . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in."[146] If the commodity is traded as a future, it must be traded on an exchange approved by the CFTC.[147] The court clarified, that like the Securities Act of 1933, the CEA must be read liberally to allow broad market protection.[148]

The court determined that a commodity includes virtual currencies in both economic function and the language of the statute.[149] The court used a few different theories to lead them to this conclusion. "Black's Law Dictionary

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141. 7 U.S.C. § 5.

142. Ryan Clements, *Assessing the Evolution of Cryptocurrency: Demand Factors, Latent Value, and Regulatory Developments,* 8 MICH. BUS. ENTREPRENEURIAL L. REV. 73, 84 (2018).

143. *See McDonnell,* 287 F. Supp. 3d at 213.

144. *Id.* at 216 (brackets original).

145. *Id* at 271.

146. *Id.*

147. *Id* at 223.

148. *Id.*

149. *Id.*

defines commodity as 'an article of trade or commerce.'"[150] Common usage defines commodities as "goods sold in the market with a quality and values uniform throughout the world."[151] Virtual currencies, specifically Bitcoin in this case, appear to fit those definitions. The court also determined that the way Bitcoin was valued, based on scarcity, supply and demand, was the same as other commodities such as gold and silver, are valued.[152] There was also similarity between Bitcoin and other commodities in their ability to act as stored value instruments, as well as forms of payment.[153] The court relied on *Andrews v. Blick Art Materials, LLC,*[154] which held that the CFTC has authority over intangible commodities.[155] The court held that virtual currencies were commodities and that if a futures market existed for that commodity, the CFTC could regulate it as such.[156]

However, the CFTC's authority to bring an action against an individual or organization with respect to a commodity is limited to situations where the defendant is "utilizing a scheme to defraud investors through a contract [for] sale of [a] commodity in the interstate commerce."[157] This fraud prevention rationale has been expanded to spot transactions in order to protect public interests.[158] The CFTC has the authority to regulate futures contracts for commodities, regardless of the presence of fraud. The CFTC cannot bring suit relating to regular spot transactions of commodities, unless there is fraud. Like the *Howey* test, the CEA establishes prerequisites for CFTC authority. But, once these prerequisites are satisfied, the CFTC has broad authority to bring actions against bad actors. In its opinion, the court stated that CFTC jurisdiction over virtual currencies "does not preclude other agencies from exercising their regulatory power when virtual currencies *function* differently than commodities."[159]

150. *Id* at 224.

151. *Id.*

152. *Id.*

153. *Id.*

154. *See Andrews v. Blick Art Materials, LLC*, 268 F. Supp. 3d 381 (E.D.N.Y. 2017).

155. *Id.*

156. *McDonnell,* 287 F. Supp. 3d at 227.

157. *Id.* at 229 (brackets original).

158. *Id.*

159. *Id. 228* (emphasis added).

C. The IRS's Attempt at Taxing Cryptocurrencies.

The IRS has attempted to use its current regulations and apply them to this new technology. The IRS has applied the capital gains tax to cryptocurrency holders, requiring them to report their earnings from appreciation of cryptocurrency assets.[160] The problem with this regulation is that it nullifies what many perceive to be a key benefit of cryptocurrencies, anonymity.[161] In order to pay capital gains taxes, users must disclose their cryptocurrency purchases and sales on their tax forms, which necessarily links the assets to the individuals or institutions. Applying this regulation limits use of cryptocurrencies by requiring users to sacrifice their anonymity, thus stifling accessibility and innovation.

The issue of taxing cryptocurrencies has been prevalent throughout their emergence into the mainstream financial marketplace. Virtual currencies are not treated as foreign currencies.[162] The IRS cannot tax a user's Bitcoin like it can tax a gain on the sale of Euros or Yen.[163] "A recent study by Omri Marian suggests that cryptocurrencies are 'super tax havens' and that they could become the 'weapon of choice for tax evaders, due to anonymity.'"[164] Owners could then use the currency as payment for goods and services instead of converting to fiat currency.[165] Transactions on an anonymous decentralized network would be difficult to track down.[166]

The IRS has responded to this problem by applying the capital gains tax to gains from investments in cryptocurrencies.[167] For federal tax purposes, the IRS classifies cryptocurrencies as property. "This guidance established that general tax principles that apply to regular property transactions also apply to virtual currency transactions. Therefore, businesses that accept bitcoin and other cryptocurrencies for goods and services must pay income taxes on

160. *See* Brookes, *supra* note 22, at 87.

161. *Id.*

162. *See* Lovell, *supra* note 17, at 935.

163. *Id.*

164. Clements, *supra* note 142, at 77.

165. *Id.*

166. *Id.*

167. *See e.g.,* Hughes, *supra* note 21, at 19.

payments."[168] Each transaction must be reported in U.S. dollars, based on fair market value, as of the date of payment or receipt.[169]

However, this taxing system relies on the users to report their gains. Lack of self-reporting has been an issue for the IRS.[170] "With millions of virtual currency transactions happening annually, the IRS expected a torrential rainstorm of reporting after 2014. Instead, less than 1,000 taxpayers reported virtual currency transaction in 2014 or 2015."[171] The anonymous nature of many cryptocurrency transactions further complicates the matter.

The self-reporting issue is a direct consequence of the application of old regulations to new technology. The capital gains tax was not designed to tax cryptocurrencies. When it is then applied to cryptocurrencies, there are necessarily going to be gaps and inconsistencies in the application, giving rise to issues like this one.

The IRS took a similar approach to the one they used to tax unreported off shore income, issuing a John Doe Summons.[172] "A John Doe summons does not identify a particular U.S. taxpayer, but a class of U.S. taxpayers that fall within a certain group of those who may have broken the tax laws."[173] In this case the IRS worked with the Department of Justice to serve Coinbase such a summons."[174] Coinbase is a popular online exchange which provides customers "virtual wallets" where they can store and trade cryptocurrencies. The summons sought information on all of Coinbase's users from 2013 to 2015.[175] In this case, the target group of taxpayers was those who use Coinbase to trade cryptocurrencies. The Northern California court limited the summons, forcing Coinbase to give information to the IRS, but only that of those users who "bought, sold, sent, or received more than $20,000.00 worth of cryptocurrencies in a single year between 2013 and 2015."[176] This excluded

168. *Id.*

169. *Id.*

170. *See e.g.*, Hochman, *supra* note 24, at 17.

171. *Id.*

172. *Id.* at 18.

173. *Id.* at 17.

174. *Id.* at 18.

175. *Id*. at 17.

176. *Id.*

roughly 14,300 accounts from disclosure.[177] Regardless, it set an important precedent, giving the IRS the authority to issue similar summons to other wallets and exchanges. They will be able to cross-reference the users' personal information from the exchange with their tax filings, and take action if there are unreported gains from cryptocurrencies.

D. Financial Crimes Enforcement Network (FinCEN) Regulates Money Services Businesses.

The Financial Crimes Enforcement Network, FinCEN, is a division of the Department of Treasury that handles financial crimes.[178] Its ". . . mission is to safeguard the financial system from illicit use, combat money laundering, and promote national security through the strategic use of financial authorities' collection, analysis, and dissemination of financial intelligence."[179] According to FinCEN, cryptocurrencies are subject to regulation because they can serve a substitutive purpose of facilitating exchanges of goods or services.[180] They subsequently extended their oversight to "exchangers and administrators of virtual currencies."[181] This includes companies like Coinbase. FinCEN's goal was to prevent money laundering, and protect national security by regulating cryptocurrencies, ultimately ensuring they are not used for illicit purposes, such as funding terrorism.

Under the Bank Secrecy Act (BSA), FinCEN has the authority to regulate "money services business" (MSBs).[182] MSBs include "any person doing business, whether or not on a regular basis or organized business concern, in one or more of the following capacities: (1) Currency dealer or exchanger; (2) Check casher; (3) Issuer of traveler's checks, money orders or stored value; (4) Seller or redeemer of traveler's checks, money orders, or stored value; (5) Money transmitter; or (6) U.S. Postal Service."[183] Cryptocurrencies function

177. *Id.*

178. *See e.g.*, Liedel, *supra* note 23, at 125.

179. *Mission*, FINANCIAL CRIMES ENFORCEMENT NETWORK, https://www.fincen.gov/about/mission, (last visited Apr. 25, 2019).

180. *See e.g.,* Liedel, *supra* note 23, at 126.

181. *Id.*

182. *See e.g.*, Essaghoolian, *supra* note 30, at 318.

183. Liedel, *supra* note 23, at 127.

as both currencies and stored value instruments. Any person doing business as a cryptocurrency dealer or exchanger, or issuer or seller of stored value, will be considered a MSB, and can be regulated by FinCEN.[184] Additionally, money transmitters are defined by FinCEN "to 'include a person that provides money transmission services.'"[185] Such services include "acceptance of currency, funds, or other value that substitutes for currency, from one person, and the transmission of currency, funds, or other value that substitutes for currency, to another location or person by any means."[186] A company which exchanges virtual currencies for cash or vice versa will be a money transmitter as they are conducting transmission services. Accordingly, they will be a MSB under the BSA and can be regulated by FinCEN.[187]

MSBs are required to register with FinCEN[188], which ". . . may bring an enforcement action for violations of the reporting, recordkeeping, or other requirements of the BSA."[189] In December 2018, UBS Financial Services was assessed a civil money penalty of $14,500,00.00 for "willful violations" of the BSA and the anti-money laundering (AML) program.[190] In July 2017, FinCEN assessed BTC-E a civil money penalty of $110,003,314.00[191] and its founder a $12,000,000.00 penalty. BTC-E had customers in the United States, conducted transactions in the United States, and operated on servers in the United States[192], deemed enough to qualify as an MSB and to invoke jurisdiction over it.

FinCEN's authority to regulate MSBs and enforce the BSA is broad. The potential penalties for violations are severe. However, its regulations do not

184. *Id.*

185. *Id.*

186. *Id.*

187. *Request for Administrative Ruling on the Application of FinCEN's Regulations to a Virtual Currency Trading Platform,* FINANCIAL CRIMES ENFORCEMENT NETWORK, FIN-2014-R011 (2014), https://www.fincen.gov/sites/default/files/administrative_ruling/FIN-2014-R011.pdf.

188. *See e.g.*, Essaghoolian, *supra* note 30, at 319.

189. *Enforcement Actions*, FINANCIAL CRIMES ENFORCEMENT NETWORK, https://www.fincen.gov/news-room/enforcement-actions.

190. *See UBS Fin. Serv., Inc.*, 2018 U.S. Dist. LEXIS at 3.

191. *In the Matter of BTC-E*, No. 2017-06 (Assessment of Civil Money Penalty Jul. 26, 2017).

192. *Id*.

extend to users.[193] Users "do not transmit the value of funds to another person or location."[194] This leaves a gap in FinCEN's authority.

E. New York's BitLicense is Tailored Specifically for Cryptocurrency Regulation.

New York has enacted regulations for cryptocurrencies. In contrast to the other regulations discussed above, New York's BitLicense was designed specifically for cryptocurrency regulation. In New York, no business involving cryptocurrencies is to be conducted without a BitLicense. The BitLicense offers straight forward guidance to users who wish to buy, sell, trade, or issue cryptocurrencies. The statute which gave rise to the BitLicense, is specific, and leaves little room for judicial interpretation. The definition for what qualifies as "business activity" is in statute. Courts and applicants do not need to guess whether registering for a BitLicense is necessary because the conditions are specifically stated in the statute. The statute makes compliance easy for users which encourages them to register and thus encourages cryptocurrency use.

New York has taken the initiative in regulating this new technology. In June 2015, the New York Department of Financial Services (NYDFS) published a framework for its BitLicense and began accepting applications from financial institutions.[195] The amended New York statute states, "[n]o person shall, without a license obtained from the superintendent as provided in this part, engage in any Virtual Currency Business Activity."[196] The statute exempts from registration "persons that are chartered under the New York Banking Law and are approved by the superintendent to engage in Virtual Currency Business Activity,"[197] as well as "merchants and consumers that utilize Virtual Currency solely for the purchase or sale of goods or services or for investment purposes."[198] This shows that BitLicenses are not meant to prevent individuals from utilizing cryptocurrencies. It also encourages

193. *See e.g.*, Middlebrook & Hughes, *supra* note 6, at 829.

194. *Id.*

195. *NYDFS Announces Approval of First Bitlicense Application From a Virtual Currency Firm,* N.Y. DEPT. FIN. SERV. (Sept. 22, 2015), https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1509221.

196. N.Y. COMP. CODES. R. & REGS. tit. 23, § 200.3.

197. *Id.* at § 200.3(c)(1).

198. *Id.* at § 200.3(c)(2).

established firms who comply with banking laws to engage in virtual currency business by waiving them from registration. These types of companies are exempt because there is already a consumer protection framework in place concerning them. The risk of fraud is much lower.

Additionally, any company that was engaging in virtual currency business prior to the introduction of BitLicense had 45 days after the regulation was effective to apply.[199] Even businesses located outside of New York State had to apply if they had customers within the State.

This approach is intended to protect consumers from fraudulent activity and deter crimes facilitated by cryptocurrencies like money laundering.[200] In a press release, the NYDFS superintendent stated, "[a]s the financial technology marketplace continues to evolve, New York is committed to fostering innovation and ensuring responsible growth."[201]

Since 2015, NYDFS has granted just 16 companies BitLicenses.[202] The NYDFS approach may be limiting the number of companies doing business in New York. There was pushback when the regulation was first implemented.[203] Some would rather pull their virtual currency business than go through the costs and time of applying for and keeping a BitLicense. However, more recent trends seem to indicate that more and more companies are applying for licenses.[204]

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199. *Virtual Currency Businesses, Frequently Asked Questions*, N.Y. DEPT. FIN. SERV., https://www.dfs.ny.gov/apps_and_licensing/virtual_currency_businesses/bitlicense_faqs, (last visited Apr. 25, 2019).

200. Katten Munchin Roseman, LLP, *New York Bitlicense Regulations Virtually Certain to Significantly Impact Transactions in Virtual Currencies,* FIN. SERV. ADVISORY (July 8, 2015), https://www.kattenlaw.com/New-York-BitLicense-Regulations-Virtually-Certain-to-Significantly-Impact-Transactions-in-Virtual-Currencies.

201. *DFS Continues to Foster Responsible Growth in New York's Fintech Industry with New Virtual Currency Product Approvals,* N.Y. DEPT. FIN. SERV., https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1809101, (Sept. 10, 2018) (last visited Apr. 25, 2018).

202. Kirill Bryanov, *Blockchain and the City: New York State as a "Tough" Model of Crypto Regulation,* COINTELEGRAPH (Feb. 21, 2019), https://cointelegraph.com/news/blockchain-and-the-city-new-york-state-as-a-tough-model-of-crypto-regulation.

203. *Id.*

204. *Id.*

IV. ARE THESE REGULATORS EFFECTIVELY REGULATING CRYPTOCURRENCIES?

The regulations analyzed thus far have been somewhat effective in regulating cryptocurrencies. Users are more protected than they were before the SEC, CFTC, IRS, FinCEN, and NYDFS took action to regulate exchanges. These regulations deter crimes like fraud and money laundering which were extremely prevalent in the early days of cryptocurrency trading.[205] However, it is important to remember that outside of the BitLicense, these regulations were not designed for cryptocurrency regulations. The SEC's authority is limited by the definition of a security in the Securities Act.[206] Based on this definition the SECs authority in the cryptocurrency context is limited outside of ICOs.[207] This leaves the SEC little authority with regard to many other cryptocurrencies and cryptocurrency transactions, including the most popular one, Bitcoin. That is more than half of the cryptocurrency market that the SEC may not be able to regulate.[208]

The CFTC is similarly limited. If the transaction or coin does not qualify as a commodity, the CFTC has no authority.[209] Even if the transaction does involve a commodity, the "CFTC does not have regulatory authority over simple cash or spot transactions that do not involve fraud or manipulations."[210]

FinCEN only has jurisdiction over Money Services Businesses.[211] If an entity was committing fraud or was money laundering, but was not a Money Services Business, the victims of those crimes would have to look elsewhere to recover from the damages suffered.

The IRS's attempt at regulating cryptocurrencies has also been largely ineffective.[212] Even within the limited scope where the IRS has authority, thus

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205. *E.g.*, *Remarks from Under Sec'y of Terrorism & Fin. Intelligence David S. Cohen on "Addressing the Illicit Fin. Risks of Virtual Currency",* Treas. JL-236, 2014 WL 1017944 (Mar. 18, 2014).

206. 15 U.S.C. § 78c(a)(10).

207. *See e.g. Release 81207*, *supra* note 16.

208. *BTC Dominance*, COINMARKETCAP, https://coinmarketcap.com/ (last visited Apr. 25, 2019).

209. *See generally, McDonnell,* 287 F. Supp. 3d at 213.

210. *Id.* at 227.

211. Brookes, *supra* note 22, at 95.

212. *See generally, U.S. v. Coinbase,* 2017 WL 3035164 (N.D. Cal. 2017).

far it has been ineffective at regulating that space because compliance has largely been through voluntary reporting.

V. POTENTIAL SOLUTION

One potential solution to the irregular regulation of cryptocurrencies is a single federal agency tasked with overseeing cryptocurrency trading based on New York's BitLicense program. NYCRR sections 200.1-200.22 all apply to those institutions who have been awarded BitLicenses.[213] Among the requirements are: reporting of material changes to business activity or products; maintenance of a "surety bond or trust account" with a "qualified custodian" in order to protect customer assets; submission of quarterly financial reports; approval of mergers or acquisitions that would alter the control of the licensee; and internal assessments of risks associated with business activities that could lead to money laundering.[214] All of the requirements were designed specifically with cryptocurrencies in mind. Unlike SEC, CFTC, IRS, and FinCEN regulations, BitLicense requirements were tailored to protect cryptocurrency users and at the same time encourage businesses' innovation when dealing with cryptocurrencies. This specific tailoring leaves fewer gaps in regulations and authority. If an institution is conducting virtual currency business they are required to register and comply.[215] Compliance is not dependent on the function of cryptocurrency or other various factors surrounding the cryptocurrency activities. These extensive requirements are necessary to adequately protect user interests. However, it is becoming more evident that these extensive requirements are not deterring institutions from applying for BitLicenses.[216]

The BitLicense program is not limited to those trading cryptocurrency-based securities, commodities, or any other one area of cryptocurrencies. Businesses that utilize cryptocurrencies in any way have to register.[217]

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213. *See generally,* N.Y. COMP. CODES. R. & REGS. tit. 23, § 200.

214. *Id.*

215. *Id.* at § 200.2(q).

216. Kirill Bryanov, *Blockchain and the City: New York State as a "Tough" Model of Crypto Regulation,* COINTELEGRAPH (Feb. 21, 2019), https://cointelegraph.com/news/blockchain-and-the-city-new-york-state-as-a-tough-model-of-crypto-regulation.

217. N.Y. COMP. CODES. R. & REGS. tit. 23, § 200.2(q).

Registration will prevent money laundering and other crimes.[218] This will protect individuals from fraud by prescreening the institutions capable of dealing in the cryptocurrency space.[219] Individuals will in turn allow these companies to disclose their transactions to the IRS. This is a trade-off. In exchange for legitimate enterprises facilitating their transactions and protecting them from fraud, the users will disclose their transactions to the IRS. National adoption of the BitLicense is a reasonable and responsible way to take advantage of the benefits of cryptocurrencies while limiting the risks.

This registration program rewards those institutions willing to meet the requirements by allowing them to have exclusive access to the consumers in the cryptocurrency space. Those who operate without registration will face enforcement actions such as the civil penalties seen above.[220]

The SEC, CFTC, IRS, and FinCEN, will all still be able to regulate aspects of cryptocurrencies that fall into their jurisdictions, but they will not be the primary regulator. They were not designed to regulate cryptocurrencies. Rather they were designed to regulate securities, commodities, and to tax people.

VI. CONCLUSION

Cryptocurrencies popularity exploded in 2017.[221] The potential impact of this technology is well beyond what the majority of people, including government officials imagined. The coins have many uses including stored value, efficient transactions, fund raising, currency substitutes, payment for goods and services, among many others. Institutions as well as individuals should not have to sacrifice these benefits because the coins are ineffectively regulated. At this point, the government should recognize the utility of this tool that continues to grow in popularity. Instead of passively regulating, trying to fit it into other regimes, the government needs to take active steps in regulating these coins with the goal of providing their benefits, while mitigating the risk. This is not going to happen overnight. NY's BitLicense took two years to become effective from the time NY officials began contemplating a regulatory

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218. *See generally, id.* at § 200.

219. *Id.*

220. *See UBS Fin. Serv., Inc.*, supra note 190.

221. *Global Charts - Total Market Capitalization*, COINMARKETCAP, https://coinmarketcap.com/charts/, (last visited Apr. 24, 2019).

strategy.[222] But, if the government acts now, it can implement a regulatory structure that is properly designed for cryptocurrencies. This is a far better option than passing off the responsibility to previously established, overworked agencies whose main concerns lie outside the cryptocurrency space.

222. *NYDFS Announces Approval of First Bitlicense Application From a Virtual Currency Firm,* N.Y. DEPT. FIN. SERV. (Sept. 22, 2015), https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1509221.

CASES & MATERIALS

Lance McCardle

The Second Circuit Rules that MetLife was not Obligated to Arbitrate Dispute with Former Employee Relating to Events that Occurred Long After MetLife and Employee Ceased to be Affiliated with FINRA
Metro. Life Ins. Co. v. Bucsek, 919 F.3d 184, 187 (2d Cir. 2019)

Bucsek, a former employee of MetLife, initiated a FINRA arbitration against MetLife, asserting claims related to unfair compensation during the time period from 2011 to 2016. Bucsek had been employed by MetLife from 2002 to 2016, but MetLife terminated its membership with FINRA (then, the NASD) in 2007. Thus, all of Bucsek's claims related to the period of his employment that took place four years *after* the time that MetLife had been a FINRA member.

In response to Bucsek's statement of claim, MetLife submitted a letter/motion to FINRA seeking dismissal of Bucsek's claims on the basis that MetLife was not required to arbitrate the dispute under the Code. The Director of FINRA Office of Dispute Resolution denied MetLife's application for dismissal. MetLife then filed an action in the Southern District of New York, seeking an injunction barring Bucsek from pursuing his claims in arbitration. The district court granted a preliminary injunction, staying the arbitration. Bucsek then appealed to the Second Circuit, arguing that the district court erred in two respects: first, in finding that MetLife had shown probability of success as to the non-arbitrability of the dispute, and second, in ruling on the question of arbitrability, rather than leaving it to the arbitrators to decide.

The Second Circuit began by summarizing important guidance by the Supreme Court. Citing *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 83, 123 S.Ct. 588, 154 L.Ed.2d 491 (2002), the Second Circuit noted that "right of access to courts is of such importance that courts will retain authority over the question of arbitrability of the particular dispute unless 'the parties clearly and unmistakably provide[d]' that the question should go to arbitrators." *Bucsek,* 919 F.3d at 190. And citing *Henry Schein Inc. v. Archer & White Sales*, Inc., —— U.S. ——, 139 S.Ct. 524, 202 L.Ed.2d 480 (2019), the Second Circuit observed that the Supreme Court had recently confirmed that, "when the parties have contracted to submit the question of the arbitrability of a dispute to arbitrators, courts must respect and enforce that contractual choice." *Id.* at 190.

Regarding the arbitrability of the dispute, the Court ruled that the "NASD/FINRA Code cannot reasonably be interpreted to provide for arbitration of Bucsek's claims…because his claims are based on events that occurred years after he and MetLife had ceased to have any connection with FINRA/NASD." *Id.* at 192. The Court specifically found Bucsek's argument—that an entity that was once a member remains a member subject to the arbitration Code forever as to any future dispute—"is untenable and would produce absurd results that could not have been intended by FINRA or any of the contracting parties that subjected themselves to the FINRA Code." *Id.* at 192. Regarding whether the question of arbitrability should have been left to the arbitrators to decide, Bucsek argued that FINRA Rule 13413, which provides that the arbitration panel "has the authority to interpret and determine the applicability of all provisions of the Code," specifically delegates the resolution of arbitrability to the Panel. The Second Circuit disagreed, holding that "this provision fails to support a clear and unmistakable inference that the contract intended to confer the resolution of arbitrability on the arbitrator."

Second Circuit Holds that Plaintiff's Claims Under the Commodities Exchange Act Accrue on the Date of Discovery of the Injury
Levy v. BASF Metals Ltd., 917 F.3d 106, 107–08 (2d Cir. 2019)

Levy began trading in the platinum futures market in 2008; and on August 15, 2008, the platinum market crashed, causing her to lose her entire investment. After filing an earlier lawsuit in 2012 against a different set of defendants for market manipulation, Levy filed a new action in the Southern District of New York in September 2015, after receiving a copy of a class action complaint alleging claims against several new defendants for conspiring to manipulate the market in violation of the Commodities Exchange Act ("CEA") and other laws. Levy specifically alleged that the 2014 class action complaint first apprised her of this misconduct as well as the identities of the parties involved. Defendants filed a motion to dismiss the claims under the CEA as time-barred by the statute's 2-year statute of limitation. *See* 7 U.S.C.A. § 25(c) ("Any such action shall be brought not later than two years after the date the cause of action arises.). The district court granted the motion, and Levy appealed.

The Second Circuit noted that "[f]ederal courts ... generally apply a discovery accrual rule when a statute is silent on the issue ...." *Levy,* 917 F3d at 108 (citing *Rotella v. Wood*, 528 U.S. 549, 555, 120 S.Ct. 1075, 145 L.Ed.2d 1047 (2000); *Koch v. Christie's Int'l PLC*, 699 F.3d 141, 148 (2d Cir. 2012)). But the Court further noted that "[i]n applying this rule, it is 'discovery of the injury, not discovery of the other elements of a claim,' that "starts the clock." *Id.* (citing *Rotella*, 528 U.S. at 555, 120 S.Ct. 1075).

Levy argued that the district court erred in conflating the date that she suffered her losses with the date on which her CEA claims accrued. The Court disagreed noting:

> The relevant inquiry, however, is not whether Levy had discovered the identity of the defendants or whether she had discovered the manipulation scheme she alleges in her complaint. Rather, the question is when Levy discovered her CEA injury—that is, a loss that was the result of a CEA violation.

Id. at 108. Acknowledging that Levy had alleged in her complaint that she was well aware of the damages by 2008, the Court had "little difficulty concluding that Levy discovered her CEA injury in 2008" and concluded that that once she was aware of this injury, "the CEA gave her two years to ascertain the facts necessary to bring her suit." *Id.* at 109.

California Appeals Court Overturns Elder Abuse Award Based on Arbitrator's Failure to Disclose Involvement in Similar Case

Trottier v. Morgan Stanley Smith Barney, LLC, No. B287643, 2019 WL 2559753, at *1 (Cal. Ct. App. June 21, 2019)

On behalf of the estate of his grandmother, Trottier initiated a FINRA arbitration against Morgan Stanley Smith Barney and one of its advisors (collectively, "MSSB"), alleging that MSSB aided and abetted the financial elder abuse of his grandmother that was committed by a third party. Trottier alleged that prior to her death, his grandmother was suffering from paranoid delusions that her neighbors were spying on her. He further alleged that the owner of a security company took advantage of the grandmother's delusions to induce her to buy an elaborate and unneeded security system for more than $300,000. The owner of the security company was subsequently sentenced to three years in prison. At a preliminary hearing in the criminal proceeding, a doctor testified that the grandmother's mental vulnerability would be apparent to anyone dealing with her in business transactions.

The money paid to the security company came from the grandmother's MSSB retirement account, and MSSB's financial advisor had to sell securities to cover the amount of the withdrawals. In the FINRA case, Trottier alleged that MSSB knew or should have known that his grandmother was a victim of elder abuse and was obligated to halt the transactions and contact law enforcement. The arbitration panel (on which Arbitrator Michael Harrison served as the Chairperson) issued a 2-1 decision. Harrison and one of the other arbitrators found MSSB liable and issued an award for nearly $400,000, while the third arbitrator issued a lengthy dissent. MSSB petitioned the Court to vacate the award.

MSSB argued that the award should be vacated because Harrison failed to disclose to his involvement as a Probate Volunteer Panel (PVP) attorney for an elderly victim of alleged financial abuse in a conservancy proceeding. The trial court agreed and vacated the award.

On appeal, the California Court of Appeal made four primary findings: (1) as PVP counsel in the conservancy proceeding, Harrison had accused the proposed conservatee's privately retained attorney of aiding the perpetration of financial elder abuse by advocating the proposed conservatee's wishes regarding the distribution of her property to her alleged abuser; (2) as PVP counsel, Harrison became personally embroiled in the conservancy proceeding, going so far as to recommend that the court should consider barring the proposed conservatee's privately retained attorney from representing her; (3) as PVP counsel, Harrison made the unusual recommendation that the court direct the Sheriff's Department to pursue criminal charges against anyone "suspected" of engaging in financial elder abuse of the proposed conservatee; and (4) Harrison's involvement in the conservancy proceeding ended less than a year before his first disclosure statement in the FINRA arbitration. *Trottier,* 2019 WL 2559753, at *1.

The Court noted that an arbitrator's ongoing duty to disclose under FINRA Rule 12405 (as construed by FINRA) includes the duty to disclose "any relationship, experience and background information that may affect—or even appear to affect—the arbitrator's ability to be impartial and the parties' belief that the arbitrator will be able to render a fair decision." *Id.* at *2. The Court further noted that Harrison checked "No" on his disclosure form in response to the question, "Have you, your spouse, or an immediate family member been involved in a dispute involving the same or similar subject matter as the arbitration?" *Id.*

The Court found that the allegations in the conservancy proceeding were analogous to the allegations made in the FINRA proceeding, and it noted the following:

> [T]his record discloses "extreme circumstances ... not directly related to the case" …that demonstrate a specific reason to doubt whether Harrison could be fair to [MSSB] in the instant arbitration. A reasonable person aware of all the facts of Harrison's conduct in the [] conservancy proceeding could reasonably conclude that Harrison was overzealous and personally embroiled in this very atypical conservancy proceeding.

Id. at 8 (citing *Haworth v. Superior Court*, 235 P.3d 152, 161 (Ca. 2010)). The Court acknowledged that an "arbitrator cannot reasonably be expected to identify and disclose all events in the arbitrator's past, including those not connected to the parties, the facts, or the issues in controversy, that conceivably might cause a party to prefer another arbitrator;" but that this constituted "the rare case contemplated by *Haworth*—one in which the arbitrator should have understood, despite the differences in parties, facts, and issues between the two proceedings, that the prior dispute in which he was involved created reasonable concerns about his ability to be impartial in the current arbitration." The Court affirmed the vacatur of the arbitration award because Harrison did not disclose his involvement in the conservancy proceeding. *Id.* at 10.

Fifth Circuit Holds That Hedge Fund Investors Have Standing To Pursue Direct Claims Against Financial Advisor

Broyles v. Commonwealth Advisors, Inc., No. 17-30092, 2019 WL 4051862, at 1 (5th Cir. Aug. 28, 2019) [hereinafter "App. Ct. Op."].

In *Broyles,* a Registered Investment Advisor, Commonwealth Advisors, Inc., and its CEO, Walter Morales, had solicited plaintiffs to invest in one or more "pooled asset" hedge funds (formed under Delaware law) that were created and controlled by Commonwealth. *See Broyles v. Cantor Fitzgerald & Co.,* 10-854, 2014 WL 6886186, at 1 (M.D. La. Dec. 8, 2014) [hereinafter "Dist. Ct. Op."]. Following tens of millions of investor losses, multiple lawsuits were filed against Commonwealth, Morales, and certain broker-dealers alleging fraudulent conduct before and after the plaintiffs invested. *Id.* Plaintiff Broyles filed two lawsuits—one alleging direct claims on behalf of investors for various misrepresentations and breaches of fiduciary duties, and another alleging derivative claims on behalf of the hedge funds in which in the plaintiffs had invested. *Id.*

In 2014, the broker-dealer defendants moved to dismiss plaintiffs' direct claims, arguing that the plaintiffs lacked standing to bring a direct suit because "(1) the injury they claim is one that must have affected the [hedge funds] as a whole, (2) the [hedge funds] have asserted the same claims against the same Defendants, and (3) these claims asserted [] are derivative, not direct." Dist. Ct. Op. at 2. Rejecting the plaintiffs' arguments that they had suffered distinct and direct injuries and finding that broker-dealer defendants had demonstrated the risk of double recovery, the district court dismissed plaintiffs' direct claims against the broker-dealer defendants for lack of standing. *Id.* at 4. Then, in February 2017, the district court *sua sponte* granted summary judgment to

Commonwealth and Morales holding that the plaintiffs were required to bring a derivative claim on behalf of the hedge funds. App. Ct. Op. at 1.

The Fifth Circuit began by noting that "[t]o establish a securities fraud claim under Louisiana law a plaintiff must show that "(1) the defendant made an untrue statement of a material fact; (2) the plaintiff did not know of the untruth; and (3) the defendant knew, or in the exercise of reasonable care could have known, of the untruth." *Id.* (citing *Meadaa v. Karsan*, 822 F.3d 202, 206 (5th Cir. 2016)). The Court further noted that plaintiffs' complaint stated a cause of action against Commonwealth and Morales "for fraudulently inducing them to purchase over $95 million in falsely inflated securities." *Id.*

The Court concluded that plaintiffs did have Article III standing and vacated the district court's summary judgment. Indeed, the Fifth Circuit held:

> The investor plaintiffs adequately supported their motion for partial summary judgment demonstrating their Article III standing with appropriate evidence of their injury-in-fact that arose immediately upon their purchase of the falsely overvalued securities; were induced and caused by the defendant advisers' fraudulent advice and solicitations; and likely will be redressed by a favorable decision on the merits.

Id. (citing *Lujan v. Defs. of Wildlife*, 504 U.S. 555, 560–61 (1992)).

In support of its holding, the Court further noted that the Delaware Supreme Court had "made clear that securities fraud claims directly against perpetrators created by the laws of other states for the fraudulent inducement of the purchase, sale or holding of securities are not converted into derivative actions merely because the securities were issued by a Delaware corporation or entity." App. Ct. Op. at 1 (citing *Citigroup Inc. v. AHW Investment Partnership*, 140 A.3d 1125, 1126, 1139–41 (Del. 2016)).

District Court Refuses Investor's Request to Vacate Arbitration Award Based on Manifest Disregard of Law
Warren v. Geller, 386 F. Supp. 3d 744, 745 (E.D. La. 2019)

In *Warren,* plaintiffs (the widow and children of former professional New Orleans Saints football player Frank Warren) filed an arbitration proceeding against Raymond James & Associates (as successor to Morgan Keegan) and two of its registered representatives (collectively referred to as Raymond James). Claimants alleged that Raymond James conspired with and acted in concert with the former trustee of a trust created for the benefit of Claimants that maintained a trust account with Raymond James. Claimants alleged that Raymond James committed breach of fiduciary duty, negligence and gross negligence, and fraud by facilitating the theft of investment funds by the trustee. In October 2018, a FINRA arbitration panel dismissed Claimants' claims in their entirety.

Raymond James filed a motion to confirm the award, and Claimants filed a motion to vacate the award. Claimants acknowledged that they did not have a statutory basis for vacatur but nevertheless argued that the award must be vacated because the panel "'committed a manifest disregard of the law' when it reached the conclusion that 'the Investment Firm and Investment Advisors were not required to conduct any investigation into the obviously suspicious and fraudulent behavior,' despite acknowledging the applicable law requiring an investment firm or advisor to investigate suspicious activity." *Warren,* 386 F. Supp. 3d at 750–51.

In response, Raymond James argued that the Fifth Circuit has found that the statutory grounds for vacatur under the FAA are the only permissible grounds for vacatur and that Plaintiff has not asserted a basis under any of these grounds. *Id.* at 753. Defendants further argued that the Fifth Circuit's previous opinions recognizing a separate ground for vacatur based on "manifest disregard of the law" have since been rejected by the Fifth Circuit. *Id. See, e.g., Citigroup Glob. Markets, Inc. v. Bacon*, 562 F.3d 349, 358 (5th Cir. 2009) ("In the light of the Supreme Court's clear language that, under the FAA, the statutory provisions are the exclusive grounds for vacatur, manifest disregard of the law as an independent, nonstatutory ground for setting aside an award must be abandoned and rejected.") (citing *Hall St. Assocs., L.L.C. v. Mattel, Inc*., 552 U.S. 576, 584 (2008) ("We now hold that §§ 10 and 11 respectively provide the FAA's exclusive grounds for expedited vacatur and modification.")).

The Court first noted that "[t]he district court's review of an arbitration award is "extraordinarily narrow" and "exceedingly deferential." *Warren,* 386 F. Supp 3d at 754. The Court also observed that under the FAA, the district court has the authority to vacate an arbitration award if: (1) the award was procured by corruption, fraud, or undue means; (2) there is evidence of partiality or corruption among the arbitrators; (3) the arbitrators were guilty of misconduct which prejudiced the rights of one of the parties; or (4) the arbitrators exceeded their powers. *Id.* at 755. Declining to rule whether the "manifest disregard" standard still applied to motions to vacate or not, the Court stated that "[a]ssuming that the 'manifest disregard' ground is valid, in order to succeed on a motion to vacate, [claimants] must show that the arbitrators 'appreciated the existence of a clearly governing [legal] principle but decided to ignore or pay no attention to it.'" *Id.* at 758. The Court ultimately concluded that the claimants did not make the required showing:

> Based on the plain language of the award, the Panel considered the existence of governing law, but found that a fiduciary duty did not exist under this law. Plaintiff's issue with the arbitration decision is not that the Panel ignored the law entirely, but that the Panel did not reach Plaintiff's desired outcome when applying the law. Therefore, even under the "manifest disregard of the law" standard, Plaintiff's motion for vacatur fails.

Id. at 759.

Fourth Circuit Reverses Summary Judgment in Favor of Financial Advisor On Issue of Contributory Negligence of the Customers.
Berkenfeld v. Lenet, 921 F.3d 148, 150 (4th Cir. 2019)

In *Berkenfeld,* Plaintiffs filed suit against their financial advisor, Gary Lenet, and his employer, Morgan Stanley & Co., L.L.C., in the United States District Court for the District of Maryland. Plaintiffs had inherited some annuities, and they alleged that Defendants' negligent advice resulted in less favorable tax distribution options. Specifically, Plaintiffs alleged that Lenet had advised them there was only one way for them to receive their share of the annuities—through a single lump-sum payment. Plaintiffs later learned, however, that they had other options available to them and that they would have saved a significant amount in taxes through another option.

Defendants filed a motion for summary judgment, requesting that the claims be dismissed because the Plaintiffs were barred from recovery under Maryland's contributory negligence law. The district court noted that Plaintiffs had established that "Lenet owed Plaintiffs an ordinary duty of care and a professional duty of care as their financial advisor and therefore was obliged 'to exercise the skill and knowledge normally possessed by members of [his] profession or trade.'" *Berkenfeld*, 921 F.3d at 152. But the district court further held that Plaintiffs were contributorily negligent as a matter of law. In support of its finding, the district court noted that Plaintiffs had prior experience with annuities, Plaintiffs failed to heed Lenet's suggestion that they obtain independent tax advice; and the election forms which Plaintiffs used to select a lump-sum distribution clearly identified other distribution alternatives. *Id.* at 153. Plaintiffs appealed.

The Fourth Circuit began its analysis by noting the following:

> Maryland courts have attempted to mitigate contributory negligence's "harsh justice" by "adopt[ing] a very restrictive rule about taking cases from the jury in negligence actions." Thus, "the issue of contributory negligence is a question for the jury where there is a conflict of

> evidence as to material facts relied on to establish contributory negligence, or more than one inference may be reasonably drawn therefrom." To establish contributory negligence as a matter of law—and thus remove the issue of contributory negligence from the province of the factfinder—"the evidence must show some prominent and decisive act which directly contributed to the accident and which was of such a character as to leave no room for difference of opinion thereon by reasonable minds."
>
> Accordingly, this Court must apply this high bar to determine whether there was **"no room for difference of opinion"** as to whether Plaintiffs were contributorily negligent in electing to rely on Lenet's advice and receive the proceeds of the annuity in a single lump-sum distribution…

Id. at 153–54 (internal citations omitted/emphasis added).

Noting Lenet's claimed experience and expertise and familiarity with the annuity products, the Court found that there was "room for difference of opinion" as to whether a reasonably prudent person would rely upon Lenet's alleged advice that the only available distribution option was a single lump-sum payment. *Id.* at 156. The Court further held that there was also "room for difference of opinion" as to whether a reasonable person in Plaintiffs' position would rely on Lenet's advice as to the available distribution options, without reviewing the language in the distribution or consulting with another financial advisor. *Id.* Regarding that the forms themselves identified different distribution options, the Court observed that "the forms at issue were lengthy and that there is a significant 'disparity of knowledge and skill' between a layperson and a financial planner," such that "a factfinder could determine that Plaintiffs were not contributorily negligent in relying on Lenet's advice rather than reading the fine print of the annuity contracts and election forms." *Id.*

The Court reversed the district court's grant of summary judgment, concluding that "none of the considerations that the district court relied upon meet the high bar applied by Maryland courts for taking questions of contributory negligence from the factfinder.." *Id.* at 157-58.

District Court Throws Out Securities Fraud Claims for Lack of Specificity

Estate of Bogue v. Adams, 18-1425, 2019 WL 3496756, at 1 (D. Colo. Aug. 1, 2019).

In *Bogue,* Plaintiffs (the Estate of Jon Bogue and the Executrix of the Estate) filed claims against several registered investment professionals and their affiliated entities. Plaintiffs alleged that Defendants took advantage of Jon Bogue, who prior to his death was a retired pilot and truck driver without any investment expertise, experience, or sophistication. Plaintiffs specifically alleged that Defendants organized and managed certain Pooled Investment Vehicles ("PIVs") and that Defendants

> knowingly and with an intent to defraud their investor clients, perpetrated a complicated scheme whereby they offered and sold securities and provided investment advisory and broker-dealer services to clients, while at the same time systematically manipulating the investments they were selling for their own benefit and for their own enrichment, to the detriment of their unsuspecting and often elderly investors, who lacked investment expertise and experience.

Bogue, 2019 WL 3496756, at 2. Plaintiffs further alleged that Defendants exercised discretionary authority over Bogue's investment funds and placed over 70% of Bogue's investable assets and 50% of his net worth in the high-risk PIVs, without disclosing all of the risks to Bogue or providing required documentation to him. Plaintiffs alleged several claims against Defendants, including claims for securities fraud and aiding and abetting securities fraud under Colorado law and breach of fiduciary duty and duty of loyalty, among others.

Defendants moved to dismiss the claims against them under Rule 12(b)(6) of the Federal Rules of Civil Procedure. Regarding the fraud claims, the Court noted that

> Fed. R. Civ. P. 9(b) requires that "[f]or any claim alleging fraud, the circumstances constituting fraud or mistake must be stated with particularity." *In re Accelr8 Technology Corp. Securities Litigation*, 147 F.Supp.2d 1049, 1054 (D. Colo. 2001) (citing Fed. R. Civ. P. 9(b)). Thus, a plaintiff in such a case must plead "the time, place, and contents of the false representation, the identity of the party making the false statements and the consequences thereof." *Koch v. Koch Industries, Inc.*, 203 F.3d 1202, 1236 (10th Cir. 2000). Rule 9(b)'s purpose is to afford defendants fair notice of a plaintiff's claims and the factual ground on which they are based. *Id.*

Bogue, 2019 WL 3496756, at 6. Addressing Plaintiffs' securities fraud claims, the Court held that Plaintiffs failed to allege with any specificity "facts forming the basis for each Defendant's liability" and that the complaint was "silent regarding any representation made—by anyone—to induce Bogue to invest." *Id.* at 7. The Court also noted that the complaint did not allege that any of the investments made by Bogue "was made in connection with or as the result of a specific statement or omission." *Id.* Finally, the Court observed that the complaint failed to "identify what statements were made, by whom, and when, from which alleged material facts were omitted." *Id.* Accordingly, the Court held the allegations "do not provide fair notice to the Defendants as to the securities fraud claims being asserted against each of them and the factual grounds for those claims." *Id.* at 8.

The Court did find, however, that the complaint's allegations of Defendants' ongoing breaches of fiduciary duties in connection with the management of Bogue's investment accounts (including failures to disclose conflicts of interest, failing to disclose excessive compensation, and other wrongful conduct) were, when viewed in the light most favorable to Plaintiffs, sufficient to survive Defendants' motion to dismiss. *Id.* at 9.

Court Rules That Customer Can Present Punitive Damages Claim Against Merrill Lynch at Trial For Its Role in Film Production Plan

Metcalf v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 11-00127, 2019 WL 3494364, at 1 (M.D. Pa. Aug. 1, 2019)

Solar Wind Productions ("SWP") was a film production company that offered a program designed to help independent film producers obtain the funding for their films. The program involved three primary steps: (1) the producer would deposit 10% of their film's budget into a brokerage account; (2) the deposit would be converted to a certificate of deposit; and (3) a line of credit to be used to finance the film would be obtained using the CD as collateral. SWP utilized Merrill Lynch, Pierce, Fenner & Smith, Inc. ("MLPFS") as its brokerage firm in connection with the program.

Plaintiffs, a film writer and producer, used SWP's film financing program. Plaintiffs opened their account with the understanding that they would have total control over the funds therein. But, at some point, MLPFS commingled Plaintiffs' funds with those of another SWP and MLPFS client. Facing competing claims from Plaintiffs, SWP, and the other client, MLPFS paid off the line of credit owed to it and interpleaded the funds in state court. Plaintiffs received some money from the interpleader action, but they still lost a significant amount of their original deposit. As a result, Plaintiffs sued MLPFS.

As the trial date was approaching, Plaintiffs had four remaining claims against MLPFS. (1) a fraud claim; (2) a conversion claim; and (3) a civil conspiracy claim; and (4) a breach of fiduciary duty claim. MLPFS filed a motion to preclude Plaintiffs from seeking punitive damages at the trial.

The Court first noted that Pennsylvania had adopted Section 908 of the Second Restatement of Torts, which states that:

> (1) Punitive damages are damages, other than compensatory or nominal damages, awarded against a person to punish him for his outrageous conduct and to deter him and others like him from similar conduct in the future.
>
> (2) Punitive damages may be awarded for conduct that is outrageous, because of the defendant's evil motive or his reckless indifference to the rights of others. In assessing punitive damages, the trier of fact can properly consider the character of the defendant's act, the nature and extent of the harm to the plaintiff that the defendant caused or intended to cause[,] and the wealth of the defendant.

Metcalf, 2019 WL 3494364, at 8. The Court confirmed that to seek punitive damages at trial, "Plaintiffs must point to evidence from which a jury, 'mak[ing] a careful analysis of the entire trial record,' could find that Defendants 'acted in a fashion which [wa]s particularly egregious.'" *Id.* (citing *In re Lemington Home for the Aged*, 777 F.3d 620, 631 (3d Cir. 2015)). The Court further stated that "[s]uch a finding requires evidence that Defendants 'had a subjective appreciation of the risk of harm to which [P]laintiff[s] w[ere] exposed' and 'acted or failed to act in conscious disregard of that risk.'" *Id.* (citing *Mifflinburg Telegraph, Inc. v. Criswell*, 277 F. Supp. 3d 750, 805-06 (M.D. Pa. 2017)).

The Court found that a rational jury could make such a finding. In support, the Court noted that MLPFS and its representatives were "involved… intimately" in SWP's film financing program, knew about the risks associated with the program, and proceeded to open Plaintiffs' account with MLPFS without advising them of changes in the program concerning control over the funds. *Id*. The Court also focused on the fact that "[r]ather than submit its own creditor claim to the interpleader action,...Merrill Lynch decided to take its share off the top by paying itself first." *Id.* at 10. In sum, the Court ultimately concluded:

> There may be innocent explanations for all that occurred. Or [Plaintiffs'] loss may be the result of sheer negligence on Defendant's part. But in light of the story this Court has been able to weave from the existing evidentiary strands, a reasonable jury would be able to find that Defendants were actually aware of the risk created to [Plaintiffs'] funds by its actions; that Defendants acted deliberately in light of that risk; and that Defendants' conduct, considered as a whole, was outrageous.

Id.

RECENT ARBITRATION AWARDS

Christopher J. Gray

This issue's survey features several arbitration awards in which FINRA panels awarded statutory damages, attorneys' fees, and punitive damages in cases involving the sale of non-conventional investments or "NCIs", illustrating the relatively favorable results that claimants have experienced in such cases that advance to hearing. Also featured are two "selling away" cases in which FINRA panels held a broker-dealer financially responsible for damages arising from an associated person's sale of securities that were not approved by the firm. Finally, continuing a theme from last issue, we report two cases in which the arbitration panels granted substantial awards of attorneys' fees, and appeared to attempt to make Claimants whole by awarding them attorneys' fees equal to a contingent fee of approximately one-third of the damages awarded.

Jerry & Louise Trawick, Richard & Marilyn Bjornas, and Chad & Michelle Greer (Claimants) v. Berthel, Fisher & Company Financial Services, Inc., Jerry Dewayne McCutchen, Sr., Thomas Joseph Berthel, Ronald Odin Brendengen, and Richard Maurice Murphy (Respondents)
Case No. 17-01368
Atlanta, Georgia
Hearing Dates: November 12, 2018 – November 16, 2018; April 15, 2019 – April 18, 2019.
Award Date: July 15, 2019
Counsel:

Counsel for Claimants:	Michael C. Bixby, Esq., Levin, Papantonio, Thomas, Mitchell, Rafferty & Proctor, P.A., Pensacola, Florida.
Counsel for Respondents:	Vincent D. Louwagie, Esq. and Peter J. McElligott, Esq., Anthony Ostlund Baer & Louwagie P.A., Minneapolis, Minnesota.

Arbitration Panel:
Mark A. Myers, Public Arbitrator, President Chairperson;
Lita S. Menkin, Public Arbitrator;
Mollie Wagner Neal, Public Arbitrator.

Investments at Issue:

Investments in equipment leases, Direct Participation Programs, Limited Partnerships, and various non-traded Real Estate Investment Trusts (REITs) including the following: American Realty Capital Trust, Atel Fund 14, Behringer Harvard Multifamily REIT I, Cole Credit Property Trust III, Hines Global REIT, ICON Equipment and Corporate Infrastructure (Icon Leasing Fund 12), Noble Royalty Access Fund V, Northstar Income Opportunity REIT, United Development Funding III, United Development Funding IV, and Virtus Storage Investment IV.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Violations of the Alabama Securities Act;
(2) Breach of Fiduciary Duty;
(3) Violation of FINRA/NYSE rules;
(4) Breach of Contract and Negligence;
(5) Negligent Supervision;
(6) Fraudulent Inducement to Hold Investment; and
(7) Control Person Liability under Alabama and Federal Securities Laws.

Relief Requested:

(1) Actual damages of no less than $626,000.00 (being estimated losses in excess of $272,000.00 for the Trawicks, $180,000.00 for the Bjornases and $174,000.00 for the Greers);
(2) Damages for the loss of income that would have been received had Claimants' money been managed properly, as well as all other losses, foreseeable or not, including non-pecuniary losses;
(3) Disgorgement and return of all fees, management charges and commissions;
(4) Interest on Claimants' losses at the legal rate;
(5) Claimants' costs, legal fees and expenses;
(6) Rescission and/or statutory damages;
(7) Punitive damages; and
(8) Other relief deemed just and proper.

Award:

(1) Respondents were found to be joint and severally liable and ordered to pay to the Trawicks $231,827.00 in compensatory damages and interest of 7.5% per annum per AL Code 8-8-10 until paid in full;
(2) Respondent Berthel, Fisher & Company Financial Services, Inc. was found to be liable and ordered to pay to the Trawicks $50,000.00 in punitive damages per AL Code 6-11-20;

(3) Respondent Jerry Dewayne McCutchen Sr. was found to be liable and ordered to pay to the Trawicks $10,000.00 in punitive damages per AL Code 6-11-20;
(4) Respondents were found to be joint and severally liable and ordered to pay to the Bjornases $220,288.00 in compensatory damages and interest of 7.5% per annum per AL Code 8-8-10 until paid in full;
(5) Respondent Berthel, Fisher & Company Financial Services, Inc. was found to be liable and ordered to pay to the Bjornases $50,000.00 in punitive damages per AL Code 6-11-20;
(6) Respondent Jerry Dewayne McCutchen Sr. was found to be liable and ordered to pay to the Bjornases $10,000.00 in punitive damages per AL Code 6-11-20;
(7) Respondents were found to be joint and severally liable and ordered to pay to the Greers $169,420.00 in compensatory damages and interest of 7.5% per annum per AL Code 8-8-10 until paid in full;
(8) Respondent Berthel, Fisher & Company Financial Services, Inc. was found to be liable and ordered to pay to the Greers $50,000.00 in punitive damages per AL Code 6-11-20;
(9) Respondent Jerry Dewayne McCutchen Sr. was found to be liable and ordered to pay to the Greers $10,000.00 in punitive damages per AL Code 6-11-20;
(10) Respondents were found to be joint and severally liable and ordered to pay $248,614.00 in attorneys' fees pursuant to AL Code 8-6-19 and $110,966.00 in costs; and
(11) All other claims denied.

Analysis:

This $1,161,115 award (exclusive of interest) is significant because even though Mr. McCutchen retired from Berthel, Fisher & Company Financial Services, Inc. in 2014, the firm was found to be directly and/or jointly liable for all damages except for the $30,000 in punitive damages awarded individually against Mr. McCutchen. The firm was also assessed punitive damages in an amount five times greater than Mr. McCutchen. Further, the Panel found control persons of Berthel, Fisher & Company Financial Services, Inc. joint and severally liable for nearly $1 million of the damages awarded to Claimants. Claimants argued for control person liability primarily under the Alabama Securities Act and presented substantial evidence that the control people of the firm were aware of Mr. McCutchen's business practices and not only approved of them but participated and encouraged the business practices, even attending Mr. McCutchen's client events where the subject investments were promoted.

Respondents filed a Pre-Hearing Motion to Dismiss under Rule 12206, arguing that all but one purchase was ineligible for arbitration (most of the purchases occurred between 2007 and 2009, though one Claimant had one purchase in 2012). Respondents' motion was denied, as was a subsequent motion to dismiss on Rule 12206 grounds at the close of Claimants' case in chief. In opposing the Rule 12206 eligibility motions, Claimants successfully argued that Respondents provided continuing recommendations and breached their fiduciary duties and violated the FINRA rules and standards on an ongoing basis.

Joseph Cage, Susan Cage, Patricia Harrison Adams, Richard Beach, Michael Cage, Christian Service Program Institute, Roy and Ann Fish Family Trust, Roy Fish, John Hayter, Nina Hayter, Elizabeth Hennigan, Christian Harrison, Randy Kornrumph, Barbara Kornrumph, Johnny Ray Maddox, Elizabeth Ann Maddox, Sharon Mathews, David McClamroch, James McClamroch, M.D., N. Harris McClamroch, Susan McClamroch Dixon, Dorothy McClamroch Family Limited Partnership, Bob Pettitt, Jr., Paul Gladden Pettitt Trust, Charles Clark Pettitt Trust, Richard Eugene Pettitt Trust, Alden Reeves, Adrane Reeves, Roland Toups, Judith Burford, Hall Burford, Galilee Baptist Church, Jerald Harper, Harvey Kemper, IV, Candace Kemper, Juanita Tucker, Rory White, Pamela White, David Wilkins, Brenda Viselli, and Tracy Toups (Claimants) v. Thomas Whitmeyer O'Brien and Raymond James & Associates, Inc. (Respondents)
Case No. 17-02973
Shreveport, Louisiana
Hearing Dates: May 13, 2019 – May 17, 2019; May 20, 2019 – May 24, 2019; June 17, 2019; June 19, 2019 – June 21, 2019; June 24, 2019 – June 28, 2019; July 23, 2019 – July 26, 2019; August 19, 2019 – August 24, 2019; August 26, 2019 – August 31, 2019.
Award Date: October 28, 2019
Counsel:

Counsel for Claimants:	Frank "Kim" Breese, III, Esq., Breese Law Office, PLLC, Ridgeland, Mississippi.
Counsel for Respondents:	Stephen H. Kupperman, Esq. and George C. Freeman, III, Esq., Barraso Usdin Kupperman Freeman & Sarver, LLC, New Orleans, Louisiana.

Arbitration Panel

John P. Cullem, Public Arbitrator, Presiding Chairperson
Langfred W. White, Public Arbitrator
Stuart K. Furman, Public Arbitrator

Investments at Issue:

Investments in various oil and gas master limited partnerships and unit investment trusts, including Linn Energy, Memorial Production Partners, Calumet Partners and Cushing MLP Funds, as well as allegations of overconcentration, an alleged unauthorized trading pattern in Claimants' accounts by unnamed party Mr. L, and unlawful commissions received.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Violations of FINRA Rules and Industry Standards;
(2) Breach of Contract;
(3) Breach of Federal and State Laws;
(4) Fraudulent and/or Negligent Representation; and
(5) Fraudulent Concealment.

Relief Requested:

(1) Compensatory damages exceeding $5,000,000.00;
(2) Punitive damages;
(3) Interest;
(4) Attorneys' fees
(5) Costs; and
(6) Forum Fees.

Relief Requested Post Hearing: $8,906,685.00 in damages.

Award:

(1) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Patricia Harrison Adams $120,096.00 in compensatory damages and interest of 6% per annum until paid in full;
(2) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Richard Beach $78,697.50 in compensatory damages and interest of 6% per annum until paid in full;
(3) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimants Joseph and Susan Cage $214,227.75 in compensatory damages and interest of 6% per annum until paid in full;
(4) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Joe Cage IRA $24,004.50 in compensatory damages and interest of 6% per annum until paid in full;
(5) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Susan Cage IRA $34,914.75 in compensatory damages and interest of 6% per annum until paid in full;

(6) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Michael Cage, Jr. $217,210.40 in compensatory damages and interest of 6% per annum until paid in full;
(7) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Michele McDonald Trust FBO Jordan Caroline Cage, Michael Cage, Trustee $123,365.97 in compensatory damages and interest of 6% per annum until paid in full;
(8) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Michele McDonald Trust FBO Taylor Virginia Cage, Michael Cage, Trustee $129,270.24 in compensatory damages and interest of 6% per annum until paid in full;
(9) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Christian Service Program Institute $12,666.35 in compensatory damages and interest of 6% per annum until paid in full;
(10) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Galilee Baptist Church $111,029.55 in compensatory damages and interest of 6% per annum until paid in full;
(11) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Jerald Harper 401k $233,808.90 in compensatory damages and interest of 6% per annum until paid in full;
(12) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant John Hayter 401k $120,620.25 in compensatory damages and interest of 6% per annum until paid in full;
(13) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Nina Hayter 401k $6,867.75 in compensatory damages and interest of 6% per annum until paid in full;
(14) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Nina Hayter IRA $4,251.00 in compensatory damages and interest of 6% per annum until paid in full;
(15) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Elizabeth Hennigan $117,292.50 in compensatory damages and interest of 6% per annum until paid in full;
(16) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Dorothy McClamroch Family Limited Partnership – David R. McClamroch, General Partner $336,468.80 in compensatory damages and interest of 6% per annum until paid in full;
(17) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimants J.R. and Elizabeth Maddox $38,011.50 in compensatory damages and interest of 6% per annum until paid in full;

(18) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Bob Pettitt, Jr. $94,689.00 in compensatory damages and interest of 6% per annum until paid in full;

(19) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Paul G. Pettitt Trust, Paul Pettitt, Trustee $24,006.75 in compensatory damages and interest of 6% per annum until paid in full;

(20) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Charles C. Pettitt Trust, Charles Pettitt, Trustee $20,700.75 in compensatory damages and interest of 6% per annum until paid in full;

(21) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Richard E. Pettitt Trust, Bob Pettitt, Jr. Trustee $28,521.75 in compensatory damages and interest of 6% per annum until paid in full;

(22) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Roland Toups $281,015.00 in compensatory damages and interest of 6% per annum until paid in full;

(23) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Tracy Toups $160,757.85 in compensatory damages and interest of 6% per annum until paid in full;

(24) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Brenda Viselli $124,885.50 in compensatory damages and interest of 6% per annum until paid in full;

(25) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Rory White IRA $47,511.10 in compensatory damages and interest of 6% per annum until paid in full;

(26) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Pamela White IRA $15,920.00 in compensatory damages and interest of 6% per annum until paid in full;

(27) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant David Wilkins $102,939.30 in compensatory damages and interest of 6% per annum until paid in full;

(28) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Randall Fish as Trustee of the Roy and Ann Fish Family Trust $80,321.25 in compensatory damages and interest of 6% per annum until paid in full;

(29) Respondent Raymond James & Associates was found to liable and ordered to pay to Claimant Christian Harrison $82,637.00 in compensatory damages and interest of 6% per annum until paid in full;

(30) Respondent Raymond James & Associates was found to liable and ordered to pay to all Remaining Claimants $140,000.00 in expert witness fees;
(31) Respondent Raymond James & Associates was found to liable and ordered to pay to all Remaining Claimants $25,000.00 in costs;
(32) Respondent Raymond James & Associates was found liable for and ordered to pay to reimburse Remaining Claimants $750.00 as the non-fundable fee paid to FINRA Office of Dispute Resolution
(33) All Remaining Claimant's claims against Respondent Thomas Whitmeyer O'Brien denied;
(34) Respondent Thomas Whitmeyer O'Brien's request for Expungement was granted as it was found that he was the branch manager to over 11,000 accounts, not the financial advisor to Claimants, and Claimants were not a verifiable/homogeneous group; and
(35) All other claims denied.

Analysis:

The case is noteworthy because of the large across-the-board award of damages to Claimants in a case that consumed 73 hearing sessions over a three-month period. The compensatory damages awarded reportedly exceeded the Claimants' net out-of-pocket losses. The Panel assessed all damages against Respondent Raymond James and Associates Inc., assigning financial responsibility to Raymond James for the conduct of its (now-barred) former broker James Edward "Eddie" Lyons.

Sandra Althaus, individually and for the Sandra Althaus IRA, Sandra Althaus Roth IRA and Sandra Althaus SEP IRA (Claimant) v. TD Ameritrade Clearing, Inc., and TD Ameritrade, Inc. (Respondents).

Case No. 18-00253
Reno, Nevada
Hearing Dates: August 20, 2019 – August 22, 2019
Award Date: August 29, 2019
Counsel:

Counsel for Claimant:	Philip M. Aidikoff, Esq., Aidikoff, Uhl & Bakhtiari, Beverly Hills, California.
Counsel for Respondents:	James J. Vihstadt, Esq., TD Ameritrade, Omaha, Nebraska.

Arbitration Panel:

Daniel I. Levine, Public Arbitrator, Presiding Chairperson
Daniel M. Yamshon, Public Arbitrator
Michael Lancaster Garcia, Public Arbitrator

Investments at Issue:

Investments in "Wealth Strategies Funds" offered by Bayliss & McAninch Inc. of Carson City, Nevada.

Claimant's Claims:

Causes of Action in Statement of Claim:

(1) Wrongful Conduct;
(2) Breach of Fiduciary Duty;
(3) Fraud by Misrepresentation and Omission;
(4) Breach of Written and Oral Contract;
(5) Failure to Supervise and Control; and
(6) Violations of State, Federal, and Industry Rules and Regulations.

Relief Requested:

(1) General and compensatory damages in the amount of $407,050.00;
(2) Lost opportunity costs;
(3) Rescission of all unsuitable investments;
(4) Costs of proceedings;
(5) Interest at the legal rate on all sums recovered;
(6) Attorneys' fees and costs; and
(7) Other relief deemed just and proper.

Award:

(1) Respondents were found to be joint and severally liable and ordered to pay the Claimant $720,816.60 in compensatory damages, prejudgment interest, and expert witness fees;
(2) Respondents were jointly and severally liable for and ordered to pay to Claimant interest of 7.5% per annum from October 1, 2019 until paid in full based upon Nevada Senate Bill 45 and established by the Nevada State Court Administrator;
(3) Respondents were jointly and severally liable for and ordered to pay to reimburse Claimant $300.00 as the non-fundable fee paid to FINRA Office of Dispute Resolution; and
(4) All other claims denied.

Analysis:

This award is significant because the FINRA Panel awarded damages against Respondents based entirely on the theory of lack of oversight of an affiliated advisor of TD Ameritrade, Michael D. Bayliss. Claimant had contended that TD Ameritrade performed inadequate due diligence before allowing the so-called Wealth Strategies Funds to be onboarded onto its custodial platform, and took the word of Bayliss's firm as to the valuation of the funds rather than having a third party assign value to the fund shares. In addition, the Panel awarded $720,816 to Claimant, even though she had sought only $407,050 in compensatory damages, suggesting that the Panel was attempting to make Claimant whole net of contingent attorneys' fees.

Paul Leyder (Claimant) v. Network 1 Financial Securities Inc. (Respondent)
Case No. 18-03033
New York, New York
Hearing Dates: September 16, 2019 – September 19, 2019.
Award Date: October 18, 2019
Counsel:

Counsel for Claimant:	Darryl Bouganim, Esq. and Jenice Malecki, Esq., Malecki. Law, New York, New York.
Counsel for Respondent:	Martin P. Unger, Esq., Wexler Burkhart Hirschberg & Unger, LLP, Garden City, New York.

Arbitration Panel
Francis Carling, Public Arbitrator, Presiding Chairperson
Richard W. Vallario, Public Arbitrator
Fred S. Pieroni, Public Arbitrator
Investments at Issue:
Investments in Proshares Ultra Bloomberg Crude Oil 2x ("UCO").
Claimant's Claims:
Causes of Action in Statement of Claim:
(1) Misrepresentation;
(2) Omissions;
(3) Unsuitable Investment Recommendations;
(4) Lack of Supervision; and
(5) Breach of Contract and Industry Rules.
Relief Requested:
(1) Compensatory damages in the amount of $191,025.00;
(2) Consequential damages;
(3) Punitive Damages;
(4) Interest;
(5) Attorneys' fees;
(6) Costs; and
(7) Disciplinary referral.
Relief Requested Post Hearing: $203,029.99 in compensatory damages.

Award:

(1) Respondent was found to be liable and ordered to pay to the Claimant $203,029.00 in compensatory damages;
(2) Respondent was found to be liable and ordered to pay to the Claimant 5% interest per annum from May 7, 2018 until paid in full;
(3) Respondent was found to be liable and ordered to pay to Claimant $67,000.00 in attorneys' fees pursuant to *Synergy Gas Co. v. Sasso*, 853 F.2d 59 (2d Cir. 1988), cert. denied, 488 U.S. 994 (1988); and (2) *McLaughlin, Piven*, *Vogel Securities, Inc v. Ferrucci*, 67 A.D.3d 405 (1st Dept. 2009;
(4) Respondent was found to be liable for and ordered to pay to reimburse Claimant $300.00 as the non-fundable fee paid to FINRA Office of Dispute Resolution;
(5) Respondent's requests for Expungement for unnamed parties Robert Thomas Ciaccio, Jr. and Mark Andrew Miranda were denied; and
(6) All other claims denied.

Analysis:

This award is significant because the Panel assessed the full $203,029.99 in compensatory damages sought by Claimant at the close of the hearing against Respondent, and also awarded almost exactly one-third of the compensatory damages as attorneys fees' in what appears to be an attempt to make Claimant whole for his losses, net of attorneys' fees. The award of attorneys' fees, based on state common law, is even more noteworthy given New York's reputation as a difficult jurisdiction in which to obtain an award of attorneys' fees and the unavailability of a private cause of action under New York's Blue Sky law, the Martin Act.

Rodney Eaves and Melissa Eaves (Claimants) v. First Financial Equity Corporation (Respondent)

Case No. 18-00452

Phoenix, Arizona

Hearing Dates: December 3, 2018 – December 7, 2018.

Award Date: January 7, 2019

Counsel:

Counsel for Claimants:	Paul A. Conant, Esq., Conant Law Firm, PLC, Phoenix, Arizona.
Counsel for Respondent:	Kevin R. Heaphy, Esq. and Jason L. Cassidy, Esq., Ryley Carlock & Applewhite, Phoenix, Arizona.

Arbitration Panel:

Richard Marc Weinroth, Public Arbitrator, Presiding Chairperson
Maureen Beyers, Public Arbitrator
Renee Bryna Gerstman, Public Arbitrator

Investments at Issue:

Investments in USA Barcelona Realty Advisors, LLC and affiliates, securities offered and sold by a representative of First Financial Equity Corporation.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Control Person Liability under A.R.S. § 44-1999(B).

Relief Requested in the Statement of Claim:

(1) Recovery of $780,000.00 invested monies, minus monies received by investment;
(2) Attorneys' fees
(3) Costs; and
(4) Statutory interest;
OR
(1) Damages proven in the alternative according to A.R.S. §§ 44-2001 and/or 44-2002.

Requested Relief at Close of Hearing:

(1) Compensatory damages in the amount of $920,197.54 (consisting of $780,000.00 in compensatory damages, plus accrued interest at 4.25% at $178,397.54 through January 6, 2019, minus income received of $38,200.00);
(2) Costs in the sum of $58,550.91; and
(3) Attorneys' fees in the sum of $246,458.27.

Award:

(1) Respondent was liable and ordered to pay Claimants compensatory damages in the amount of $920,197.54;
(2) Respondent was liable and ordered to pay Claimants interest of 4.25% per annum from January 6, 2019 until paid in full;
(3) Respondent was liable and ordered to pay Claimants $125,000.00 in attorneys' fees pursuant to A.R.S. § 44-2001(A);
(4) Respondent was liable and ordered to pay Claimants $5,233.60 in costs;
(5) Respondent was ordered to reimburse Claimants $425.00 as the non-fundable fee paid to FINRA Office of Dispute Resolution; and
(6) All other claims denied.

Analysis:

The award is significant because of the substantial award of damages, which appear to equal the full sum of rescission damages requested by Claimants, as well as attorneys' fees under Arizona's Blue Sky law. The total relief awarded appears to equal approximately the entire sums sought by Claimant, in a "selling away" case in which the Respondent's responsibility for the outside activity of the broker was hotly contested.

Betty H. Bailey, Individually and on Behalf of her IRAS (Claimants) v. UBS Financial Services Inc. (Respondent)

Case No. 18-03141

Houston, Texas

Hearing Dates: August 26, 2019 – August 28, 2019

Award Date: September 11, 2019

Counsel:

Counsel for Claimants:	David W. Miller, Esq. and Samuel B. Edwards, Esq., Shepherd, Smith, Edwards & Kantas, LLP, Houston, Texas.
Counsel for Respondent:	Paul D. Flack, Esq., Pratt & Flack, LLP, Houston, Texas.

Arbitration Panel:

Heather Gaile Layton, Public Arbitrator, Presiding Chairperson

Lynne M. Gomez, Public Arbitrator

Camille Morris Tankersley, Public Arbitrator

Investments at Issue:

Unsuitable investments that resulted in significant losses, including private placement investments in Isospec Technologies, LP and Reproductive Research Technologies, LP, alleged to be Ponzi schemes, and a "private annuity" issued by Respondent's employee.

Claimants' Claims:

Causes of Action in Statement of Claim:

(1) Breach of Contract and Warranties;
(2) Promissory Estoppel;
(3) Unfair Trade and Deceptive Practices;
(4) Violation of Texas Securities Statutes;
(5) Violation of Texas Fraud Statutes;
(6) Intentional and Negligent Misrepresentations of Fact;
(7) Unjust Enrichment;
(8) Breach of Fiduciary Duty; and

(9) Vicarious Liability.

Relief Requested:

(1) Damages in the amount of $100,000.00 - $500,000.00, including all direct/consequential damages, statutorily and/or punitive damages, interest and costs;
(2) Rescission;
(3) Statutory damages;
(4) Punitive damages;
(5) Pre-award and post-judgment interest; and
(6) Costs.

Relief Requested Post Hearing: $1,282,235.87 in compensatory damages.

Award:

(1) Respondent was found to be liable and ordered to pay to the Claimants $530,000.00 in compensatory damages;
(2) Respondent was found to be liable and ordered to pay to the Claimants $25,000.00 in costs; and
(3) All other relief denied.

Analysis:

This award is significant because the Panel awarded substantial damages against Respondent in a "selling away" case despite UBS's not having approved the subject investments, and despite UBS's denial of any knowledge of the subject transactions in securities (Isospec Technologies and Reproductive Research Technologies) that were part of an alleged Ponzi-type scheme. The subject securities were sold by (nonparty to the arbitration) William Andrew Hightower, a former UBS registered representative who has since been barred by FINRA and also indicted by federal law enforcement authorities.

FROM THE EDITOR

Joseph Wojciechowski[1]
Editor In Chief

After spending the last two years as the Managing Editor and then Editor in Chief of the PIABA Bar Journal, I now step aside for new blood and new leadership to take the reins and bring the Bar Journal into 2020 and beyond. Although my role is changing, the PIABA Bar Journal won't be able to get rid of me yet. So much has happened since January 2019 with the Journal. We are on track to successfully publish three editions this calendar year, which was the goal set out by this committee, while not sacrificing a shred of quality content. To the contrary, the content submitted by these authors has been better than ever. Due to the hard work and dedication of many, the Journal is set up for success for years to come.

For investors, the more things change, the more they stay the same. Over this past year, the Trump administration spearheaded Regulation Best Interest – a confusing, muddled, and complicated regulation for both investors and, in fairness, advisors alike. The line between "financial" advisor and "investment" advisor is as confusing as ever. In a world where one person can wear two hats and have drastically different legal obligations to their investor clients, it was the province of the federal government to straighten this mess out. Instead, the SEC chose to side with the deep pockets of SIFMA and Wall Street.

What's always been most troubling to me as an investor advocate, attorney, and editor of this Journal, is the extraordinary resistance Wall Street has successfully put up to avoid any semblance of a universal fiduciary duty. They much prefer a landscape where they can exploit their conflicts of interest as opposed to acting in their clients' best interest. How else could brokerage firms ever justify selling grossly conflicted private placements and other alternative investments like non-traded REITs? The non-traded REIT landscape remains riddled with carcasses from over a decade of conflict-laden mismanagement and unsuitable recommendations – names like Inland American, Behringer Harvard of pre-financial crisis days come to mind. More recently United Development Funding – a REIT company so structurally weak and with accounting and business practices so questionable, all it took was a blog from a hedge fund manager calling the company out for being what he considered to be a Ponzi scheme, to wipe out 80% of investors' money.

1. The opinions expressed in this letter are my own and should not be interpreted as those of PIABA, its Directors, or its Members.

Another massive REIT company whose riches were raised through retail investors, American Realty Capital, resulted in enormous losses to investors.

What has changed since before the financial crisis? Well, in the REIT space, nothing. Sales are reaching all-time highs off the backs of retail investors. Names readers of this journal know all too well – KBS, Inland, to name a few, have been raising capital in record numbers. My personal favorite in the new REIT space was the formerly-known-as "Rich Uncles REIT" which took out radio advertisements in Chicago, and elsewhere, promising outlandish returns and riches if you just called the phone number.[2] Mind you, not from institutions; for obvious reasons they tend to stay clear of these awful deals. It is the retail investor who relies on his "financial" advisor who he believes to be a fiduciary, who puts his retirement money into these shams. When the REIT collapses; when he loses 20% or more of his retirement nest egg in one fell swoop and looks to the advisor who he trusted to act like a professional and in his best interest, he will be referred to boilerplate offering memoranda and subscription agreements where he, or possibly the advisor, checked boxes acknowledging various risks. He will then either accept his fate or call one of the brilliant lawyers in this organization to enforce his rights.

Laws passed over the last several years have begun to accumulate. It has become easier for companies to raise capital privately from retail investors than ever before. Online brokerage firms like Fidelity and Schwab now offer $0 equity trades – making it even less costly for investors or their RIAs to trade away and "time the market". $0 stock trades is a moral hazard; it feeds into the behavioral blackhole that causes untrained investors and their egotistical advisors to believe they can beat the market if only the trades were free. That is simply not how it works and $0 trading makes this more convenient and more troubling.

The rise of portfolio margin has created an environment where even really sophisticated, brilliant traders lose everything because of bad practices at brokerage firms, or simply because the market went sideways on the wrong day and at the wrong time. Portfolio margin allows retail investors to trade with loaned money many times their net equity. Day traders, and especially options traders, crave this sort of liquidity for their trading strategies. But when the market turns on them, these retail investors cannot depend on the brokerage firms whom gave them both the can of gasoline and the matches, to also provide them with a bucket of water. Instead, typically, they liquidate holdings in no particular order and fail to provide clients with a reasonable amount of

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2. *See, In the Matter of BrixInvest, LLC (f/k/a Rich Uncles, LLC and Nexregen, LLC,* SEC Adm. Pro. No. 3-19533, September 26, 2019. https://www.sec.gov/litigation/admin/2019/33-10702.pdf.

time to come up with additional capital, all in the name of protecting the brokerage firm's bottom line. In short, the brokerage firm also lights the match and flicks it into the air.

What a service our members provide to their clients. PIABA members give people hope when it has been lost. They are a beacon to fairness and setting things right. Regardless of who the President is or what nonsense drivel the SEC passes, we all know how to plead fiduciary duty, and in a handful of enlightened states where fiduciary duties of financial advisors is already set in the common law – I'm talking to you California, South Dakota, Missouri to name a few – PIABA members carry the sword and the shield and know how to wield them.

The work done by those on this committee over the last year has been inspiring to me. Without the extraordinary dedication of a few core editors – David Robbins, John Sutherland, Brad Stark, and Jeff Koncius; our authors especially those who the Journal can count on for articles every year, including Fred Rosenberg; and those authors who dedicate their time to writing for every edition, the Cases and Materials, and Arbitration Awards authors, Lance McCardle and Chris Gray; your consistency and dedication is outstanding. I would be remiss if I failed to mention the guidance of Mike Edmiston, who has become Editor Emeritus to this Journal, at least that's what I call him. He has been material to both my success and sanity as Editor in Chief. Ryan Cook, last year's Editor in Chief, was a signpost I relied on to stay on the road. Lastly, Robin and Tiffany's assistance and back-office work to actually get this book published and printed multiple times per year is just incredible. They deserve our admiration and respect, of which they both forever have mine.

The torch is passed to Sara Hanley, the next Editor in Chief, whose support as my Managing Editor was irreplaceable, and to her Managing Editor Lance McCardle. In closing, the fuel for both this Journal and PIABA is volunteerism. Too much work is done by too few. The practice of law is an all-encompassing career that blurs the lines between life and work. I ask you to become an editor for the PIABA Bar Journal. We need your talent and the reward of having your name stamped on an edition of this Journal is as rewarding as any volunteering opportunity offered by this organization.

WHERE WE STAND

Historically, PIABA has commented on a number of issues,[1] on both a formal and an informal basis, which are directly applicable to our promotion of the interests of public investors in securities arbitration proceedings that are conducted before the Financial Industry Regulatory Authority ("FINRA").

For example, among the issues that generated the most interest, from and/or on behalf of the members of our association, were proposed amendments to the rules concerning:

- Abusive pre-hearing dispositive motion practices; and
- The adoption of specific procedures that arbitrators will be required to follow before granting the extraordinary remedy of the expungement of prior customer complaints from the registration records of registered representatives.

In this section of the *PIABA Bar Journal*, we will share with our readers the comment letters and formal positions that have been submitted on behalf of our association, during the quarter, to the various regulatory authorities so that all of our constituents will know exactly where we stand.

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Christine Lazaro at lazaroc@stjohns.edu, Samuel Edwards at sedwards@sseklaw.com or Robin S. Ringo at rsringo@piaba.org for assistance.

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The following letter was submitted to Vanessa Countryman, Secretary of the Securities and Exchange Commission by Christine Lazaro and Samuel Edwards on September 24, 2019. (prepared with the assistance of Hugh Berkson, Jason Kane, Dayton Haigney, Dave Neuman, Aaron Israels, Chris Gray, and Darlene Pasieczny).

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F St NE
Washington, DC 200549-1090

RE: Concept Release on Harmonization of Securities Offering Exemptions File No. S7-08-19

Dear Ms. Countryman:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors. Since its formation in 1990, PIABA has promoted the interests of the public investor in all dispute resolution forums, while also advocating for public education regarding investment fraud and securities industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Securities and Exchange Commission (the "Commission") relating to investor protection.

PIABA appreciates the opportunity to comment on the Concept Release on Harmonization of Securities Offering Exemptions (the "Concept Release") and notes its general agreement with the Commission that simplifying and improving the framework of exempt offerings is a noble goal. However, it appears the Commission has lost sight of its primary objective – protecting investors – in the Concept Release. With few exceptions, each section of the Concept Release – from its discussion of the "accredited investor" definition to Secondary Trading of Certain Securities – is more concerned with providing greater access to funds for exempt offering issuers than it is in providing necessary protections to public investors. Expansion of exempt offerings to retail investors will almost certainly increase the risks to which retail investors are exposed while decreasing the information available to investors attempting to perform due diligence. It will also substantially increase the number of instances in which investors fall prey to fraudulent investment schemes. These implications are significant and must be addressed if the Commission is to honor its mission of protecting the investing public. If the Commission is to expand the pool of investors who may be eligible to invest in exempt offerings, it must simultaneously improve investor protections for those who are eligible to invest.

PIABA offers comments on the topics set forth in the Concept Release below. We have chosen to focus on a few questions specifically relating to the current exempt offering framework.

Generally, investors are not adequately protected under the existing exempt offering framework. The exempt offering framework should only be amended to the extent such amendments strengthen investor protections. With the understanding that registration is a key component of the American securities regulation system, and that disclosure of key information should be a crucial part of an investor's decision-making process, we recognize that there currently exists a well-established framework regarding regulation requirements and exemptions therefrom. PIABA is concerned that modifications to that system that would make it easier to avoid registration, or more pointedly, allow de-facto continuous unregistered security sales, would run afoul of the purpose underlying the current framework.

I. Non-Accredited Investor Participation in the Exempt Offering Market

PIABA believes that non-accredited investors should be able to participate in private securities transactions under only exceptional circumstances. The exempt offering framework assumes that the investors to whom exempt offerings are sold do not need the full protections of the securities laws. We note, however, that those investors are generally not in a financial position to bear the risk associated with private placements. The problem is compounded when many private securities exemptions do not restrict dollar amounts that non-accredited investors can invest, but rather, only restrict the number of non-accredited investors that can participate. The limits on the number of non-accredited investors who may participate in an exempt offering provides little protection to those who are investing. To the extent the Commission believes that non-accredited investors should continue to be allowed to invest in exempt offerings, it should consider placing limitations on the amount any individual non-accredited investor may invest.

II. Accredited Investor Definition

The purpose of providing exemptions from registration under Regulation D is to allow smaller, private companies to raise capital without incurring the considerable expense and time of complete registration of the offering with the Commission. While the assumption of Regulation D is that "accredited investors" have both the sophistication to comprehend the risks and characteristics of said limited offerings and also have the financial means to withstand the potential financial losses posed by private placement investments, PIABA's members have all too often found that those who meet the current definition of "accredited investors" have neither the sophistication to understand nor the means to withstand losses in Regulation D investments.

Regulation D offerings now raise in excess of $1.5 trillion a year. While a certain proportion of those offerings are offered to institutional investors and financial professionals, many Regulation D offerings are actively sold to retail investors around the nation. Increasing the thresholds or other "accredited investor" requirements would help to protect the most vulnerable public investors from being victimized by these investments.

a. Concerns with the Existing Accredited Investor Definition

PIABA believes that the definition of "accredited investor" is long overdue for revision, most significantly because efficacy of the income and net worth thresholds for financial eligibility to invest in Regulation D offerings have been diminished due to the passage of time and the impact of inflation since they were put in place in 1982. Since that time, income and net worth thresholds have been used to define individual accredited investor as follows: an individual with a net worth in excess of $1 million, or with an individual income in excess of $200,000 or joint income with his or her spouse in excess of $300,000, is deemed an "accredited investor."

Now, some 37 years later, these standards have not been substantially modified from a time when a newspaper cost 20 cents, and a can of Coke from a vending machine cost 35 cents. In short, due to the passage of time and inflation, there are more people than ever who qualify as "accredited investors." According to the SEC's review in connection with the Accredited Investor Staff Report, the census data from 1983, a year after the thresholds were established, demonstrated that only 0.5% of households met the individual income threshold, only 1.7% met the net worth threshold, and only 1.8% met either threshold. Now, according to census data cited by the Concept Release, 8.9% of households qualify based on the individual income threshold of $200,000, 4.6% of households qualify based on the joint income threshold of $300,000, 9.4% of households qualify based on the net worth threshold of $1 million, and, overall, 13.0% of United States households qualify as accredited investors. In short, thanks exclusively to inflation and the passage of time, more than 7 times as many investors qualify as "accredited investors" today compared to the time the regulation was first put in place. Conspicuously absent from that increase is any sort of meaningful improvement in financial literacy for retail investors.

While there has been a significant increase in the number of "accredited investors," a large number of these investors are not genuinely in a position to take on the risks typically associated with Regulation D investments. For example, a retiree with a net worth of $1 million might be relying on that net worth to generate income to supplement the investor's social security payment to cover their basic living expenses (without regard to exceptional expenses). While the investor has the necessary net worth to qualify as an accredited investor, this person is not able to bear the risk associated with investment in a private placement. This investor cannot bear to lose any principal. Additionally, that $1 million net worth could have easily been achieved through long-term participation in a company retirement plan that was likely administered by someone other than the retiree. The person could easily be a line worker from a manufacturing company that worked a very long time and earned that retirement amount. However, that is not the type of person who would generally be considered a "sophisticated" investor who does not need the protection of the securities laws. This is clearly not what was intended when the original financial thresholds were put in place almost 40 years ago, yet it is where natural forces of inflation have brought the investing public.

b. Those Engaged in Fraud are Drawn to the Larger Pool of Available Participants in Exempt Offerings

In addition to being concerned about investors being unable to understand the risks and characteristics of Regulation D offerings, PIABA is particularly concerned about the use of these offerings to defraud innocent investors. It is important to note that the current accredited investor standard, in creating a comparatively large pool of investors qualified to be offered Regulation D securities, makes these offerings a particularly attractive tool to promote fraudulent schemes. Our members have seen investors harmed by a string of Regulation D offerings in the last 10 years that have turned out to be nothing more than Ponzi schemes.

The following make up a small sampling of the litigation and press releases of SEC enforcement actions targeted at private offerings over the past decade:

- **SEC Obtains Asset Freeze in $485 Million Nationwide Offering Fraud**[1]

The Commission alleged that Provident Royalties LLC made a series of fraudulent offerings of preferred stocks and limited partnership offerings to more than 7,700 investors between 2006 and 2009.

- **SEC Obtains Asset Freeze Against Co-Founder of Canopy Financial in $75 Million Offering Fraud**[2]

The Commission alleged that between 2008 and 2009, Canopy Financial solicited approximately $75 million from investors for a private placement offering for preferred shares of Canopy.

- **SEC Charges Two Florida Men in Ponzi Scheme Defrauding Teachers and Retirees**[3]

The Commission alleged that two men raised approximately $22 million from over 100 investors, many of them Florida teachers or retirees. The men allegedly operated a Ponzi scheme disguised as a private equity fund.

- **SEC Charges Chicago-Based Investment Firm with Misleading Investors in Private Equity Offerings**[4]

The Commission alleged that Advanced Equities Inc., a broker dealer and investment advisory firm, misled investors in connection with two private equity offerings in 2009 and 2010. The firm agreed to a $1 million penalty.

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1. Press Release, SEC, SEC Obtains Asset Freeze in $485 Million Nationwide Offering Fraud (July 7, 2009), https://www.sec.gov/news/press/2009/2009-151.htm.

2. Press Release, SEC, SEC Obtains Asset Freeze Against Co-Founder of Canopy Financial in $75 Million Offering Fraud (Dec. 2, 2009), https://www.sec.gov/news/press/2009/2009-257.htm.

3. Press Release, SEC, SEC Charges Two Florida Men in Ponzi Scheme Defrauding Teachers and Retirees (Aug. 29, 2011), https://www.sec.gov/news/press/2011/2011-171.htm.

4. Press Release, SEC, SEC Charges Chicago-Based Investment Firm with Misleading Investors in Private Equity Offerings (Sept. 12, 2012), https://www.sec.gov/news/press-release/2012-2012-191htm.

- **SEC Charges Atlanta-Based Adviser with Operating Ponzi-Like Scheme Involving Private Investment Funds**[5]

The Commission alleged that a private fund manager defrauded investors through a fund of funds, and the creation of two private funds. The Commission further alleged that investors lost an estimated $17 million.

- **SEC Charges Sarasota-Based Private Fund Manager with Stealing Investor Money and Conducting Ponzi Scheme**[6]

The Commission alleged that a fund manager raised $3.8 million from investors between 2008 and 2013 by soliciting them to invest in notes in his private investment funds. Many of the investors were individuals the fund manager met through his church.

- **SEC Charges Chicago-Based Investment Fund Manager with Stealing Investor Money and Conducting Ponzi Scheme**[7]

The Commission charged a fund manager with operating a Ponzi scheme after he raised more than $11.4 million from investments in four private funds he managed.

- **Atlanta Businessman Charged in Nursing Home Investment Scheme**[8]

The Commission charged an Atlanta-based businessman with fraud after he raised nearly $190 million through dozens of municipal bond and private placement offerings. The investors were purportedly to earn interest from revenues generated by a nursing home, assisted living facility, or other retirement community investment. The Commission alleged that, instead, the man diverted funds to other business ventures and personal expenses.

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5. Press Release, SEC, SEC Charges Atlanta-Based Adviser with Operating Ponzi-Like Scheme Involving Private Investment Funds (Sept. 19, 2012), https://www.sec.gov/news/press-release/2012-2012-192htm.

6. Press Release, SEC, SEC Charges Sarasota-Based Private Fund Manager With Stealing Investor Money and Conducting Ponzi Scheme (May 21, 2014), https://www.sec.gov/news/press-release/2014-103.

7. Press Release, SEC, SEC Charges Chicago-Based Investment Fund Manager With Stealing Investor Money and Conducting Ponzi Scheme (May 29, 2014), https://www.sec.gov/news/press-release/2014-108.

8. Press Release, SEC, Atlanta Businessman Charged in Nursing Home Investment Scheme (Nov. 20, 2015), htts://www.sec.gov/news/pressrelease/2015-264.html.

- **SEC Charges Operators of $1.2 Billion Ponzi Scheme Targeting Main Street Investors**[9]

The Commission filed charges against a group of unregistered investment companies, the Woodbridge Group of Companies LLC, for allegedly bilking thousands of investors in a $1.2 billion Ponzi scheme. Sales agents pitched the investments to investors, many of whom were seniors, as low cost, conservative investments. In 2019, a federal court in Florida ordered the company to pay $1 billion in penalties and disgorgement.[10]

- **SEC Obtains Judgments against Stephen DiCarmine and Joel Sanders**[11]

In 2018, a federal court entered judgements against two former Dewey & LeBoeuf, LLP executives in connection with a fraudulent $150 million bond offering. The Commission alleged that one of the men falsified financial statements which were incorporated into a private placement memorandum for the offering.

- **SEC Charges San Diego-Based Investment Adviser with Running a Ponzi Scheme**[12]

The Commission charged an investment adviser and the companies he controlled with soliciting investments in tax-free private placements. The Commission alleged that the adviser's clients included school district employees and veterans. He raised $7 million for the investments, which were allegedly a Ponzi scheme.

Collectively, these allegedly fraudulent investment schemes raised over $2 billion from investors. More recent private placements such as those issued by GPB Capital (which reportedly raised proceeds of over $1.8 billion, largely from retail investors) have exhibited significant signs of distress and may also end up resulting in near-total losses for investors.

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9. Press Release, SEC, SEC Charges Operators of $1.2 Billion Ponzi Scheme Targeting Main Street Investors (Dec. 21, 2017), https://www.sec.gov/news/press-release/2017-235.

10. Press Release, SEC, Court Orders $1 Billion Judgment Against Operators of Woodbridge Ponzi Scheme Targeting Retail Investors (Jan. 28, 2019), https://www.sec.gov/news/press-release/2019-3.

11. Litigation Release No. 24119, SEC, SEC Obtains Judgments against Stephen DiCarmine and Joel Sanders (Apr. 23, 2018), https://www.sec.gov/litigation/litreleases/2018/lr24119.htm.

12. Litigation Release No. 24461, SEC, SEC Charges San Diego-Based Investment Adviser with Running a Ponzi Scheme (Apr. 26, 2019), https://www.sec.gov/litigation/litreleases/2019/lr24461.htm.

Private placements are often heavily marketed through independent broker-dealer networks and are "sold, not bought." Financial professionals push these products to unsophisticated investors – those same investors do not beg their advisors for access to non-public investments. PIABA's members see the investments presented as alternative income investments appealing to elderly investors often living on a fixed income. Unscrupulous financial advisors pitch the products as offering income higher than what is available in conventional fixed-income securities, and/or also providing diversification to the investor's portfolio because their value is not correlated to the stock market or other conventional asset classes. Many clients solicited to invest in these types of products end up losing their entire investment. In fact, the Commission itself warns investors that it "may be difficult or impossible to recover the money you invest in an offering that turns out to be fraudulent."[13]

So long as the bright-line tests of net worth and income are used to define "accredited investors," an ever-larger group of retail investors have been exposed to the common mis-application of the intention underlying the rule. For the protection of the investing public, this needs to change.

c. Changes to the Definition of Accredited Investor

PIABA believes that the current definition of "accredited investor" is outdated. The income and net worth thresholds established in 1982 suggest a considered policy judgment that Reg. D investments were meant for a very small percentage of the investing public. While imperfect, the thresholds served as a pragmatic rule of thumb that limited investments in Reg. D offerings to those investors who, on some level, could financially afford to withstand the potential losses posed by private placement investments. Accordingly, PIABA supports the proposal contained in the Accredited Investor Staff Report that would raise the net worth threshold and the income threshold for accredited investors. The U.S. Government CPI data reveals that the cumulative rate of inflation since 1982 is more than 2,490%. While PIABA recognizes that raising the thresholds by that amount may be unpalatable, it suggests that raising the net worth threshold to $2.5 million and income threshold to $500,000/$750,000 for individuals and couples would be a meaningful step forward in moving back to the original intention of limiting the pool of accredited investors.

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13. SEC, Investor Bulletin: Private Placements Under Regulation D (Sept. 24, 2014), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html.

Moreover, PIABA supports a regular review and adjustment of these thresholds. ***After being increased to new higher thresholds as suggested above,*** these thresholds should then be reviewed every few years and adjusted to account for inflation. PIABA recommends that the thresholds be automatically adjusted every four years based on the Consumer Price Index, in conjunction with the periodic review of the accredited investor definition mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). Automatic adjustment of the thresholds every four years would keep the thresholds reasonably in line with inflation without creating unnecessary administrative issues. The periodically adjusted thresholds would thus remain a useful, if imperfect, rule of thumb.

d. Other Options for Accredited Investor Determination

PIABA does not believe there should be exceptions to the accredited investor financial thresholds based on other measures of sophistication, other than those currently in place for non-individual investors such as banks, broker-dealers, and insurance companies not currently subject to any assets test. Adding subjectivity to the standards would almost certainly lead to uncertainty and abuse.

However, and in additional to the net worth and income thresholds, there should be some sophistication qualification for individual investors who meet the definition of an accredited investor. Investors who otherwise meet the requisite net worth threshold may not be sophisticated enough to appreciate the significant risks of investing in private placements and limited offerings. This is especially true as the population ages and many face cognitive impairment issues. It therefore makes sense to include a requirement that the accredited investor be sophisticated enough to gauge the risks inherent in the investment. The analysis can be somewhat objective to the extent it relies upon the prospective investor's profession (including *when* the investor practiced in that profession), or their prior investing experience. However, a sophistication qualification should supplement, not replace, the bright-line income and net worth requirements.

The Concept Release asked whether the Commission should "permit an investor… that is advised by a registered financial professional to be considered an accredited investor?" PIABA's response to this question is a resounding "No." In our members' experience, the involvement of registered representatives of a broker-dealer or Investment Adviser Representatives is too often the problem, and not the solution. This is especially true as private placements typically pay much higher commissions to the financial professionals who sell them than do more traditional investments. Commission-motivated investment professionals too often indiscriminately recommend Regulation D offerings to retail investors and use Regulation D qualifications without regard to any suitability analysis whatsoever. Substituting registered financial professional advice for the other standards to establish accrediting investor status would swallow the rule and eliminate the protections of the accredited investor definition for those who need it most - retail investors who risk being steered into private placements that they do not understand by trusted advisors.

e. Further Protections

All too often, financial professionals and others who offer investment advice conflate the "accredited investor" definition with the suitability standard. That is, if a customer qualifies for the private placement, many financial professionals wrongly believe the investment is, by definition, an appropriate investment for that customer. The accredited investor definition is often treated by investment professionals and the financial firms charged with supervising them as a *de facto* suitability affirmation, arguing that the Regulation D definition confirms that the investment was suitable for *any* investor who qualified and purchased the private placement. The argument has been too often compellingly persuasive for unsophisticated arbitrators, resulting in public investors losing arbitrations related to obviously inappropriate investments. Raising the thresholds and adding additional non-financial criteria should protect investors from that flawed defense. But, the Commission also needs to make clear to brokers and others who manage client investments that the "accredited investor" definition is *not* a replacement to the obligation to make only suitable recommendations to clients that are in the client's best interests. A simple statement from the Commission that accreditation as an "accredited investor" does not mean that a private placement investment is *de facto* suitable for an investor would be tremendously helpful to public investors.

Additionally, PIABA supports the idea that there should be a verification of an investor's accredited status. Too often account paperwork for investment accounts may be signed while blank or filled in by registered representatives in a self-serving manner that overstates the customer's income, net worth, and investing experience. By requiring simple verification, the Commission will likely reduce the risk that investors' eligibility for Regulation D offerings may be fudged by unscrupulous salespeople. The verification process need not be unduly complicated and should include simple steps like the review of W-2s, tax returns, bank and brokerage statements, credit reports and the like (as currently set forth in Rule 506(c)).

Despite guidance from the Commission as to what methods of verifying accredited investor status are acceptable, many issuers, particularly those who are selling their investment without the assistance of a broker-dealer, still rely on accredited investor questionnaires as the sole method of verification. PIABA believes the Commission should impose stronger penalties on issuers that fail to properly verify accredited investors status. These penalties could include fines but could also provide for relief available to civil litigants, such as personal liability of the officers of the issuers.

III. Expanding Exempt Offerings

PIABA does not believe the exempt offerings framework should be further expanded. For example, PIABA does not believe it is prudent to increase the $5 million limit for Regulation D's Rule 504 offerings. The Commission has not offered any particularly compelling arguments regarding why the increase is required. Rather, such an increase would simply expose more retail investors to potential abusive sales practices.

Moreover, PIABA opposes any effort to expand which companies are eligible to use Rule 504 exemptions. Investment companies such as closed-end mutual funds, open-end mutual funds, and UITs (Unit Investment Trusts) are currently ineligible for Rule 504 exemptions. Many investors, including those considered to be unaccredited and unsophisticated, invest in products like mutual funds and UITs and may not be aware of the further risk associated with the expanded use of Rule 504 by investment companies. Considering how often the investing public invests in investment company products, these companies should remain ineligible under Rule 504.

Additionally, PIABA is opposed to the growth of unregulated crowdfunded offerings. Our members often find that unsophisticated retail investors are the ones more likely to fall victims to fraudulent offerings. The Commission should not increase or waive the current annual cap on investors, accredited or not. More control and review will protect investors, therefore PIABA supports increasing offering document disclosure and auditing as well as regulating or limits on promotion and advertising.

The Commission also seeks comment on whether it should create a new exemption for micro-offerings. While a micro-offering (which the Commission proposes to cap at $250,000) could allow small business access to investors' capital, businesses seeking relatively small amounts of capital should use traditional forms of financing, like commercial loans. The risk inherent in micro-offerings is not the type of risk that should be passed onto investors. Further, the ability of a business to issue a new micro-offering every thirty to ninety days would create a loophole for fraudsters to exploit, allowing them to raise larger amounts of capital than should be allowed under a micro-offering exemption.

IV. Disclosure Obligations

While unlawful conduct by financial professionals cannot be "cured" by disclosures in offering materials, PIABA emphasizes the importance of public access to accurate, complete financial information and disclosures about a potential investment. This is particularly true when considering any illiquid or restricted investment purchase, and regardless of whether an investor meets the "accredited investor" qualifications. Disclosures should emphasis the difficulty of further re-sale, provide relevant and current financial disclosures by the issuer, and be provided at or before the time of solicitation. If information is available on-line through a centralized directory, disclosures should provide a clear, direct, and accurate link to such information.

PIABA does not support any proposed measure that would diminish the amount of information required to be given to investors prior to making private investments. To the contrary, PIABA believes that better information should be provided to investors. The information that often accompanies private investments is written in technical language and small print, making it very difficult for the average investor to understand and read. Moreover, the disclosures are often hundreds of pages long. Often, an investor is presented with these documents and then immediately asked to sign a subscription agreement or other document indicating that the investor read everything and understood it. Knowing the investor never read the prospectus or offering circular, the financial advisor is happy to secure the signed acknowledgement to close the sale and receive the enhanced commission such investments often offer.

Disclosure is not effective when presented in this manner. The Commission should not only strengthen requirements related to the quality of information, but also, place time restrictions on when the information must be provided and require a cooling off period to allow Investors a better evaluation of the information they have been provided.

V. Integration Standards

In simple terms, PIABA contends that relaxing the integration standards, or expanding the safe harbor provisions, would unquestionably cause retail investors harm.

The Commission asks whether the six-month integration safe harbor set forth in Regulation D's Rule 502(a) should be shortened to ninety or even thirty days. PIABA's members' clients have repeatedly fallen victim to Ponzi schemes whereby a continual stream of unregistered securities is offered, with each new offering funding the payoff of an older, maturing one. Registration is avoided by carefully minding the six-month measure. Just such a scheme was used by the fraudsters behind the Medical Capital debacle, who raised billions of dollars in the process. Shortening that period will undoubtedly serve to promote those Ponzi schemes, allowing unscrupulous issuers to issue a never-ending stream of securities to fund older issues. The schemes will run well for a while if the wrongdoers know they will have access to fresh capital every thirty or ninety days. The constant inflow will provide a stream of "returns" to the early investors – which streams will be used to promote the future offerings and thereby bring a host of new victims into the scheme. This is, effectively, how all Ponzi schemes work and reducing the time period between these issuances will only serve to hurt more investors.

While PIABA takes no issue with any rule changes that promote clarity and thereby make it easier for issuers to determine, early in the process and in a conclusive manner, whether registration is required, we cannot support any changes that would loosen the existing strictures and make it easier to issue unregistered securities absent the institution of appropriate measures to fight fraud and promote investor protection.

VI. Secondary Trading of Securities Issued Pursuant to an Exemption

PIABA does not believe that a reduction of minimum holding periods, from either six months or one year, to, respectively, three months or six months, in order to qualify for the safe harbor resale exemptions under Rule 144 and Section 4(a)(1), will provide any benefit to most retail investors. It is unlikely that a retail investor, especially a "buy and hold" investor, will base their decision on whether to invest in an exempt offering on how long they must hold the securities.

More often, PIABA members see cases where the investor is unaware of the liquidity or illiquidity of an investment which they are holding. Investors believe their financial advisor has sold them an appropriate investment and discover that the investment is illiquid when they attempt to sell the investment.

The Commission also asks whether secondary trading opportunities should be created for closed end funds or BDCs. While a secondary market will certainly address certain liquidity issues inherent in those investments, PIABA cautions that any purchasers within the secondary market be held to the same standards used for the original purchasers. It is important that downstream investors have the same protections as the original investors.

Further, PIABA does not believe that the Commission should extend federal preemption to secondary sales of exempt offerings. PIABA is concerned that extension of federal preemption may put into question state law that offers even greater protection to retail investors.

Conclusion

Once again, PIABA appreciates the opportunity to respond to the Commission's Concept Release. We urge the Commission to remember its central and primary mission to investors while it tackles the legitimate goal of simplifying the exempt offering framework. Although increasing the efficiency of the capital markets and ability of companies to raise money is a laudable goal, it cannot be done at the expense of investor protection.

PIABA would be happy to engage with the Commission further on this issue, including working with the Commission to provide access to investors who have been hurt by the wrongful sale of various exempt offerings so that the Commission can fully understand the personal costs when investor protection fails the public.

Sincerely,

Christine Lazaro,
PIABA President

Samuel Edwards,
PIABA Executive Vice-President/President-Elect