Securities Arbitration and Mediation 2017:
The Courage to Simplify

NYSBA CLE Program

Thursday, April 6, 2017
NYC & Live Webcast

7.0 MCLE Credits | 2.0 Professional Practice, 4.0 Skills, 1.0 Ethics

www.nysba.org/SAM2017

Co-sponsored by the Securities Litigation and Arbitration Committee of the Commercial and Federal Litigation Section and the Committee on Continuing Legal Education of the New York State Bar Association

This program is offered for educational purposes. The views and opinions of the faculty expressed during this program are those of the presenters and authors of the materials. Further, the statements made by the faculty during this program do not constitute legal advice.

Lawyer Assistance Program 1.800.255.0569

Q. What is LAP?

A. The Lawyer Assistance Program is a program of the New York State Bar Association established to help attorneys, judges, and law students in New York State (NYSBA members and non-members) who are affected by alcoholism, drug abuse, gambling, depression, other mental health issues, or debilitating stress.

Q. What services does LAP provide?

A. Services are **free** and include:

- Early identification of impairment
- Intervention and motivation to seek help
- Assessment, evaluation and development of an appropriate treatment plan
- Referral to community resources, self-help groups, inpatient treatment, outpatient counseling, and rehabilitation services
- Referral to a trained peer assistant – attorneys who have faced their own difficulties and volunteer to assist a struggling colleague by providing support, understanding, guidance, and good listening
- Information and consultation for those (family, firm, and judges) concerned about an attorney
- Training programs on recognizing, preventing, and dealing with addiction, stress, depression, and other mental health issues

Q. Are LAP services confidential?

A. Absolutely, this wouldn't work any other way. In fact your confidentiality is guaranteed and protected under Section 499 of the Judiciary Law. Confidentiality is the hallmark of the program and the reason it has remained viable for almost 20 years.

Judiciary Law Section 499 Lawyer Assistance Committees Chapter 327 of the Laws of 1993

Confidential information privileged. The confidential relations and communications between a member or authorized agent of a lawyer assistance committee sponsored by a state or local bar association and any person, firm or corporation communicating with such a committee, its members or authorized agents shall be deemed to be privileged on the same basis as those provided by law between attorney and client. Such privileges may be waived only by the person, firm or corporation who has furnished information to the committee.

Q. How do I access LAP services?

A. LAP services are accessed voluntarily by calling **800.255.0569** or connecting to our website **www.nysba.org/lap**

Q. What can I expect when I contact LAP?

A. You can expect to speak to a Lawyer Assistance professional who has extensive experience with the issues and with the lawyer population. You can expect the undivided attention you deserve to share what's on your mind and to explore options for addressing your concerns. You will receive referrals, suggestions, and support. The LAP professional will ask your permission to check in with you in the weeks following your initial call to the LAP office.

Q. Can I expect resolution of my problem?

A. The LAP instills hope through the peer assistant volunteers, many of whom have triumphed over their own significant personal problems. Also there is evidence that appropriate treatment and support is effective in most cases of mental health problems. For example, a combination of medication and therapy effectively treats depression in 85% of the cases.

Personal Inventory

Personal problems such as alcoholism, substance abuse, depression and stress affect one's ability to practice law. Take time to review the following questions and consider whether you or a colleague would benefit from the available Lawyer Assistance Program services. If you answer "yes" to any of these questions, you may need help.

1. **Are my associates, clients or family saying that my behavior has changed or that I don't seem myself?**
2. **Is it difficult for me to maintain a routine and stay on top of responsibilities?**
3. **Have I experienced memory problems or an inability to concentrate?**
4. **Am I having difficulty managing emotions such as anger and sadness?**
5. **Have I missed appointments or appearances or failed to return phone calls? Am I keeping up with correspondence?**
6. **Have my sleeping and eating habits changed?**
7. **Am I experiencing a pattern of relationship problems with significant people in my life (spouse/parent, children, partners/associates)?**
8. **Does my family have a history of alcoholism, substance abuse or depression?**
9. **Do I drink or take drugs to deal with my problems?**
10. **In the last few months, have I had more drinks or drugs than I intended, or felt that I should cut back or quit, but could not?**
11. **Is gambling making me careless of my financial responsibilities?**
12. **Do I feel so stressed, burned out and depressed that I have thoughts of suicide?**

There Is Hope

CONTACT LAP TODAY FOR FREE CONFIDENTIAL ASSISTANCE AND SUPPORT

The sooner the better!

Lawyer Assistance Program

1.800.255.0569

Program Description

The key to successful securities arbitration and mediation is telling your story in memorable and persuasive fashion. This program will help you master those skills while also bringing you up-to-date on recent developments in the law. Gathered from the "best and brightest" of the New York State Bar, this program will, in one day, highlight the most critical advancements in securities arbitration and mediation since this program was last presented.

Our faculty is usually large so that our attendees get the best cross-section possible of experienced practitioners. The subjects selected are based on the assessment of our faculty. Don't miss this opportunity to get a complete update on the law and a thorough analysis of how to succeed in Securities Arbitration and Mediation!

Overall Program Co-Chairs

James D. Yellen, Esq. | Yellen Arbitration and Mediation Services
David E. Robbins, Esq. | Kaufmann Gildin & Robbins LLP

Commercial and Federal Litigation Section Chair

Mark A. Berman, Esq. | Ganfer & Shore, LLP

Additional information about the program can be found at www.nysba.org/SAM2017.

Program Agenda

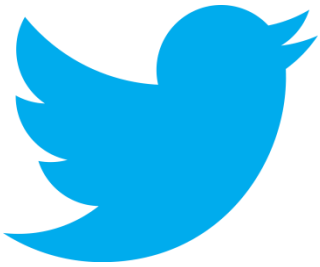
9:00 a.m. – 9:10 a.m.	Welcome and Introductions
9:10 a.m. – 10:00 a.m.	**Developments and Trends in Securities Arbitration and Mediation Cases** **Moderator** David E. Robbins, Esq. | Kaufmann Gildin & Robbins LLP **Speakers** Richard W. Berry, Esq. | FINRA Dispute Resolution Martin L. Feinberg, Esq. | Martin L. Feinberg Richard P. Ryder | Securities Arbitration Commentator, Inc.
10:00 a.m. – 10:50 a.m.	**Telling Your Story Simply from Intake to Closing Statements** **Moderator** Jonathan L. Hochman, Esq. | Schindler Cohen & Hochman LLP **Speakers** Aegis J. Frumento, Esq. | Stern Tannenbaum & Bell LLP Prof. Paul Radvany | Fordham University School of Law Angela A. Turiano, Esq. | Bressler, Amery & Ross, P.C.
10:50 a.m. – 11:05 a.m.	Refreshment Break
11:05 a.m. – 11:55 a.m.	**Securities Industry Experts' Perspective on Securities Arbitration** **Moderator** Alan S. Rafterman, Esq. | Wells Faro & Company **Speakers** Mark Conner | Corporate Treasury Investment Consulting, LLC Jerry DeNigris | Riverside Financial Group, LLC Ross Tulman | Trade Investment Analysis Group
11:55 a.m. – 12:45 p.m.	**Supervisory and Clearing Firm Liability** **Moderator** Michael G. Shannon, Esq. | Thompson Hine LLP **Speakers** Paul Carroll | Sententia LLC Henry F. Minnerop, Esq. | Henry F. Minnerop Tim O'Connor, Esq. | The Law Offices of Timothy J. O'Connor

12:45 p.m. – 1:45 p.m.	Lunch (on your own)
1:45 p.m. – 2:35 p.m.	**Whether and When to Settle a Securities Mediation** **Moderator** James D. Yellen, Esq. | Yellen Arbitration & Mediation Services **Speakers** Alida Camp, Esq. | ADR Offices of Alida Camp Philip S. Cottone, Esq. | Philip S. Cottone Michael Pysno, Esq. | Michael Pysno Attorney and Mediator William P. Thornton, Jr., Esq. | Stevens & Lee
2:35 p.m. – 3:25 p.m.	**Proving and Defending Bond Cases** **Moderator** Kenneth Crowley, Esq. | UBS Wealth Management Americas **Speakers** William Briendel, Esq. | Greenberg Traurig LLP Seth E. Lipner, Esq. | Deutsch & Lipner Matthew C. Plant, Esq. | Bressler, Amery & Ross, P.C.
3:25 p.m. – 3:40 p.m.	Refreshment Break
3:40 p.m. – 4:30 p.m.	**Ethics and Expungements** **Moderator** Barry Temkin, Esq. | Mound Cotton Wollah & Greengrass LLP **Speakers** Darya Geetter, Esq. | LPL Financial Jenice L. Malecki, Esq. | Malecki Law David E. Robbins, Esq. | Kaufmann Gildin & Robbins LLP Robert Usinger, Esq. | One Beacon Insurance Group
4:30 p.m.	Adjournment

Course Materials for this program are available at the following URL:

www.nysba.org/SAM2017Materials

Supplemental Outlines will be posted post-program.



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http://nycourts.gov/rules/jointappellate/NY-Rules-Prof-Conduct-1200.pdf

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The Courage to Simplify

Topic 1:
Developments and Trends in
Securities Arbitration and Mediation Cases

Arbitration Pleadings: The Courage To Simplify

James D. Yellen

"Writing is easy," said Red Smith, the premier sports journalist of his day. "You just sit at a typewriter until blood appears on your forehead."

Writing really is hard. Millions of people opened the sports pages to read what Red Smith wrote about games from the night before, but even he thought writing was hard. To read a final product that "sings"—that reads smoothly, effortlessly, and enjoyably—it belies the sweat the writer went through to get the work to such a clean state.

“Arbitration Pleadings: The Courage To Simplify” by James D. Yellen argues that arbitration lawyers do a disservice to their cause by using overly legalistic, verbose, and formulaic writing. The author submits that following basic rules of Plain English will result in more effective pleadings and will “tell your story” more directly. The chapter then reviews ten practical suggestions for better writing in arbitration.

Introduction[1]

Arbitrators are busy people. They tend to review your pleadings—Statement of Claim and Answer—at three crucial junctures: 1) when they arrive in the mail, just to get a look at what the case is about; 2) on their way to the hearing (subway, bus, train, or car); and 3) when raised during the hearing when counsel argues that a point will be met or obliterated. The first two reviews are usually forgotten, but the third can have a big impact.

Can your writing be more effective? The answer is a surprising yes. But why bother? First, it's a question of first impression—your pleading should have the panel "lean" toward you. Second, your pleading is the first chance to tell your story. Telling your story directly, credibly, and with appropriate, but not extreme, advocacy is the key—and that starts with the pleading. Don't get lost in lengthy build-ups or revert to pages of rote paragraphs from other matters. The three most powerful pages, and your only shot at simplicity, is your summary of facts at the beginning.

The following are my top ten Plain English tips for effective and simplified pleadings in securities arbitration. Follow these, and you just might grab one, two, or three of the panel members. Yes, you have a shot. Yes, it's worth a try.

The Ten Golden Rules for Persuasive Arbitration Pleadings

1. Omit Needless Words.[2]

Plain English, reviewed in countless books on writing,[3] comes down largely to this basic rule.[4] Justice Brandeis said it best: "There is no such thing as good writing.

[1] This article is an update of the author's "Arbitration Pleadings: The Courage To Simplify" published in PLI Seminar Counselbook in 2005 and edited then by co-chair David Robbins. The state of legal writing in arbitration and litigation has not advanced since then—if anything, due mostly to overuse of e-mail, electronic submission, and overworked attorneys and client desire not to pay for "training," it is probably worse.

[2] E. B. White and William Strunk Jr., The Elements of Style 23-24 (4th ed. 1999); see also Richard C. Wydick, Plain English for Lawyers 9-24 (4th ed. 1998). When William Strunk taught at Cornell in the early 20th Century, he would shout out to his class, "Omit needless words! Omit needless words! Omit needless words!"

[3] See, e.g., Wydick, supra note 2.

[4] See Bryan A. Garner, Legal Writing, Student Lawyer, May 2003, at xiv.

There is only good rewriting."[5] When you edit drafts, omit surplus words.[6] Search out compound constructions[7] and the passive voice.[8] "At that point in time" becomes "then." "For the reason that" becomes "because." "In order to" becomes "to." "I personally" becomes "I" and "in the instant proceeding"[9] becomes "here." When you see these lawyer-like phrases, get rid of them. Simplify. Have no fear—the arbitrators will appreciate it.

Even our introductions could use trimming. Is there any doubt that the average arbitrator understands that your client is Morgan Stanley or Citibank? So why start with "Respondent Solomon Smith Barney ('SSB' or 'Respondent'), sued herein as Solomon Smith Barney Citibank, a wholly owned subsidiary of Parent Corporation, by its attorneys, Contra Strunk & White, respectfully submits as and for its Answer a response to the Statement of Claim of John and Mary Jones (collectively 'Claimants' or 'the Joneses') the following for the consideration by the Panel . . . "?

After this exhausting introduction, the arbitrator may not read much further. There is nothing wrong (and a lot right) with: "Respondent [name] answers the claim as follows." No long wind-up. To the point. The panel knows this is your answer. It knows the party you represent. It knows your name. No other information is necessary. Omit needless words.

[5] See Richard K. Neumann, Jr., Legal Reasoning and Legal Writing: Structure, Strategy, and Style 61 (4th ed. 2001).
[6] Wydick, supra note 2, at 9-24; Strunk & White, supra note 2, at 23-24. There are online sources that provide exercises to practice omitting needless words. See, e.g., BRUSSELS LEGAL, Tip Two—Omit Needless Words (available at http://www.brusselslegal.com/article/display/2563/Tip_2_Omit_needless_words); see also Bryan A. Garner, Legal Writing in Plain English: A Text with Exercises, The University of Chicago Press (2001) (available at http://press-pubs.uchicago.edu/garner/documents/section5.html).
[7] Wydick, supra note 2, at 13-14. Thomas Jefferson put it best when he said, "The most valuable of all talents is that of never using two words when one will do."
[8] Wydick, supra note 2, at 24-29; Strunk & White, supra note 2, at 18-19; see also Bryan A. Garner, Legal Writing, Student Lawyer, May 2003, at 10-11 (discussing both nominalizations and the passive voice).
[9] Or "in the case at bar . . ." or "in the above-captioned case . . ."

2. Avoid Redundant Legal Phrases or Couplets.[10]

Lawyers like to use a pair or string of words that mean the same thing: null and void; last will and testament; free and clear; good and sufficient; confesses and acknowledges; deposes and says. The use has ancient roots in legal writing;[11] tradition dies slowly. Bottom line: these legal couplets are no longer necessary.[12] Avoid redundant repetition (including phrases like that).

3. Use Base Verbs, Not Nouns (Avoid Nominalizations).[13]

Lawyers for some reason like to "make statements" instead of "state." Watch for forms of the verb "to make" or "to do" followed by nouns ending in "-ment," "-tion," "-al," "-ence," and "-ity." These are nominalizations.[14] Have your cars collide, not enter into collisions. Assume, do not make assumptions, and ask panels to decide, not to make decisions. At the next hearing, I will take care to "state why I object," rather than "ask to be permitted to make a statement as to why I am interposing an objection to counsel's question at this time."[15]

In the same vein, use real words, not bureaucratese. A "detonation device" is a bomb. A "home surveillance protection system" is an alarm. "To communicate orally" is to talk.

4. Use Short Sentences and Short Paragraphs.[16]

I count words in my drafts. Sentences should be fewer than 25 words.[17] Paragraphs should have an introduction, a middle, a conclusion, and should be three to

[10] Wydick, supra note 2, at 19-24.
[11] These couplets came into existence in England following the Norman Conquest about 1,000 years ago. See TransLegal, "Doublets or Couplets" (April 10, 2012) (available at https://www.translegal.com/legal-english-lessons/doublets-or-couplets).
[12] See Wydick, supra note 2, at 19-24.
[13] Id. at 25-27; see also Garner, supra note 6, at 10-11.
[14] See Wydick, supra note 2, at 25-27; see also Matthew Salzwedel, Eliminating Nominalizations/Buried Verbs in Legal Writing, Lawyerist (July 3, 2012) (noting that aside from the passive voice, the use of nominalizations is perhaps the best sign of poor legal writing).
[15] Wydick, supra note 2, at 25.
[16] See id. at 35-41; see also Strunk & White, supra note 2, at 15-17.
[17] See Wydick, supra note 2, at 38.

five or six sentences long.[18] One thought per sentence;[19] one argument per paragraph.[20] Everything you do to help the reader helps you and your client. Attention will be paid if you pay attention to what you write.

5. Arrange Your Words With Care.[21]

Keep the subject of the sentence close to the verb.[22] Be careful in the placement of clauses and phrases. "The defendant was arrested for fornicating under a little-used state statute."[23] This may bring a smile to the reader, but vague antecedents will not advance your cause. "My client has discussed your proposal to fill the drainage ditch with his partners" is another favorite.[24] Arrange your words with care.

6. Use Concrete Words; Avoid Lawyerisms.[25]

Choose your words with precision; make every word tell. We often lapse into lawyerisms out of bad habit, laziness, or an ill-conceived attempt to impress.[26] Plain English in writing is often similar to plain speaking in everyday conversation.[27] You would not say at the dinner table, "Those are wonderful string beans; please pass said beans."[28] Don't write that way either. Henceforth, lose the aforesaids, heretofores, and hereinafters from your writing.[29]

[18] See Sue Carol Rakow, The Essentials of Good Legal Writing at 24-25, A Survival Guide for New Attorneys (available at http://www.lacba.org/Files/LAL/Vol28No7/SGNA11.pdf).
[19] Id.
[20] See Strunk & White, supra note 2, at 15-17.
[21] See Wydick, supra note 2, at 43-56.
[22] See id. at 43-46.
[23] Id. at 49.
[24] Id.
[25] See id. at 57-63; see also Strunk & White, supra note 2, at 21-23; Matthew Salzwedel, Face It – Bad Legal Writing Wastes Money, Michigan Bar Journal, March 2013, at 52 (citing studies of readers' responsiveness to plain English as compared to lawyerisms).
[26] As the T-shirt reads, "Eschew obfuscation."
[27] See Garner, supra note 6, at 48-50; see also Bryan A. Garner, Garner on Language and Writing 48 (2009) ("[I]f you wish to write well, you'll have to resist sounding like a machine. Or an old-fashioned pontificator. You'll have to learn to sound like the best version of yourself.").
[28] Wydick, supra note 2, at 61.
[29] Id. at 61-63; see also Gerald Lebovits, On Terra Firma With English, N.Y. St. B.J., Sept. 2001, at 57, 64 ("Legalese . . . adds nothing of substance, gives a false sense of precision, and obscures gaps in analysis.").

Always choose the active voice over the passive voice.[30] Given the choice, use familiar words over the unfamiliar.[31] Prefer English root words to the Latin-based words (e.g., explain for elucidate; see for observe; use for utilize; free for liberate).[32] Plain English saves time and money by increasing a reader's ability to understand and retain what he has read.[33]

7. Use Strong Nouns and Verbs.[34]

Legal writing should be declaratory and direct.[35] Don't dilute your points with vague, "purple-prosy" sentiments. Long sentences unnecessarily complicate legal writing.[36] "The witness intentionally testified untruthfully about the issue raised in paragraph 42 of the Claim." The witness lied. "The Claimant was very, very upset at the prognosis of the decline in value of her portfolio and her present budgetary circumstances." She was enraged. The losses were large and they hurt. Sophistication of expression should always be sacrificed if it detracts from clarity.[37]

8. Avoid Long Quotes and Legal Treatises.

Submitting a claim or answer in arbitration is the first chance you have to "tell your story." The first three to five pages are critical—they create your first impression. Most panelists wait for the hearing to absorb the finer details. Your theme should be precise and succinct, colorful and credible. Trade long passages for short sentences.[38] A claim

[30] See Anne Enquist and Laurel Currie Oates, Just Writing: Grammar, Punctuation, and Style for the Legal Writer 76-77 (2d ed., 2005) (noting three primary benefits in preferring active voice: (1) active voice makes the sentence more concise; (2) active voice uses a more vigorous verb; and (3) active voice allows information to be processed more readily).
[31] See Kristin K. Robbins, The Inside Scoop: What Federal Judges Really Think About the Way Lawyers Write, 8 Legal Writing 257, 284 (2002).
[32] See Wydick, supra note 2, at 60-61.
[33] See Charles R. Calleros, Legal Method and Writing 271 (6th ed. 2011) ("The readers of such [long] sentences must assimilate too much information before pausing, and they often lose track of the proper relationships of the ideas expressed.").
[34] Id. at 77-78; see also Strunk & White, supra note 2, at 71-72.
[35] Wydick, supra note 2, at 77.
[36] See Veda R. Charrow, Myra K. Erhardt & Robert P. Charrow, Clear & Effective Writing 163–64 (4th ed. 2007).
[37] See Antonin Scalia & Bryan A. Garner, Making Your Case: The Art of Persuading Judges 107 (2008).
[38] See, e.g., Charrow, supra note 36, at 165 (4th ed. 2007) (instructing legal writers to break long passages into shorter sentences); Neumann, supra note 5, at 229 (instructing legal writers to break long sentences "in two"); Terrill Pollman et al., Examples and Explanations: Legal Writing 278 (2011) (encouraging legal writers to avoid drafting sentences that exceed four typed lines).

is not a legal brief. The use of endless quotes from case law bores most arbitrators. If the panel wants a brief on a particular legal issue, it will ask for one. Long legal recitations also smack of form pleading with cookie-cutter claims or defenses.[39]

The sooner you lose the reader, the sooner you lose the case. We all suffer from the tendency to believe that if words came from a published source, they must be good. Be shrewd enough to delete and revise.[40] Avoid legal jargon with no purpose and use technical language only when necessary to convey your argument clearly and concisely.[41]

9. Punctuate Carefully.[42]

The rules are too numerous for review here.[43] But remember that punctuation is a guide to meaning.[44] Sloppy punctuation doesn't only affect the meaning of your sentence,[45] but also implies, like sloppy citations, a sloppy and careless writer.

By inference, the grammarian panelist thinks "Sloppy writing, sloppy research, sloppy reasoning." The result again is a bias against your client rather than for your client.[46] This may strike you as minor or picayune. But small mistakes add up to an

[39] It helps the defense's cause greatly when plaintiff's counsel neglects to proofread the final product carefully. You cannot blame anyone else when an old Respondent's name turns up in your new Statement of Claim against a new Respondent. Likewise for defense counsel, stating as an affirmative defense that "Claimant ratified his trades," in response to the claim of Sally Jones does not impress.
[40] See Strunk & White, supra note 2, at 72-73.
[41] See, e.g., Bryan A. Garner, The Myth of Precision, A Dictionary of Modern Legal Usage 580, 663 (2d ed. 1995).
[42] Wydick, supra note 2, at 85-115; see also Strunk & White, supra note 2, at 1-9.
[43] See also John C. Dernbach et al., A Practical Guide to Legal Writing & Legal Method 200 (3d ed. 2007) (stating that errors in grammar, punctuation, and spelling suggest that the writer is sloppy and careless—qualities that people do not want in a lawyer); Neumann, supra note 5, at 224 (stating that correct punctuation and grammar make writing clearer and easier to understand); Wydick, supra note 2, at 84 (noting that when you write, you should punctuate carefully, in accordance with ordinary English usage).
[44] Wydick, supra note 2, at 89.
[45] The importance of punctuation is stressed with great style and humor in "Eats, Shoots and Leaves" by Lynn Truss (1st ed. 2004). Her thesis is that through sloppy usage and the informality of Internet writing, we have made proper punctuation an endangered species. The book title derives from the following story:

> A panda walks into a café. He orders a sandwich and eats it, then draws a gun and fires two shots in the air. "Why?" asks the confused waiter. As the panda exits, the panda produces a badly punctuated wildlife manual and tosses it over his shoulder. "I'm a panda," he says, at the door. "Look it up." The waiter turns to the relevant entry and, sure enough, finds an explanation. "PANDA. Large black-and-white bear-like mammal, native to China. Eats, shoots and leaves."

So, punctuation really does matter, the author notes, even if it is only occasionally a matter of life and death.
[46] See Neumann, supra note 5, at 51-53.

impression that you do not care enough. Assume that everything in arbitration makes a difference because anything might.[47]

10. Be Shrewd Enough to Revise. Edit, Edit, then Edit.[48]

There should be no cookie-cutter complaint or answer. Your client's story is always unique. Each arbitration is different. If you believe there is no such thing as good writing, only good rewriting, then editing is crucial.[49] Always proofread once more than you think is necessary. Make it your story. Make every word tell. Again, recall Brandeis ("Just good rewriting").

Conclusion

If you follow this recipe, the finished product will be smooth and effortless to understand. It is through your labors that clear writing will emerge. You know you have succeeded when your thoughts are so clear that the reader does not notice your choice of words or the structure of your sentences.

Keep these suggestions in mind. They are useful guidelines. You will need your voice and your style to make your story sing in the most compelling way. As an example, I offer an old (if somewhat extreme) English tax court decision. In the early days of common law, courts included the parties' positions in publications.

> Defendant: "With God as my judge, I do not owe this tax."
> Court: "He's not. I am. You do".

Strive to write well and be concise. It will serve everyone's interest. Be both good and short.

[47] See Dernbach, supra note 43, at 200 ("Minor errors distract the reader from the message to be conveyed. Major errors may distort the message or make it unintelligible.").
[48] See Strunk & White, supra note 2, at 72-73.
[49] See id.; Neumann, supra note 5, at 61-63.

James D. Yellen is the President of Yellen Mediation Services and past Executive Director in the Law Division of Morgan Stanley. He is also an Adjunct Professor of Law at Fordham Law School, where he teaches Legal Writing and Research as part of the first year curriculum. He is co-chair of the Securities Law and Arbitration Committee of the New York State Bar Association. He is an N.A.S.D., N.Y.S.E., and NFA Arbitrator and is on the Board of Editors of the Securities Arbitration Commentator. The author acknowledges with thanks the assistance of Lauren Paylor, a third year law student at Fordham Law School, for her help with this article.

Financial Industry Regulatory Authority

THE FINANCIAL INDUSTRY REGULATORY AUTHORITY'S DISPUTE RESOLUTION ACTIVITIES

Revised February 21, 2017

I. BACKGROUND

The Financial Industry Regulatory Authority (FINRA) administers a dispute resolution forum for investors, brokerage firms, and their registered employees in the U.S. through its network of 71 hearing locations, including at least one in each state and Puerto Rico. FINRA annually administers between 4,000 and 8,500 arbitrations and numerous mediations. FINRA maintains a diverse roster of over 7,100 arbitrators and 200 mediators. The National Arbitration and Mediation Committee (NAMC), which is composed of investor, industry, and neutral (arbitrator and mediator) representatives, provides policy guidance to FINRA's Dispute Resolution staff. A majority of the NAMC members and its chair are public. FINRA is regulated by the United States Securities and Exchange Commission (SEC).

FINRA's Dispute Resolution program is administered out of four regional offices: Northeast, Southeast, Midwest, and West, located in New York City, Boca Raton, Chicago, and Los Angeles, respectively, with headquarters in New York City. Contact information for the regional offices, as well as for other FINRA staff, is available on FINRA's website at www.finra.org. Below is a map showing the hearing locations and the regional offices to which they are assigned:

To accommodate changing and diverse cases, FINRA continually adjusts its procedures. Below are highlights on: Statistics and Trends; FINRA Dispute Resolution Task Force; Recent Significant Rule Change; Proposed Rule Changes; Regulatory Notice on Forum Selection; Significant Initiatives; FINRA Neutrals; Office of Dispute Resolution Technology Initiatives; FINRA Investor Education Foundation; and Mediation.

II. STATISTICS AND TRENDS

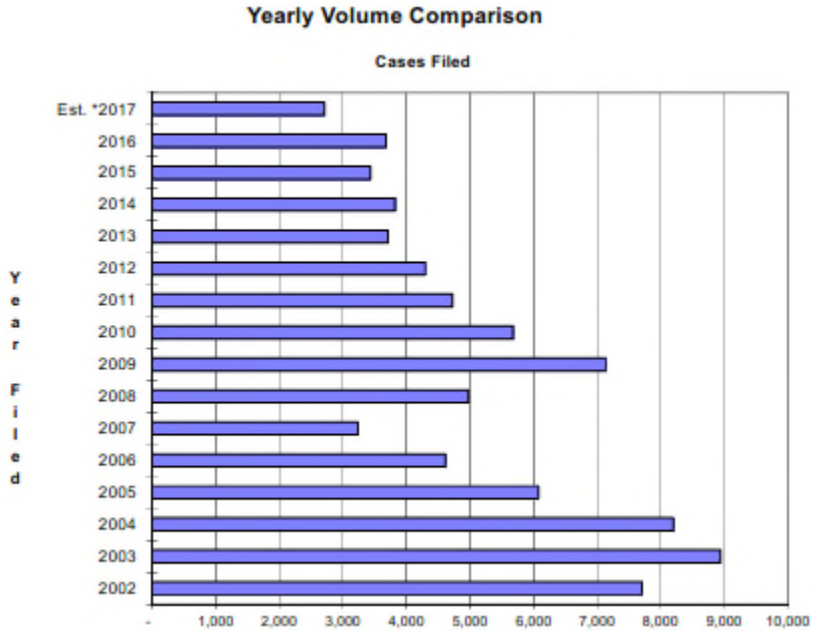
Arbitration case filings decreased in January 2017 compared to January 2016. In January 2017, parties filed 226 cases – a 14% decrease from the 264 cases filed in January 2016. Customer claims decreased by 15% compared to January 2016. In January 2017, 35% of filed claims were intra-industry cases.

Mediation cases decreased in January 2017 versus January 2016. In January 2017, parties filed 45 mediation cases – a 42% decrease compared to the 77 mediation cases filed in January 2016.

Case Filing Statistics for 2017 - This section provides key filing data and trends.

- Overall arbitration case filings

  Through January 2017: 226 (14% decrease compared to 2016)



- Mediation case filings

  Through January 2017: 45 (42% decrease compared to the same time in 2016)

Customer Award Statistics

- Cases in which customers are awarded damages

- Through January 2017:
  - Overall: 42% (41% in 2016, 42% in 2015, and 38% in 2014).
  - Hearing cases (not including cases decided by review of documents only): 53% (42% in 2016, 45% in 2015, and 42% in 2014.)
- Through January 2017, approximately 83% of customer claimant cases resulted, through settlements or awards, in monetary or non-monetary recovery for the investor.

Case Processing Statistics

- Processing times from service of the claim to close of the case
  - January 2017:
    - Overall: 14.5 months (1% increase compared to January 2016)
    - Hearing cases: 13.7 months (4% decrease compared to January 2016)
    - Simplified cases (decided on the documents submitted without a hearing): 7.3 months (3% decrease compared to January 2016)
- Percentage of cases closed by award
  - January 2017: 20% (compared to 21% in 2016, 24% in 2015 and 23% in 2014).

Statistic Enhancements

In December 2015, we made multiple enhancements to our monthly statistics. Our charts now display case filing volume for the 15 most popular controversy and security types over a five-year period. The information is further separated by customer cases and intra-industry case filings. We also added a new interactive map that displays the number of pending cases and the number of arbitrators by type in each hearing location.

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

Type of Controversy*		2017 Cases Served	2016	2015	2014	2013
Breach of Fiduciary Duty	Through January	181	142	120	144	160
	Year-End	--	2,002	1,807	2,064	1,802
Negligence	Through January	173	115	111	148	153
	Year-End	--	1,862	1,667	1,977	1,714
Failure to Supervise	Through January	168	119	104	141	132
	Year-End	--	1,802	1,554	1,733	1,476
Suitability	Through January	155	110	86	101	112
	Year-End	--	1,606	1,364	1,401	1,243
Misrepresentation	Through January	151	108	99	122	134
	Year-End	--	1,670	1,499	1,593	1,507
Breach of Contract	Through January	138	109	99	127	117
	Year-End	--	1,495	1,444	1,755	1,390
Fraud**	Through January	134	73	45	--	--
	Year-End	--	1,301	1,069	41	--
Omission of Facts	Through January	133	75	78	93	102
	Year-End	--	1,394	1,216	1,384	1,242
Violation of Blue Sky Laws**	Through January	50	21	7	--	--
	Year-End	--	344	236	--	--
Unauthorized Trading	Through January	28	29	12	23	35
	Year-End	--	362	264	239	255
Manipulation	Through January	27	19	11	7	11
	Year-End	--	236	208	173	161
Churning	Through January	27	18	21	13	21
	Year-End	--	254	247	213	236
Margin Calls	Through January	6	7	7	8	6
	Year-End	--	84	97	83	55
Errors-charges	Through January	4	4	4	3	7
	Year-End	--	56	64	71	75
Transfer	Through January	3	1	5	3	1
	Year-End	--	35	45	56	59

**Each case can be coded to contain multiple controversy types. Therefore, the columns in this table cannot be totaled to determine the number of cases served in a year.*
***These categories were not tracked in years which no data appear.*

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

Type of Security *		2017 Cases Served	2016	2015	2014	2013
Common Stock	Through January	55	57	39	44	63
	Year-End	--	646	610	572	547
Mutual Funds	Through January	38	16	17	23	31
	Year-End	--	352	373	369	296
Municipal Bonds	Through January	31	37	23	18	8
	Year-End	--	433	569	553	67
Real Estate Investment Trust	Through January	27	10	15	19	20
	Year-End	--	184	191	232	299
Municipal Bond Funds	Through January	25	37	22	25	1
	Year-End	--	480	607	684	66
Limited Partnerships	Through January	20	11	8	7	9
	Year-End	--	199	79	82	84
Variable Annuities	Through January	19	7	2	5	12
	Year-End	--	115	104	116	160
Government Securities	Through January	16	1	1	1	1
	Year-End	--	96	169	31	25
Annuities	Through January	15	8	9	14	12
	Year-End	--	127	81	105	111
Private Equities	Through January	14	9	5	11	7
	Year-End	--	114	92	77	108
Options	Through January	13	8	17	12	11
	Year-End	--	124	128	143	109
Exchange-Traded Funds	Through January	11	10	12	7	17
	Year-End	--	133	127	120	99
Corporate Bonds	Through January	11	6	7	5	12
	Year-End	--	154	194	66	86
401(k)	Through January	8	0	--	--	--
	Year-End	--	27	--	--	--
Unit Investment Trust	Through January	4	3	0	1	1
	Year-End	--	41	13	26	11

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

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

Type of Controversy*		2017 Cases Served	2016	2015	2014	2013
Breach of Contract	Through January	49	35	24	28	33
	Year-End	--	386	373	347	465
Promissory Notes	Through January	40	28	29	39	43
	Year-End	--	401	401	476	632
Compensation	Through January	24	12	8	14	11
	Year-End	--	163	140	146	155
Commissions	Through January	18	3	5	8	5
	Year-End	--	60	73	77	85
Wrongful Termination	Through January	17	10	4	8	12
	Year-End	--	127	123	79	117
Libel or Slander on Form U-5	Through January	15	10	8	9	14
	Year-End	--	124	119	110	99
Libel/Slander/Defamation	Through January	14	12	5	7	6
	Year-End	--	124	115	99	101
Clearing Disputes	Through January	8	0	0	0	1
	Year-End	--	43	6	4	1
Discrimination or Harassment**	Through January	7	8	1	6	1
	Year-End	--	56	54	43	53
Breach of Fiduciary Duty	Through January	3	1	1	6	7
	Year-End	--	18	29	52	78
Manipulation	Through January	2	0	0	0	0
	Year-End	--	4	1	5	1
Indemnification	Through January	2	1	0	1	0
	Year-End	--	14	12	16	17
Raiding Disputes	Through January	2	3	2	2	3
	Year-End	--	42	40	39	21
Partnerships	Through January	1	1	0	1	1
	Year-End	--	11	12	5	6
Misrepresentation	Through January	1	1	1	3	4
	Year-End	--	21	17	33	24

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

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

Award Outcomes

In 2016, investors prevailed 43 percent of the time (63 out of 145) in cases decided by all-public panels and 36 percent of the time (26 out of 72 cases) in cases decided by majority-public panels. Through January 2017, investors prevailed 75% of the time (3 out of 4 cases) in cases decided by all-public panels and 50% of the time (1 out of 2 cases) in cases decided by majority-public panels. **Comparison of Results of All-Public Panels and Majority-Public Panels in Customer Claimant Cases**

Year Decided	Cases Decided by All-Public Panels	Number of Cases Decided by All-Public Panels Where Customer Awarded Damages	Percentage of Cases Decided by All-Public Panels Where Customer Awarded Damages	Cases Decided by Majority-Public Panels	Number of Cases Decided by Majority-Public Panels Where Customer Awarded Damages	Percentage of Cases Decided by Majority-Public Panels Where Customer Awarded Damages
2014	135	59	44%	104	39	38%
2015	163	77	47%	84	38	45%
2016	145	63	43%	72	26	36%
YTD 2017	4	3	75%	2	1	50%

III. FINRA DISPUTE RESOLUTION TASK FORCE

In 2014, FINRA formed the FINRA Dispute Resolution Task Force to suggest strategies to enhance the transparency, impartiality, and efficiency of FINRA's securities dispute resolution forum for all participants. The Task Force brought together a diverse group of leading investor advocates, academics, regulators, and industry representatives to help ensure that FINRA's arbitration and mediation processes continue to serve the needs of the investing public. Seven Task Force members serve on FINRA's arbitrator roster.

The Task Force established an email inbox, which was available throughout the process, to solicit comments from interested parties. It also directly solicited written comments from more than 30 interested organizations and individuals. Over a period of 14 months, the Task Force held four in-person meetings, and its ten subcommittees met 57 times. On December 16, 2015, the Task Force issued its final report and recommendations Final Report and Recommendations of the FINRA Dispute Resolution Task Force). The Task Force recommendations focus, among other matters, on arbitrator training and recruitment, and expanded use of explained decisions and mediation.

FINRA Dispute Resolution Task Force members:

- Barbara Black – Retired Professor and Director, Corporate Law Center, University of Cincinnati College of Law (Chair);
- Philip Aidikoff – Investor attorney, Aidikoff, Uhl & Bakhtiari;

- Joseph Borg – Director, Alabama Securities Commission;
- Philip Cottone – FINRA arbitrator and mediator;
- John Cullem – FINRA arbitrator;
- Sandra Grannum – Industry attorney, Davidson & Grannum;
- Mark Maddox – Investor attorney, Maddox Hargett & Caruso;
- Kevin Miller – General Counsel, Securities America;
- Joseph Peiffer – Investor attorney, Peiffer Rosca Wolf Abdullah Carr & Kane;
- Barbara Roper – Director of Investor Protection, Consumer Federation of America;
- Lisa Roth – President, Tessera Capital Partners (formerly Principal, Keystone Capital Corporation);
- Edward Turan – Managing Director, Citigroup Global Markets; and
- Harry Walters – Managing Director, Morgan Stanley Wealth Management.

On September 30, 2016, FINRA published a status report detailing the progress on the FINRA Dispute Resolution Task Force recommendations. As of October 19, 2016, FINRA ODR staff had discussed all of the recommendations with the NAMC. FINRA has taken action on 35 of the 51 recommendations; 16 are pending.

Many of the recommendations, particularly those involving forum transparency, arbitrator recruitment and training, and case administration processes did not require rulemaking and were implemented in 2016. Among those, FINRA received 945 arbitrator applications in 2016, far exceeding its goal to recruit 750 new arbitrators. FINRA's latest arbitrator demographic survey, which was conducted by an external consulting firm, showed particular progress in adding women and African-Americans to the roster. In 2016, 33 percent of the arbitrators added were women (compared to 26 percent in 2015) and 14 percent were African-American (compared to 4 percent in 2015).

FINRA commenced the rulemaking process on six of the recommendations. Of those, the SEC has already approved two proposals related to the number of public arbitrators on lists and motions to dismiss; there are four proposals in various stages in the rulemaking process, including a proposal addressing the task force recommendation to develop an intermediate form of adjudication for small claims.

FINRA staff will continue working on recommendations related to new staff procedures, technology enhancements and rulemaking, and provide periodic updates on its progress going forward.

IV. RECENT SIGNIFICANT RULE CHANGE

Rule Change Regarding Award Offsets

On August 11, 2016 the SEC approved SR-FINRA-2016-015, which amends the Customer and Industry Codes of Arbitration Procedure to provide that when arbitrators order opposing parties to make payments to one another, the monetary awards shall offset and the party assessed the larger amount shall pay the net difference. The amendments streamline the payment of arbitration awards, and mitigate the risk of failure to pay by an opposing party that may arise when multiple parties in a dispute are found to owe non-equivalent awards simultaneously.

See Securities Exchange Act Release No. 34-78557, published in the *Federal Register* on August 17, 2016 (Vol. 81, No. 159, p. 54901).

Rule Change for Panel Selection in Cases with Three Arbitrators

On September 14, 2016, the SEC approved amendments to FINRA Rule 12403 of the Code of Arbitration Procedure for Customer Disputes to increase the number of arbitrators on the public arbitrator list that FINRA sends to parties during the arbitration panel selection process, from ten to fifteen. The amendments also increase the number of strikes to the public arbitrator list from four to six, so that the proportion of strikes is the same under the amended rule as it is under the current rule. FINRA believes that this rule change will provide greater choice of public arbitrators during the panel selection process, and minimize the burden of vetting additional public arbitrators later in the process.

The amendments are effective for all arbitrator lists FINRA sends to parties on or after January 3, 2017 for panel selection in customer cases with three arbitrators.

See Securities Exchange Act Release No. 34-78836, published in the *Federal Register* on September 20, 106 (Vol. 81, No. 182, p. 64564).

Rule Change on Motions to Dismiss

On November 10, 2016, the SEC approved amendments to Rules 12504 and Rule 13504 of the Customer and Industry Codes of Arbitration Procedure to provide that arbitrators may act upon a motion to dismiss a party or claim prior to the conclusion of a party's case in chief if the arbitrators determine that the non-moving party previously brought a claim regarding the same dispute against the same party, and the dispute was fully and finally adjudicated on the merits and memorialized in an order, judgment, award, or decision.

The rule change, effective January 23, 2017, allows arbitrators to grant a motion to dismiss relating to a particular controversy if they believe the matter was adjudicated fully, even in instances where a claimant adds a new cause of action, or adds additional facts. FINRA believes this will enhance efficiency for forum participants because arbitrators will be permitted to dismiss previously adjudicated cases at an earlier point in an arbitration proceeding.

See Securities Exchange Act Release No. 34-79285, published in the *Federal Register* on November 17, 2016, (Vol.81, No. 222, p. 81213).

Rule Change to Mandatory Use of the Party Portal

On November 14, 2016, the SEC approved amendments to the Customer and Industry Code of Arbitration Procedure to require all parties, except customers who are not represented by an attorney or other person, to use the FINRA Office of Dispute Resolution's Party Portal to file initial statements of claim and to file and serve pleadings and other documents on FINRA or any other party. FINRA is also amending the Code of Mediation Procedure to permit mediation parties to agree to use the Party Portal to submit and retrieve all documents and other communications.

The amendments are effective for all cases filed on or after April 3, 2017.

See Securities and Exchange Act Release No. 34-79296, published in the *Federal Register* on November 18, 2016 (Vol. 81, No. 223. p. 81844).

Rule Change on Broadening Chair Eligibility

On December 2, 2016, the SEC approved amendments to FINRA Rules 12400 and 13400 of the Customer and Industry Codes of Arbitration Procedure to provide that an attorney arbitrator is eligible for the chairperson roster if he or she has completed chairperson training provided by FINRA and served as an arbitrator through award on at least one arbitration, instead of two, administered by a self-regulatory organization in which hearings were held. The amendments apply to all chairperson applicants.

This rule change, effective January 9, 2017, is expected to provide a greater selection of local chairpersons for forum users, thereby potentially reducing the number of instances in which chairpersons must travel for hearings.

See Securities Exchange Act Release No. 34-79455, published in the *Federal Register* on December 8, 2016 (Vol. 81, No. 236, p.88720).

V. PROPOSED RULE CHANGES

Proposed Rule Change to Codify the Expanded Expungement Guidance

The Board authorized FINRA to file with the SEC proposed amendments to Rules 12805 and 13805 (Expungement of Customer Dispute Information under Rule 2080) of the Codes of Arbitration Procedure in September 2015. The proposed amendments would codify the best practices from the Expanded Expungement Guidance that was issued as a notice to parties and arbitrators in 2013, and last updated in December 2014. The guidance provides arbitrators with best practices and recommendations to follow, in addition to the existing expungement framework, when deciding expungement requests.

VI. REGULATORY NOTICE ON FORUM SELECTION PROVISIONS INVOLVING CUSTOMERS, ASSOCIATED PERSONS AND MEMBER FIRMS

In July 2016, FINRA published *Regulatory Notice 16-25* to remind member firms that customers have a right to request arbitration at FINRA's arbitration forum at any time and do not forfeit that right under FINRA rules by signing any agreement with a forum selection provision specifying another dispute resolution process or an arbitration venue other than the FINRA arbitration forum. In addition, FINRA reminded member firms that FINRA rules do not permit member firms to require associated persons to waive their right to arbitration under FINRA's rules in a pre-dispute agreement.

VII. SIGNIFICANT INITIATIVES

Expanded Expungement Guidance for Arbitrators and Parties

Notice to Arbitrators and Parties: In October 2013, the forum sent to all arbitrators a notice and published on its website guidance for parties and arbitrators concerning expungement requests. The guidance emphasizes the extraordinary nature of expungement relief and advises arbitrators to consider the importance of the Central Registration Depository (CRD) information to regulators, firms, and investors (through BrokerCheck) when considering requests for expungement. The guidance encourages arbitrators to request any documentary or other evidence they believe is relevant to the expungement request, particularly in cases that settle before an evidentiary hearing or in cases where only the requesting party participates in the expungement hearing. It also suggests that arbitrators ask the broker requesting expungement to provide a current copy of his or her BrokerCheck report when determining the appropriateness of expungement. The guidance further recommends that arbitrators identify in the award the specific documentary evidence that they relied upon when recommending expungement.

On July 22, 2014, the SEC approved FINRA Rule 2081, which prohibits conditioned settlements, and it became effective on July 30, 2014. In August 2014, the forum sent to all arbitrators a notice and published on its website updated guidance wherein we addressed settlement payments and prohibited conditions relating to expungement of customer dispute information. The updated guidance reminds arbitrators to consider whether the party seeking expungement contributed to the settlement. Further, the updated guidance provides that if arbitrators learn of prohibited conditions, as described in Rule 2081, they should consult FINRA's procedures on disciplinary referrals.

In September 2014, we e-mailed to arbitrators a notice and published on our website updated guidance wherein we addressed the importance of allowing customers and their counsel to participate in the expungement hearing in settled cases. This section of the updated guidance reminds arbitrators to allow the customer, among other things, to introduce documents and evidence at the expungement hearing, cross-examine the broker and other witnesses called by the party seeking expungement, and to present opening and closing arguments if the panel allows any party to present such arguments.

In December 2014, we published on our website updated guidance about cases in which an associated person will file an arbitration claim against a member firm solely for the purpose of seeking expungement, without naming the customer in the underlying dispute as a respondent. This section of the updated guidance reminds arbitrators to order the associated persons to provide a copy of their Statement of Claim to the customer in the underlying arbitration to ensure that the customer is aware that an expungement claim is pending regarding his or her prior dispute. This will also give the customer an opportunity to advise the arbitrators and parties (in writing or through participation in the expungement hearing) of their position on the expungement request, which may assist arbitrators in making the appropriate finding under Rule 2080.

Neutral Workshop: In February 2015, FINRA filmed a neutral workshop addressing expungement, among other matters. In May 2014, FINRA conducted a neutral workshop that provided expanded expungement guidance and an overview of the proposed new rule to address expungement of customer dispute information. In December 2013, FINRA conducted a neutral workshop that provided an overview of CRD and BrokerCheck, stressing the important role arbitrators play in safeguarding the integrity of the information in

CRD in the expungement process. The recorded workshop can be found on the Neutral Workshop page under our website, along with other recorded neutral workshops, providing an additional resource for information to neutrals. FINRA pre-records the workshops to allow neutrals to pause and playback the audio file.

The Neutral Corner: The December 2013 edition (Volume 4, 2013) of the arbitrator newsletter, *The Neutral Corner*, was devoted to the topic of expungement. The issue included an article emphasizing the procedural requirements in recommending expungement and another article discussing the limitations on the types of disclosures that may be expunged from CRD through arbitration. The September 2014 edition (Volume 3, 2014) included articles about the revised Award Information Sheet, the new Rule 2081 to address prohibited conditions relating to expungement of customer dispute information, and expanded expungement guidance for arbitrators to allow customers and their counsel to participate in the expungement hearing. The October 2015 edition (Volume 3, 2015) included information on recent court decisions on expungement. The December 2015 edition (Volume 4, 2015) included information on parties making second expungement requests after a previous denial.

We also developed enhanced online training for arbitrators that expanded on and emphasized the points addressed in our expungement guidance.

Online Arbitration Claim Filing Guide: FINRA revised the Online Arbitration Claim Filing Guide to include new information that asks claimants filing expungement claims to provide the occurrence number for the underlying disclosure and other registration information.

Award Information Sheet: To assist arbitrators with the updated expungement guidance, FINRA revised the Award Information Sheet.

We believe the above initiatives will help arbitrators safeguard the integrity of the information in CRD.

Renewed Emphasis on Arbitrator Disclosure

FINRA continually stresses to arbitrators the need to make complete and accurate disclosures. Below are recent measures we have taken to emphasize the importance of disclosing all information that may be relevant:

Further Enhancements to Disclosure Language: In February 2014, FINRA added the following language to: the arbitrator application and arbitrator training; the portal for neutrals and related user guides; and the FINRA Website:

> You must disclose any circumstance or event that might affect your ability to serve impartially or might create an appearance of bias. This includes, but is not limited to, lawsuits (even non-investment related lawsuits); any publications (even if they appear only online); professional memberships; service on boards of directors; etc. When in doubt disclose. Failure to disclose may result in vacated awards which undermine the efficiency and finality of our process. Failure to disclose may also result in removal from the roster.

Oversight of Arbitrators and Mediators: In 2013, FINRA implemented new procedures whereby staff conducts Internet searches of neutrals prior to appointment to a case. If staff finds information during an Internet search that the neutral should have disclosed but did not, staff contacts the neutral, confirms the validity of the information, and requests the neutral's permission to disclose the information on the neutral's Disclosure Report. If an arbitrator does not authorize disclosure of the information, FINRA may seek the arbitrator's recusal from the case or removal from the roster. During 2013 – 2014, FINRA also worked with a third-party vendor to complete an extensive review of the entire neutral roster which included criminal background checks and verification of professional licenses, among other criteria. The project was an additional means of identifying unknown disclosure issues.

In September 2015, FINRA hired additional temporary staff to verify the accuracy of arbitrator disclosure by conducting Internet searches of the entire arbitrator roster. To date, we have reviewed more than 920 arbitrators.

In October 2015, FINRA started conducting reviews of arbitrators with CRD records through its Enterprise Alert system. By leveraging FINRA's regulatory and disclosure functions, ODR is able to timely identify arbitrators with disclosure events on their CRD records.

Neutral Workshop: In July 2014, FINRA conducted a neutral workshop that emphasized the arbitrator's continuous and imperative duty to disclose. In November 2015, FINRA filmed a neutral workshop focusing on practical tips for arbitrators, including: how to make disclosures, how to use the Neutral Portal, and how to conduct a successful hearing. In April 2016, we filmed a neutral workshop featuring arbitrators who provided tips on case management and using the portal including conducting conflict checks and making disclosures through the portal. The recorded workshops can be found on the Neutral Workshop page of our website, providing an additional resource for information to neutrals. FINRA pre-records the workshops to allow neutrals to pause and playback the audio or video file.

The Neutral Corner: In 2014, two editions (Volumes 1 and 3, 2014) of the arbitrator newsletter, *The Neutral Corner,* included articles about FINRA's expanded background verification and Internet search procedures. FINRA continues to publish regular notices and articles about disclosure in *The Neutral Corner*.

Notice to Arbitrators: In May 2013, FINRA sent a broadcast e-mail to all arbitrators reminding them to disclose all professional affiliations and legal representations. In 2015, FINRA started sending a quarterly disclosure reminder email to all arbitrators. We sent our last disclosure reminder email on August 23, 2016 and continue to remind arbitrators of their disclosure obligations in each issue of *The Neutral Corner.*

FINRA Website: FINRA added a page to the Dispute Resolution portion of the corporate website that explains what arbitrators must disclose, with links and guidance to help arbitrators make proper disclosures.

Disclosure Checklist: FINRA revised the Arbitrator Disclosure Checklist to elicit more effectively disclosures from arbitrators. Among other items, the Checklist adds new questions to seek information about memberships with professional organizations, publications, and non-investment related lawsuits. FINRA also reformatted the Checklist as a fillable PDF format that can be submitted through e-mail or through the portal for neutrals.

This new format will make it easier for arbitrators to complete the form and provide thorough answers.

We believe these initiatives to increase arbitrators' awareness of the importance of making timely and complete disclosures will help to maintain the integrity of the forum and to ensure the finality of awards.

Updated Arbitrator Reimbursement Guidelines

FINRA recently updated its reimbursement guidelines to decrease the mileage reimbursement rate to 53.5 cents per mile (per IRS Regulation). FINRA has also expanded the number of arbitrators who will get reimbursement for transportation and lodging under our reimbursement guidelines. Arbitrators who live or work more than 75 miles (decreased from 120 miles) away from their primary hearing location are now eligible. We have also increased the daily meal allowance for arbitrators who travel at FINRA's expense to a hearing to $75 per day (up from $55 per day).

The updated reimbursement guidelines can be found at www.finra.org.

Short List Option to Reduce Extended List Appointments

Forum constituents want to select their own neutrals from the roster and thus have complained about the appointment of "extended list" arbitrators. Extended list arbitrators are not selected by the parties and may only be challenged for cause. (FINRA has virtually eliminated the appointment of extended list arbitrators in the initial appointment process.) FINRA has increased parties' options to reduce the likelihood of extended list appointments when an arbitrator withdraws or is no longer available, no ranked arbitrators remain on the parties' initial ranking lists, and hearing dates are scheduled in a case. Under the "short list option," parties may stipulate to use a list of three arbitrators to select a replacement arbitrator. All parties must agree to use the short list option. Each side may strike one arbitrator's name from the list and may rank all remaining arbitrators' names in order of preference within a prescribed number of days.

If a hearing is scheduled within five calendar days of an arbitrator's withdrawal, removal, or unavailability, parties need to postpone the hearing to use the short list option. The postponement allows FINRA staff time to prescreen arbitrators for conflicts and to ensure they are available for scheduled hearing dates and to provide parties with time to review the list and strike and rank arbitrators. A postponement fee is charged in accordance with current FINRA rules. An additional fee is assessed for postponements granted within three business days of the hearing date, also in accordance with current FINRA rules. Arbitrators may allocate the fees among the parties that agreed to the postponement. Arbitrators may also waive the fees.

FINRA began to highlight the parties' ability to use this option in February 2012. As of December 2016, 64% of qualifying cases have used the short list option to select a replacement arbitrator.

Voluntary Program for Large Cases

On July 2, 2012, FINRA implemented a voluntary program in all regional offices for large cases (i.e., cases with damages claims of at least $10 million exclusive of interest, costs, and attorneys' fees). FINRA Office of Dispute Resolution processes many cases that involve very substantial amounts in dispute. Currently, FINRA is administering approximately 200 cases that seek damages of at least $10 million. While the rules give the parties flexibility to agree on an ad hoc basis to vary from the procedures in the Arbitration Codes, the large case program was introduced to provide a more formal approach to these cases.

Upon receiving written party agreement to use the program, the Regional Director and an experienced, specially trained case administrator will conduct an early administrative conference with counsel to develop a plan for the administration of the case. Areas to be discussed will include: arbitrator qualifications and the procedures for appointing arbitrators; the use of depositions and interrogatories; the form of the hearing record; and different hearing facilities (costs would be paid by the parties). Parties can use arbitrators from outside of FINRA's roster or provide FINRA with criteria/qualifications to screen arbitrators on FINRA's roster. Parties may pay additional compensation to arbitrators above the standard FINRA honorarium. There is also a non-refundable administrative fee of $1,000 for each separately represented party to use the program. As of August 30, 2016, nine cases have opted into the program, five of which have been decided by award. The Northeast Regional Office has administered five of the cases that have been filed to date, the West Regional Office has administered three cases, and the Southeast Regional Office has administered one case. The large case program is available to eligible cases in each of our regional offices.

The program is targeted at cases involving damages claims of at least $10 million. However, any case can participate in the program where all parties agree and are represented by counsel.

A list of frequently asked questions and the news release for the voluntary program for large cases are available on our website.

VIII. FINRA NEUTRALS

Renewed Emphasis on Arbitrator Recruitment

A primary goal of FINRA's arbitrator recruitment program is to identify and train a qualified pool of potential arbitrators from which parties can choose to hear their disputes. The strategic goal has been to continue to shift the balance of the arbitrator pool to include more public arbitrators and a more diverse roster nationwide. FINRA has implemented an aggressive recruitment campaign to seek individuals from diverse backgrounds from across different industries to serve as arbitrators. Ongoing recruitment initiatives thus far have included more than 100 women and minority organizations nationwide to source and recruit all types of people through on-site events, targeted recruiting advertisement and direct marketing campaigns.

To help maximize our resources and opportunities further, we leveraged our staff talent in the regions to assist with recruitment efforts, particularly in reaching women-focused groups, LGBT communities and other untapped diverse organizations. We also hired an additional

full-time national recruiter in 2015. FINRA's latest arbitrator demographic survey, which was conducted by an external consulting firm, showed that we had particular success in adding women and African-Americans to the roster. In 2016, 33 percent of the arbitrators added were women and 14 percent were African-American.

Finally, to become more flexible in how we communicate our message, we have begun using social media to recruit arbitrators, and released our first formal recruitment video on several social media platforms in December 2016: https://vimeo.com/188349814.

Arbitrator Application and Approval

Individuals interested in becoming an arbitrator can apply to our roster using the online arbitrator application available in the "Become an Arbitrator" section of our website. Applicants can complete the arbitrator application and submit it electronically along with a completed Consent to Background Search and Investigation Form and Social Security Number Verification Form. FINRA conducts a preliminary review of a completed application before forwarding it to a subcommittee of the NAMC for final approval. FINRA processes applications and notifies applicants within 120 days from the date of receipt.

In 2016, we received 945 arbitrator applications, and the average time for application process completion was 69 days. The number of public arbitrators on our roster increased by 19% between 2015 and 2016; as of February 2017, there are 3251 public arbitrators on our roster.

Arbitrator Training

Arbitrator applicants must complete the Required Basic Arbitrator Training program: 1) online basic training; 2) online expungement training; and 3) classroom training. After successfully completing the online basic and expungement courses, candidates must attend the classroom training at one of our regional offices or by live video. FINRA offers live video training in an interactive WebEx format to allow candidates to participate remotely. In 2016, the average time it took arbitrators to complete this training was 85 days.

To be considered for the chairperson roster, arbitrators must complete FINRA's online chairperson training and satisfy the case service requirement. FINRA staff has discretion to select arbitrators to serve on the chairperson roster from among those arbitrators who have completed the online chairperson training and: 1) have a law degree, are a member of a bar of at least one jurisdiction, and served as an arbitrator through award in at least one arbitration administered by an SRO; or 2) if not an attorney, served as an arbitrator through award in at least three arbitrations administered by an SRO (Customer Code Rule 12400(c) and Industry Code Rule 13400(c)).

In addition to the required trainings, FINRA offers advanced, subject-specific courses.

IX. OFFICE OF DISPUTE RESOLUTION TECHNOLOGY INITIATIVES

Online Portals

Portal for Parties. In November 2016, the SEC approved a rule change to make use of the Portal mandatory for all parties, excluding pro se investors. This rule change applies to all cases filed on or after April 3, 2016.Parties using the Portal can sign in to a secure website and perform many functions online, including:

- filing a claim;
- receiving service of a claim;
- submitting an answer to a received claim;
- submitting additional case documents;
- viewing the status of a case;
- viewing case documents;
- striking and ranking arbitrators online;
- viewing and downloading disclosure reports of prospective arbitrators;
- scheduling hearing dates online; and
- paying invoiced fees.

To date, we have processed over 7300 portal cases, with 78% of parties registering to use the Portal on a voluntary basis.

Portal for Neutrals. In October 2012, we successfully implemented an online Portal for neutrals. Arbitrators and mediators must register in the Portal to take advantage of the numerous functions it provides, such as:

- viewing and printing their disclosure reports;
- viewing and updating their personal profiles and disclosures;
- accessing information about their assigned cases, including upcoming hearings and payment information;
- viewing case documents;
- submitting documents;
- scheduling hearing dates; and
- viewing how often their names have appeared on arbitrator ranking lists sent to parties, and how often they are ranked or struck on those lists.

Paperless Office Initiative

All Regional Offices have digitized their respective paper-based arbitration files (including portal and non-portal cases). Any paper documents received will be converted to an electronic format, and all case documents will be stored in electronic arbitration and mediation case files. The initiative involves the use of an electronic mailbox for organizing and distributing staff assignments. FINRA has also started digitizing neutral files.

FINRA Office of Dispute Resolution Website

FINRA Office of Dispute Resolution's website, www.finra.org, provides various resources for parties and neutrals regarding FINRA's arbitration and mediation processes. Through the website users can obtain, among other things: an overview of arbitration and mediation; information on how to file a claim; forms that parties and arbitrators need in the arbitration process; arbitrator and mediator application and certification information; the Codes of Arbitration Procedure; and rule filing information. The website also contains a "What's New" section, where users can access case statistics and information on recent FINRA initiatives and announcements.

In December 2015, we made multiple enhancements to our monthly statistics. Our charts now display case filing volume for the 15 most popular controversy and security types over a five-year period. The information is further separated by customer cases and intra-industry case filings. We also added a new interactive map that displays the number of pending cases and the number of arbitrators by type in each hearing location.

Arbitration Awards Online

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

In addition, users can access all NYSE arbitration awards, as well as the awards of all arbitration programs absorbed over the years by FINRA (which include the American Stock Exchange, Chicago Board Options Exchange, International Stock Exchange, Philadelphia Stock Exchange, and Municipal Securities Rulemaking Board) and NYSE (which includes Pacific Exchange/NYSE ARCA).

The database provides users with instantaneous access to awards and the ability to search for awards by using multiple criteria, such as by case number, keywords within awards, arbitrator names, date ranges set by the user, and any combination of these features. FINRA now includes in customer awards information about the panel selection method and panel composition.

Videoconferencing

All four of FINRA's regional office locations now have videoconferencing capabilities. With the consent of all parties or with the permission of the arbitration panel, parties or witnesses may appear at hearings by videoconference for hearings held in one of the regional office locations. There is no additional cost to use the videoconferencing equipment at FINRA. Parties are encouraged to notify their case administrator at least 30 days prior to the hearing to request videoconferencing services. All videoconferencing requests are honored in the order they are received.

In addition, the following companies offer videoconferencing services compatible with FINRA's:

- Regus
  www.regus.com

1-800-633-4237

- Veritext
  www.veritext.com
  (contact phone numbers vary by region and are listed on the Veritext website).

Additional information on specific Regus and Veritext locations, costs, and reservations to use videoconferencing services are available by contacting these companies directly. All costs to use videoconferencing services outside of a FINRA regional office location are the responsibility of the party reserving the facilities.

X. FINRA INVESTOR EDUCATION FOUNDATION

The FINRA Investor Education Foundation (Foundation) undertakes and supports research and innovative educational projects that give underserved Americans the knowledge, skills, and tools necessary for financial success throughout life.

In 2004, the Foundation awarded a grant to the Northwestern University School of Law to establish the first securities arbitration clinic in the Midwest to provide legal representation for small investors with limited income. As part of the grant project, Northwestern developed the *Guidelines for Establishing a Law School Investor Advocacy Clinic* to provide practical advice and tools for other law schools interested in starting a clinic. The manual is available on the Foundation's website at www.finrafoundation.org.

The Foundation also funded the development of the Pace Law School *Investor's Guide to Securities Industry Disputes* through a 2006 grant. The *Guide* takes investors through the arbitration and mediation processes and seeks to assist investors representing themselves by providing a foundation in the basic rules and procedures in arbitration and mediation. The *Guide*, updated in 2013 through a second Foundation grant, is available on the Foundation's website.

Through three rounds of grant making in 2009, 2010 and 2012, the Foundation provided start-up funding and assistance to law schools located in high-need areas not served by existing clinics. These clinics joined a roster of clinics across the country that may be found on the FINRA website at www.finra.org/FindAnAttorney.

For more information about the Foundation and its programs, visit www.finrafoundation.org.

XI. MEDIATION

Mediation remains an important service that FINRA offers. Since the program's inception in 1995, FINRA's mediation staff has administered thousands of cases involving a wide variety of securities disputes with over 80 percent resulting in settlement between the parties.

Parties interested in mediation can fill out an online Request for Mediation Form on FINRA's website at www.finra.org. In order to solicit parties' use of mediation and raise awareness of

its mediation program, FINRA provides an annual “Settlement Month” program every October, which offers reduced mediation fees for smaller cases.

Mediation Program for Small Arbitration Claims

Since January 2013, FINRA has offered reduced fee and pro bono telephone mediation to parties in simplified cases. Under the program, mediators serve on a pro bono basis on cases alleging $25,000 or less in damages. We have also offered significantly reduced fee mediation at $50 per hour on cases alleging damages between $25,000.01 and $50,000. The program benefits forum users by: 1) increasing the number of cases that settle and giving parties more control over the results of their cases; 2) reducing travel and preparation costs; and 3) providing an alternative for senior, seriously ill, and physically challenged parties who may find traveling to and attending an in-person mediation especially difficult; and 4) offering parties in small cases an efficient and cost-effective option to meet their needs within our forum.

Separately, the program provides newer mediators with an opportunity to demonstrate their mediation skills. Staff has processed hundreds of arbitration requests to mediate through the Mediation Program for Small Arbitration Claims with parties settling over 80% of cases mediated. FINRA continues to communicate the opportunity for parties to mediate through this program to all eligible cases, and highlights the benefits of this affordable mediation option for small claims.

Discontinuation of Mediator Annual Membership Fee

The $200 Mediator Annual Membership Fee was has been discontinued in order to increase FINRA’s mediator roster and add diversity and visibility to an expanded pool of mediators. FINRA mediators who were unavailable to mediate due to non-payment of the annual fee may email mediate@finra.org should they wish to become available again.

FINRA DR Portal

User Guide for Arbitrators and Mediators

December 2016

Disclaimer

Table of Contents

Welcome to the FINRA DR Portal

Introduction

FINRA Dispute Resolution developed this user guide to help neutrals become familiar with the FINRA Dispute Resolution Portal (DR Portal). The DR Portal is a web-based system that allows neutrals to log into a secure section of our website for self-service access to update their profile and view assigned case information.

The DR Portal has two parts: the **DR Neutral Portal** is for FINRA neutrals (arbitrators and mediators) serving on the Dispute Resolution roster, and the **DR Party Portal** is for arbitration and mediation case participants. This user guide describes the DR Neutral Portal. A separate user guide is available that explains the use of the DR Party Portal for case participants.

If you happen to be both a FINRA neutral and a participant to a case, you can register the same User ID to access both sides of the DR Portal. Registered neutrals who are also case participants may access the party portal by clicking on the link "Go to Party Portal" found near the top of the homepage once you are logged in. Likewise, case participants may access the neutral side of the DR Portal by clicking on the link "Go to Neutral Portal" from the homepage.

Portal Access

Neutrals can access the DR portal from FINRA.org after completing the initial registration step. Neutrals can also create a "favorite" or "bookmark" in their browser for easy access to the DR Portal. We recommend that you create the bookmark **after** you successfully log into the portal. You should use the following URL as the bookmark for the portal: https://drportal.finra.org

Note: you can NOT use your FINRA Firm Gateway account to access the DR Portal. You must create a separate account using the self-registration procedures described below. You only need one account to access all of your cases; you do not need to create a new account for each case.

Compatible Browsers

The DR Portal is compatible with the following browser versions (or higher): Internet Explorer 11 (including Microsoft Edge), Firefox 22, Google Chrome 27, and Safari 6.

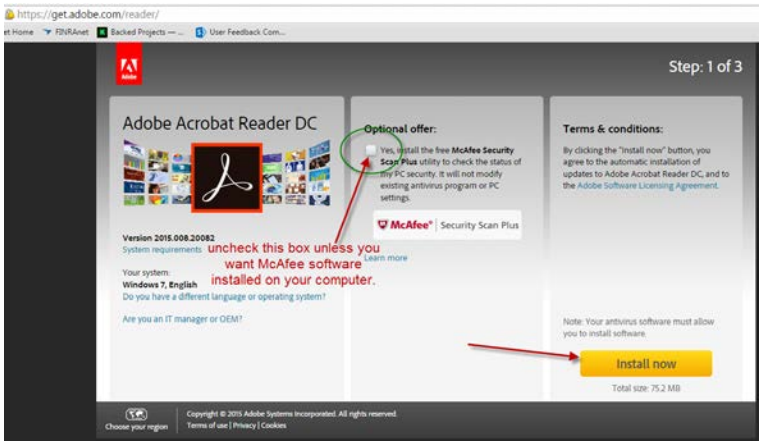
Pop-Up Blockers

Some features of the portal open extra tabs in your browser or pop-up windows. We suggest that you add *.finra.org to your browser's list of Trusted Sites and to your pop-up blocker's exception list. You may also disable your pop-up blockers.

Completing PDF Forms

A number of PDF forms, such as the Oath of Arbitrator and the Initial Prehearing Conference Scheduling Order can be found on the "Forms and Tools" page of the finra.org website at http://www.finra.org/arbitration-and-mediation/forms-tools. These are **Adobe Acrobat PDF** forms that contain blank fields for you to enter information. In order for these forms to work properly, you MUST use the free Adobe Acrobat Reader program on your computer. This is ESPECIALLY true for Apple Mac computers. Mac computers come with a program called "Preview" that allows you to view and edit PDF forms, but it does not let you save your work consistently and will cause you difficulties. You should download Adobe Acrobat Reader from https://get.adobe.com/reader/

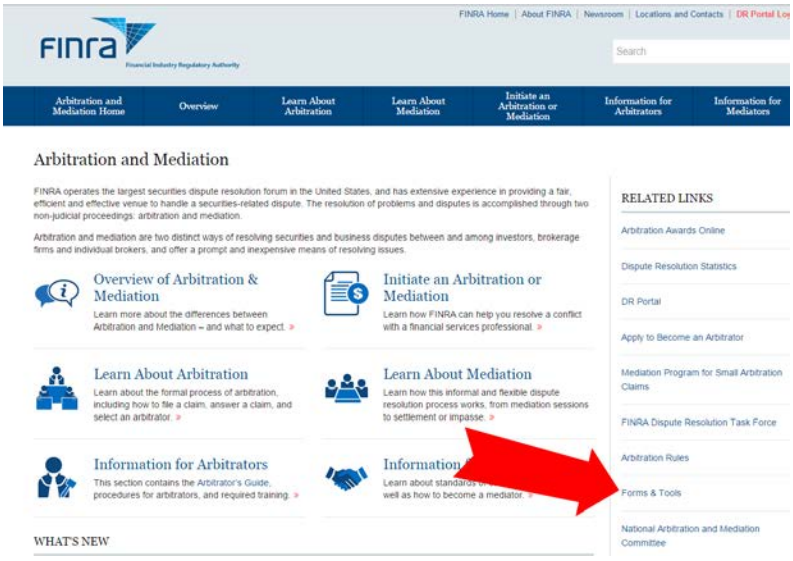
You should disable the optional offers if you do not want them, then click on "Install now" and follow the instructions.



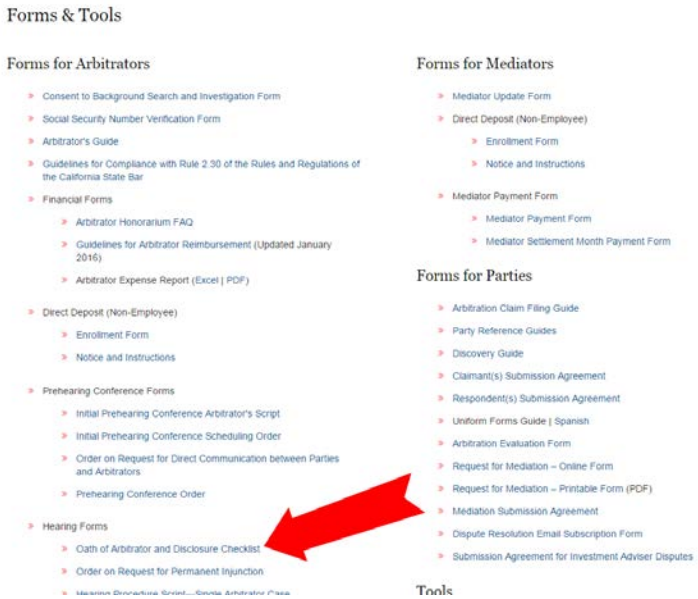
Once installed, you should make sure that your computer defaults to opening PDF documents using Acrobat Reader. Run Acobat Reader and it should ask you if you want it to be the default program for viewing PDF files. Select Yes. You can find more information about making Adobe Reader the default PDF viewing program here: https://helpx.adobe.com/acrobat/kb/cant-open-pdf.html

To complete a PDF form found on the finra.org website, perform the following steps:

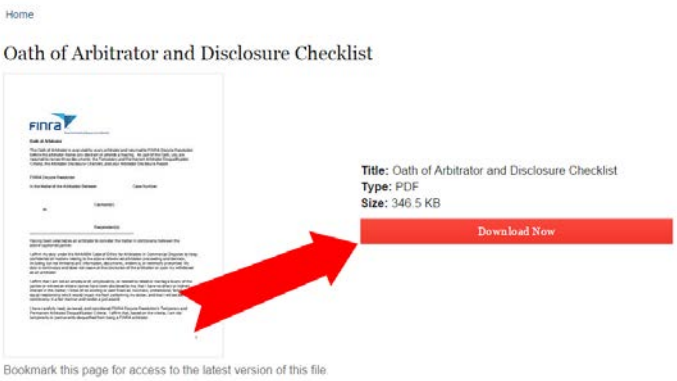
1. Go to the finra.org Arbitration and Mediation page http://www.finra.org/arbitration-and-mediation
2. Go to the Forms and Tools page.



3. Find the form you are looking for (e.g., the Oath of Arbitrator form).



4. Click on the form link, and then click on the red "Download Now" button.



5. Depending on your computer configuration, the form will likely open in your browser.

6. DO NOT begin typing in the form. Most browsers do not let you fill out PDF forms properly. Instead, click on the Save icon and save the blank PDF form on your computer. Remember where you saved the blank form on your computer.

7. Close your browser.
8. Open Adobe Acrobat Reader on your computer, and choose the File – Open menu option.
9. Find the saved PDF form on your computer, click on it, and click on the Open button.
10. Fill out the PDF form, entering all of the required information.
11. When you are finished, choose the File – Save menu option to save your changes. Then exit out of Adobe Acrobat.
12. Follow the steps under "Submitting Documents" on page 17 to submit this form through the DR Portal to Dispute Resolution.

Mobile Devices (coming soon)

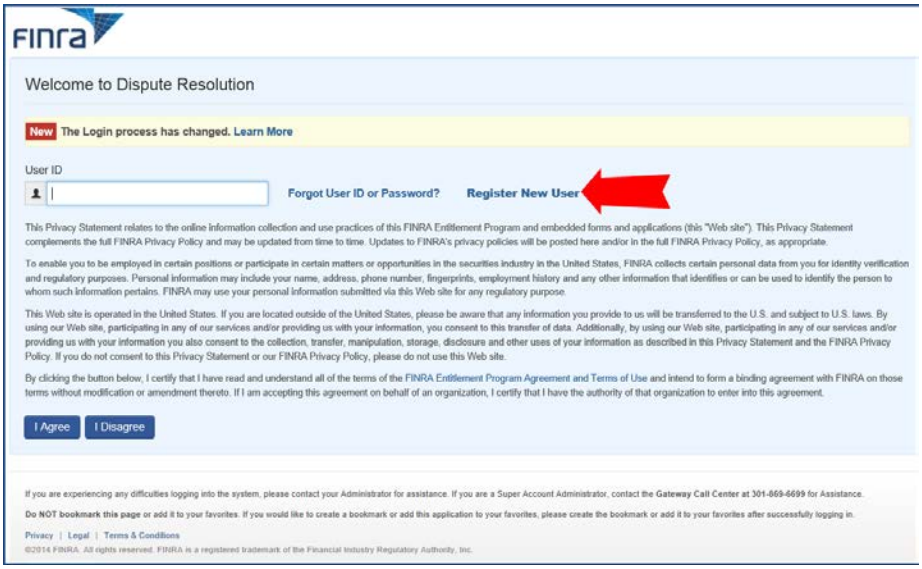
Neutrals will be able to access the DR Portal on a mobile device—such as a smartphone or tablet (e.g., iPhone, iPad)—using the same URL as you would on your computer: https://drportal.finra.org. Although you can view your case and profile information, you will **not** be able to update your profile using these devices. To update your profile, you will need to log into the portal using your desktop or laptop computer.

Registration Process

FINRA sent you an invitation containing a personalized link to register for the DR Portal. Please follow these steps to register:

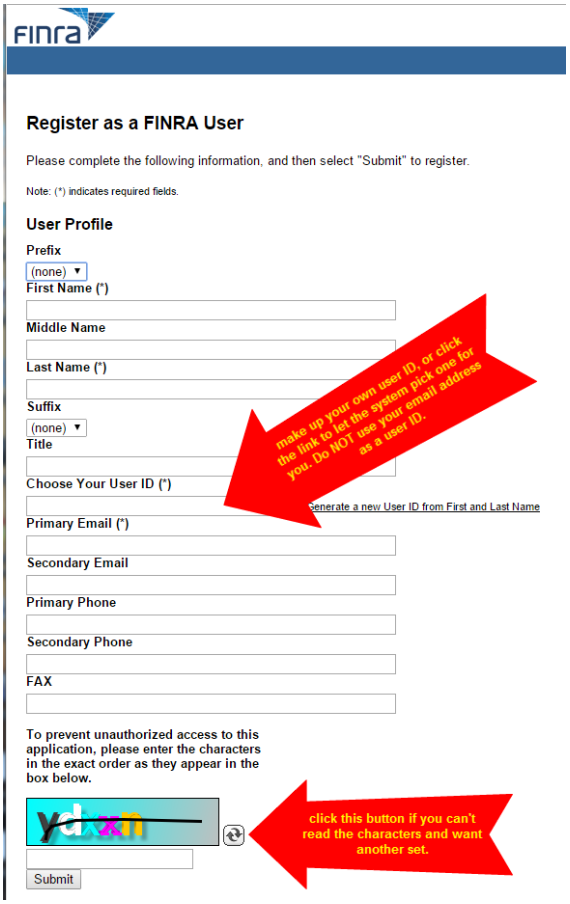
1. Click on the link in the email with the subject line **"Welcome to the FINRA Dispute Resolution Portal**." You will be brought to the "**Welcome to Dispute Resolution**" login page and have the option to log into or create your FINRA account.
   If you have already created an account, skip to step 7.

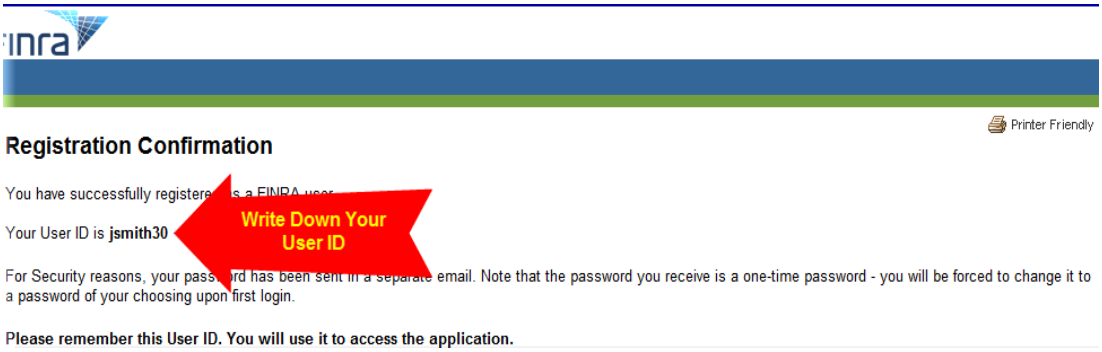
2. Click on **"Register New User"** to create a new account.



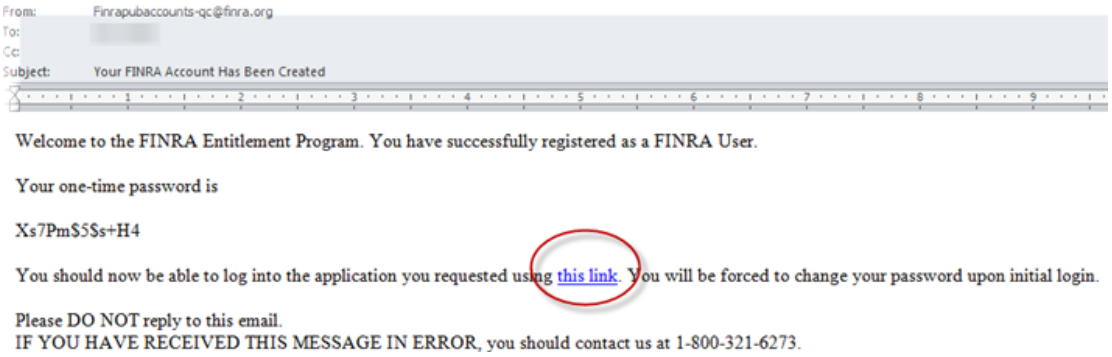
3. Enter the registration information. You can make up your own User ID (letters and numbers only; an email address cannot be used as your User ID). You will also need to enter the characters shown in the box before submitting the information. You can click the refresh button if you need a new set of characters.

4. The email address that you provide in the "Primary Email" field in this initial registration form will be the email that is reflected as your primary email address in your neutral profile with FINRA. If you need to update your email address with FINRA, you will need to make this change by updating your account information using the "manage my account" quick link menu option on the Homepage of the DR Portal. Please see "**Email Address**" on page 25. Note that this change cannot be made by FINRA staff. Note that FINRA DR staff does not use the "Secondary Email" address.
5. You will receive a **"Registration Confirmation"** with your User ID. Be sure to write down your User ID or print this screen. If you leave this screen and cannot remember your user name, please send an email to FINRADRNM@finra.org to request a new invitation.

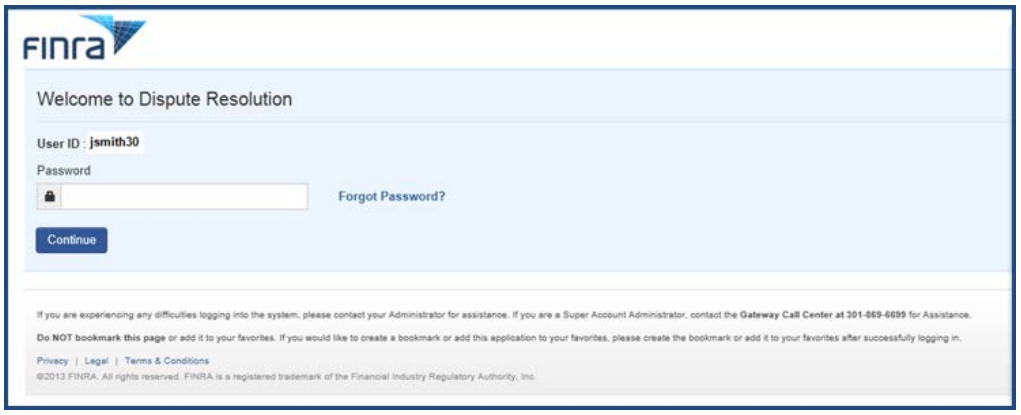




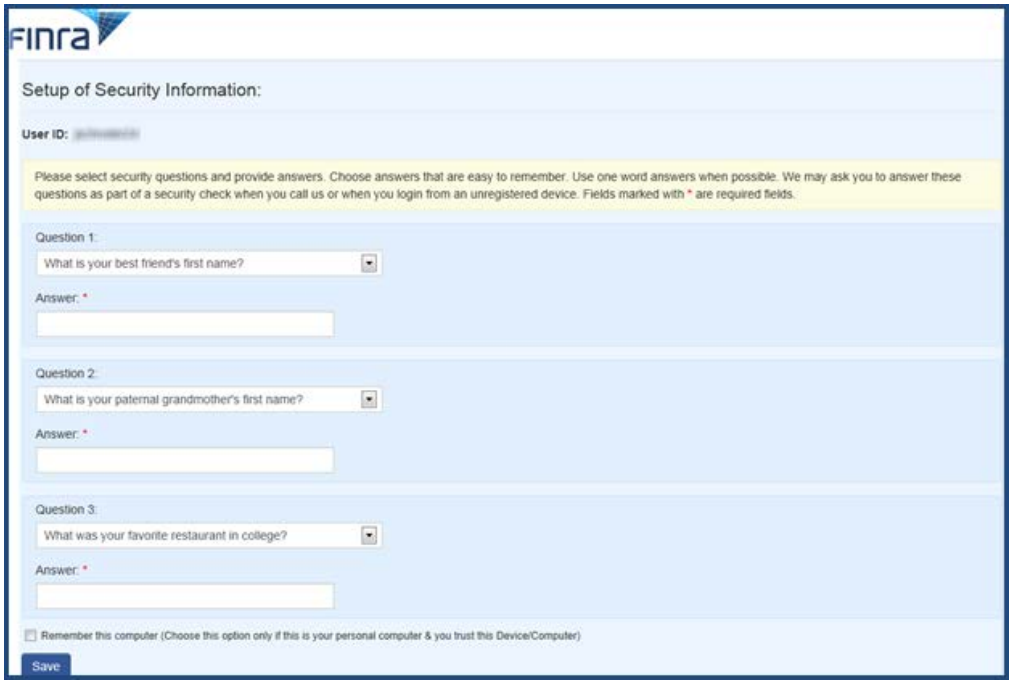
6. You will receive an email with a temporary password. Copy the password and click on the words "**this link**" in the email to log into the system so you can change your password.



7. On the "**Welcome to Dispute Resolution**" page, enter your User ID and click "**I agree**."
8. The system will capture your User ID and prompt you to enter your password. Enter your temporary password and click **"continue."**



9. You will be prompted to reset your password. Once you reset your password click "**Continue**."
10. Log into the DR Portal by entering your **new password**. The first time you log in, you will be asked to select and answer three security questions. From time to time (especially if you use a computer that you have never used before), the system may ask you one of these questions to confirm your identity.



11. You will see a new screen with additional challenge questions to answer. You will only need to answer these questions once.
12. You will then receive a message "**Welcome to the FINRA Dispute Resolution Portal**." Click on the link to access the portal.
13. You can access the DR Portal from the DR Portal page on www.finra.org after completing the initial registration. Neutrals can also create a "favorite" or "bookmark" in their browser for easy access to the DR Portal. You should create the bookmark **after** you successfully log into the portal. You should use the following URL as the bookmark to the access the portal: https://www.drportal.finra.org

Note: As a security measure, FINRA passwords automatically expire after a set period of time. When this occurs, you will be asked to change your password when you are logging in. You cannot select a password that you used previously.

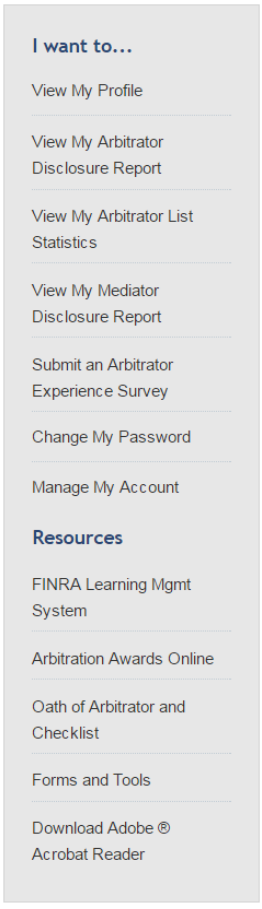
DR Portal Functionality

Overview

On the FINRA DR Portal Homepage, you will see a menu of options across the top heading bar:

- **Home** displays your current and upcoming arbitration and mediation cases;
- **Arbitration Cases** displays all arbitration cases you have ever been assigned to;
- **Mediation Cases** displays all mediation cases you have ever been assigned to;
- **Messages** displays all of the messages that have been sent to you regarding activity on your cases being handled through the DR Portal;
- **Profile** is where you can view and update your profile information.

There are also quick access links to:



View My Profile – takes you to the same place as the Profile menu on top.

View My Arbitrator Disclosure Report – this is the same report provided to arbitration parties during arbitrator selection.

View My Arbitrator List Statistics – shows you how often your name is appearing on arbitrator ranking lists.

View My Mediator Disclosure Report – this is the same report provided to mediation parties during mediator selection.

Submit an Arbitrator Experience Survey – takes you to a PDF form. As with all PDF forms, you should download the form to your computer and then complete it using Adobe Acrobat Reader.

Change My Password

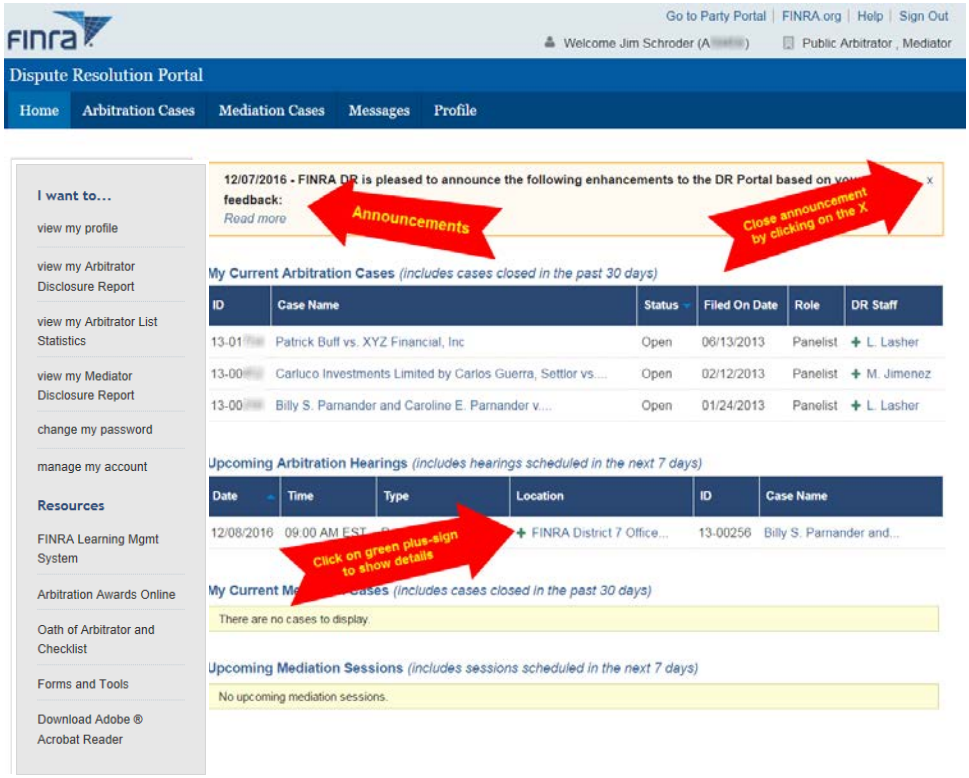
Manage My Account – if you need to change your email address.

There are also quick access links to **Resources** like the **FINRA Learning Management System, Arbitration Awards Online,** the **Oath of Arbitrator and Checklist** PDF form, the Forms and Tools page on the www.finra.org website, and a link to download Adobe Acrobat Reader for viewing PDF documents and completing PDF forms.

Home

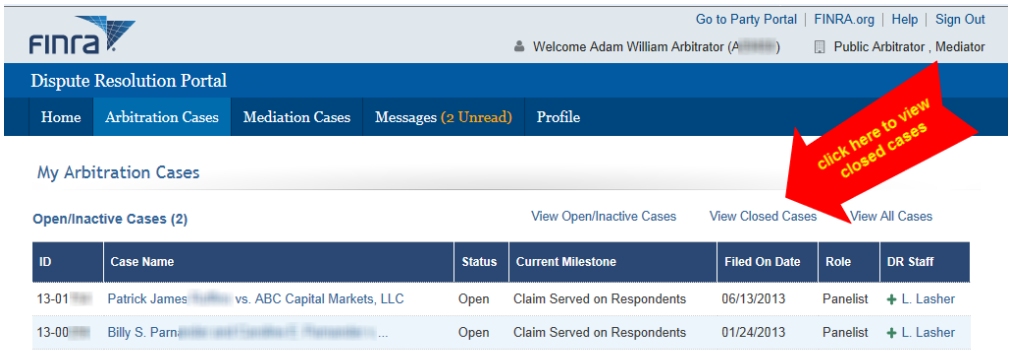
The Home page allows neutrals to view information about their currently assigned cases. The Home page provides a display of open arbitration and mediation cases, as well as a list of the upcoming arbitration hearings and mediation sessions that neutrals are scheduled to attend. It also displays announcements (in the orange banners near the top of the page) regarding the DR Portal or relevant FINRA DR activity.

Clicking on any of the green plus signs (such as the one next to the name of the DR staff person assigned to your case) will expand the view to show more details. Clicking on it again will hide the details.



Arbitration Cases and Mediation Cases

These home page menus take you to a page that lists all of your cases.



These pages default to show only open cases. You can click on "View Closed Cases" or "View All Cases" to change what is displayed in the list. You can also click on the column headings to change the sort order of the list.

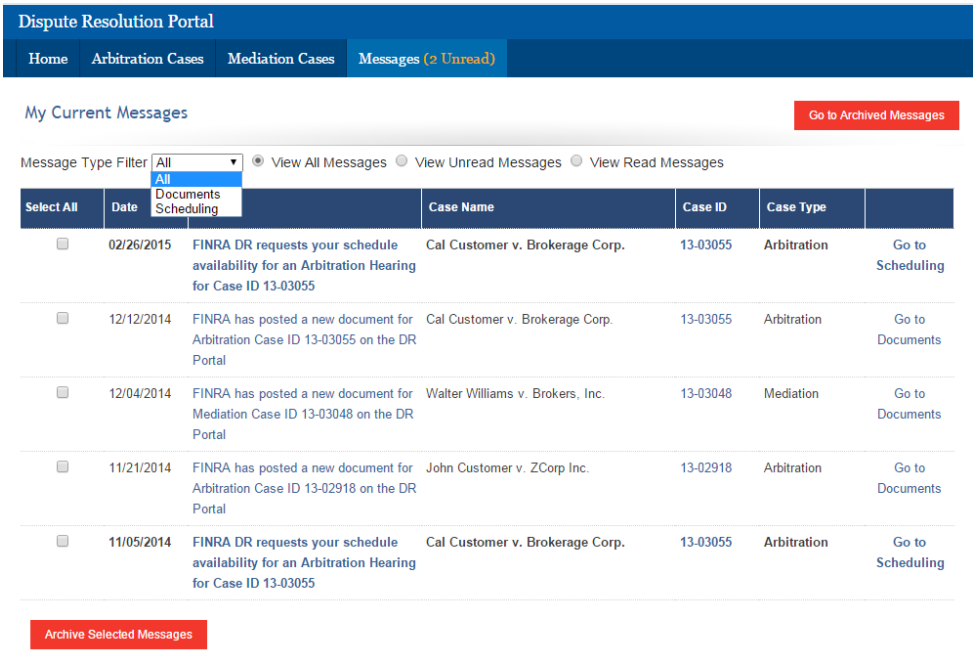
You can see every case on which you have served, regardless of whether the case resulted in an award. Clicking on any of these listed cases—open or closed—will display the same detailed case view and allow you to access the **"Messages", "Details," "Hearings," "Scheduling," "Payments," "Documents" and "Drafts and Submissions"** information.

Messages

This menu option takes you to a page showing all of the messages that have been sent to you regarding activity on your cases being handled through the DR Portal. You also receive these messages as email alerts. The number in orange indicates the number of unread messages. The view defaults to showing all received messages that you have not already archived. Unread messages are displayed in bold type. You can limit the view to just your unread messages by clicking on "View Unread Messages." You can also filter the messages to show just those relating to documents that have been published to you on the Portal or scheduling requests. Select "Documents" or "Scheduling" in the Message Type Filter drop-down menu.

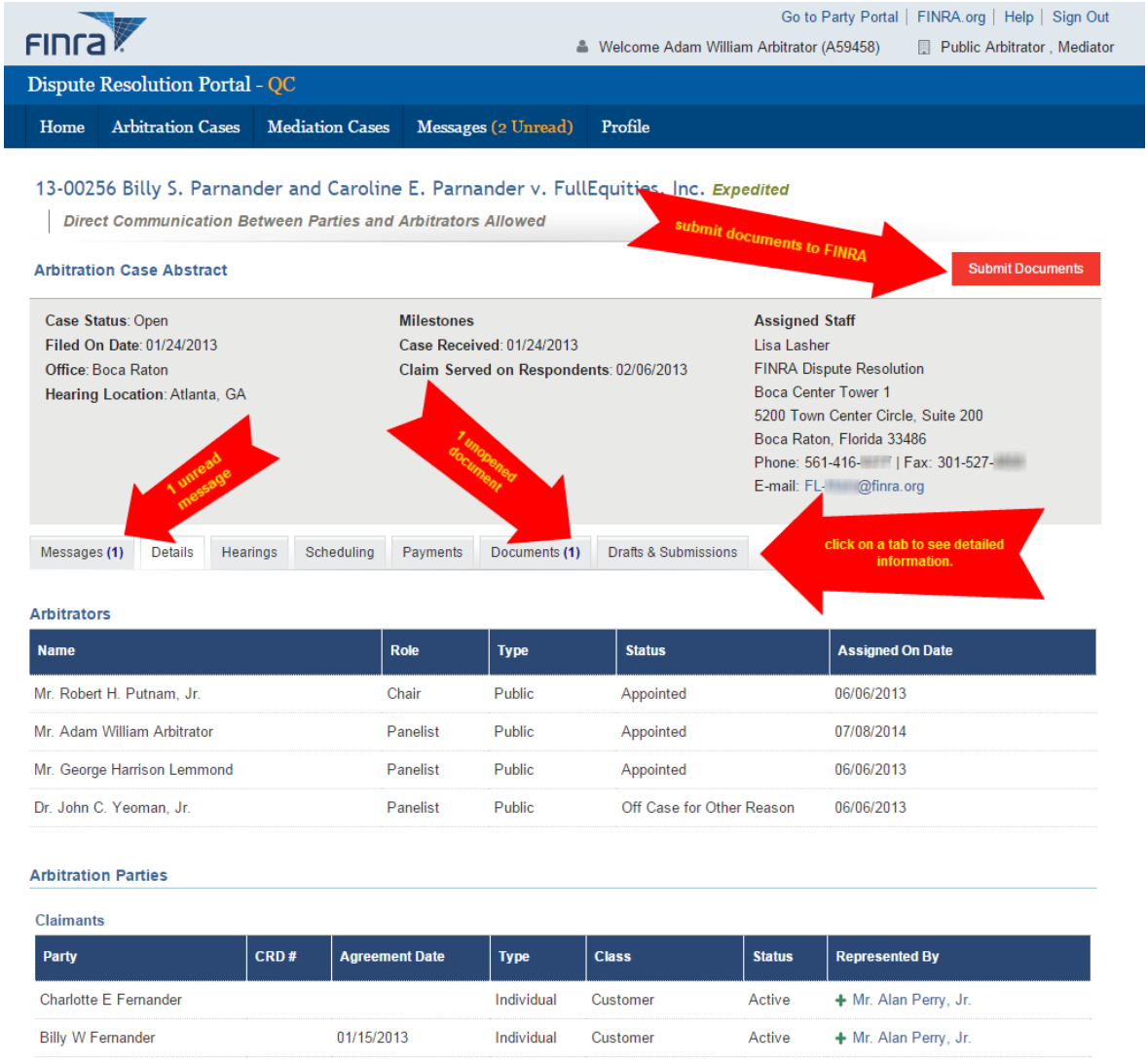
To archive messages, click on the checkbox to the left of the message to select them (or click on "Select All" to select all messages), and then click on the **Archive Selected Messages** button. To view your archived messages, click on the **Go to Archived Messages** button.

In addition, any announcements that you deleted from the Home page (by clicking on the **X** next to the announcement) can be found on the Archived Messages page.



Case Details

By clicking on a case name listed on the Home page, Arbitration Case page or Mediation Case page, you can see the Case Abstract along with a row of tabs providing additonal information about the case.



Messages

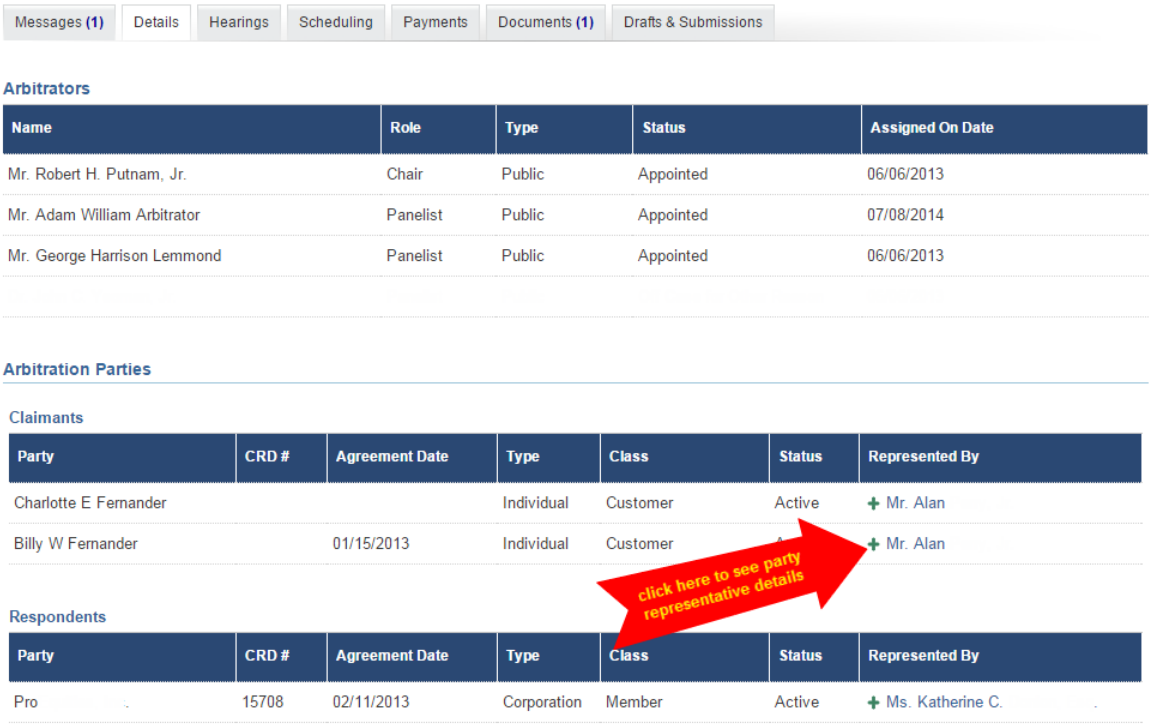
The **Messages** tab shows the messages you have received from FINRA regarding this case. The number in blue indicates the number of unread messages. The view defaults to showing all received messages for this case that you have not already archived. Unread messages are displayed in bold type. You can limit the view to just your unread messages by clicking on “View Unread Messages.”

To archive messages, click on the checkbox to the left of the message to select them (or click on “Select All” to select all messages), and then click on the **Archive Selected Messages** button.

To view your archived messages, click on the **Go to Archived Messages** button. You can return archived messages back to your current message page by selecting the archived messages (using the small checkbox to the left of each message) and clicking on **Unarchive Selected Messages** button.

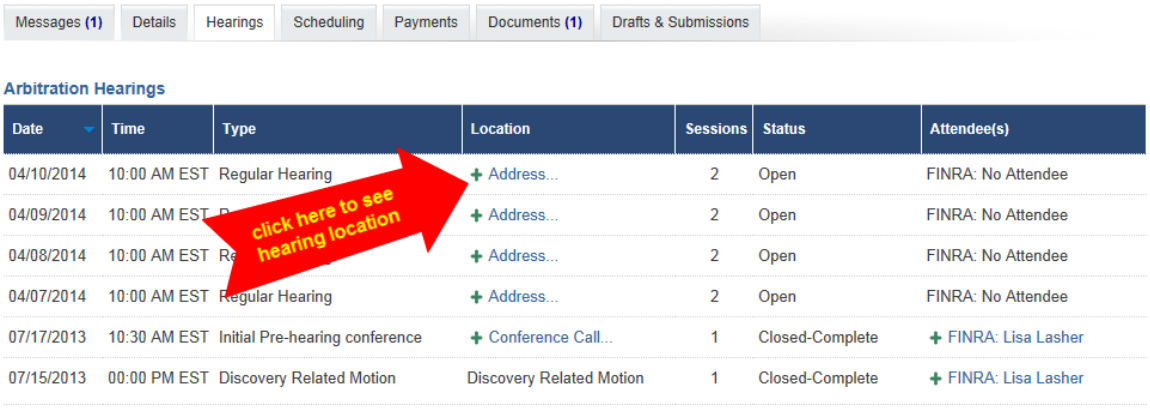
Details

You can view the names of your co-arbitrators and the assigned FINRA staff member. You can also view the names of the parties and their representatives. By clicking on the representatives' names, you can see their contact information.

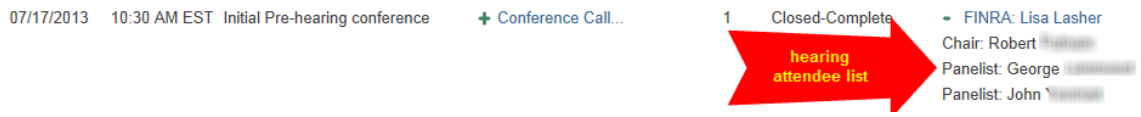


Hearings

The **"Hearings"** tab shows all of the hearings that are scheduled or have already been held for the case. You can also view the address and phone number for a hearing location.

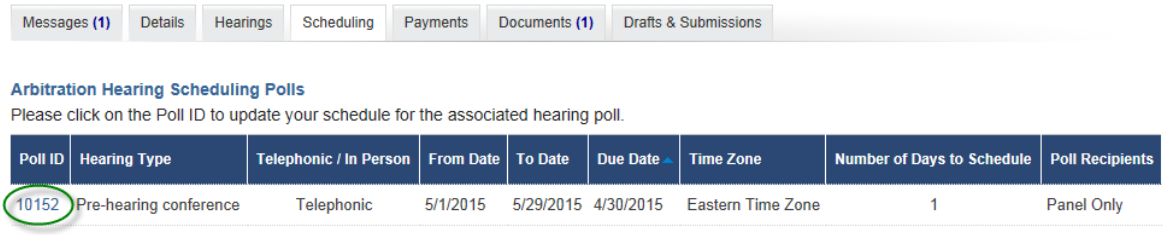


The Hearings page also provides information about which arbitrators and FINRA staff attended a particular hearing.



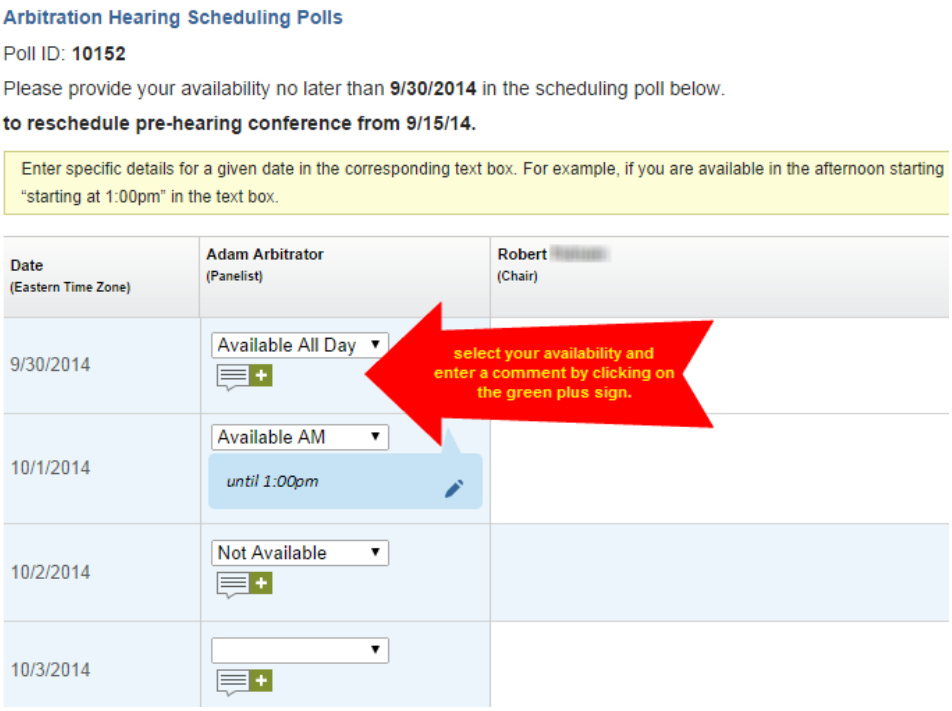
Scheduling

The **"Scheduling"** tab provides a collaborative tool that allows the party representatives and neutrals to find mutually agreeable dates for scheduling (or rescheduling) arbitration hearings or mediation sessions.

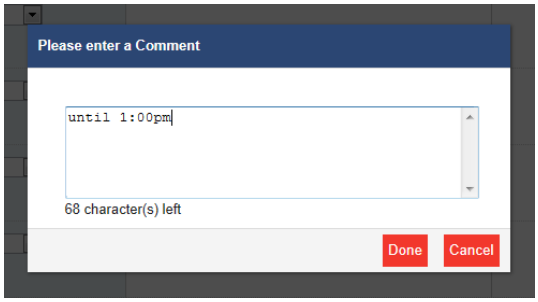


When a hearing or session needs to be scheduled or rescheduled, FINRA will propose a range of dates by creating a "scheduling poll." When FINRA publishes a poll on the DR Portal, each of the required attendees will receive an email notification telling them to log into the DR Portal to complete the poll by providing their availability.

Click on the Poll ID to open the poll.



For each date, enter your availability. You can also enter a comment in the box for by clicking on the green plus sign, entering your comment, and then clicking on **Done**.



Once you are finished, click on **Save** at the bottom of the poll. Your entries and comments will be immediately viewable by all other attendees on the case, as well as by FINRA staff.

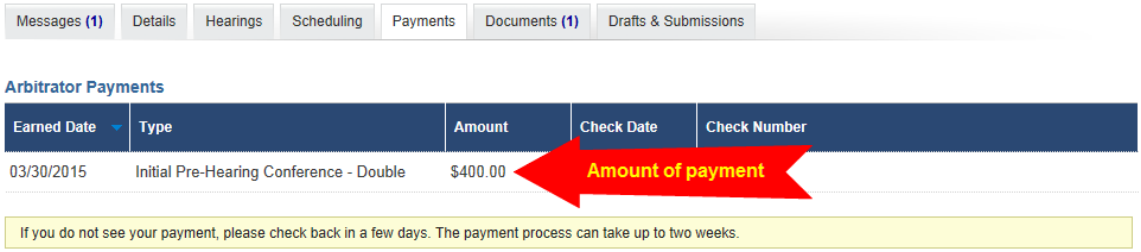
You can come back to the poll to make changes and update your comments in order to try and reach consensus on acceptable dates, all without having to speak in person. Click on **Save** after you make changes so that other attendees can see your latest updates.

Note that the process is the same for mediation scheduling polls.

Payments

The **"Payments"** tab shows all payments you have earned for a case as well as check dates and check numbers. If you do not see information in the Payments section for a hearing you

participated in, the system will advise you to allow time to process the payment and to check back.

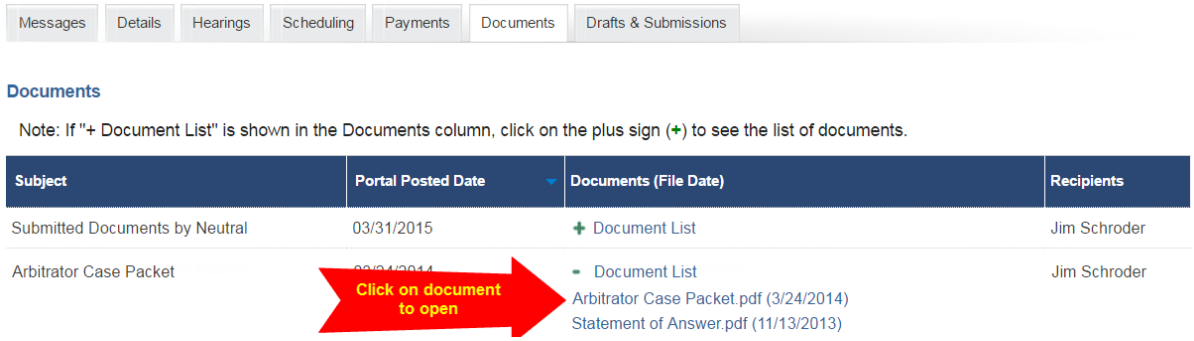


Documents

The **"Documents"** tab shows a list of documents contained in the case file that have been made available for viewing through the portal. This would include documents you submitted as well as documents published by FINRA staff to the portal.

If there are multiple documents, you will see a **"+ Document List"** link, which you can click to open up the list of documents. You MUST disable your pop-up blockers to view the documents.

Note: all documents in the DR Portal are saved as Adobe PDF files. Make sure you have the latest version of Adobe Acrobat Reader installed on your computer to avoid problems opening the files.

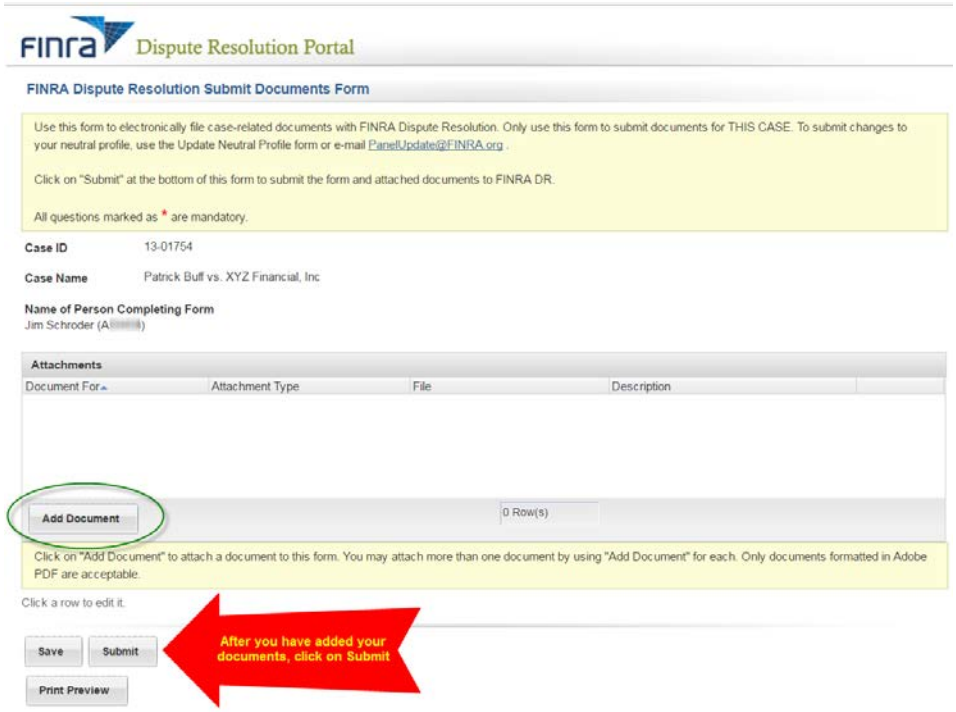


Submitting Documents

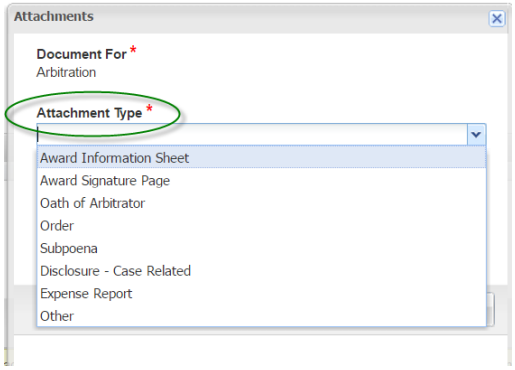
You can submit PDF documents through the portal. After selecting the case you are working on, click the **Submit Documents** button in the upper right hand corner to submit documents through the portal rather than faxing or emailing the document. This will open the Submit Documents form in a separate browser tab (although some browsers may behave differently.)

Step 1: Click on the **Submit Documents** button. This should open a separate tab in your browser.

Step 2: Choose the PDF(s) from your computer to submit by selecting the **Add Document** button.

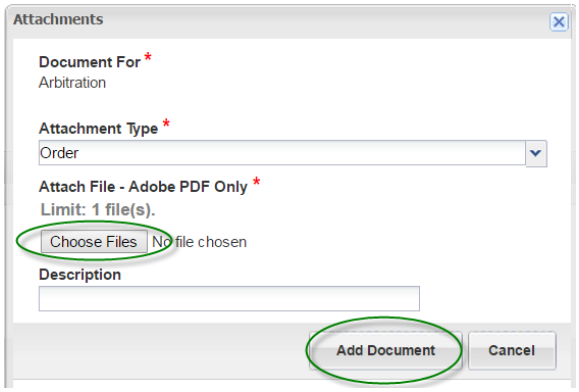


Step 3: Select the “Attachment Type” from the dropdown menu that describes the document you are submitting.

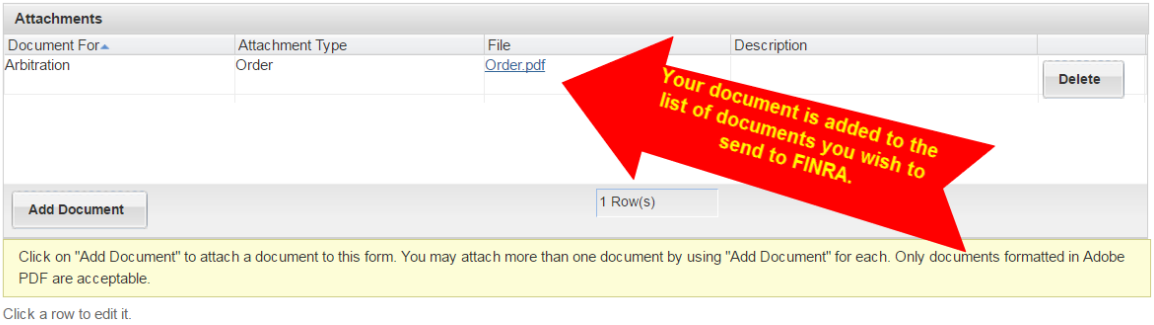


Step 4: Click the **Browse** button to choose the PDF document from your computer. Enter a brief description of the file in the Description field.

Step 5: After you select your document, click the **Add Document** button.



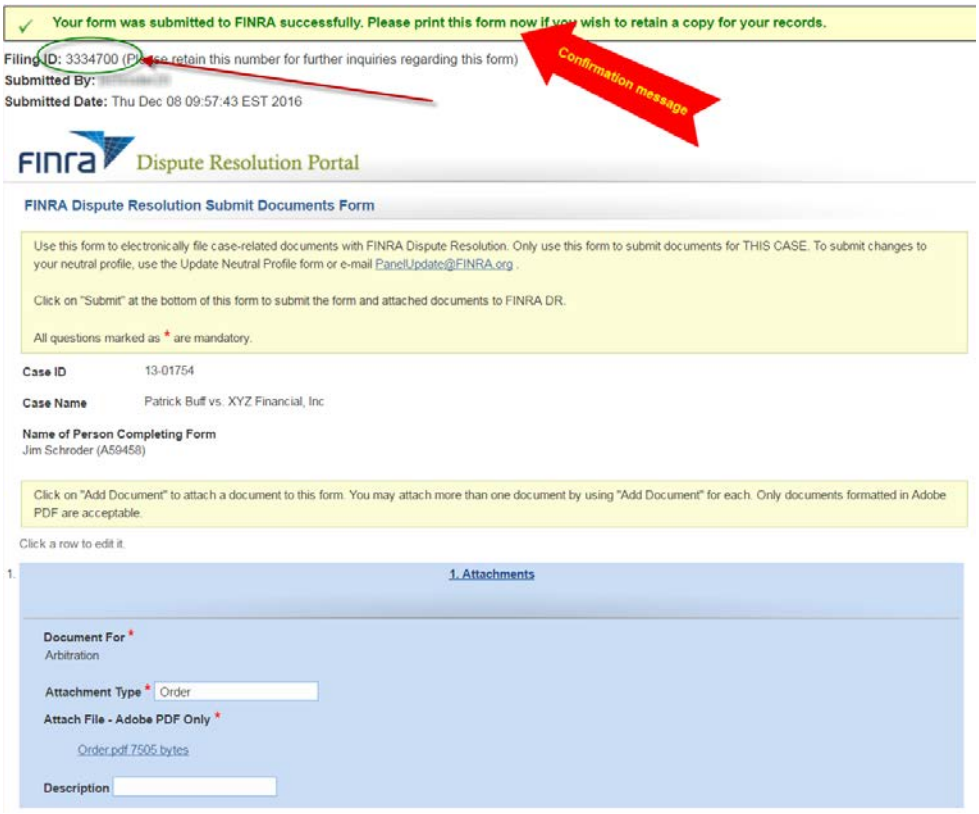
Your document is added to the list of attached documents you wish to send to FINRA.



Note: you can add more than one document to this form by repeating steps 2 through 5.

Step 6: To finalize your submission, you must click the **Submit** button. If you are not yet ready to submit your documents, you can click on the **Save** button. That will save an in-progress draft of this form in your "Drafts & Submissions" tab that you can return to later.

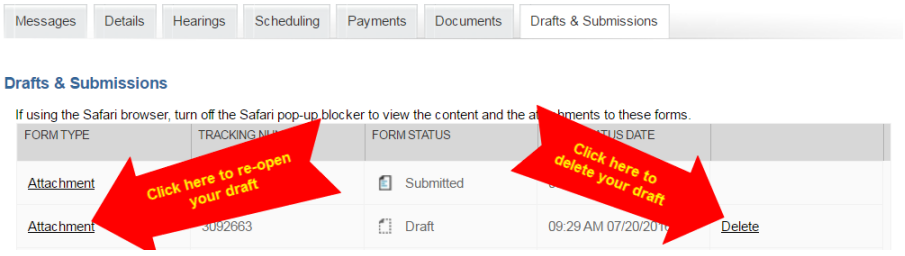
After you click on **Submit**, you should receive a confirmation on your screen that your form was submitted successfully. Once you are done, you can close this tab in your browser. The DR Portal should still be open in the other browser tab.



Drafts and Submissions

The “Drafts & Submissions” tab shows forms (with attached documents) that you save as a draft before submitting to FINRA. A draft is created the moment you click on the “Submit Documents” button. You can continue working on your draft by clicking on the “Attachment” link in the first column. A draft can be deleted by clicking on the “Delete” link in the last column.

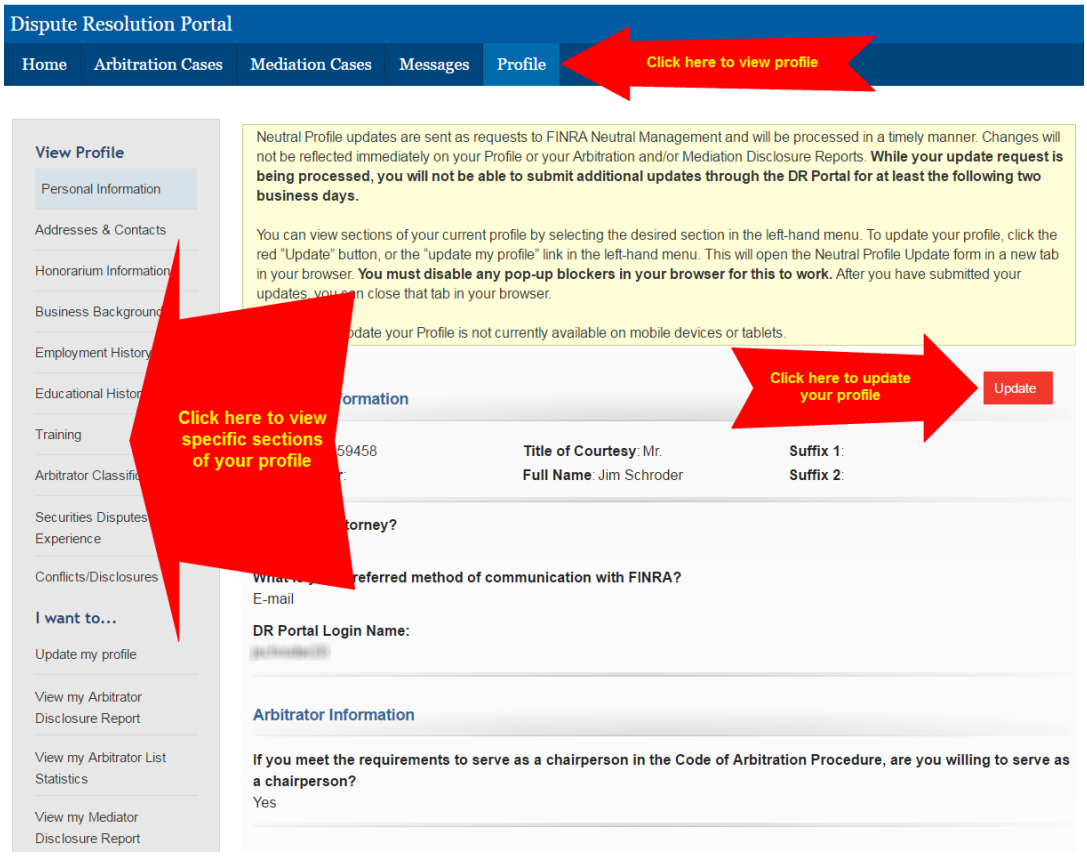
This tab also shows forms that you successfully submitted to FINRA. You can view your submission by clicking on the “Attachment” link in the first column.



Neutral Profile View

Neutrals will be able to view their profile information in the portal. To view your profile:

Click on **"Profile"** in the heading bar. The **Profile** page will open on the **Personal Information** tab. Click on any of the headings in the left-hand menu to view the specific information in your profile.



Viewing Your Disclosure Report

If you would like to see your current disclosure report before making updates, click on "**view my Arbitrator Disclosure Report**" or "**view my Mediator Disclosure Report**" found on the left-hand menu. You will see a PDF version of your current disclosure report. You can also choose to print the report by selecting print from your browser menu.

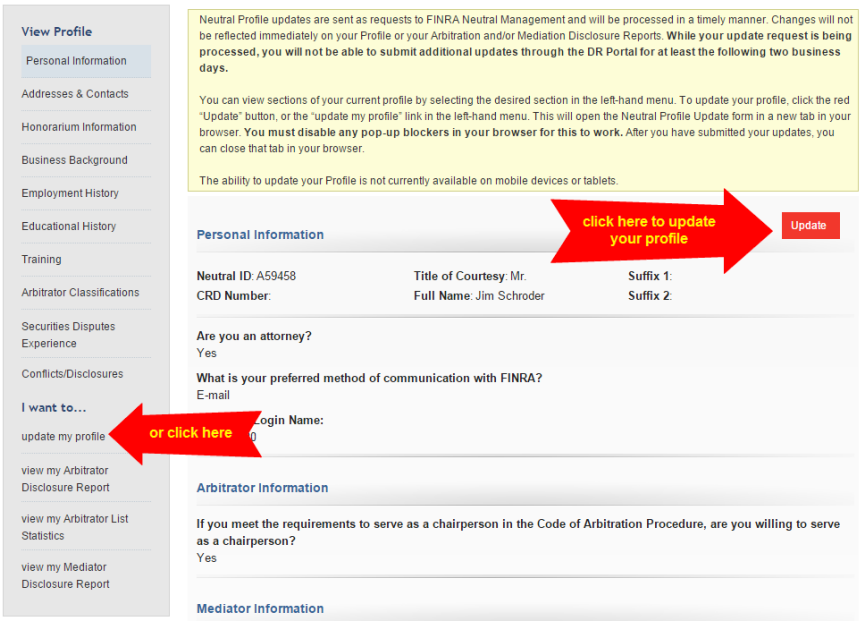
Neutral Profile Update

Neutrals can make updates to their disclosure reports through the Portal.

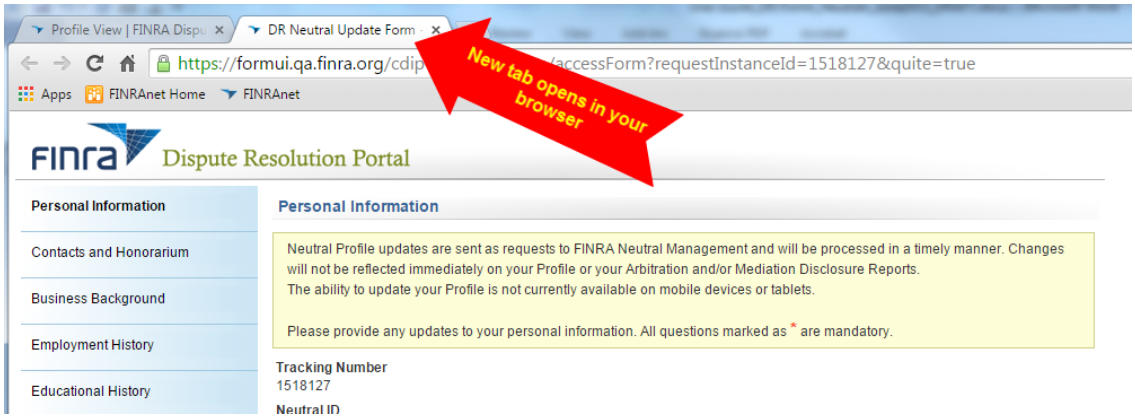
Note: If you currently have a pending update that has not yet been processed, you must wait at least two business days before trying to submit your update through the DR Portal. If you need to submit your update sooner, you can send it by email to panelupdate@finra.org.

To update your profile, do the following:

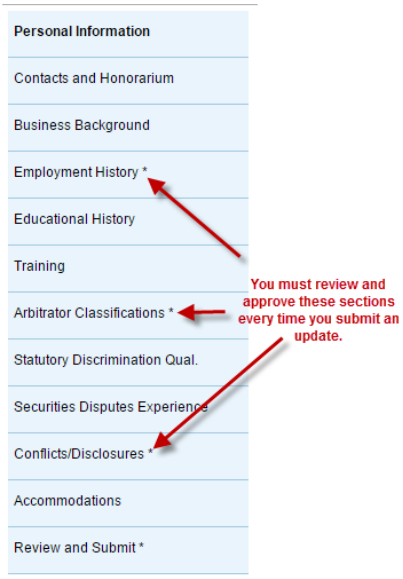
1. Click on the red **Update** button, or the "update my profile" link on the left-hand menu.



This opens the DR Neutral Profile Update Form in a new tab in your browser. You must disable any pop-up blockers in your browser for this to work.



2. The Profile Update form will begin with **Personal Information,** however, you may skip to a specific section either by clicking **"Next"** at the bottom of the page, or by clicking on the section name that you want to jump to in the left-hand menu.



You do not need to complete each section or go in sequential order. However, you **must** review and affirm your responses in the Employment History, Arbitrator Classifications (if you are an arbitrator) and Conflicts/Disclosures sections **each** time you submit an update form.

Some of the profile information is for viewing only and cannot be updated directly. The system will identify what information you can and cannot modify.

Please read the specific update instructions on the top of each page. All questions with a red asterisk (*) are required.

3. Once you have made your changes, go to the "Review and Submit" section at the end of the form and press the "Submit" button.

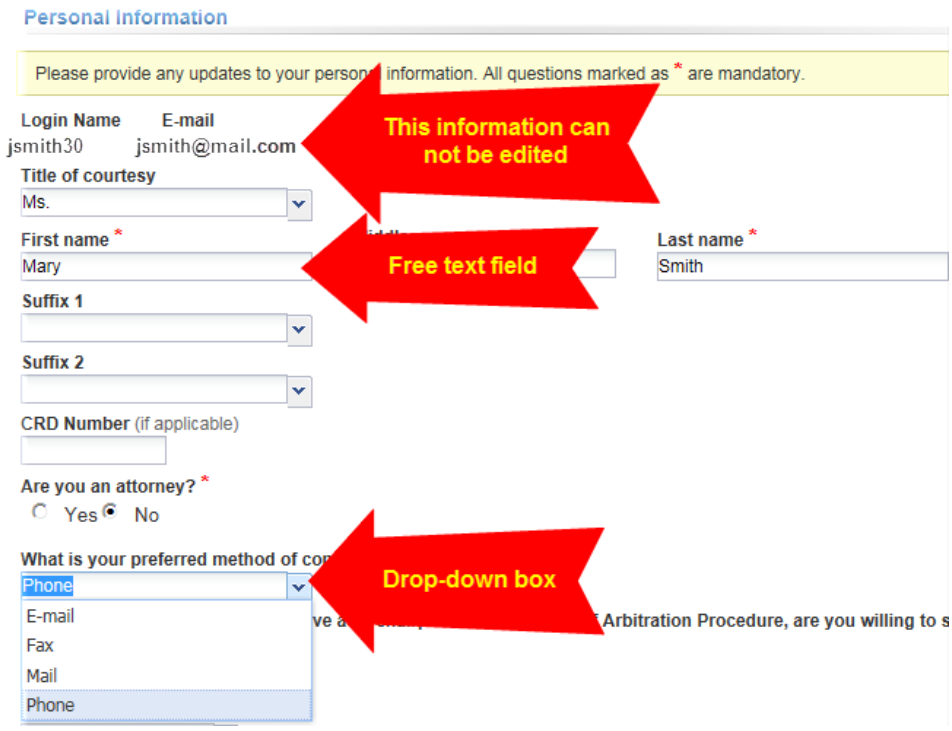
4. After you have submitted your updates, you can close the DR Neutral Profile Update Form tab in your browser.

Personal Information

The following information is part of your personal information section. You may update some of this information. Any sections that are view only are indicated below.

- Neutral ID (view only)
- Title
- First Name
- CRD Number (view only; you must call FINRA if there is a change to your CRD number)
- Are you an attorney?
- Preferred method of communication
- Login name to DR Portal (view only)
- Arbitration specific question: willing to serve as chairperson
- Mediator specific questions: style, mediation by phone, etc.

Personal information can be updated by entering text in the free text fields and using the drop-down options.



Contacts and Honorarium

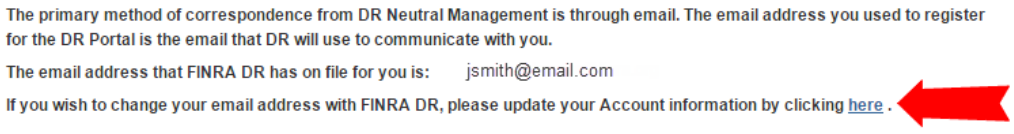
You can update your address and change which address should be the preferred address.

Email Address

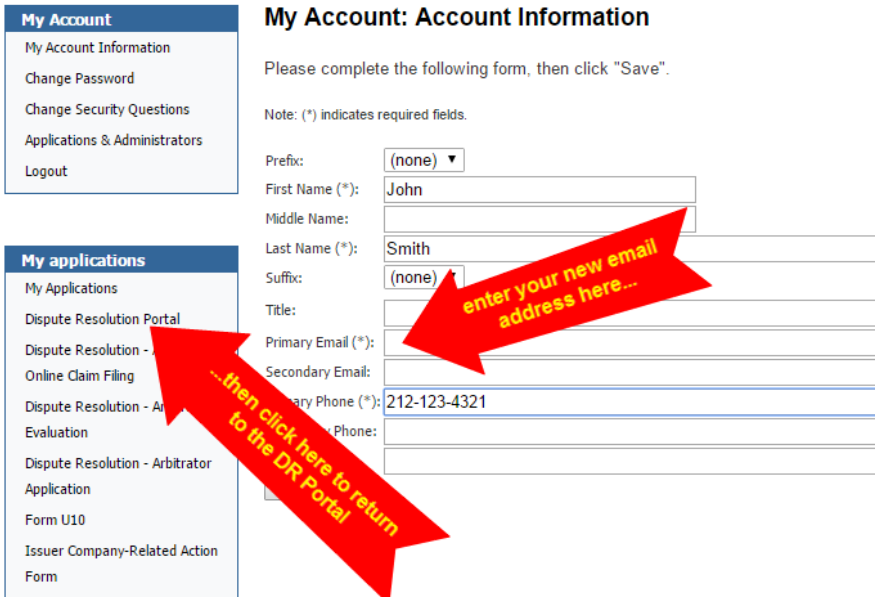
Please note that you cannot change your email address by submitting a change directly on the Profile Update form. Your email address is tied to your DR Portal login. Therefore, you can only change your email address by updating your account information.

1. On the DR Portal Homepage, you can select the "**manage my account**" quick link menu option to change your email address.

2. You may also use the **Account Information** link on the Contacts and Honorarium section of the update form.



3. Enter your new Primary Email address and click "Save."



Addresses

Click anywhere on the address line to edit it.

You can also delete any outdated addresses by using the "**delete**" button.

To add a new address, click the "**Add New**" button and enter the required fields. Be sure to designate at least one address as your preferred address. Do not enter the same address more than once.

You can make similar changes to your **telephone and fax numbers**.

Honorarium/Mediator Payment

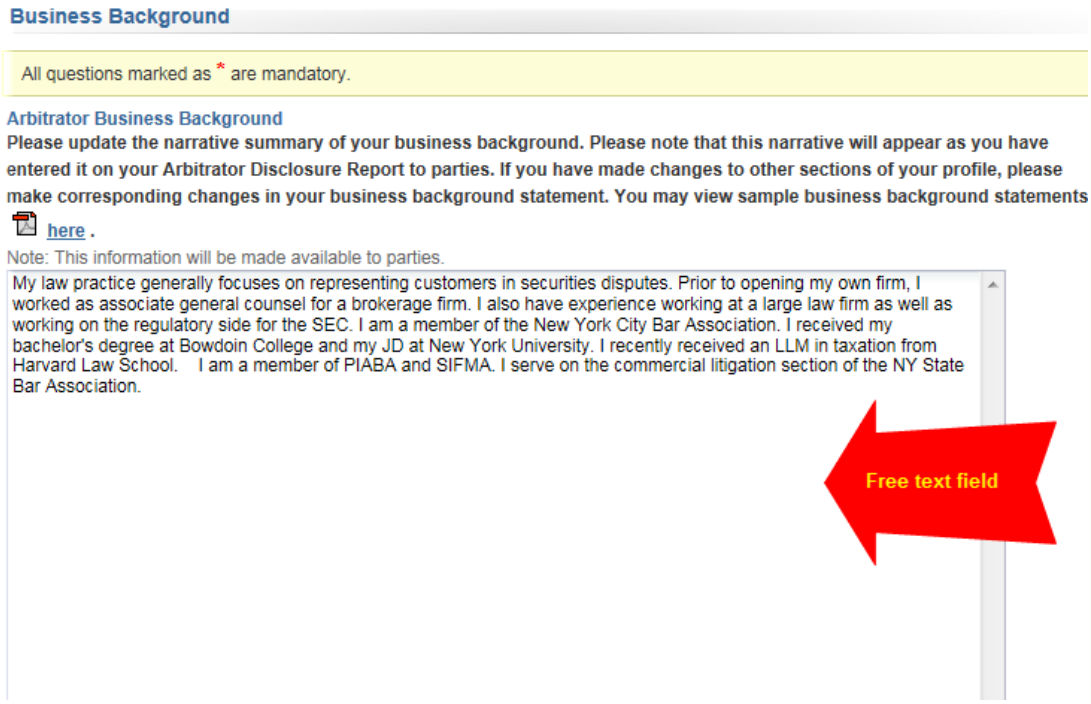
You may change where you would like your honorarium to be sent. You may also choose to waive the honorarium at any time. Be sure to answer the required questions about honorarium.

Business Background

You may edit your business background by typing in new text and deleting outdated information. You can make changes directly into your existing business background. You should not leave this section blank.

You will not be able to attach documents. However, you will be able to cut and paste text from a document into the business background section. We ask that you do not delete any notations entered by FINRA staff in this section.

You should review your new business background for any typos and spelling errors. Once you submit your new business background, FINRA staff will review and—barring obvious mistakes—will process the new background directly into your profile.



Employment History

You will only be able to add new employment information and edit existing entries. You will not be able to delete any previous employment information.

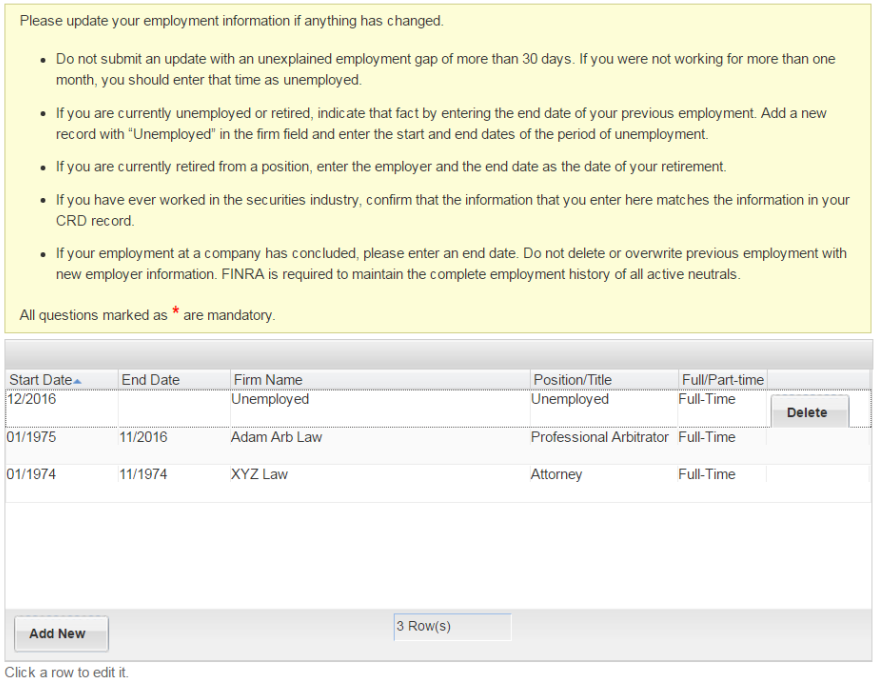
You must check the box affirming that the answers you provided in this section are accurate each time you submit an update form.

FINRA will continue to use the same rules when it comes to employment information. You cannot have an unexplained gap of more than 30 days in between employment. The system will not automatically flag your entry if it contains an unexplained gap of more than 30 days, so you must carefully review it to ensure that there are no gaps.

Retired or Unemployed

If you are retired or unemployed, please indicate this by entering an end date for your last employment and adding a new entry for your time of retirement or unemployment.

- In the list of your employment entries, click on an entry to edit it.
- Make your changes and click on the "Update Row" button (e.g., add an End Date for the date you retired.)
- Then, click on the "Add New" button to add a new entry for the start of your retirement. Enter "Unemployed" for the Firm Name and Position, and "Full-Time" for the Type.



Educational History

You will only be able to add new education information and edit existing entries. You will not be able to delete any previous education information. This works the same way as all grids on this form; click on a row to edit it, and click on "Add New" to add a new entry.

Training

You will only be able to add new training information and edit existing entries. You will not be able to delete any previous training information.

You will have the option to classify training as either arbitration training, mediation training, or other training.

You should enter the name of the course under the "Details" field, then click "Add Row" to add the entry.

Arbitrator Classifications (action required for arbitrators)

To ensure that arbitrators are properly classified as "public" or "non-public," FINRA will ask you to affirm your classification. On your first visit to the update section of the portal, you will be required to answer a series of questions related to your classification.

On subsequent visits, you will be required to affirm your previous answers to these classification questions—if further modification is not necessary. However, you will not need to re-answer the same questions each time you make an update to your profile.

If you provide responses that raise a question about your classification, you will receive a message to contact FINRA.

Statutory Discrimination Qualifications

In order to serve as the chairperson on statutory discrimination cases, you must qualify under Rule 13802 of the Code of Arbitration Procedure. If you are interested in serving in this capacity, you may answer the questions in this section of the update form. You must also provide a summary of your qualifications in this area of law.

Staff will review your responses to make sure that you qualify under the Code of Arbitration Procedure before making this update to your profile.

Securities Disputes Experience

You may add new securities disputes expertise to your profile. These skills are listed on your disclosure report that parties review during the arbitrator selection process. For example, if you have a particular expertise in breach of contract disputes or auction rate securities, you can add this information.

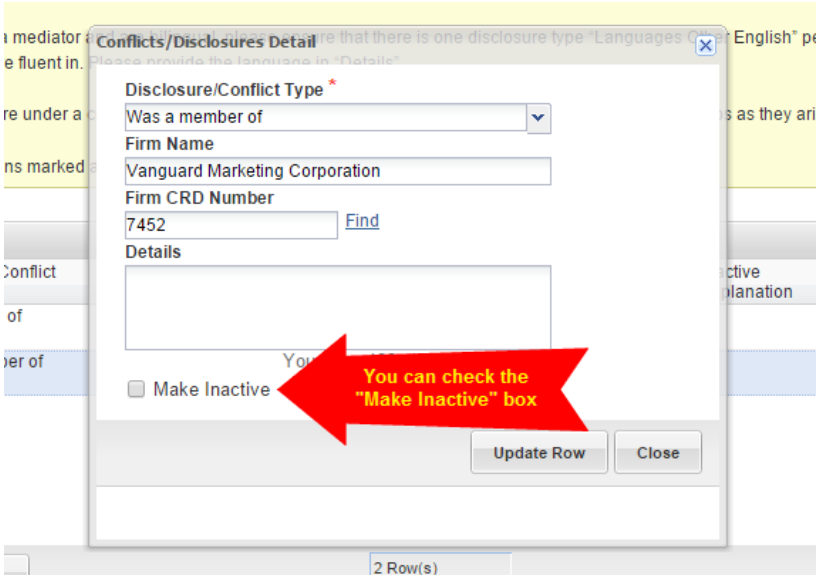
You will also need to provide a written explanation justifying your expertise. The form will require you to enter text, explaining your expertise. Staff will review this information before adding it to your profile. In some cases, staff may contact you for additional information.

Conflicts/Disclosures (action required for all neutrals)

This section captures information that you provided in the Legal/Regulatory and Conflicts/Disclosures sections of the arbitrator application. For example, you may update or add information about your brokerage accounts, litigation (including non-securities related lawsuits), publications (including publications that appear only online), professional licenses, service as an expert witness, service on boards of directors, disclosures related to your spouse or immediate family member (definition for immediate family member is part of the definition for "public arbitrator,"), etc. This section captures any and all disclosures that may not fit neatly into another section of your disclosure profile. As an arbitrator you are under a continuing duty to update information initially provided in the application and provide new disclosures as they arise. **When in doubt, disclose**. Failure to disclose may result in vacated awards which undermine the efficiency and finality of our process. Failure to disclose may also result in removal from the roster.

You will **not** be able to delete any previous entries to this section. The only edits you may make to a previous conflict/disclosure is to designate that it is no longer active. You may provide a written explanation to describe any changes that you submit.

You must check the box affirming that the answers you provided in this section are accurate each time you submit an update form.



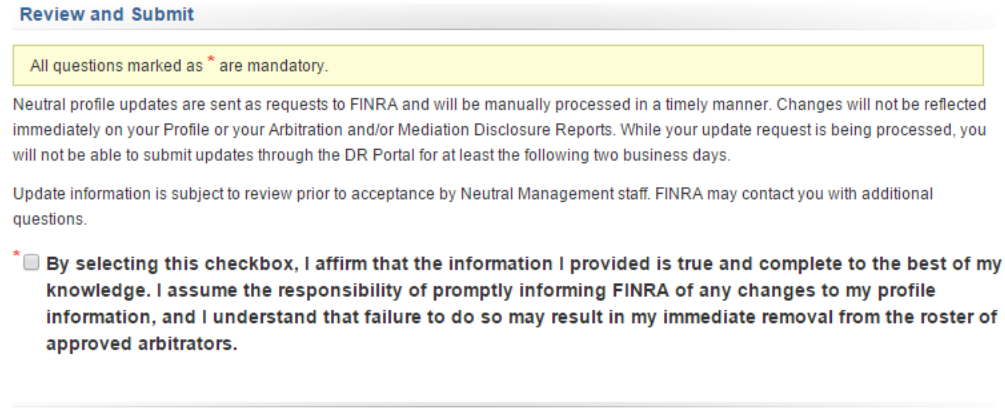
Accommodations

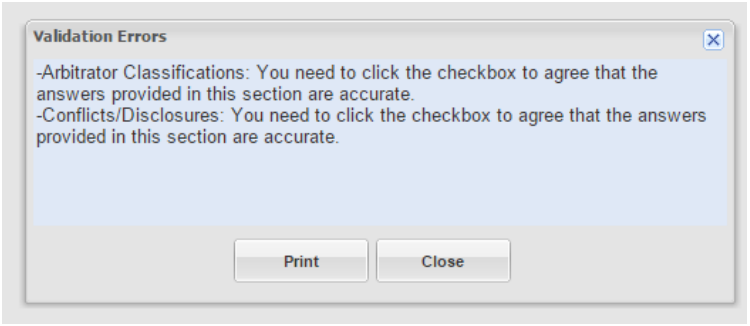
Please let us know if you have any special accommodations when serving as a neutral.

Review and Submit

Check for Errors Button

Before you submit your update form, click on the **Check for Errors** button to see if you have any unresolved entries in your form.





Error Message

If you have any errors in your submission, the system will show you a message with the sections in which you have errors. The sections with errors will appear immediately before the colon; they will correlate with the sections that appear in the left hand navigation menu of the form. You must correct the errors before the system accepts your update form.

To help remember what errors need to be fixed, you can select the “Print” button to print out the error message.

Submit

You must check the box affirming that the information in your profile is true and complete to the best of your knowledge.

When you submit the form successfully, you will receive a confirmation email with a tracking number to reference in case you have questions about your submission. You should also print out a copy of the form you submitted. You can then close the tab in your browser.

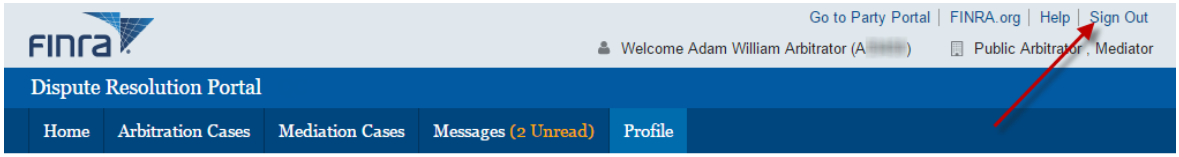
When Will the Updates Appear in Your Profile?

If you are currently serving on a case, FINRA will endeavor to make the update to your profile within one business day. If you are not currently serving on a case, FINRA will try to make the update within three to five business days. Therefore, you will not immediately see the updates in the DR Portal.

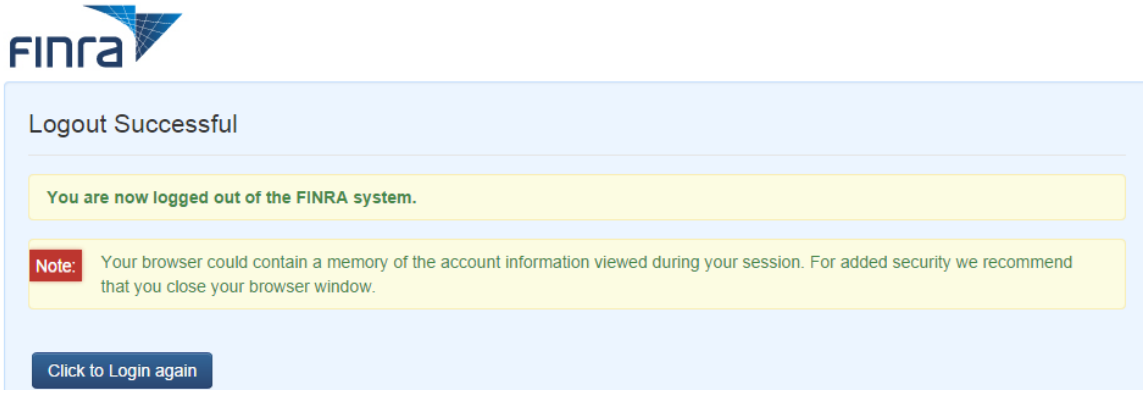
If you recently submitted an update through the Portal and we have not processed the form yet, you will not be able to submit a new update through the Portal. If it is urgent, you can send it by email to panelupdate@finra.org or fax at (301) 527-4910.

Log Out of Portal

When you are done with your session in the DR Portal, be sure to log out by clicking on the **Sign Out** link in the top right corner.



Once you click the **Sign Out** link you will receive confirmation that your Logout was successful.



Additional Help

If you have any questions about the DR Portal, please contact Neutral Management Staff toll free at **(855) 209-1620** or in New York at **(212) 858-3999.** If your account is locked, call the Gateway Call Center at **(301) 590-6500**. If you are having a technical problem other than your account being locked and need immediate assistance, please call **(800) 700-7065**.

If you would like to provide feedback regarding the DR Portal or make any suggestions for possible future enhancements, please send an email to drportalfeedback@finra.org. We appreciate your thoughtful comments and suggestions.

FINRA DR Portal

User Guide for Arbitration and Mediation Case Participants

December 2016

Disclaimer

Table of Contents

Welcome to the FINRA DR Portal

Introduction

The FINRA Office of Dispute Resolution developed this user guide to help arbitration and mediation case participants become familiar with the Dispute Resolution Portal (DR Portal). The DR Portal is a web-based system that allows invited participants to log into a secure section of our website for self-service access to submit documents and view their case information.

The DR Portal has two parts: one for FINRA neutrals (arbitrators and mediators) serving on the Dispute Resolution roster, and another part for arbitration and mediation case participants. This User Guide describes the DR Party Portal. A separate User Guide is available that explains the use of the DR Neutral Portal for arbitrators and mediators. If you happen to be both a FINRA neutral and a participant to a case, you can register the same User ID to access both sides of the DR Portal. Case participants may access the neutral side of the DR Portal by clicking on the link, "Go to Neutral Portal" found near the top of the homepage once you are logged in. Likewise, registered neutrals who are also case participants may access the party portal by clicking on the link "Go to Party Portal" from the homepage.

Portal Access

FINRA Dispute Resolution forum participants can access the DR Portal from FINRA.org after creating a DR Portal account. **For detailed information on how to create an account, see Appendix A.**

Note: you can not use a FINRA Firm Gateway account on the DR Portal. You must create a separate account. You only need one account to access all cases to which you are invited. You should NOT create a new account for each case you receive, and each account should use the unique email address of the user. Do not use a "group mailbox" email address when creating an account.

Compatible Browsers

The DR Portal is compatible with the following browser versions (or higher): Microsoft Internet Explorer 11; Microsoft Edge; Firefox 22, Google Chrome 27, and Safari 6.

Mobile Devices

The DR Portal is only partially accessible with mobile devices. You can login and view case information, and depending on the device, may be able to view PDF files. You cannot currently use an invitation email to register for a new case or submit documents using a mobile device.

Spam Filters

You will receive automated emails coming from "drportal@finra.org" when you are invited to register for a case or when activity occurs on your case that requires your attention. In order to prevent your spam filter from blocking these emails, we suggest that you add this email address to the "safe senders" list in your spam filter software.

Note: FINRA will not complete spam filter forms that may be sent by your spam filter software. You must add the "drportal@finra.org" email address to your spam filter safe sender list in order to receive emails coming from the DR Portal.

Pop-up Blockers

Some features of the portal open extra tabs in your browser or pop-up windows. We suggest that you add ***.finra.org** to your browser's list of Trusted Sites and to your pop-up blocker's exception list. You may also disable your pop-up blockers.

DR Portal Functionality

Overview

On the FINRA DR Portal Homepage, you will see a menu of options across the top heading bar: Home, Arbitration Cases, Mediation Cases, Arbitration Claims, and Messages. There is also list of links on the left-hand side of the home page to **Receive a Case** (retrieve a filed claim using a Claim Access Code that was given to you on a Claim Notification Letter)**, File a New Arbitration Claim, File a Request for Mediation, Change My Password,** and **Manage My Account**. There is also a link to the **Arbitration Awards Online** website, as well as the Forms and Tools page where you can find various Adobe PDF forms used in the forum.

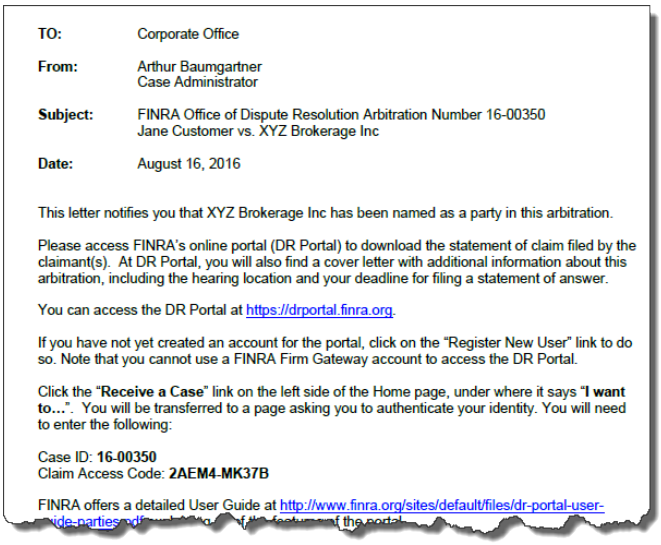
Accessing Case Information

There are two methods of gaining access to information for a case through the DR Portal:

- Using "**Receive a Case**" and a Claim Access Code found in a Claim Notification Letter;
- Receiving an email invitation from FINRA to register with the DR Portal for access to a particular case.

Claim Notification Letter

The first way to access case information is by receiving a Claim Notification Letter in the mail or by email from FINRA. This letter replaces the serving of paper documents by FINRA upon the respondents of a claim. It is sent to the named respondent parties on the case after the claim has been received by FINRA.



TO: Corporate Office

From: Arthur Baumgartner
Case Administrator

Subject: FINRA Office of Dispute Resolution Arbitration Number 16-00350
Jane Customer vs. XYZ Brokerage Inc

Date: August 16, 2016

This letter notifies you that XYZ Brokerage Inc has been named as a party in this arbitration.

Please access FINRA's online portal (DR Portal) to download the statement of claim filed by the claimant(s). At DR Portal, you will also find a cover letter with additional information about this arbitration, including the hearing location and your deadline for filing a statement of answer.

You can access the DR Portal at https://drportal.finra.org.

If you have not yet created an account for the portal, click on the "Register New User" link to do so. Note that you cannot use a FINRA Firm Gateway account to access the DR Portal.

Click the "**Receive a Case**" link on the left side of the Home page, under where it says "**I want to…**". You will be transferred to a page asking you to authenticate your identity. You will need to enter the following:

Case ID: **16-00350**
Claim Access Code: **2AEM4-MK37B**

FINRA offers a detailed User Guide at http://www.finra.org/sites/default/files/dr-portal-user-

This letter notifies the respondent that they have been named in a claim and that they may retrieve the claim documents through the DR Portal using the Claim Access Code contained in the letter.

The Claim Access Code can be used by more than one person. For example, a respondent party can use the code to retrieve a claim, and then give it to outside counsel who may then also use the same access code to retrieve the claim using their own account. Once you use the code to access the claim, you will not need to use the code again if you log out and back into the portal. You will continue to have access to this one document on this one case until the code is disabled.

Receive a Case

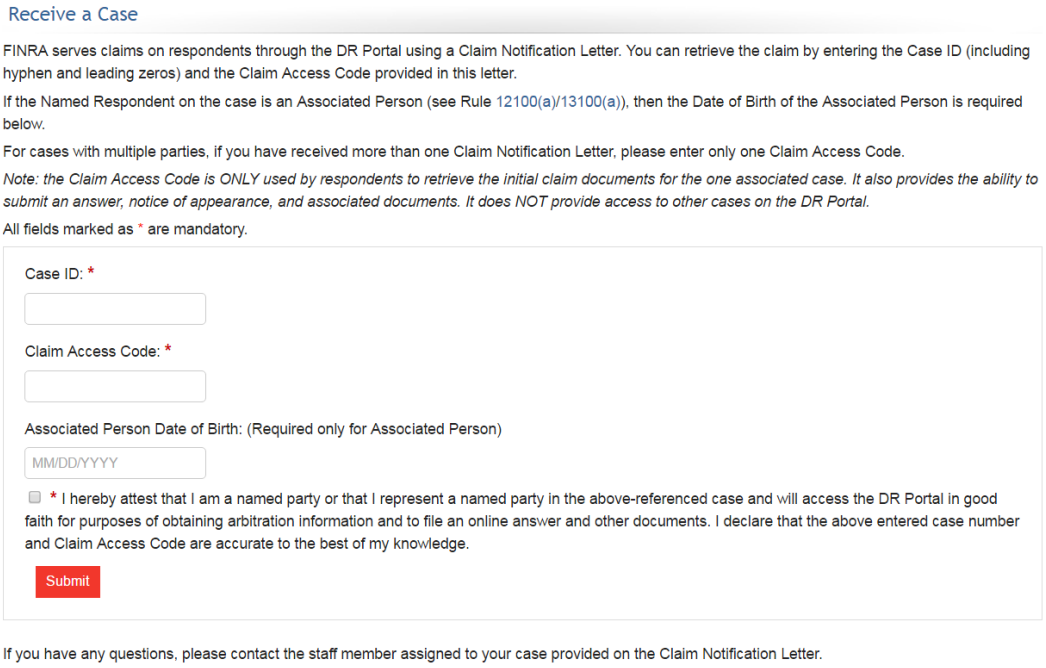
FINRA serves claims on respondents through the DR Portal using a Claim Notification Letter. If you receive this letter, you can retrieve the claim by logging into the portal and using the "**Receive a Case**" link on the left-hand menu, under where it says, "**I want to…**". You will need to enter the Claim Access Code (aka PIN) in order to access the claim documents.

Note: the Claim Access Code is ONLY used by respondents to retrieve ONLY the initial claim documents for that one case. It also provides the ability to submit an answer and associated documents. It does NOT provide access to other cases on the DR Portal or other types of documents on the associated case (this is called a "limited view" and is noted as such on the portal). Claimants do not receive these letters and should NOT attempt to use this Claim Access Code to access their case.

If you have been named in a claim and receive a Claim Notification Letter:

1. Click on the "Receive a Case" link.

2. Enter the FINRA Arbitration Number (Case ID) and the Claim Access Code from the Claim Notification letter or email you received regarding this new case. If you are a person associated with a FINRA member and you are registered with FINRA, you must also provide your date of birth.


Receive a Case

FINRA serves claims on respondents through the DR Portal using a Claim Notification Letter. You can retrieve the claim by entering the Case ID (including hyphen and leading zeros) and the Claim Access Code provided in this letter.

If the Named Respondent on the case is an Associated Person (see Rule 12100(a)/13100(a)), then the Date of Birth of the Associated Person is required below.

For cases with multiple parties, if you have received more than one Claim Notification Letter, please enter only one Claim Access Code.

Note: the Claim Access Code is ONLY used by respondents to retrieve the initial claim documents for the one associated case. It also provides the ability to submit an answer, notice of appearance, and associated documents. It does NOT provide access to other cases on the DR Portal.

All fields marked as * are mandatory.

Case ID: *

Claim Access Code: *

Associated Person Date of Birth: (Required only for Associated Person)

MM/DD/YYYY

* I hereby attest that I am a named party or that I represent a named party in the above-referenced case and will access the DR Portal in good faith for purposes of obtaining arbitration information and to file an online answer and other documents. I declare that the above entered case number and Claim Access Code are accurate to the best of my knowledge.

Submit

If you have any questions, please contact the staff member assigned to your case provided on the Claim Notification Letter.

3. If you enter the correct information, you will be taken back to the DR Portal and provided a **"Limited Case View"** of this case. At this point, you are considered a "**Preliminary User**" in the DR Portal for this case.

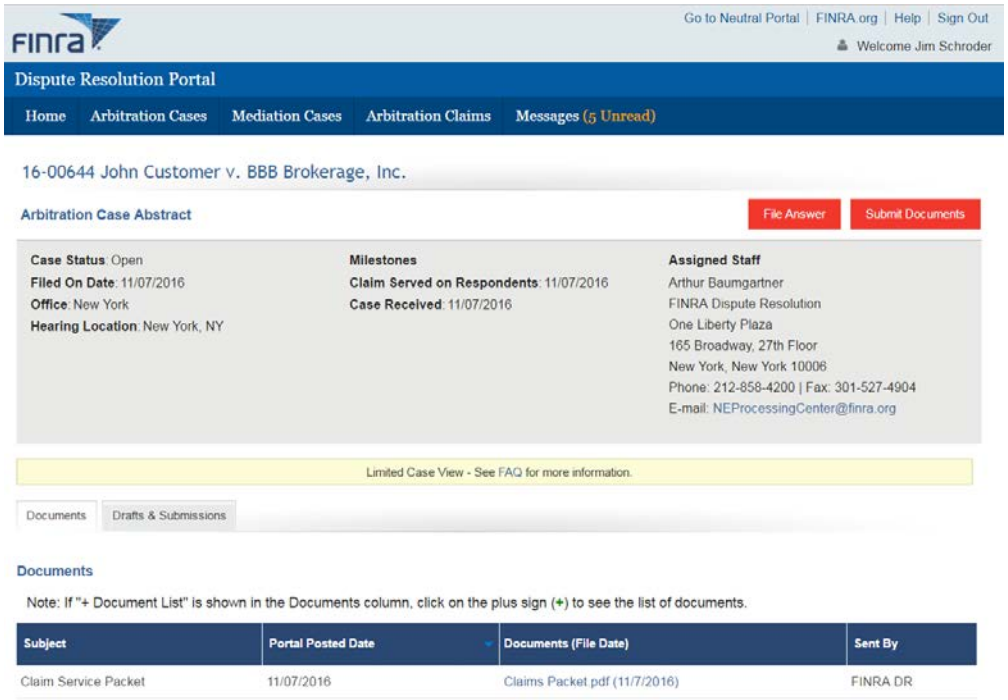
   With this limited view, you can:

   - Retrieve the initial claim documents that were filed by the claimant (called the Claim Service Packet, found in the Documents tab);
   - File an answer, including answers that contain cross, counter, or third party claims (press the red "File Answer" button to open the form in another browser tab);
   - File amendments to your submitted answer (press the red "Submit Documents" button to open the form in another browser tab).

The Claim Access Code can be used by more than one person. For example, a respondent party can use the code to retrieve a claim, and then give it to outside counsel who may then also use the same access code to retrieve the claim using their own account. Once you use the code to access the claim, you will not need to use the code again if you log out and back into the portal. You will continue to have access to this one document on this one case until the code is disabled.

Note: the Claim Access Code will be disabled:

- **Once the respondent files their answer with FINRA,**
- **If the Claim Access Code is mis-typed three times when trying to retrieve the claim,**
- **If the date that the answer is due to be filed with FINRA has passed and no extension has been filed with FINRA, or**
- **If an email invitation (see below) is accepted and the participant is registered.**



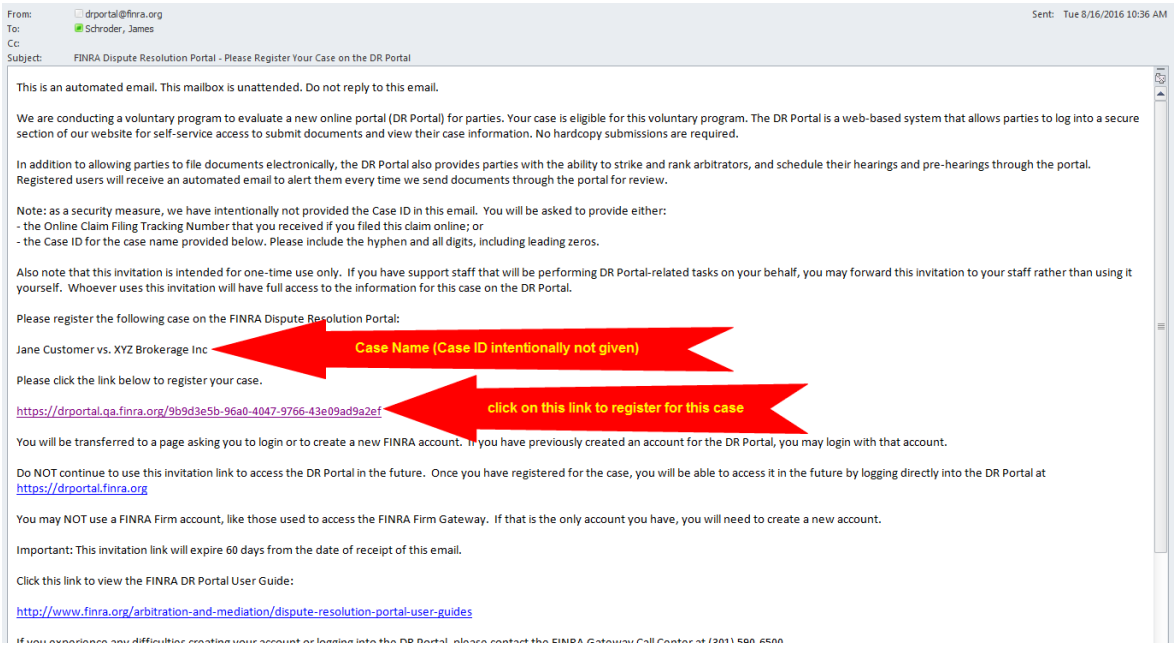
Email Invitation from FINRA

The second way to access case information is by receiving an email invitation from FINRA to register with the DR Portal for access to a particular case. This invitation email will be sent by FINRA to the party representatives on the case (as provided in the initial claim, answer, or Notice of Appearance), and will contain a personalized web address link that provides complete access to the case on the DR Portal. This email will typically be sent to the representative after FINRA receives initial documents related to the case and will be sent to the email address provided by the representative.

Once you are registered for the case, you have the ability to invite others into the DR Portal on a case by case basis (see User Management).

IMPORTANT: Unlike the Claim Access Code, this email invitation is personalized and can only be used ONCE by ONE recipient. It is intended for use by the party representative. However, the representative can instead give this invitation to a delegate (i.e. support staff), who will act on the representative's behalf for purposes of using the DR Portal. Whoever uses this invitation is considered the "Portal Contact" with regard to the Portal for this case, but this does NOT change the party representative.

FINRA will send an invitation to the named party representative with the subject line, **"FINRA Dispute Resolution Portal – Please Register Your Case on the DR Portal.**" It will contain a personalized link to register for a case:



1. Click on the link in the email underneath where it says, "Please click the invitation link below to register your case." You will be brought to the "**Welcome to Dispute Resolution**" log-in page and have the option to log into or create your FINRA account. **If you have not already created an account, see Appendix A.**

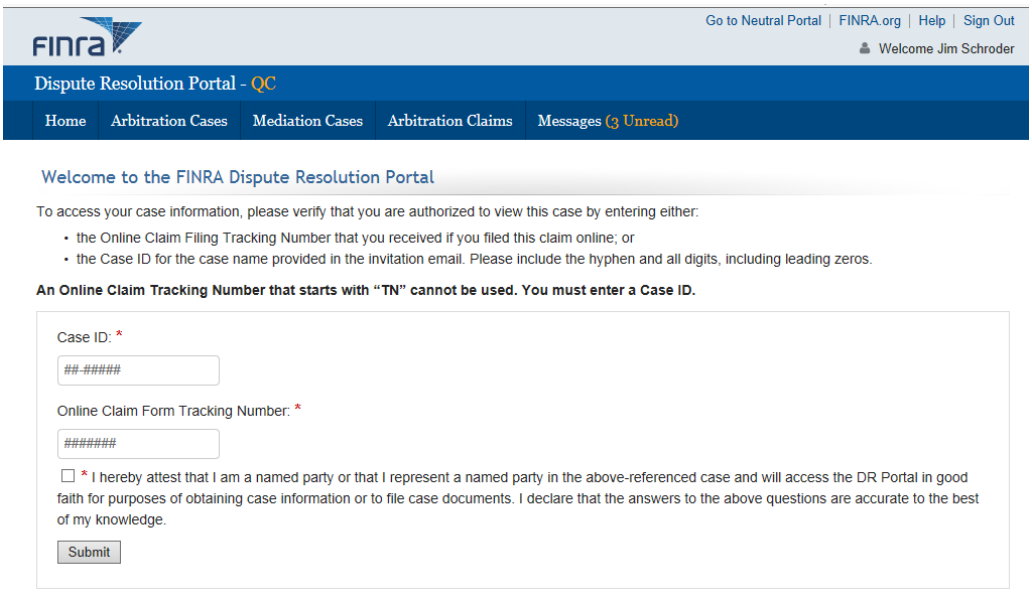
   Note: you can not use a FINRA Firm Gateway account on the DR Portal. You must create a separate account. You only need one account to access all cases to which you are invited. You should NOT create a new account for each case you receive, and each account should use the unique email address of the user. Do not use a "group mailbox" email address when creating an account.

2. Log into the DR Portal by entering your **User ID** and **password**.

You will be asked for the Case ID or your Online Claim Tracking Number as a challenge question to verify your identity.

IMPORTANT: as a security measure, this information is intentionally not included in the invitation email.

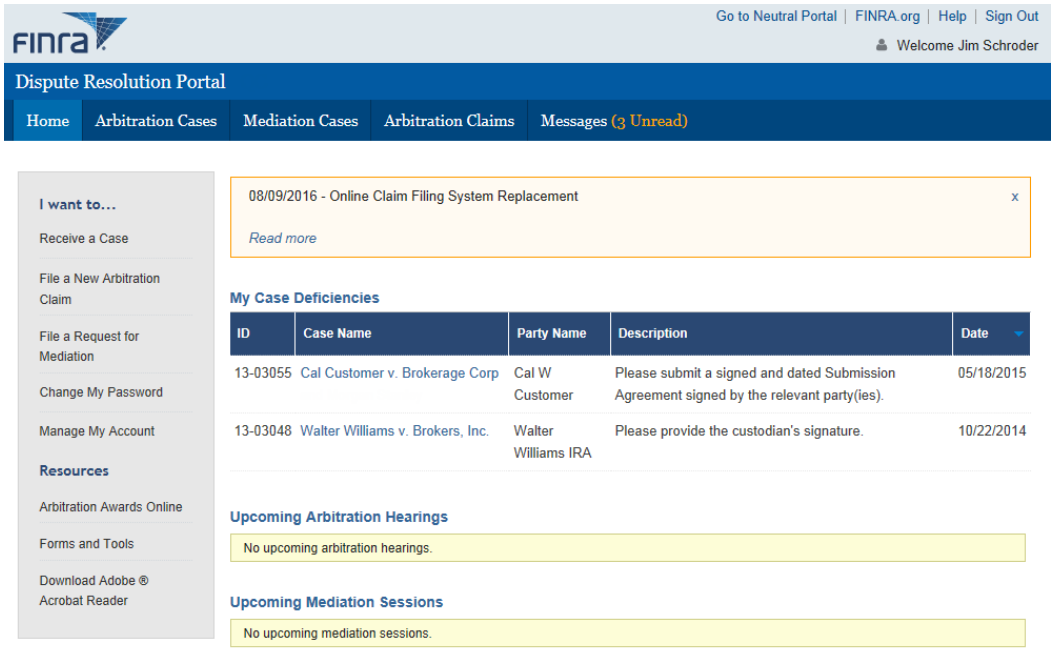
- If you are a claimant and filed your claim online through the DR Portal, your claim was assigned a Tracking Number.
- If you mailed your initial claim to FINRA, we will have emailed you the Case ID after we received your initial claim.
- If you are the respondent, you would have received the Claim Notification Letter that included the matching case name and Case ID.



3. If you answer the challenge question correctly, you will be taken to the DR Portal and be able to view all of the details for the case. At this point, you are considered the "**Portal Contact**" in the DR Portal for this case.

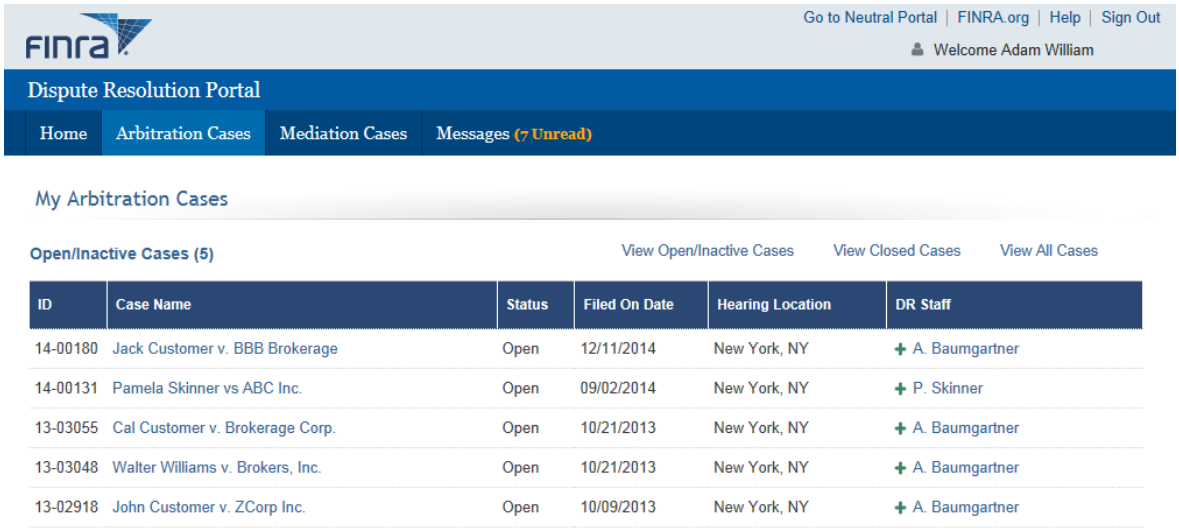
Home

The Home page displays any outstanding case deficiencies (issues to be resolved on a case) for the participant's cases, as well as any arbitration hearings or mediation sessions scheduled within the next seven days. It also displays announcements (in the orange banners near the top of the page) regarding the DR Portal or relevant FINRA DR activity. It does NOT display your complete list of cases. To see your cases, click on the "Arbitration Cases" tab or "Mediation Cases" tab next to the "Home" tab at the top of the page.



Arbitration Cases

This menu takes you to a page that lists all of the arbitration cases associated with the participant. Clicking on any of the green plus-signs (e.g., next to the name of the DR staff person assigned to the case) will expand the view to show more detail. Clicking on it again will hide the details.



To see the details of a particular case, click on a listed case name. This will open the Case Abstract along with a row of tabs providing additonal information about the case.

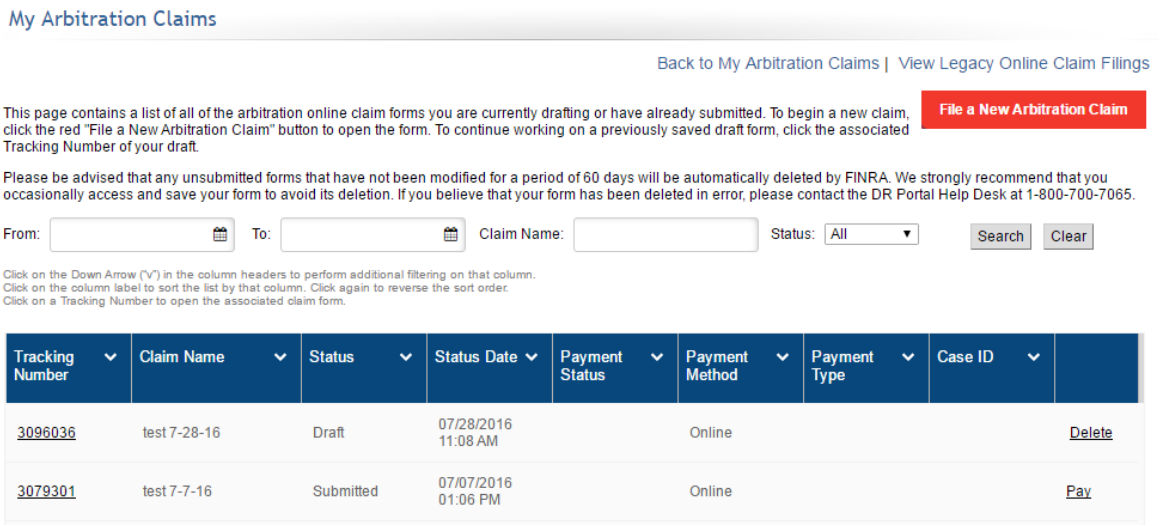
Mediation Cases

This menu takes you to a page that lists all of the mediation cases associated with the participant.

For both Arbitration Cases and Mediation Cases, the page defaults to show only open cases. You can click on "View Closed Cases" or "View All Cases" to change what is displayed in the list. You can also click on the column headings to change the sort order of the list.

Arbitration Claims

This page contains a list of all of the arbitration online claim forms you are currently drafting or have already submitted.



Filing an Arbitration Claim

- To begin a new claim, click the red **File a New Arbitration Claim** button. This will open the Online Claim Information Form. A Tracking Number is assigned to your claim as soon as you begin your draft. This number will be used to track your claim after you submit it.
- You can search for previously submitted claims or drafts using the search fields. You can search by date range, the name you gave your draft claim, or its status (draft or submitted).
- To continue working on a previously saved draft claim, click the associated Tracking Number of your draft.

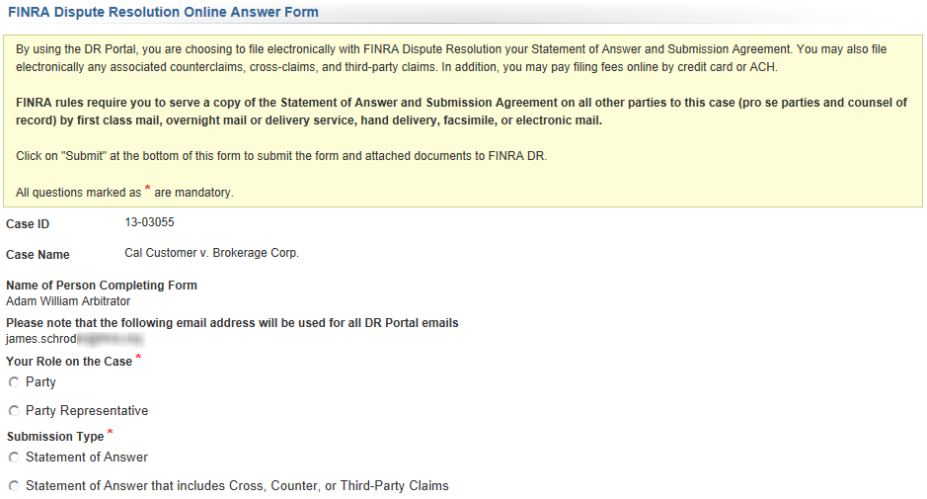
- To delete a draft claim, click the "**Delete**" link.
- If you submitted a claim but did not complete the payment process for some reason, you can click on the "**Pay**" link to complete the payment process.
- If you had submitted arbitration claims using the previous Online Claim Filing System (retired in August 2016) with the same account, you may be able to see these submitted claims by clicking on "**View Legacy Online Claim Filings**".

The Claim Information Form includes several sections that need to be completed. Each section can be accessed by clicking on the **Continue** and **Previous** buttons found on each page of the form.

You can return to your list of draft and submitted claim forms by clicking on "**Back to My Arbitration Claims**" link.

To file an arbitration claim:

1. Read all of the instructions provided on the form carefully.
2. Enter all of the required information on each of the tabs of the Claim Information Form. This information should match everything specified in your Statement of Claim.


FINRA Dispute Resolution Online Answer Form

By using the DR Portal, you are choosing to file electronically with FINRA Dispute Resolution your Statement of Answer and Submission Agreement. You may also file electronically any associated counterclaims, cross-claims, and third-party claims. In addition, you may pay filing fees online by credit card or ACH.

FINRA rules require you to serve a copy of the Statement of Answer and Submission Agreement on all other parties to this case (pro se parties and counsel of record) by first class mail, overnight mail or delivery service, hand delivery, facsimile, or electronic mail.

Click on "Submit" at the bottom of this form to submit the form and attached documents to FINRA DR.

All questions marked as * are mandatory.

Case ID 13-03055

Case Name Cal Customer v. Brokerage Corp.

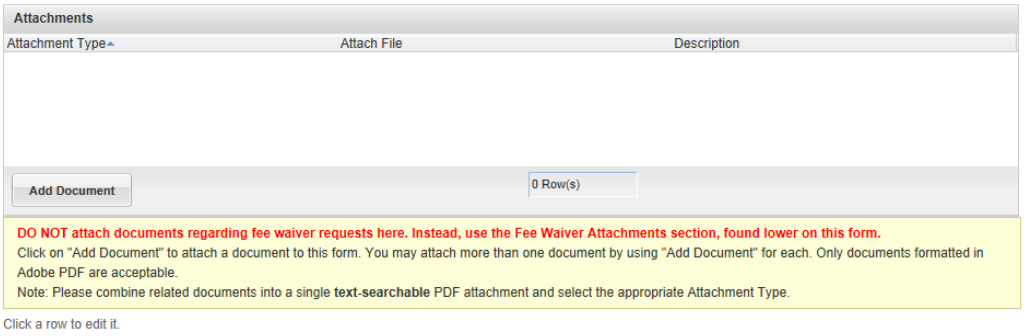
Name of Person Completing Form
Adam William Arbitrator

Please note that the following email address will be used for all DR Portal emails
james.schrod

Your Role on the Case *
- Party
- Party Representative

Submission Type *
- Statement of Answer
- Statement of Answer that includes Cross, Counter, or Third-Party Claims

3. On the Documentation tab, attach your documents. Attachments can be added by clicking on the **Add Document** button. (Note that attachments must be text-searchable Adobe PDF formatted files.)


Attachments

Attachment Type	Attach File	Description

Add Document — 0 Row(s)

DO NOT attach documents regarding fee waiver requests here. Instead, use the Fee Waiver Attachments section, found lower on this form.
Click on "Add Document" to attach a document to this form. You may attach more than one document by using "Add Document" for each. Only documents formatted in Adobe PDF are acceptable.
Note: Please combine related documents into a single **text-searchable** PDF attachment and select the appropriate Attachment Type.

Click a row to edit it.

Note: Please combine related documents (e.g., a series of exhibits) into a single text-searchable PDF attachment and select the appropriate Attachment Type. Note, however, that a single attachment cannot be larger than 500MB in size. If your combined file would be larger than this, please submit as separate files. Unrelated documents should be submitted as separate attachments by selecting the appropriate attachment type for each.

4. Attach a scanned Adobe PDF of a signed Submission Agreement, or "sign" the Submission Agreement section of the form.
5. Press the **Submit** button to submit your completed form, or press the **Save as Draft** button to save a draft of your form.
6. If you did not request a waiver of the filing fees, you will be taken to the payment page to pay the filing fee. You can pay by credit card or you can use a checking account by using the ACH (Automated Clearing House) payment option.
7. Once you complete the payment process, you can view the completed claim form.

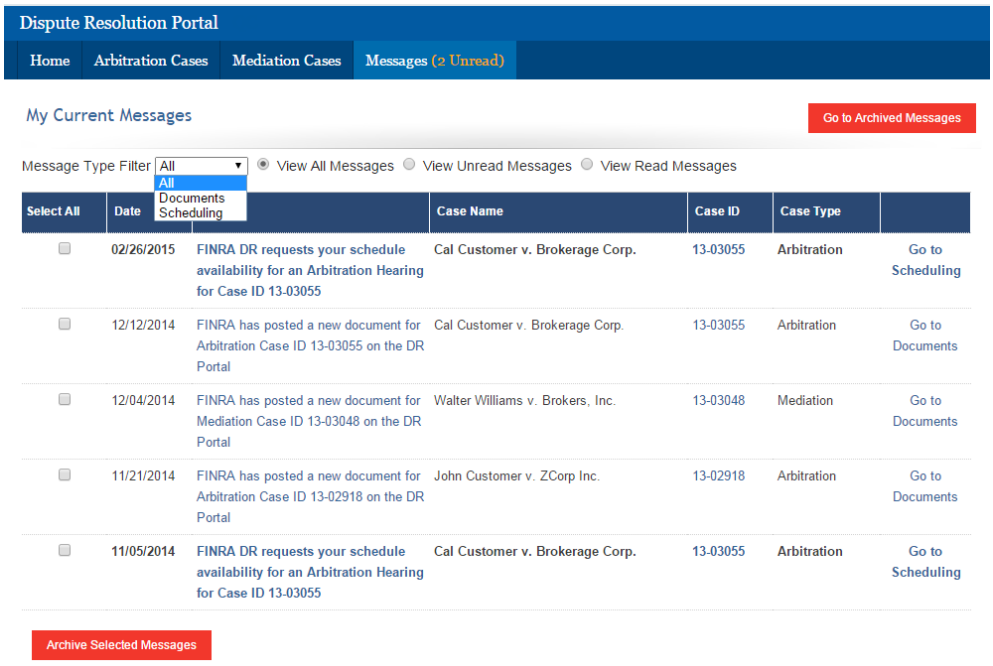
Note: A detailed description of how to complete the Claim Information Form and what happens after it is submitted can be found in Appendix B.

Messages

This menu option takes you to a page showing all of the messages that have been sent to the participant regarding activity on all of their cases being handled through the DR Portal. The participant also receives these messages as email alerts. The number in orange indicates the number of unread messages. The view defaults to showing all received messages that you have not already archived. Unread messages are displayed in bold type. You can limit the view to just your unread messages by clicking on "View Unread Messages." You can also filter the messages to show just those relating to documents that have been published to you on the Portal or scheduling requests. Select "Documents" or "Scheduling" in the Message Type Filter drop-down menu.

To archive messages, click on the checkbox to the left of the message to select them (or click on "Select All" to select all messages), and then click on the **Archive Selected Messages** button. To view your archived messages, click on the red **Go to Archived Messages** button.

In addition, any announcements that you deleted from the Home page (by clicking on the **X** next to the announcement) can be found on the Archived Messages page.



Case Details

When you click on a case name from the Arbitration Cases page, the details of that particular case are displayed.

Case Abstract

The Case Abstract provides an assortment of details about the case, including the Dispute Resolution case administrator assigned to the case with their contact information.

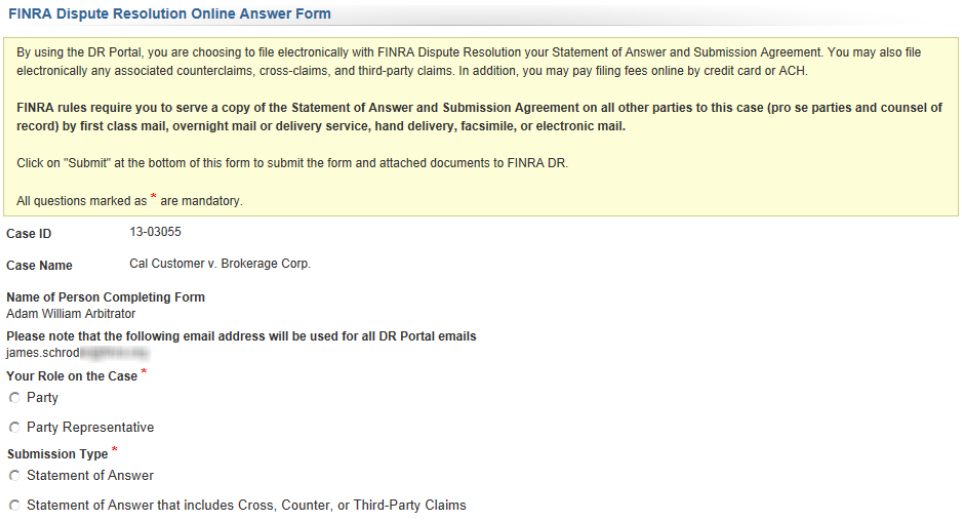
Filing an Answer

Above the Case Abstract are two buttons: **File Answer** and **Submit Documents**.

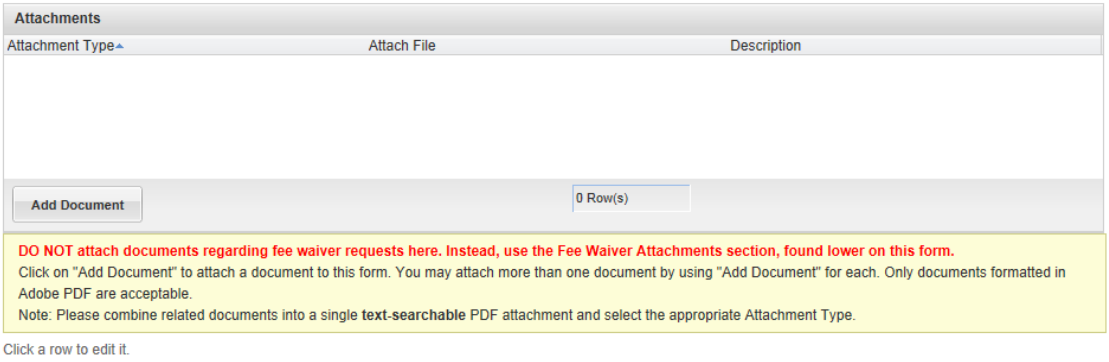
Once you have retrieved the claim documents, you can file an answer by clicking on the red **File Answer** button. This will open the Online Answer Form in a separate browser tab (although some browsers may behave differently.)

To submit an answer:

1. Enter all of the required information on the Answer Form.



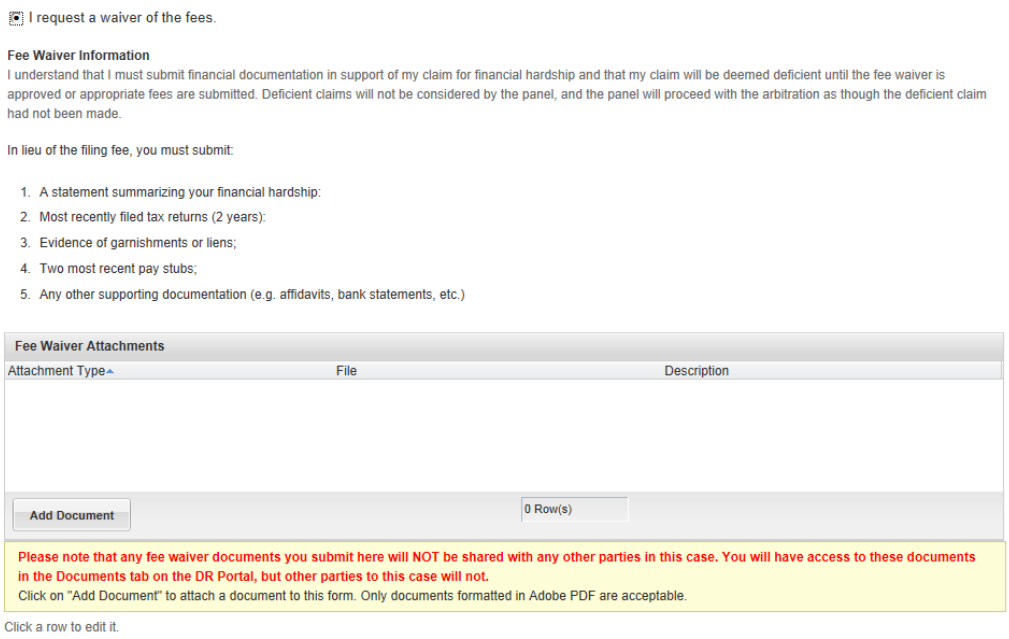
2. Attach your documents. Attachments can be added by clicking on the **Add Document** button. (Note that attachments must be Adobe PDF formatted files.)



3. Select the attachment type for each attachment.
4. Find the file on your computer using the "Browse…" button.
5. Enter a description for the attachment, if desired.
6. Click on the **Add Document** button.

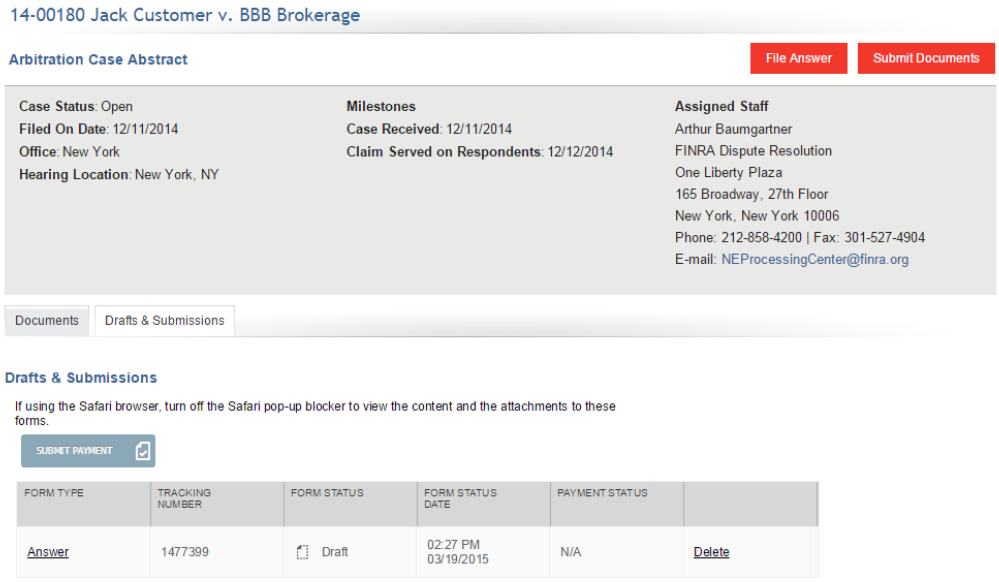
Note: Please combine related documents (e.g., a series of exhibits) into a single text-searchable PDF attachment and select the appropriate Attachment Type. Note, however, that a single attachment cannot be larger than 500MB in size. If your combined file would be larger than this, please submit as separate files. Unrelated documents should be submitted as separate attachments by selecting the appropriate attachment type for each.

7. If you selected "Statement of Answer that includes Cross, Counter, or Third Party Claim", enter the appropriate filing fee amount in the Fee Summary area so that you can submit payment along with your answer. Be sure to select the name of the party that should receive credit for the payment. If you are requesting a fee waiver based on financial hardship, you must attach the required documentation in the "Fee Waiver Attachments" section.



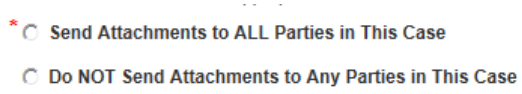
8. Check the boxes to indicate that you have served the documents upon the other parties to the case (if applicable), and that you have complied with FINRA policy regarding protecting personal confidential information.
9. Select whether you would like to send a "courtesy copy" of your attached documents to all of the other parties in this case. See "Courtesy Copy" section below for more information on this new feature.
10. Click **Submit**. A Filing ID number (also known as a Tracking Number) will be assigned to your submission so that you can refer to it later.
11. You can pay the filing fee online by credit card or ACH bank transfer from your checking account. If you are experiencing financial hardships and are not a FINRA member, then you may instead request a waiver of the filing fee. You must select one of these options in order to submit your claim. If you are paying the fees online, you will be taken to the online payment system to make your payment.
12. Once you complete the payment process, you can view the completed answer form. You can then close this browser tab and go back to the DR Portal in the other browser tab that is still open.

When you click on the File Answer button, a draft of the form will be saved in your Drafts & Submissions tab of the case so that you can return to it later. While you are working on the form you can also click on the **Save** button to save a draft of your form and return to it later. You can delete a draft form by clicking on "**Delete**". Submitted forms will also appear in the Drafts & Submissions tab, with a status of Submitted.



Courtesy Copy

We are in the process of adding the ability for parties to serve case documents on each other through the DR Portal. As a first step, we have added the ability for you to send a copy of your submissions to all parties in this case that are using the DR Portal. Note that this does NOT yet constitute actual service of these documents. Parties are still required to serve copies of filed documents directly on all parties to the case. If you select the "Send Attachments to ALL Parties in This Case" option, all of the attached documents will be sent immediately to the DR Portals of all of the parties on the case.



Courtesy copy recipients will be notified of received documents via email as well as a message on their DR Portal. Recipients will be able see these documents in their "Documents" tab for the associated case within minutes of your submission.

TIP: Some documents (such as ranking sheets and fee waiver requests) are NOT sent to other parties even if you accidentally select the "Send Attachments…" option on your submission. However, this depends upon you choosing the proper attachment type of "Non-standard Arbitrator Ranking Sheet" or using the Fee Waiver Attachment section of the form when attaching these documents. It would be safer to select the "Do NOT Send Attachments…" option when sending these types of documents.

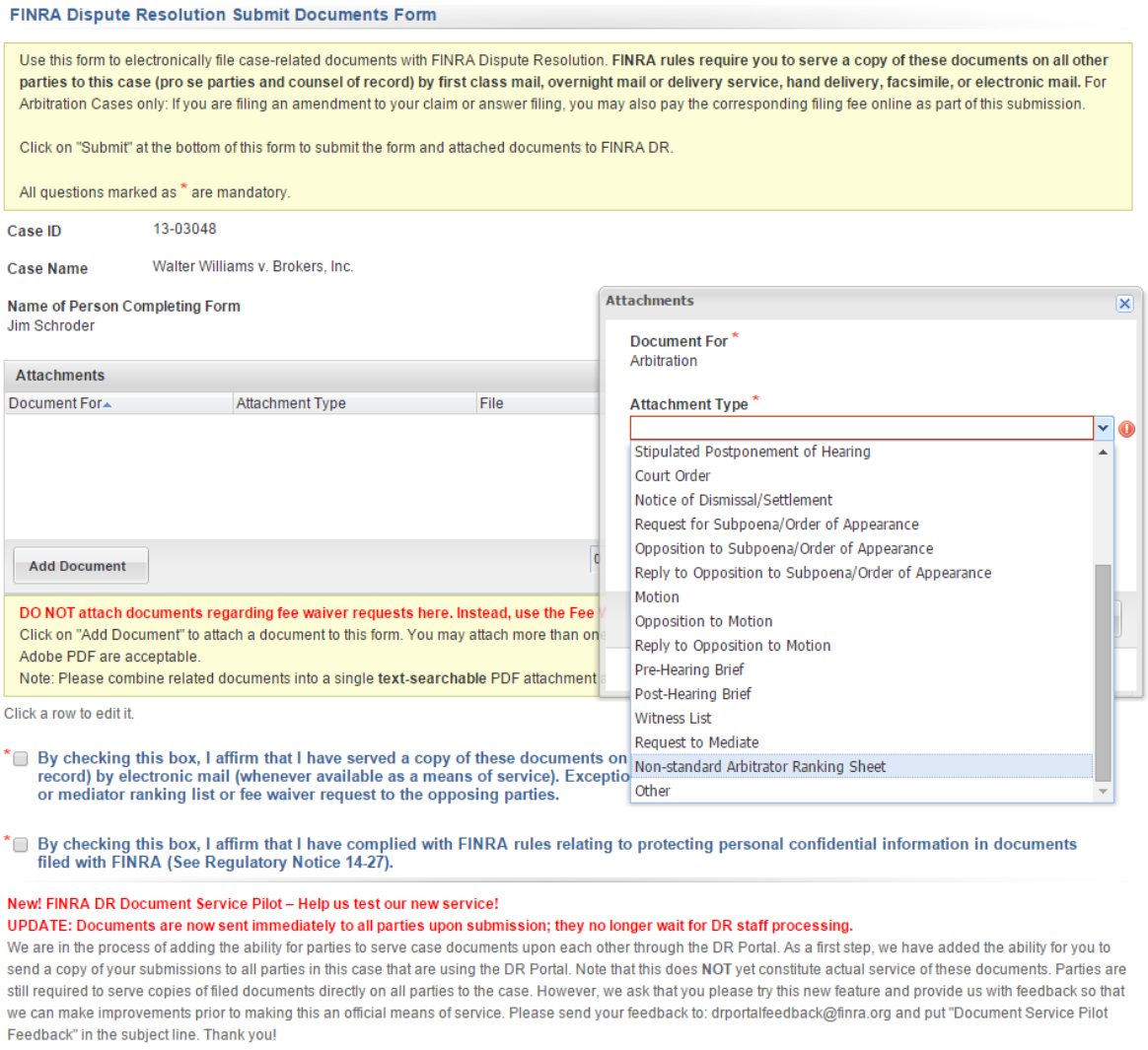
For example, if you attach a scanned ranking sheet, but incorrectly select an attachment type of "Other", and then select the "Send Attachments to ALL Parties in This Case" option, the ranking sheet WILL be sent to other parties on the case.

We ask that you please try this new feature and provide us with feedback so that we can make improvements prior to making this an official means of service. Please send your feedback to: drportalfeedback@finra.org and put "Document Service Pilot Feedback" in the subject line.

Submitting Documents

If you need to submit a document to FINRA after you have already submitted your answer, click on the **Submit Documents** button. This will open the Submit Documents form in a separate browser tab. To submit documents:

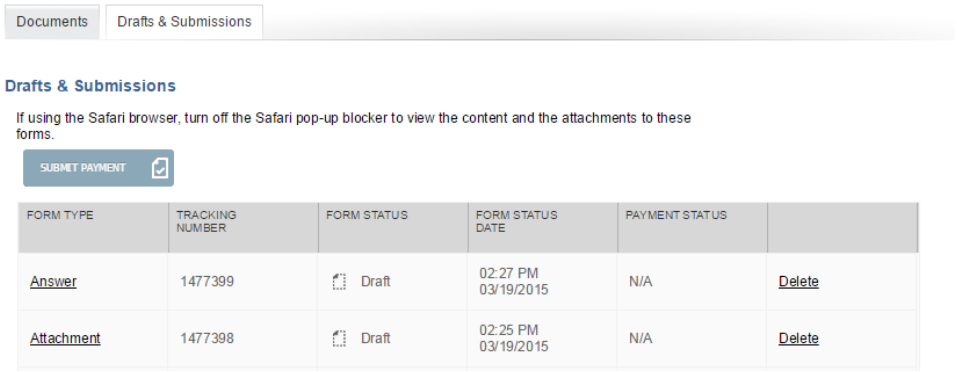
1. Attach your documents. Attachments can be added by clicking on the **Add Document** button. (Note that attachments must be Adobe PDF formatted files.)



2. Select the attachment type for each attachment.
3. Find the file on your computer using the “Browse…” button.
4. Enter a description for the attachment, if desired.

5. Click on the **Add Document** button.
6. If you selected "Amendment to Statement of Claim" or "Amendment to Statement of Answer", there may be additional fees due. Enter the appropriate amount in the Fee Summary area so that you can submit payment along with your amendment. Be sure to select the name of the party that should receive credit for the payment.
7. Check the boxes to indicate that you have served the documents upon the other parties to the case (if applicable), and that you have complied with FINRA policy regarding protecting personal confidential information.
8. **NEW:** Select whether you would like to send a "courtesy copy" of your attached documents to all of the other parties in this case. See "Courtesy Copy" section above for more information on this new feature.
9. Click **Submit**. A Filing ID number (also known as a Tracking number) will be assigned to your submission so that you can refer to it later.

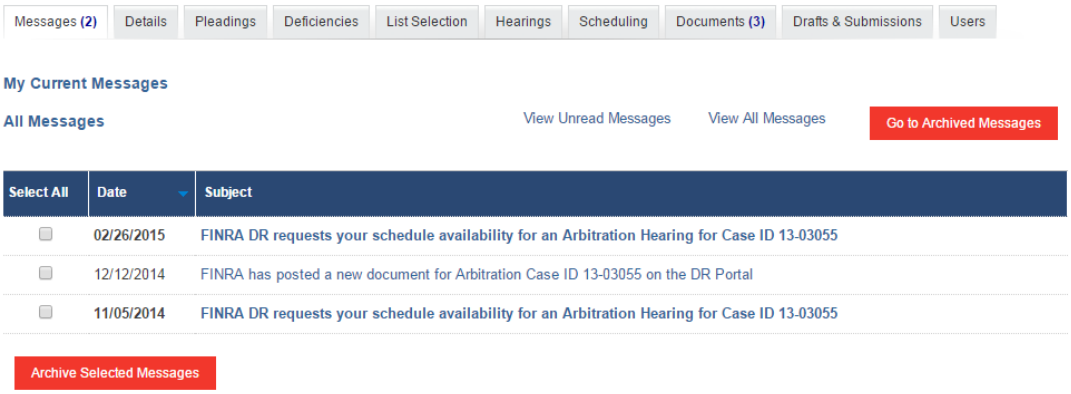
When you click on the Submit Documents button, a draft of the form will be saved in your Drafts & Submissions tab of the case so that you can return to it later. While you are working on the form you can also click on the **Save** button to save a draft of your form and return to it later. You can delete a draft form by clicking on "Delete". Submitted forms will also appear in the Drafts & Submissions tab, with a status of Submitted.



Messages

The **Messages** tab shows the messages you have received from FINRA regarding this case. The number in blue indicates the number of unread messages. The view defaults to showing all received messages for this case that you have not already archived. Unread messages are displayed in bold type. You can limit the view to just your unread messages by clicking on "View Unread Messages."

To archive messages, click on the checkbox to the left of the message to select them (or click on "Select All" to select all messages), and then click on the **Archive Selected Messages** button.



To view you archived messages, click on the **Go to Archived Messages** button. You can return archived messages back to your current message page by selecting the archived messages and clicking on **Unarchive Selected Messages** button.

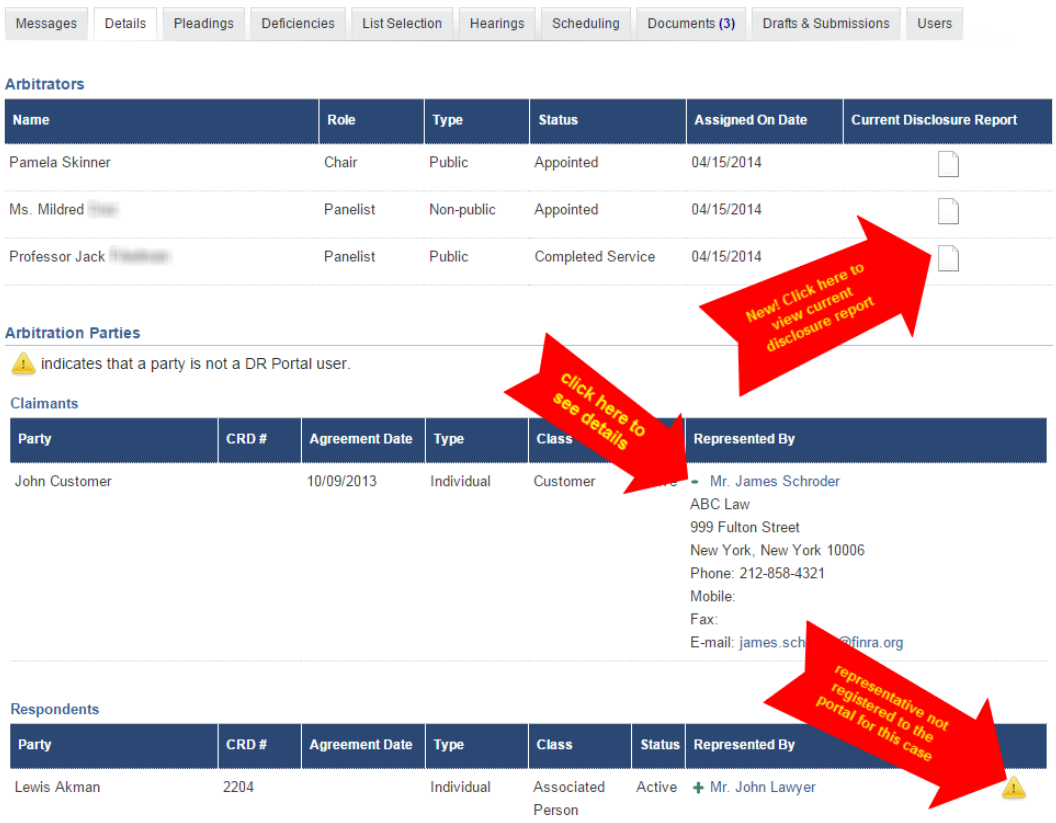
Details

The **Details** tab shows the names of the parties and their respresentatives, and the assigned FINRA staff member. By clicking on the representatives' names, you can see their contact information. You can also view the names of the neutrals assigned to the case once they have been selected.

TIP: If a party representative has not yet registered to use the Portal for the case, they will have a yellow warning indicator to the right of their name. This representative will NOT receive courtesy copies of documents you submit through the portal.

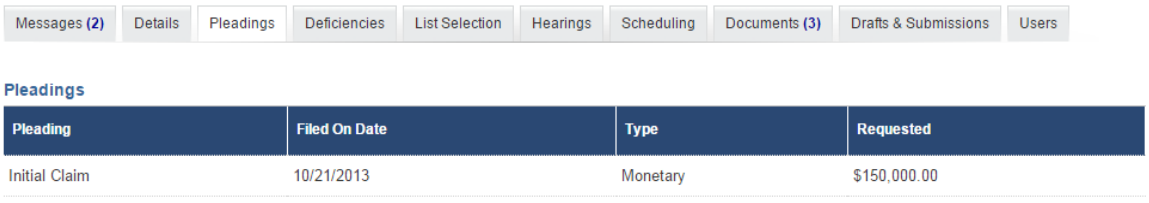
IMPORTANT: Parties may become "inactive" on a case for various reasons. If all of the parties associated with a representative become inactive, that representative will NOT be able to see that case in the portal. If you were previously able to see a case in the portal but now you cannot, this is a potential cause. Contact your case administrator for more information.

You can click on the Current Disclosure Report icon to view the current disclosure report available for each panelist on your case.



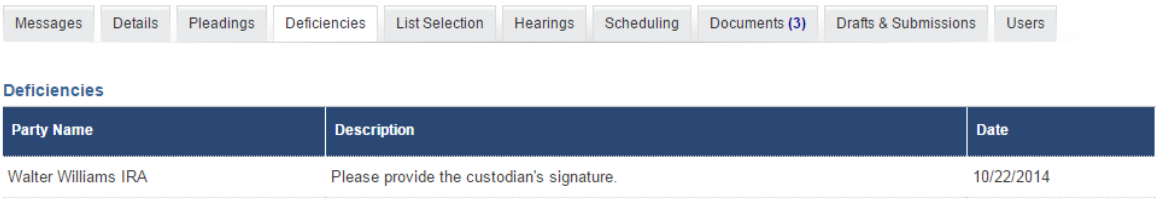
Pleadings

The **Pleadings** tab shows a summary of the pleadings that have been entered for this case. Note that the actual pleadings filed with FINRA may contain more information than is displayed here.



Deficiencies

The **Deficiencies** tab shows a list of open issues to be rectified by the listed party for this case.



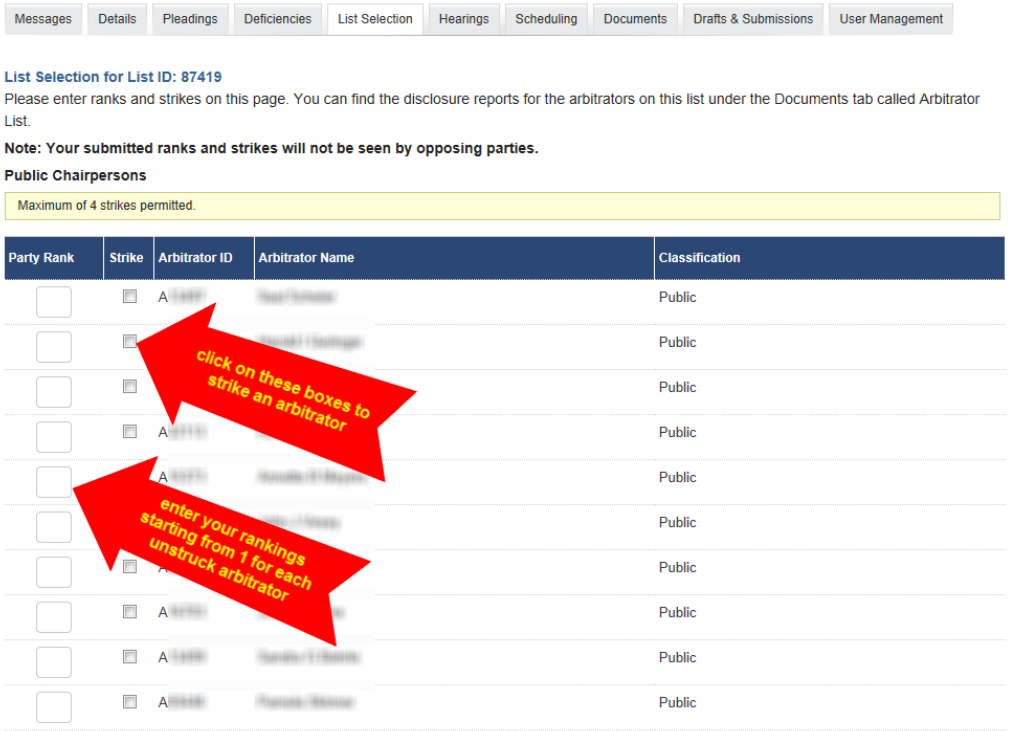
List Selection

The **List Selection** tab allows party representatives to strike and rank arbitrators on the provided arbitrator list. This ranking page replaces the use of the paper ranking form.

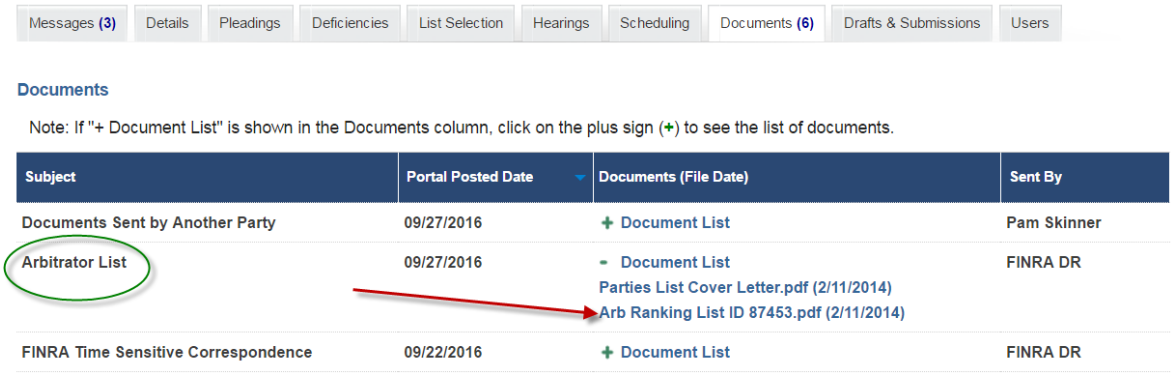
Rest assured that opposing counsel CAN NOT see the rankings you submit through the DR Portal. Your submission is only viewable by FINRA staff.

For each section of the list, strike the arbitrators that you do not wish to be on the panel, and rank the remaining arbitrators, starting at 1 for your highest ranked arbitrator in that section.

Note: You cannot save partially completed rankings and return to them later. You must complete your entries in one session. You can use the paper ranking form as a worksheet for personal use until you are ready to submit your final rankings. Do not submit this paper ranking form if you are submitting rankings through the DR Portal.



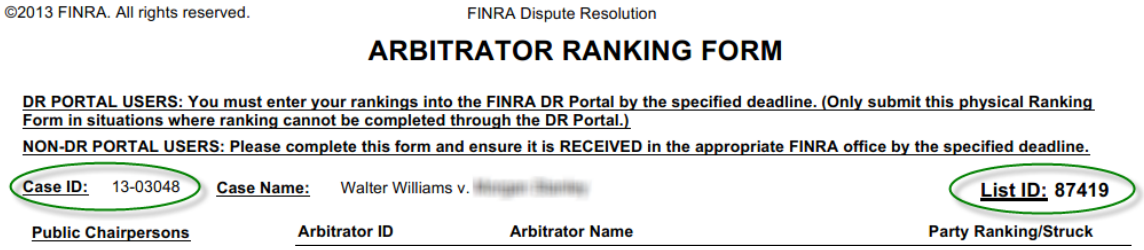
The disclosure reports for all of the arbitrators listed in the List Selection tab can be found in the Documents tab with the subject heading of "Arbitrator List."



The first page of the disclosure report is the Table of Contents, listing the names of all of the arbitrators contained within the report.

TIP: you can click on the name of an arbitrator to take you straight to that page of the document. You can also turn on the "bookmarks" feature in your PDF viewing program to easily jump to any page in the document.

The second page of the disclosure report is the ranking form. Do **NOT** submit this paper ranking form, since you will instead be ranking the arbitrators online in the List Selection tab. You should, however, confirm that the Case ID and List ID provided on the ranking form is the same as the List ID noted in the List Selection tab. The subsequent pages provide the arbitrators' disclosure reports.



Once you have entered all of your ranks and strikes, you can enter a comment for your own personal use (you should not expect these comments to be read by FINRA staff) at the bottom of the page and then click on **Submit Ranking Sheet**. Only one ranking sheet can be submitted by a representative. If a ranking sheet was submitted in error, you should contact your FINRA case administrator assigned to the case and have them delete it so that you can re-submit.

Note: Shortly after your ranking sheet is submitted, you should receive a confirmation email. In addition, a copy of your submitted rankings can be found in the Documents tab (called "Submitted Arbitrator Ranking Sheet") so that you can verify your submission. If you do not find it, contact the Dispute Resolution case administrator assigned to your case, or send an email to claimhelp@finra.org to verify that FINRA has received your rankings.

Note that the process is the same for mediator lists and ranking.

Non-Standard List Selection

The **List Selection** tab allows party representatives to strike and rank arbitrators on the initial ranking list sent out to parties. On some occasions (such as a "short list" of replacement arbitrators), a supplemental list of arbitrators needs to be used. These supplementary ranking sheets are not handled by the List Selection tab in the Portal. Instead, the following steps should be taken to submit a supplementary ranking sheet:

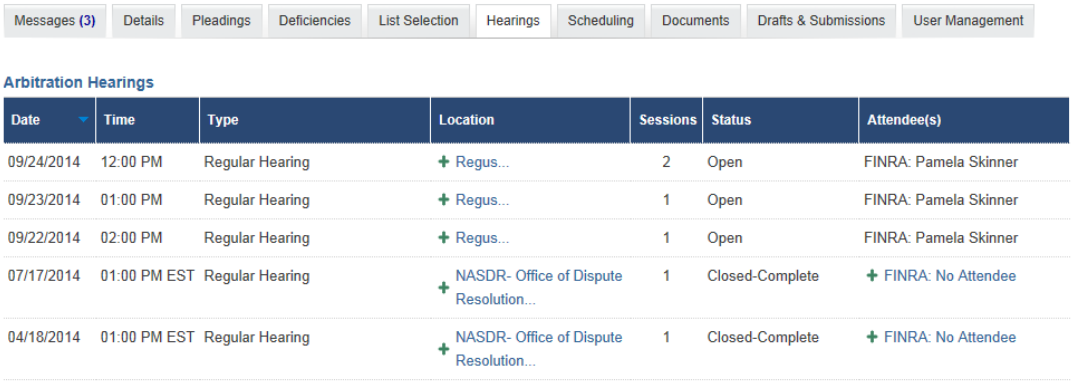
1. You will receive an email and message that an Arbitrator List has been published on the Portal, and you will find the supplemental ranking sheet in the Documents tab. However, you will not find the corresponding list in the List Selection tab.
2. Print the supplemental ranking sheet, write your ranks and strikes and other required information on it.
3. Scan your hand-written ranking sheet and create an Adobe PDF document.
4. Follow the steps for "Submitting Documents" on page 15. Select an attachment type of "Non-standard Ranking Sheet".

Note: As long as you select an attachment type of "Non-standard Ranking Sheet", your submission will NOT be sent to other parties even if you accidentally select the "Send Attachments…" option on your submission. However, this depends upon you choosing the proper attachment type when attaching these documents. It would be safer to select the "Do NOT Send Attachments…" option when sending these types of documents.

For example, if you attach a scanned ranking sheet, but incorrectly select an attachment type of "Other", and then select the "Send Attachments…" option, the ranking sheet WILL be sent to other parties on the case.

Hearings

The **Hearings** tab shows all of the hearings that are scheduled or have already been held for the case. You can also view the address and phone number for a hearing location. The Hearings page also provides information about which arbitrators and FINRA staff attended a particular hearing.

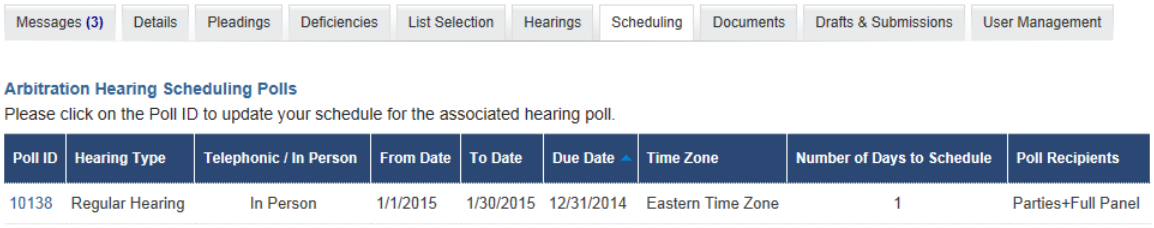


Scheduling

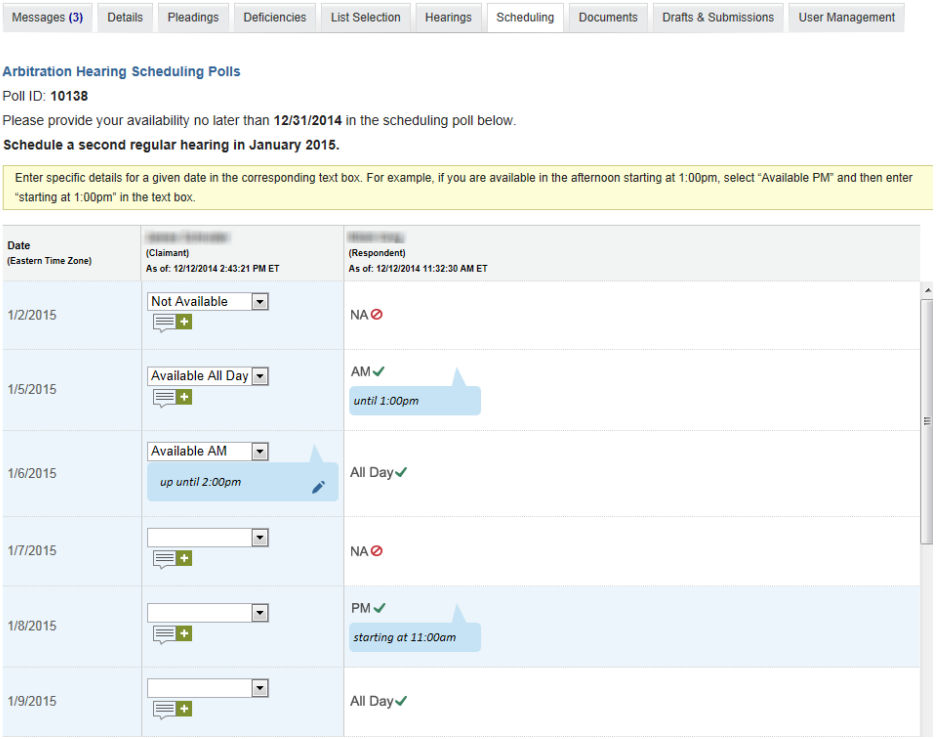
The **Scheduling** tab provides a collaborative tool that allows the party representatives and neutrals to find mutually agreeable dates for scheduling (or rescheduling) arbitration hearings or mediation sessions.

When a hearing or session needs to be scheduled or rescheduled, FINRA staff will propose a range of dates by creating a "Scheduling Poll." When DR staff publishes a poll on the DR Portal, each of the required attendees will receive an email notification telling them to come to the DR Portal to complete the poll by providing their availability.

Click on the Poll ID to open the poll.



For each date, enter your availability. You can also enter a comment in the box by clicking on the green plus sign. Once you are finished, click on **Save** at the bottom of the poll. Your entries and comments will be immediately viewable by every other attendee on the case, as well as by DR staff.

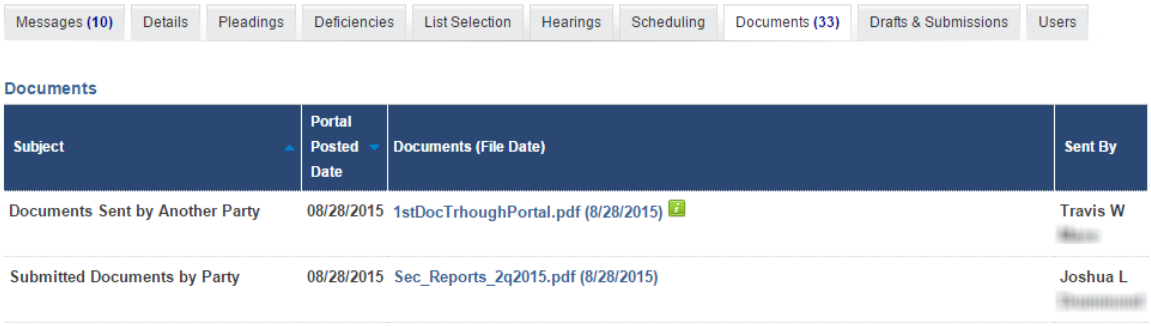


You can come back to the poll to make changes and update your comments in order to try and reach consensus on acceptable dates, all without having to speak in person. Click on **Save** after you make changes so that other attendees can see your latest updates.

Note that the process is the same for mediation Scheduling Polls.

Documents

The **Documents** tab shows a list of documents contained in the case file that have been made available for viewing through the portal. This includes documents you submitted to FINRA as well as documents published by FINRA staff to the portal. The number in blue indicates the number of unopened documents. The Sent By column tells you who sent the document to you. If it was submitted by another party and they used the "courtesy copy" feature, the party representative's name will be shown here.

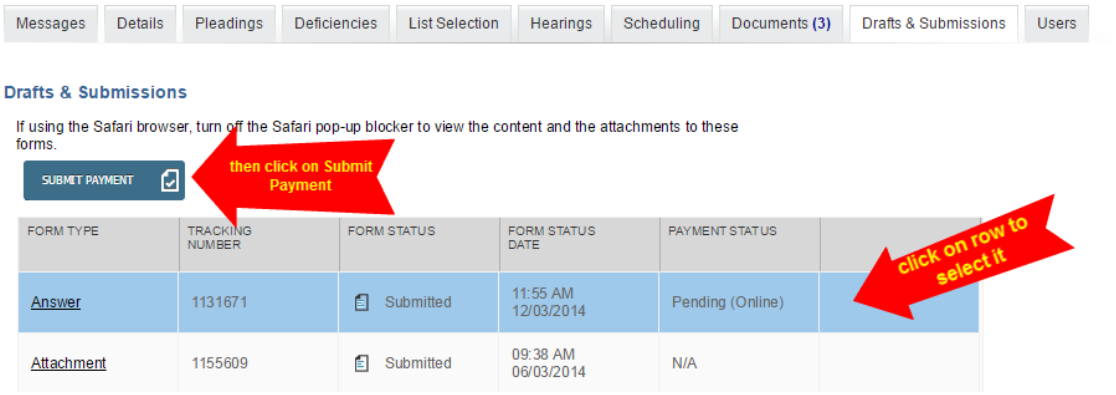


ADVANCED TIP: Portal Contacts and Secondary Contacts (see "User Management" later in this Guide) receive an automated email whenever activity occurs on one of your cases. Each type of automated email has a small, identifying code word at the bottom. For example, when FINRA publishes a document on the portal for one of your arbitration cases, the automated email will include the code word "PUBADOC". You can create "rules" in your email system to look for these code words on incoming email to automatically route the emails as you desire. Be sure that FINRA emails are not being stopped by any email spam blockers you may have.

Drafts & Submissions

The **Drafts & Submissions** tab shows a list of the forms that you are currently working on (drafts) as well as the forms you have already submitted to FINRA (submissions). Forms that have been submitted will have an assigned Tracking Number that you can refer to later.

If you submitted a form that required payment (e.g. a filing fee), but did not complete the payment process at the time of submission, you can come to this tab, select the form by clicking on the row, and then click on the "Submit Payment" button to complete the payment process.



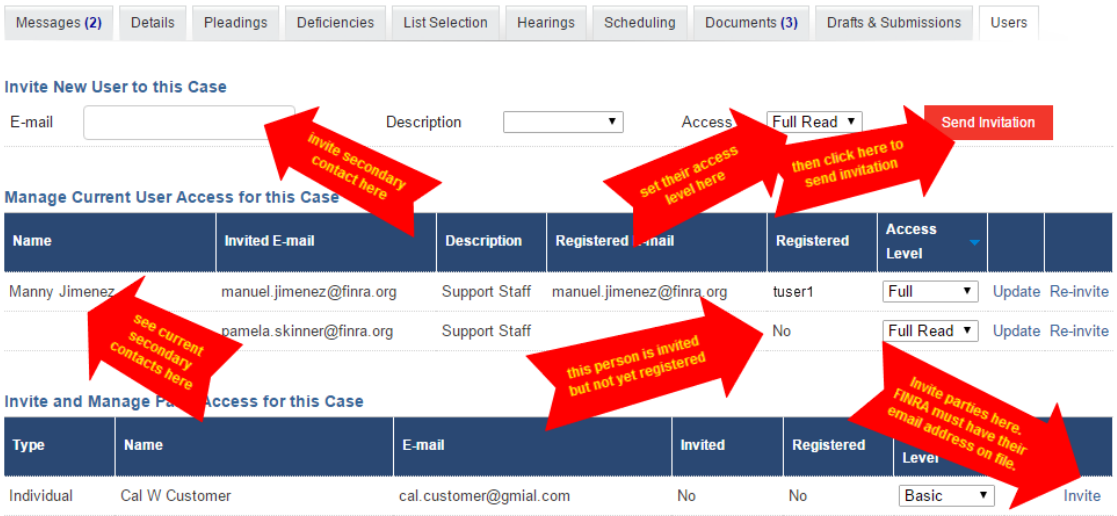
User Management

The party representative that used the invitation email that came from FINRA to register for the case is called the "**Portal Contact.**"

Note that the "Portal Contact" does not have to be the same person as the actual party representative (i.e., as provided in a notice of appearance.) If the DR Portal invitation email was used by someone other than the party representative, that person becomes the "Portal Contact" with regard to DR Portal work for the case. This does not, however, change who is named as the party representative.

It is permitted for the party representative to delegate the role of Portal Contact for DR Portal work, but the representative is responsible for all submissions made.

The **Users** tab allows a Portal Contact to grant access to the DR Portal to another individual for a particular case by sending an invitation.



Invite New User to this Case lets the Portal Contact invite anyone they choose (such as support staff) to the case by entering the email address, a basic description, an access level, and then

clicking the **Send Invitation** button. Invited individuals are sometimes called "Secondary Contacts" in the system or by Dispute Resolution staff.

Note: You should not send an invitation to yourself from this page. If you invite yourself and use that invitation, you will become a Secondary Contact on this case and no one will remain as the Portal Contact. This means that no one will have the ability to invite others from that point on. Correcting this situation will require assistance from Dispute Resolution staff.

ADVANCED TIP: You can enter more than one email address in the "E-mail" box. This will send multiple invitations at one time. Separate each email address with a comma or semi-colon.

You can set the access level all the way up to "Full" which lets the invitee do anything the Portal Contact can do on their behalf, except for inviting other Secondary Contacts (only the Portal Contact has access to the Users tab). "Basic" only gives the high-level information about the case; they cannot access the row of tabs (Case Details, Pleadings, etc). "Full Read" gives access to all of the tabs, but the invitee cannot submit documents, enter arbitrator ranks or strikes, or enter scheduling information.

IMPORTANT NOTE: The representative accepts all responsibility for the individuals they invite to maintain the confidentiality of case information, and for removing access when the invitee no longer requires access to the case. This can be done by setting their Access Level to "None".

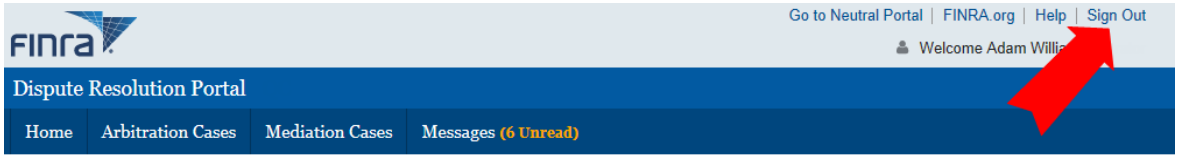
The invited individual will receive an email invitation containing a special link that will grant them the ability to register to this specific case in the DR Portal. Individuals need to be invited to each case that the Portal Contact wishes them to access. Once registered, the Secondary Contact can just log in to the DR Portal; they do not use the invitation email again.

Manage Current User Access for this Case lets the Portal Contact change or remove access to previously invited individuals (Secondary Contacts), or to re-invite individuals if they lost or deleted the invitation email. To remove access for a previously invited user, just change their access level to "None" and click on the "Update" link. The invited user will no longer see this case when they log into the Portal.

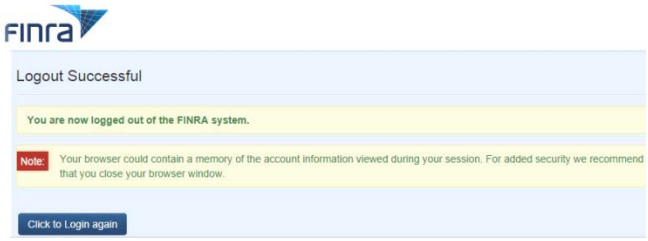
Invite and Manage Party Case Access for this Case works the same way as Invite New User to this Case, but is used to invite the actual parties that they represent to the case. The names of the parties associated with the representative are already listed in this section, along with the email address that FINRA has on file for this party. It cannot be entered on this screen. The invitation will be sent to that email address. If no email address has been provided to FINRA for the party, the party cannot be invited. Invited parties are not Secondary Contacts, and have a "read-only" view of the case (either Basic or Full Read); they cannot enter information or submit documents through the portal, and they will not receive emails or messages when documents are published on the portal.

Log Out of Portal

You can log out of the DR Portal by clicking on the **"Sign Out"** link in the top right corner.



Once you click the "**Sign-Out**" link you will receive confirmation that your Logout was successful.

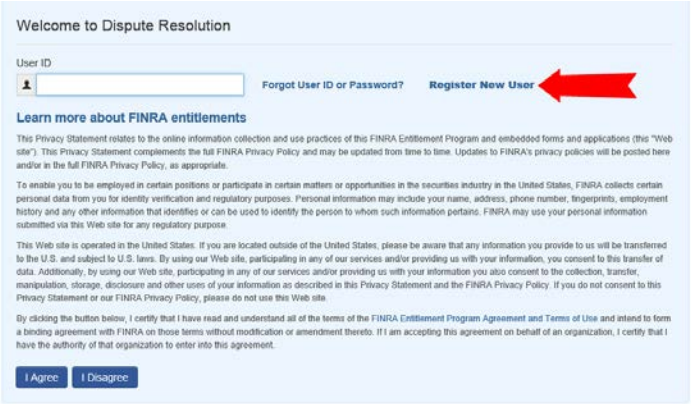


Additional Help and Providing Feedback

- If you have any questions about the DR Portal, please send an email to claimhelp@finra.org.
- Do NOT reply to the automated emails you receive from drportal@finra.org; these emails are not monitored.
- If you experience any difficulties creating your account or logging into the DR Portal, please contact the FINRA Gateway Call Center at **(301) 590-6500**.
- If you experience technical difficulties using the DR Portal other than issues logging in, please contact the DR Portal Help Desk at **(800) 700-7065**.
- If you have any suggestions for improvements you would like to see made to the DR Portal, please send your suggestions to drportalfeedback@finra.org.

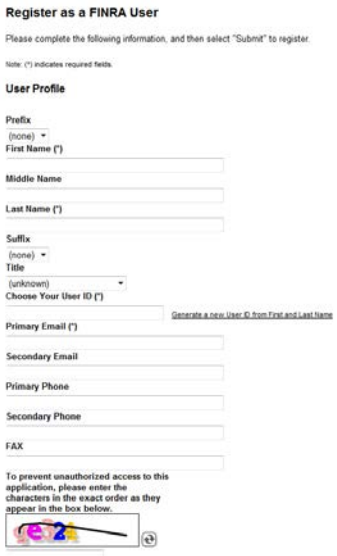
Appendix A: Creating a DR Portal Account

1. Click on **"Register New User"** to create a new account.



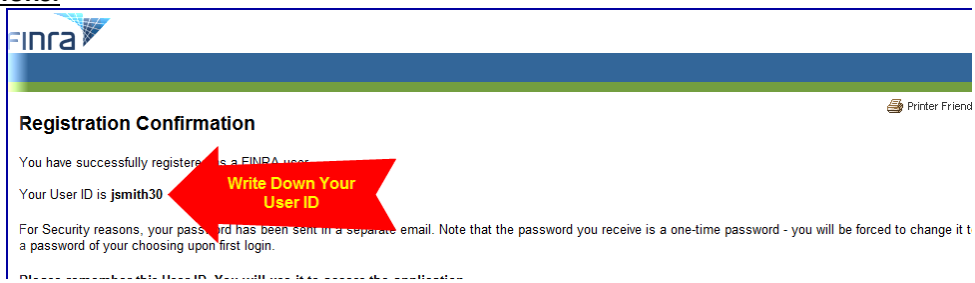
2. Enter the registration information. You can make up your own User ID (letters and numbers only; an email address cannot be used as your User ID). The email address that you provide in the "Primary Email" field in this initial registration form should be the email address that you provide with any case-related submissions to FINRA.

Note: you can not use a FINRA Firm Gateway account on the DR Portal. You must create a separate account. You only need one account to access all cases to which you are invited. You should NOT create a new account for each case you receive, and your account should use your unique email address. Do not use a "group mailbox" email address when creating an account.

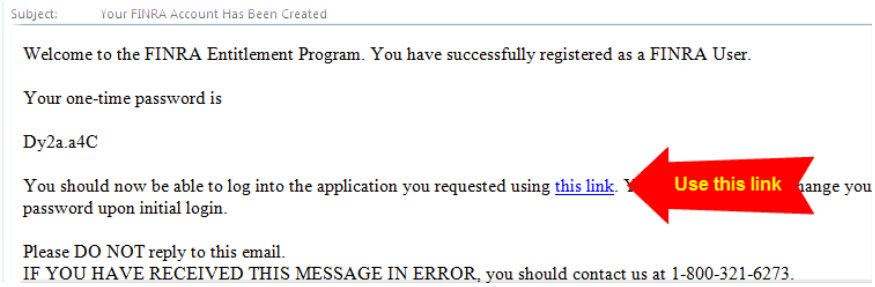


Note: If you later need to update your email address, you will need to make this change by updating your account information using the "manage my account" quick link menu option on the Homepage of the DR Portal. This change cannot be made by FINRA staff.

3. You will receive a "Registration Confirmation" with your User ID. Be sure to write down your User ID and/or print this screen. Once written down, **close all of your browser sessions.**



4. You will receive an email with a temporary password. Click on the words "**this link**" in the email to change your password.



5. On the "**Welcome to Dispute Resolution**" page, enter your user ID and temporary password and click "**I agree**."

6. You will be prompted to change your password. Once you change your password, click "**Continue**."

Note: As a security measure, FINRA passwords automatically expire after a set period of time. When this occurs, you will be asked to change your password when you are logging in. You cannot select a password that you used previously.

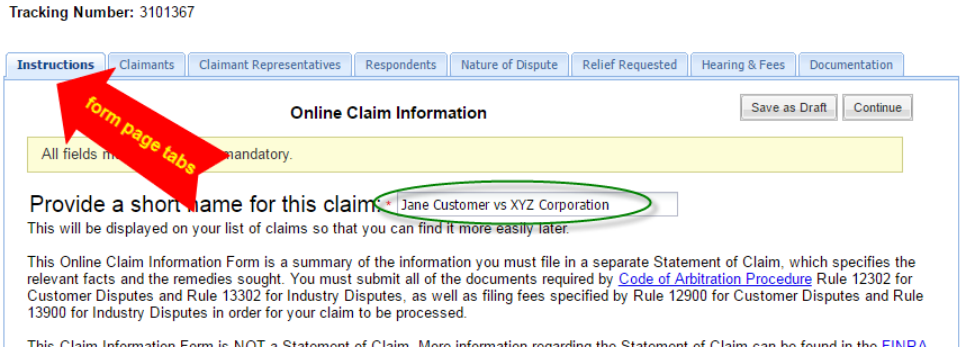
Appendix B: Completing the Online Claim Information Form

The Claim Information Form is a summary of the information contained in your Statement of Claim, which specifies the relevant facts and the remedies sought. This Claim Information Form is NOT a Statement of Claim. You must file all of the documents required by Code of Arbitration Procedure Rule 12302 for Customer Disputes and Rule 13302 for Industry Disputes, as well as filing fees specified by Rule 12900 for Customer Disputes and Rule 13900 for Industry Disputes in order for your claim to be processed. More information regarding the Statement of Claim can be found in the FINRA Arbitration Claim Filing Guide.

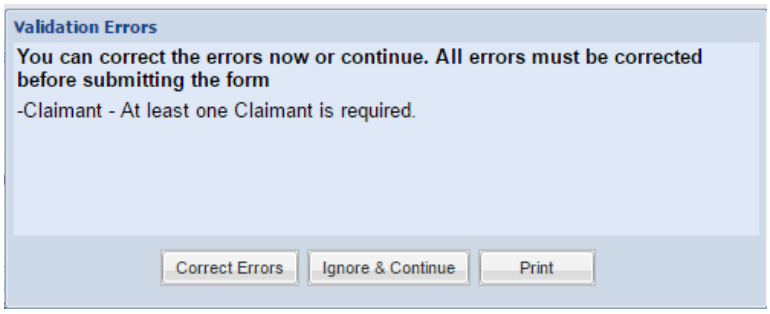
IMPORTANT NOTE: DO NOT use your browser's "Back" and "Forward" buttons to move between pages of this form. The browser's buttons do not properly save data when changing pages, nor do the form page tabs running along the top of the form. Instead, use the **Previous** or **Continue** buttons provided on each page. If you prefer to use the form tabs to move between pages, press the **Save as Draft** button periodically. Failure to do this may lead to lost data that you will need to re-enter.

Instructions

Provide a short name for your claim (e.g., the name of the claimant or respondent.) You will be able to see this name in your list of claims so that you can find it more easily later.

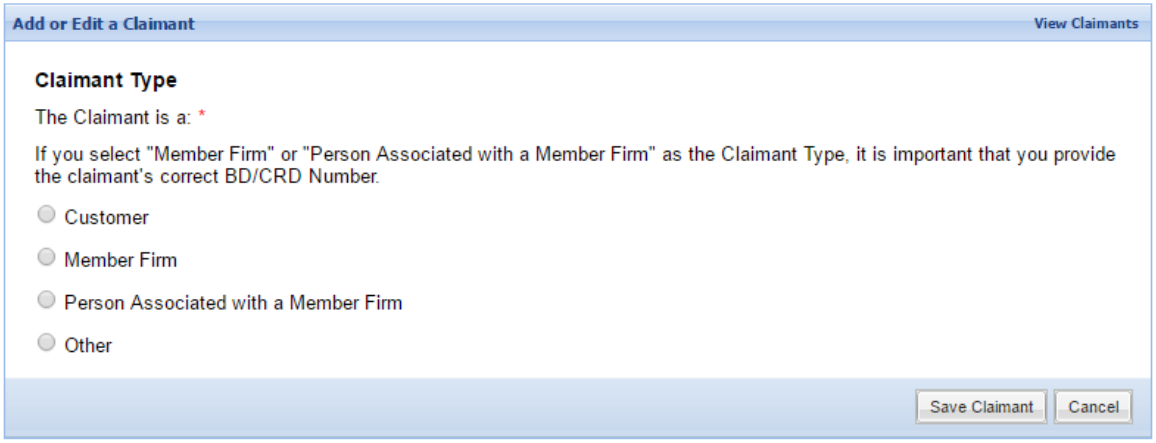


If you move between pages and you forget to complete a required field, you will receive an error message. You can press the **Correct Errors** button to return to the page, **Ignore & Continue** to ignore the error (for now) and move to the desired page, or **Print** to print out the error to save as a reminder.



Claimants

A claimant is any individual or legal entity seeking relief. If you are claiming that another individual or firm has damaged you in some way, then **you** are the Claimant. In instances where there are multiple claimants of identical type and ownership (e.g., multiple IRA accounts owned by the same individual), treat all of the identical entities as one claimant. In instances where there are multiple claimants of identical type but different ownership (e.g. John Smith as owner of his individual accounts, John Smith as trustee for Jane Smith, etc.), treat each of the entities as different claimants.



The Claimant is a: (Required)

Click on the radio button next to the type of claimant that you are entering:

Claimant Type	Description
Customer	A person or entity (not acting in the capacity of an associated person or member) that transacts business with any FINRA member firm or associated person.

Member Firm	The term "Member" means any broker or dealer admitted to membership in FINRA, whether or not the membership has been terminated or cancelled; and any broker or dealer admitted to membership in a self-regulatory organization that, with FINRA consent, has required its members to arbitrate pursuant to the Code and/or to be treated as members of FINRA for purposes of the Code, whether or not the membership has been terminated or cancelled.
Person Associated with a Member Firm (also known as an "Associated Person" or "AP")	An associated person is a natural person who is registered or has applied for registration under FINRA Rules; a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions; or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with FINRA.
Other	It is important that you only use "Other" after all attempts to look up a Member Firm or Associated Person on CRD have failed (see How to Perform a CRD Search below).

Further Describe The Claimant (Required for "Customer" or "Other")

If you selected a Claimant type of either "Customer" or "Other", you will be presented with a drop-down list box asking for additional descriptive information. Select the option that best describes the Claimant type from the choices in the drop-down list.

Note that only customer claimants of type "individual" and associated persons will be provided with the option to represent themselves (i.e., "pro se"). See **Claimant Represents Self** below.

Claimant Name (Required)

If you selected a Claimant type of either "Customer" or "Other", you will be required to enter the name of the Claimant.

If you selected a Claimant type of either "Member Firm" or "Person Associated with a Member Firm", you will provide the name by "searching" for the party in the CRD database. You must either provide the claimant's FINRA Broker-Dealer ("BD") number or FINRA Central Registration Depository ("CRD") number respectively.

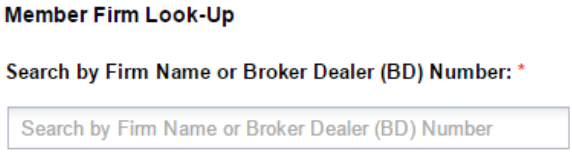
What is a BD Number/CRD Number?

FINRA gives each securities firm and each Associated Person (broker) a Broker-Dealer number (BD number) or Central Registration Depository number (CRD number) in the Central Registration

Depository when they register with FINRA. Collectively, these numbers are sometimes called a CRD/BD number or BD/CRD number.

How to Perform a FINRA Member CRD Search

There are two methods of locating a Member on CRD:



Start typing the firm name or BD number in the search box above. If the firm is registered with FINRA, a list of matching entries will be displayed. Select the appropriate firm from the list and it will populate the boxes below. If you cannot find the firm by name or BD number, you will need to change the Claimant Type to "Other", which will allow you to enter the firm's information in the boxes below. Only select the Claimant Type of "Other" if you cannot find the firm.

NOTE: Whether you know the BD number or not, you should still be "searching" the CRD database in order to have the system add the party's information into the form.

If your search results in no names being returned, it is possible that you misspelled the name, or the name is stored in CRD with different punctuation from what you entered. Try searching again with fewer characters in your search. At least the first two letters must be entered, however.

TIP: Don't worry if the results of your search return some member firm names that seem completely different from the name you entered. CRD retains the names of firms prior to mergers and acquisitions, and typically returns the current (DBA) name of a firm that has had a name change.

TIP: If you are unsure which name is the correct one (perhaps there are several names that look similar or are identical), you can visit FINRA's Brokercheck website to see more information about each FINRA member firm.
http://brokercheck.finra.org/

How to Perform an Associated Person CRD Search

Searching for an Associated Person works the same way as searching for a member firm. See "How to Perform a FINRA Member CRD Search" above.

NOTE: The CRD lookup does **NOT** populate the address information for APs onto the form.

Current Mailing Address (Required)

Enter your current mailing address. If this is not the first claimant being entered, and the address you would enter is the same as another already entered claimant, you can click on the **Copy from Another Claimant** button to copy the address information from another claimant to the current one.

Residential Address at Time of Dispute (Required)

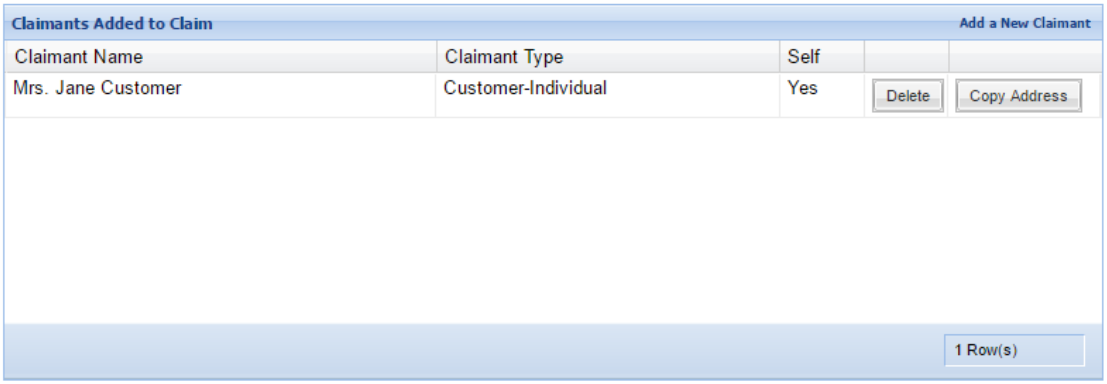
Enter your residential address at the time of the dispute. If your residential address at the time of the dispute is the same as your current mailing address, you can click on the **Copy from Current Mailing Address** button to copy the address information from the Current Mailing Address section to this section.

Claimant Represents Self

If you are an individual customer or an associated person, you can check this box if you do not have an attorney and will be representing yourself ("pro se") in this arbitration. If you will be represented by an attorney, do not check this box. You will enter your attorney's information in the Claimant Representative section of the form.

If you enter a claimant type that is not an "individual", (e.g., custodial, estate, individual retirement account, etc.), you will not be provided this option for this claimant in this section. If you will be representing your accounts pro se, you will enter yourself as the representative for these accounts on the **Claimant Representative** section of the form.

After all claimant information has been entered, press the **Save Claimant** button. This adds the claimant to the "Claimants Added to Claim" list box found lower on the page.



Adding, Editing, and Deleting Claimants on the Online Form

Once you have saved the information for the first claimant, there are three things you can do:

Add Another Claimant

You can go back to the top of the page and add another claimant.

> **TIP:** If the next claimant has the same address as the first one, you can press the Copy Address button next to the claimant in the list of claimants box. This will begin a new claimant with the address from the prior one already filled in.

Delete a Claimant

You can press the Delete button next to a claimant in the list of claimants box to delete the claimant.

> **NOTE:** You cannot delete a claimant that is currently associated with a claimant representative or named in a relief request. To delete a claimant that has no delete button, either:
>
> - Remove this claimant from all claimant representatives and relief requests that currently name this claimant, or
> - Delete all claimant representatives and relief requests that currently are associated with the claimant.
>
> This will allow the Delete button to appear so that you can delete the claimant.

Relief requests are described below later in this Guide.

Edit Claimant Information

To edit a claimant, click on the name of a claimant in the list of claimants box. The fields above will be populated with the claimant's information. Make your edits and then press the **Update Claimant** button to save your changes.

Once you have added all of the Claimants, click on the **Continue** button.

Claimant Representatives

FINRA corresponds with the party representatives. If an attorney is representing you, enter your attorney's information here. If you do not have an attorney and are representing yourself, you would have checked the "Claimant is Representing Self" checkbox back on the Claimants page, and you would NOT enter yourself again here. If all claimants are representing themselves, you can skip this section.

Associating Representatives with Claimants

If a single representative (or co-counsel) will represent all of the claimants entered in the Claimants section (other than those claimants who are representing themselves), select the "**Only one representative will be representing all claimants on this claim**" option.

> **NOTE:** If there are co-counsel, enter the name and address for one of the counsel below. When using the DR Portal, counsel can "invite" co-counsel to join the case, allowing all counsel full access to all documents and features of the portal.

If some claimants will be separately represented, you can enter more than one representative and select whom they represent. To do this, select the "**There are multiple claimant representatives on this claim**" option. Then, under "**Claimants Using This Representative**", select the associated claimants and press the **Save Representative** button.

Each claimant party (that is not representing themselves) must be associated with a representative, but a given claimant party cannot be associated with more than one representative.

Adding, Editing, and Deleting Claimant Representatives on the Online Form

Adding, editing, and deleting a claimant representative works the same as it does for the Claimants page.

Add Another Representative

You can go back to the top of the page and add another representative.

Delete a Representative

You can press the Delete button next to a representative claimant in the list of representatives box to delete the representative. Remember that each claimant that is not self-representing must have a representative.

Edit Representative Information

If you have only one representative, you can just edit the information on the page. If you have more than one representative, click on the name of the representative in the list of representatives box. The fields above will be populated with the representative's information. Make your edits and then press the **Update Representative** button to save your changes.

Once you have entered the information and selected the appropriate claimants for each representative, click on the **Continue** button.

Respondents

A respondent is any individual or legal entity you wish to name for purposes of seeking relief. If the claimant is a customer, then the respondent is typically a FINRA member firm or a person associated with a member firm. This section of the form works in a similar manner to the Clamiants section.

The Respondent is a: (Required)

Click on the button next to the type of Respondent that you are entering.

Respondent Name (Required)

If you selected a Respondent type of either "Customer" or "Other", you will be required to enter the name of the Respondent.

If you selected "Member Firm" or "Person Associated with a Member Firm" as the respondent type, then you must provide the respondent's BD number or CRD number. You can find these numbers by using the CRD Lookup Tool. See "How to Perform a CRD Search" in the Claimants section above.

NOTE: The CRD lookup does **NOT** populate the address information for APs onto the form. FINRA maintains a separate database of addresses for Dispute Resolution correspondence. You may enter the address where you believe the AP is employed.

NOTE: Do not list "John Doe" respondents in the Respondent Name field. Doing so may delay processing of your claim.

Current Mailing Address

Enter the current mailing address of the respondent, as you know it. FINRA Dispute Resolution maintains its own database of AP addresses, and may not use the one you provide. However, in case FINRA has difficulty reaching the respondent, we may attempt to reach them using the address you provide. If you do not know the AP's address, you may leave it blank.

If this is not the first respondent being entered, and the address you would enter is the same as the previous respondent, you can click on the **CopyAddress** button next to the previously entered respondent to copy the address information to the current one.

Once you have entered the information for the respondent, click the **Save Respondent** button.

Adding, Editing, and Deleting Respondents on the Online Form

Just like for Claimant entry, once you have completed all of the information for the respondent, you can add another respondent, delete a respondent, or edit the information for a respondent.

Once you have added all of the Respondents, click on the **Continue** button.

Nature of Dispute

Period of Dispute

Start Date

Enter the date that the alleged dispute began. If you are unsure of the exact date, just enter the year.

End Date

Enter the date that the alleged dispute ended. If you are unsure of the exact date, just enter the year. If the activity that you are disputing is still occurring, then instead check the "Dispute is ongoing" checkbox.

> **NOTE:** Do not check "Dispute is ongoing" if the activity is no longer occurring. This box is not intended to mean, "My dispute is ongoing, because I haven't resolved my dispute yet."

Dispute Types

Use this section to indicate the types of disputes the Claimants have with the Respondents. Select all of the types of disputes that apply to your claim.

> **NOTE:** Only select dispute types that are relevant to your claim. Selection of dispute types is optional on this form, but make sure that your Statement of Claim describes your dispute in detail. If your claim only involves a request for expungement, you do not need to select a dispute type.

Securities, Financial Instruments, and/or Investments involved in the Dispute

Use this section to indicate the types of securities that are involved in your claim. Select all of the types of securities that apply to your claim.

When you have finished selecting your dispute types and security types, click on the **Continue** button.

Relief Requested

On this page, you can request both monetary and non-monetary relief, as well as attorney's fees, costs, and interest. You can also request expungement, and also indicate if you are filing a claim alleging employment discrimination in violation of a statute.

Attorney's Fees, Costs, and Interest

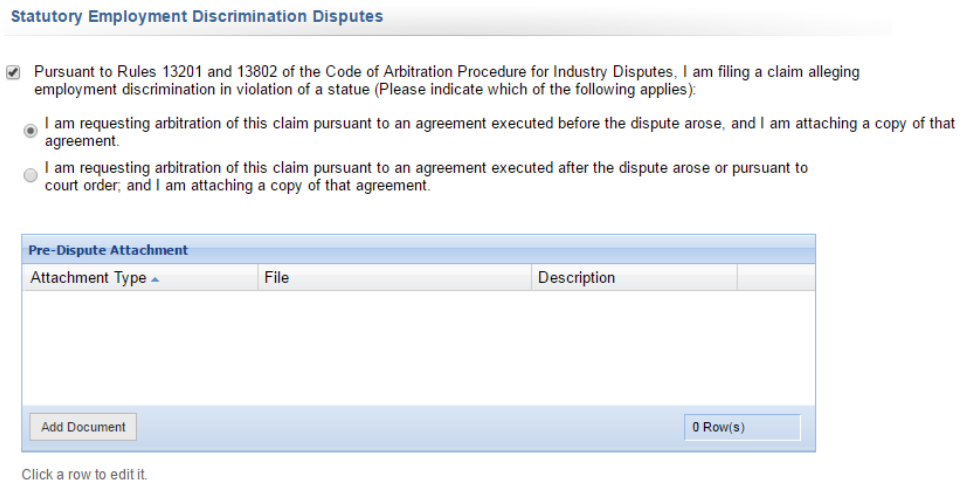
Claimants are also permitted to request compensation for various fees or loss of interest they have incurred. To make such a request:

1. Check the box next to the applicable items that you are requesting.
2. Next to the checkbox, enter the specific amount requested, if known, or leave the associated amount blank and check the "Amount is Unspecified" box to indicate that the amount is unspecified. Do not enter zero for the amount. Be sure to explain in your Statement of Claim the fee or interest you are seeking. For example, if you are seeking 3% compounded interest for the total time that certain monies should have been in your account but were not, then state this in your Statement of Claim.

Statutory Employment Discrimination Disputes

Pursuant to FINRA Rules 13201 and 13802, claimants are permitted to file a claim alleging employment discrimination in violation of a statute. Claimants are also permitted to request compensation for various fees or loss of interest they have incurred. To make such a request:

1. Check the box located in this section.
2. Select the appropriate radio button that appears under the checkbox.
3. Attach a PDF document of the agreement:
   - Press the **Add Document** button,
   - Select the Attachment Type,
   - Press the Choose Files button,
   - Find the file on your computer,
   - Enter a description, if desired,
   - Press the **Add** button.



Expungement

You can request expungement of an entry in the CRD record of an associated person.

Individuals with CRD numbers can access their registration and licensing information by requesting an Individual Snapshot Report at: http://www.finra.org/industry/web-crd/snapshot-reports#

Select Claimant: (Required)

Select the claimant that is making the expungement request.

Select Respondent: (Required)

Choose a respondent party by checking the box next to the appropriate respondent's name.

Search by CRD Number: (Required)

Enter the CRD number of the associated person for which the expungement is being sought, then click the **Retrieve Records** button to search for expungement occurrences associated with this CRD number.

> **NOTE:** This CRD number does NOT necessarily have to be that of the claimant selected above. For example, the claimaint might be a member firm that is seeking expungement on behalf of one of their brokers. The claimant would be the member firm and the CRD number entered here would be that of the broker.

Specify CRD Occurrences: (Required)

Select the CRD occurrence that you are seeking to be expunged. If you are seeking to expunge more than one occurrence, select the first one and then repeat this process for each additional occurrence.

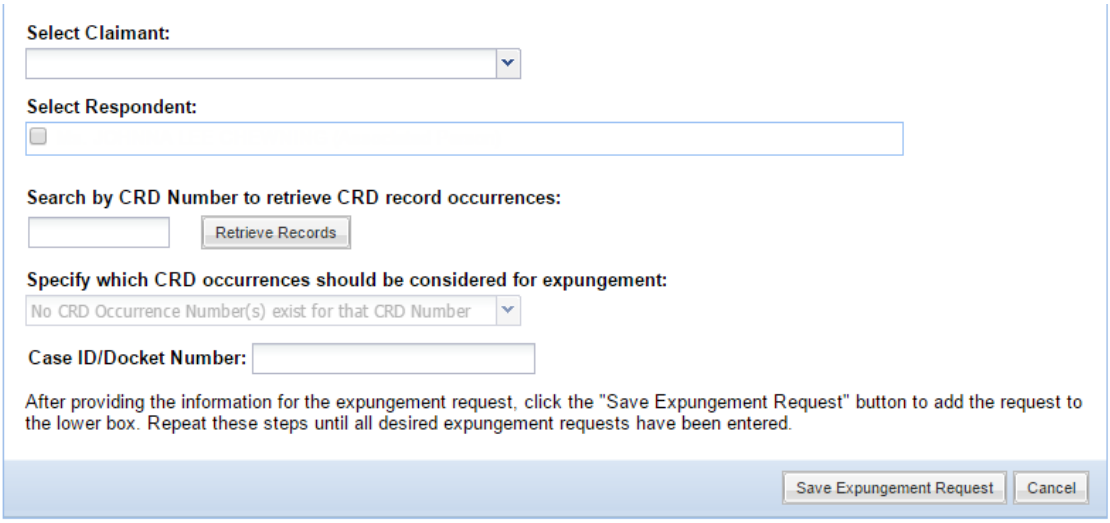
Case ID/Docket Number:

Enter the Case ID or Docket Number that gave rise to this occurrence, if applicable.

Then press the **Save Expungement Request** button. This will add the information to the list of expungement requests below. If you are seeking to expunge more than one occurrence, repeat this process for each additional expungement request.

Adding, Editing, and Deleting Expungement Requests on the Online Form

Just like for Claimant and Repsondent entry, once you have completed all of the information for the expungement request, you can add another respondent, delete a respondent, or edit the information for a respondent.



Monetary and Non-Monetary Relief Requests

The "amount in dispute" is the combined amount of monetary relief requested, and is used to calculate the filing fee. This amount must match the amount stated in your Statement of Claim. Attorney's fees, costs, and interest are not included in the calculation of the amount in dispute.

Monetary Relief Categories:

Actual/ Compensatory	Monetary sum required to compensate a party for his or her loss.
Other Monetary Relief	Other monetary relief not otherwise described.
Punitive/ Exemplary Damages	Monetary amount intended to punish the wrongdoer.
Racketeer-Influenced and Corrupt Organization Act (RICO)	Includes damages pursuant to the RICO statute or damages pursuant to federal and state laws designed to prosecute organized crime. (You may want to consult with an attorney for more information regarding the RICO statute.)

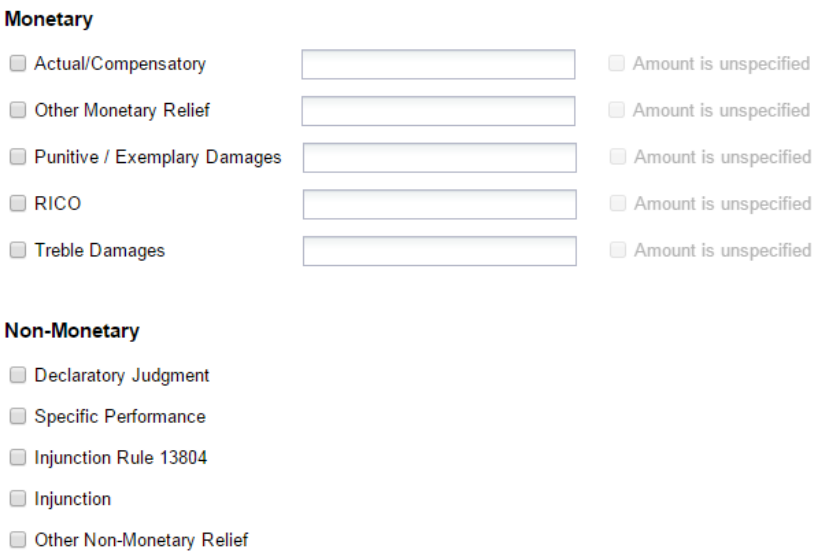
Treble Damages	Damages tripled in amount, as provided by statute. (If entering a Relief Request Entry for treble damages, multiply the actual damages by two and enter that amount in the "Amount" field. For example, if you are asking for $10,000 in actual damages and also asking for treble damages, then you would enter $20,000 for treble damages.) (You may want to consult with an attorney for more information regarding treble damages.)

Non-Monetary Relief Categories:

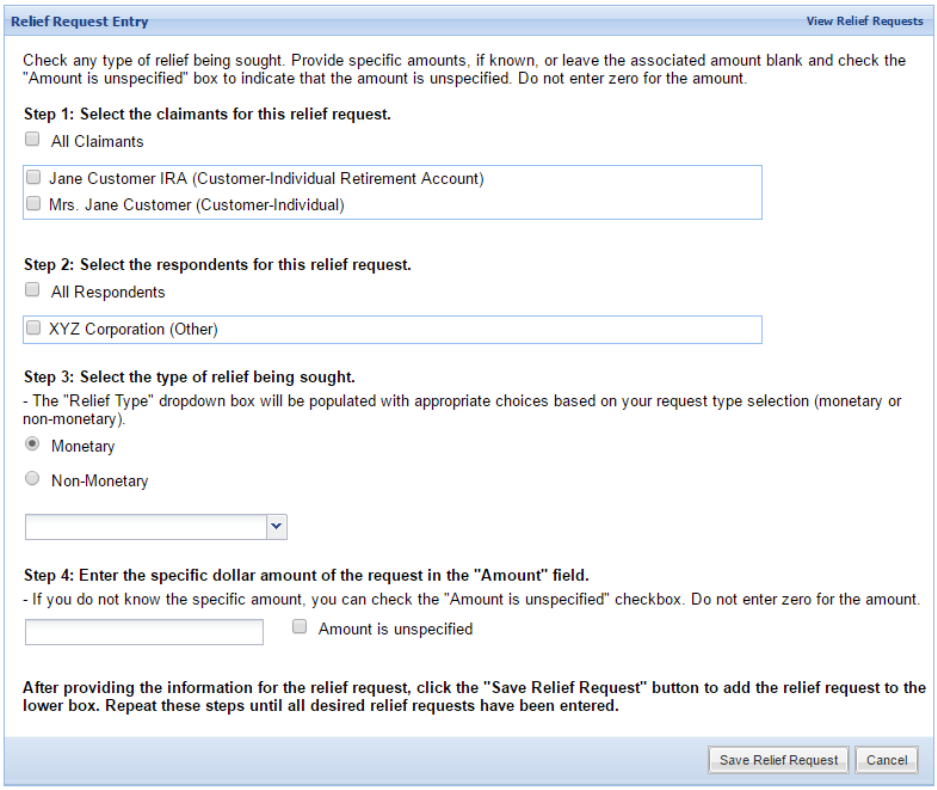
Declaratory Judgment	A binding ruling on the rights and status of the parties. (You may want to consult with an attorney for more information regarding declaratory judgments.)
Specific Performance	Requires that the respondents take some kind of action, such as turning over ownership of stock.
Injunction Rule 13804	Temporary Injunctive Orders; Requests for Permanent Injunctive Relief. Applies to claims by industry parties and not customers.
Injunction	Requires that the respondents refrain from certain actions.
Other Non-Monetary Relief	Other non-monetary relief not otherwise described.

There are two ways to enter your monetary and non-monetary relief requests: "Simple" and "Detailed". For most claims, the "Simple" method will work fine and is easier to use. It assumes that all claimants are seeking relief from all of the respondents. Check the box next to each type of relief being sought and enter the associated amount, or check “Amount is unspecified”.

Simple method:



Detailed method:



Use the "Detailed" method if:

- Some of your relief is being requested by only a sub-set of your claimants, or against a sub-set of the respondents; or
- You are seeking multiple types of non-monetary relief. For example, if you want to specify two different types of non-monetary – specific performance relief, then you would need to use the detailed method of relief entry.

TIP: You will need to itemize each relief request in this section, as described in your Statement of Claim. It will be useful to have already completed your Statement of Claim before completing this section so that you can use it as a reference.

Adding, Editing and Deleting Relief Requests on the Online Form

If you used the "detailed" method of relief request entry, all of your saved relief requests will be in the Relief Requests Added to Claim box. Just like for other parts of this form, once you have completed all of the information for one relief request, you can add, delete, or edit another relief request.

If you have no additional relief requests to add, you can click on the **Continue** button to move to the next section of the form.

Hearing and Fees

There are three primary ways in which an arbitration case is decided:

- If you are claiming $50,000 or less in damages (both actual and punitive, exclusive of interest and expenses), you may request to have your case decided by a single arbitrator based on all of the papers that are submitted by both the claimants and respondents, or after an in-person hearing by a single arbitrator.
- If you are claiming between $50,000.01 and $100,000, your claim will be decided after an in-person hearing by a single arbitrator.
- If you are claiming over $100,000.01 or unspecified damages, non-monetary relief, permanent injunctive relief, or expungement, then a panel of three arbitrators will decide your case after an in-person hearing.

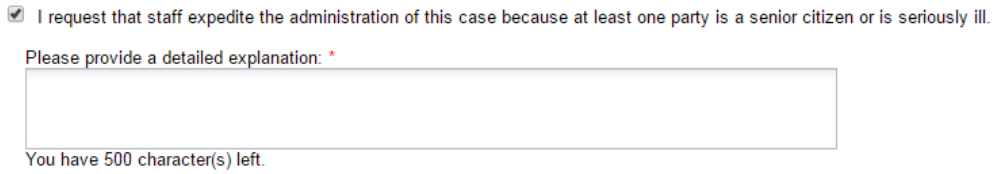
The form will deactivate choices that are invalid for your claim size.

NOTE: After you file your claim, you may request subsequently a different panel composition (for example, a panel of three arbitrators for a claim of $60,000) if all parties (claimants and respondents) agree in writing.

Expedited Proceedings for Senior and Seriously Ill Parties

Upon a party's request, staff will expedite the administration of arbitration proceedings in matters involving seniors or seriously ill parties. Staff will begin the arbitrator selection process, schedule the Initial Prehearing Conference (IPHC), and serve the final award as quickly as possible. By mutual agreement, parties are also free to reduce the time requirements contained in the Customer Code. Staff will also determine promptly whether the parties are interested in mediation, which could further expedite resolution of the dispute.

Check the box to request expedited treatment, and then provide an explanation of the circumstances.



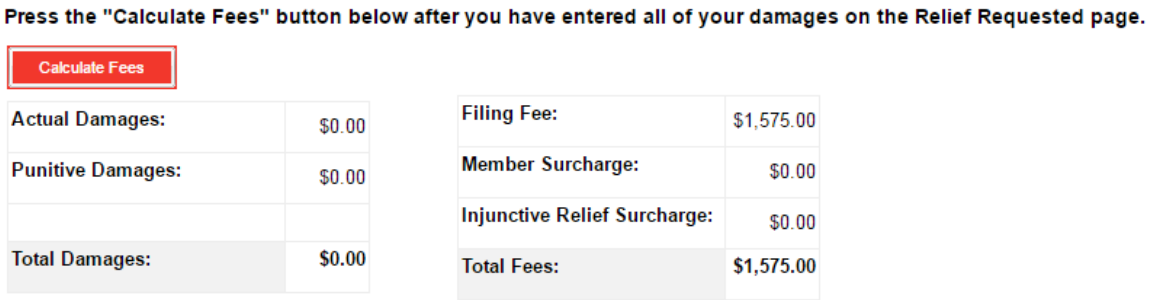
Fee Calculation

The Code contains rules regarding the fees that must be submitted with the Statement of Claim to file an arbitration claim.

In order to commence an arbitration case, you must submit a filing fee along with your Statement of Claim, signed Submission Agreement and other supporting documentation. To help you determine the fee amount, a Fee Calculator is provided. The Claim Information Form interacts directly with the Fee Calculator using the information you have already entered, calculates the appropriate fees, and displays them on the Form. You cannot directly change the displayed fees.

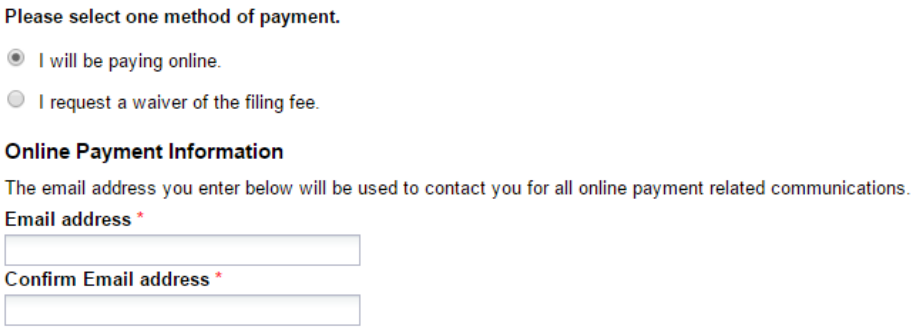
To have the system calculate the filing fee, press the **Calculate Fees** button. The system will determine the appropriate filing fee and display it on the Form.

NOTE: If you change any information in other parts of the Form, you should come back to the Fee Calculation section and press the **Calculate Fees** button again to make sure the correct fee is determined.



Payment Information

You can pay the filing fee online by credit card or ACH bank transfer from your checking account (also known as an “electronic check”). If you are experiencing financial hardships and are not a FINRA member, then you may instead request a waiver of the filing fee. You must select one of these options in order to submit your claim.



- To pay online with a credit card or by ACH bank transfer, select "**I will be paying online.**" When you select this option, you will be asked to enter an email address to be used to contact you for all online payment-related communications. The email address entered here will not be used for any other correspondence.

IMPORTANT NOTE: If you select the online payment option, you will enter your payment information **AFTER** you press the Submit button to submit your claim.

See "Paying the Filing Fee Online After Submitting Your Claim" for more information.

IMPORTANT NOTE: Only credit cards associated with an address located in the United States are accepted currently. Attempting to use a credit card with a non-US address could delay processing of your claim.

- To request a waiver:
  1. Select, "**I request a waiver of the filing fee**."
  2. Submit the following supporting documentation using the Payment Information box:
     - A statement summarizing your financial hardship;
     - Most recently filed tax returns (2 years);
     - Evidence of garnishments or liens;
     - Two most recent pay stubs;
     - Any other supporting documentation (e.g. affidavits, bank statements, etc.)

NOTE: If you request a fee waiver, you MUST submit the supporting documentation. Your claim will not be served on the respondents and will not proceed until either the waiver is approved or the filing fee is submitted.

Claimant Submitting Payment

Select one of the claimants to receive credit for the fee paid. This claimant will be assessed the initial filing fee once the claim is submitted and would also be issued any refund, if applicable, at the end of the case.

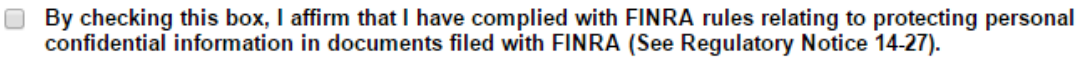
NOTE: This field will not display claimants that were identified as IRA accounts unless that was the only type of claimant that was entered. This is done to avoid potential tax problems with transactions into or out of these accounts.

Documentation

Here you can attach your Statement of Claim, signed Submission Agreement, and supporting documentation electronically. Do not mail paper copies of these documents to FINRA.

Parties and their counsel also should take steps to protect their confidential information. Parties can safeguard personal confidential information by redacting such information from pleadings, exhibits, and other documents upon agreement of the parties.

You must affirm that you have complied with FINRA rules relating to protecting personal confidential information in documents filed with FINRA (See Regulatory Notice 14-27) by checking the box on this page.



IMPORTANT NOTE: Except for arbitration awards, which are publicly available, the documents and information in FINRA Dispute Resolution case files are confidential. FINRA Office of Dispute Resolution limits access to personal confidential information to FINRA staff members who need it to perform their job functions, and to arbitrators, mediators, or other individuals involved directly in the arbitration or mediation process. Examples of personal confidential information include social security numbers; brokerage, bank, or other financial account numbers; taxpayer identification numbers and medical records.

Attaching Your Electronic Statement of Claim

Your electronic Statement of Claim should meet the following requirements:

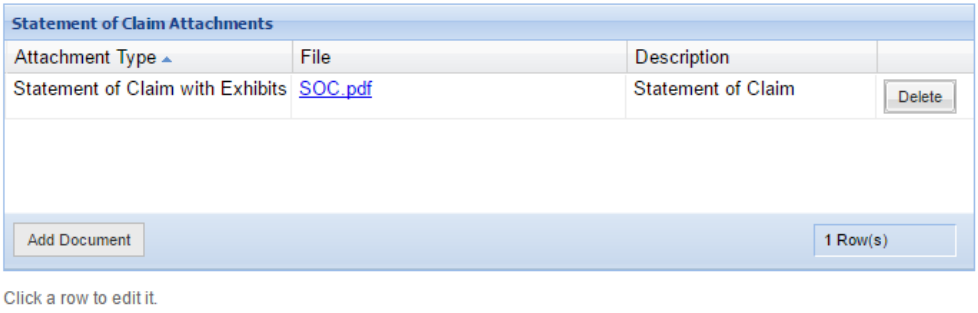
- ✓ It should be submitted in Adobe Portable Document format (PDF) only. This is the only acceptable format. Software to create Adobe PDF files can be obtained online for free from several sources. Microsoft Office applications have the built-in ability to save documents as Adobe PDF as well.
- ✓ It should be preferably in a 12-point font, using Times New Roman, Helvetica, or Arial style typeface, with 1.5 -inch margins.
- ✓ Please combine the Statement of Claim and related exhibits into a single text-searchable PDF file. Note, however, that a single attachment cannot be larger than 500MB in size. If your combined file would be larger than this, please submit as separate files.

If your Statement of Claim meets the above criteria, you may send it electronically by following the steps below:

1. Have your document files saved on your computer, ready to be sent.
2. Press the **Add Document** button.
3. Select the Attachment Type.
4. Press the **Choose Files** button.
5. Find the file on your computer.
6. Enter a description, if desired.
7. Press the **Add** button.

NOTE: Make sure that you have saved and closed your Statement of Claim document on your computer BEFORE you press the **Add** button. If the file is open, you will get an error and the upload may not work, or the file may not be transmitted properly.

8. After the file has been attached, it will be listed as shown below.



9. Once the file has been attached, you can edit the description by clicking on the attachment type, delete the file by pressing the Delete button, or view your file by clicking on the file name.

Attaching Other Supporting Documents

To attach other supporting documentation, such as a scanned image of the signed Submission Agreement, repeat steps 1 through 7 above and choose the appropriate attachment type.

Submission Agreement

The Submission Agreement is an important document to submit along with your claim. It can be provided in one of two ways:

- You can attach a scanned PDF image of the signed Submission Agreement provided in the Arbitration Claim Filing Guide.
- You can "sign" and submit the Submission Agreement electronically on this section of the form.

NOTE: If you submit a scanned image of the Submission Agreement, keep your original Submission Agreement in your files in case the validity of the signature is ever questioned. Submitting an unsigned Submission Agreement will delay processing of your claim.

If you are not attaching a scanned image of the completed Submission Agreement, then you must complete this section.

If you would like to submit your Submission Agreement as part of your online form, click the "**I will use electronic signature**" option.

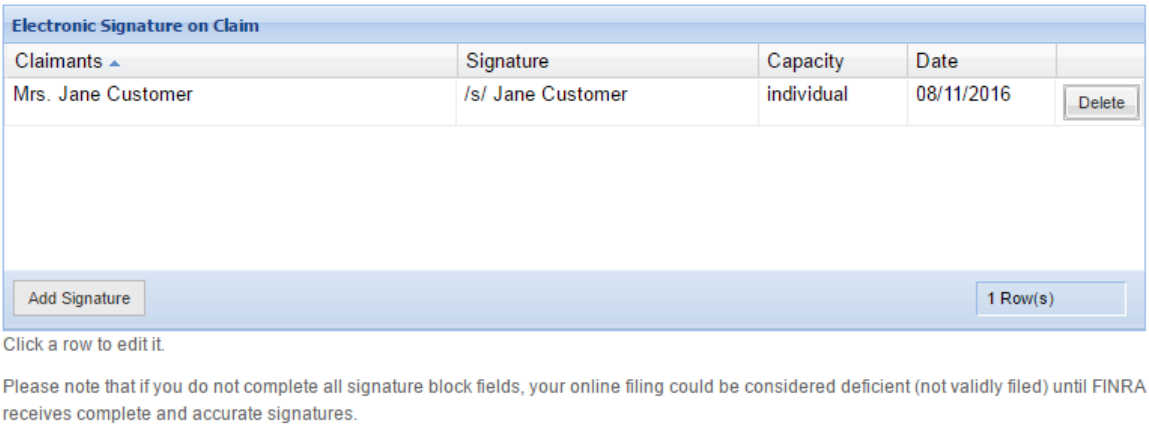
By entering your electronic signature below, you are one of the following: (1) the claimant; or (2) a person with legal authority to bind the claimant; or (3) a person with firsthand knowledge of the facts and actual or implied authority to act on behalf of the claimant; or (4) an attorney who has actual or implied written or verbal power of attorney from the claimant to sign on the claimant's behalf and thus, bind the claimant to the terms of the Submission Agreement as if the claimant signed the form personally.

To use the electronic signature, you must:

- Click "Add Signature".
- Choose the claimant name that the signature is for, and sign by entering "/s/", followed by your first name, middle initial, and last name (e.g., /s/ Jane Q. Public).
- Indicate the capacity in which you are signing (e.g., individual, representative, legal counsel, executor, trustee, corporate officer).
- Enter the date that you signed the form, and then click the "Add" button to add the signature.
- Repeat for each signature you want to add.

NOTE: If you do not complete all signature block fields according to the instructions, your online filing could be considered deficient (not validly filed) until FINRA receives complete and accurate signatures.

It is permissible for some claimant(s) to use electronic signature on the form and for other claimants to submit scanned images of the Submission Agreement.



Congratulations! You have reached the end of the form, and now have an opportunity to review all of your entries prior to submitting your Claim Information Form to FINRA.

Previewing the Tracking Form

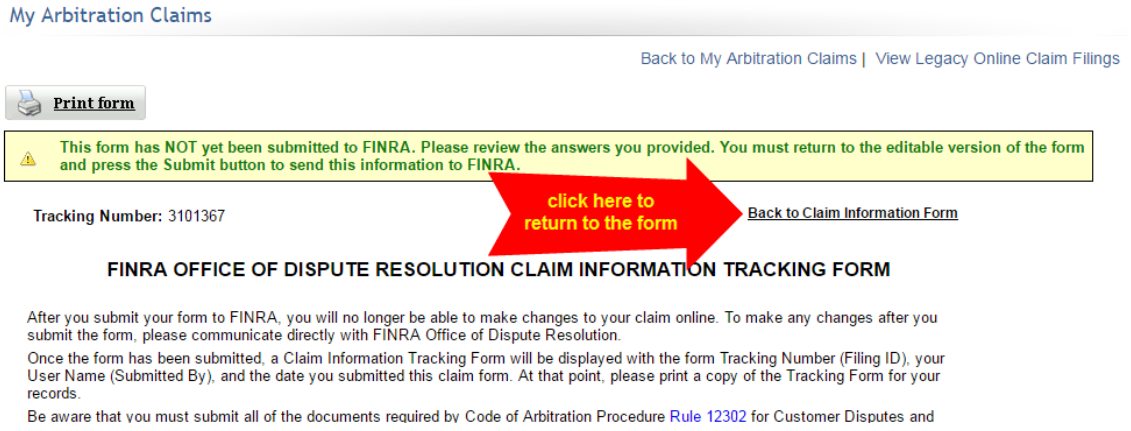
Once you complete all sections of the Online Claim Information Form, you can press the **Preview** button to see a summary of your Claim Information Form. Please read the instructions at the top of the Tracking Form.

NOTE: At this point, you have **NOT** yet submitted your Online Claim Information Form to FINRA.

The draft Tracking Form summarizes all of the information you have entered. This is your opportunity to review all of the data to be sure it is correct prior to submitting it to FINRA.

NOTE: The Preview page shows you all of the data entered on the form, but does NOT check for errors. If there are any errors on your form, you will receive an error message when you press the **Submit** button to actually file your claim.

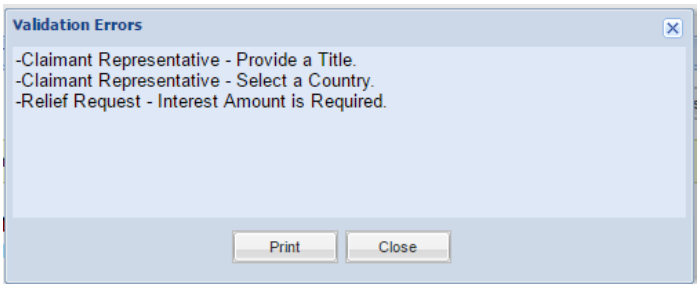
Once you are finished reviewing the preview page, click the "**Back to Claim Information Form**" link to return to the form. You can then continue to make changes, or submit the form.



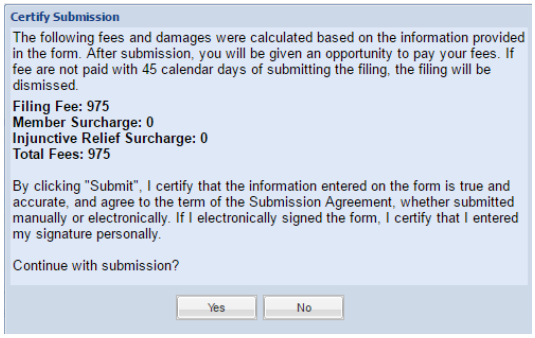
Submitting Your Claim Information Form

If you are satisfied that the information is complete and accurate, click the **Submit** button at the bottom of the form.

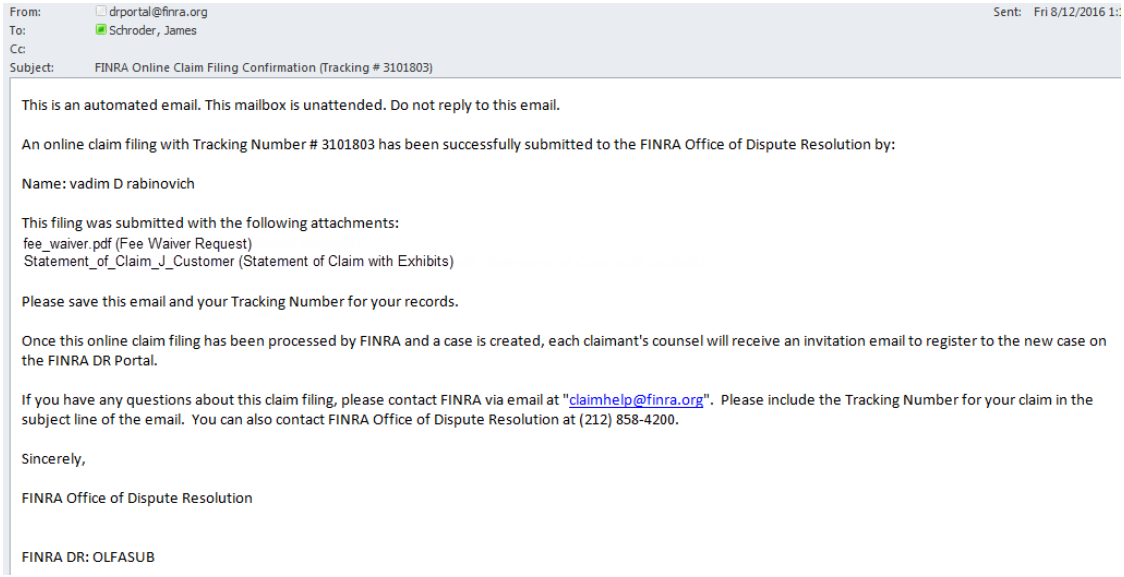
If there are any errors detected on your claim form, you will see an error message describing the corrections you need to make prior to submitting your form. Make the corrections and then press the **Submit** button again.



If there are no errors found, you will see a message regarding the filing fees and asking you if you wish to continue. Press the **Yes** button to continue to submit the claim form.



Shortly after you submit your claim, you should receive an email confirming that your claim was received.



From: drportal@finra.org Sent: Fri 8/12/2016 1:
To: Schroder, James
Cc:
Subject: FINRA Online Claim Filing Confirmation (Tracking # 3101803)

This is an automated email. This mailbox is unattended. Do not reply to this email.

An online claim filing with Tracking Number # 3101803 has been successfully submitted to the FINRA Office of Dispute Resolution by:

Name: vadim D rabinovich

This filing was submitted with the following attachments:
fee_waiver.pdf (Fee Waiver Request)
Statement_of_Claim_J_Customer (Statement of Claim with Exhibits)

Please save this email and your Tracking Number for your records.

Once this online claim filing has been processed by FINRA and a case is created, each claimant's counsel will receive an invitation email to register to the new case on the FINRA DR Portal.

If you have any questions about this claim filing, please contact FINRA via email at "claimhelp@finra.org". Please include the Tracking Number for your claim in the subject line of the email. You can also contact FINRA Office of Dispute Resolution at (212) 858-4200.

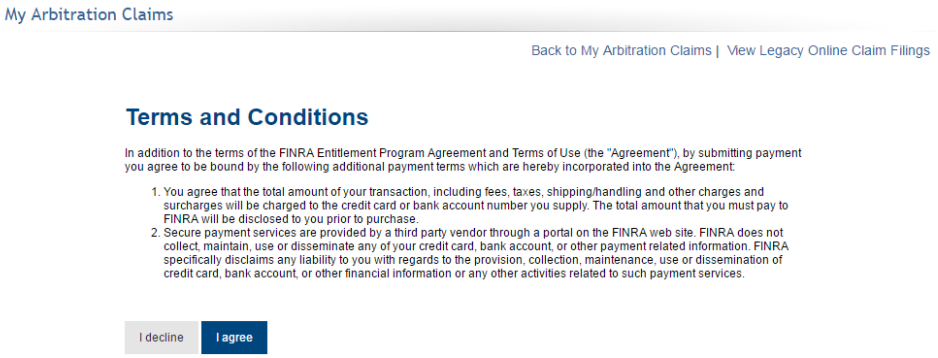
Sincerely,

FINRA Office of Dispute Resolution

FINRA DR: OLFASUB

Paying the Filing Fee Online After Submitting Your Claim

You must agree to the listed Terms and Conditions regarding use of online payment. Click "**I agree**" to agree to the conditions, or "**I decline**" to return to the Tracking Form.



My Arbitration Claims

Back to My Arbitration Claims | View Legacy Online Claim Filings

Terms and Conditions

In addition to the terms of the FINRA Entitlement Program Agreement and Terms of Use (the "Agreement"), by submitting payment you agree to be bound by the following additional payment terms which are hereby incorporated into the Agreement:

1. You agree that the total amount of your transaction, including fees, taxes, shipping/handling and other charges and surcharges will be charged to the credit card or bank account number you supply. The total amount that you must pay to FINRA will be disclosed to you prior to purchase.
2. Secure payment services are provided by a third party vendor through a portal on the FINRA web site. FINRA does not collect, maintain, use or disseminate any of your credit card, bank account, or other payment related information. FINRA specifically disclaims any liability to you with regards to the provision, collection, maintenance, use or dissemination of credit card, bank account, or other financial information or any other activities related to such payment services.

I decline | I agree

Once you click the "**I agree**" button, you will be taken to the payment page.

FINRA Office of Dispute Resolution - Arbitration Online Claim Filing

If you do not submit payment for your arbitration online claim within forty-five calendar days of submitting your claim, you will not be able to pay online.

If you have any questions, you can contact FINRA Office of Dispute Resolution at (212) 858-4200 or via email at claimhelp@finra.org. Please include the Tracking Number for your claim in the subject line of the email.

Arbitration Online Claim Form Tracking Number: 3101367

Arbitration Online Claim Form submitted on: 8/11/2016 1:47 PM Eastern Time

Email address where payment status will be sent: james.schroder@finra.org

Fees

INITIAL FILING FEE - NON-REFUNDABLE	$225.00
STAT. DISCRIMINATION FILING FEE - CLAIMANT	$.00
FILING FEE - DEPOSIT	$750.00
INJ. RELIEF EXPEDITED PROCESSING FEE	$.00
MEMBER SURCHARGE FEE	$.00
Total	*$975.00*

Payment Type

(•) Credit/Debit Card VISA MasterCard

( ) Bank Account BANK

Credit/Debit Card Information

* Denotes required field

* Card Type:
* Card #:
* Card Security Code:

The Card Security Code can be found as the last three digits in the signature panel on the back of your VISA, MasterCard, Discover card, or the four digits printed on the front of your American Express card above the embossed number.

* Expiration Date: Month: Year:

Billing Information

* Full Name (as it appears on credit card):
* Street Address Line 1:
Street Address Line 2:
* City:
* State:
Province/Region:
* Zip Code:
Postal Code:
* Country: United States

Submit Payment Information | Return to Arbitration Online Claim Filing Form

Payment Type

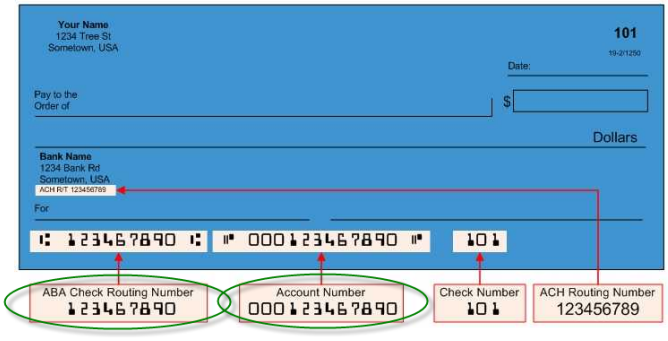
( ) Credit/Debit Card VISA MasterCard

(•) Bank Account BANK

Bank Account Information

* Denotes required field

*Account Type: Checking
*ABA Routing #:
*Bank Account #:
*Bank Account Holder's Full Name:



Submit Payment Information | Return to Arbitration Online Claim Filing Form

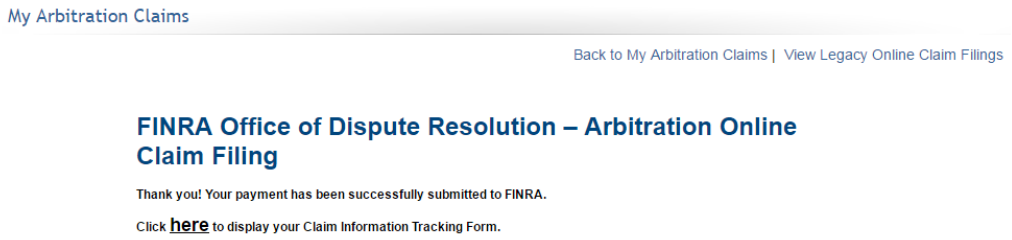
To pay online:

1. If you are paying by credit card, select the "**Credit Card**" Payment Type and enter all of the credit card and billing information for the owner of the credit card.
2. If you are paying by ACH bank transfer, select the "**Bank Account**" Payment Type, and enter the ABA routing number, checking account number, and the account owner's full name.
3. Click the "**Submit Payment Information**" button.

IMPORTANT NOTE: Only credit cards associated with an address located in the United States are accepted currently. Attempting to use a credit card with a non-US address could delay processing of your claim.

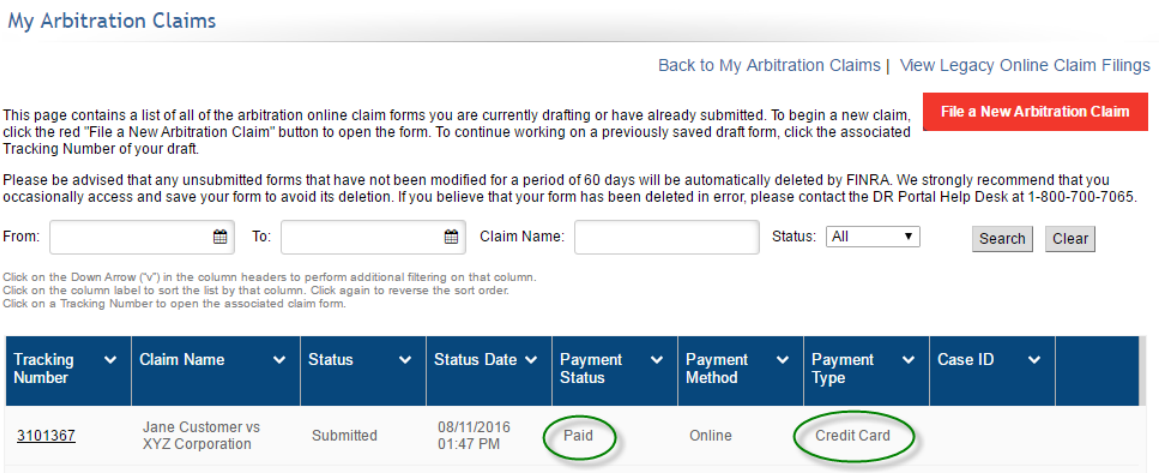
NOTE: If you need to abort making your online payment at this time, click the "**Back to My Arbitration Claims**" link instead. You will be taken back to your list of draft and submitted claim forms. You may pay the filing fee later by clicking the "**Pay**" link associated with your submitted claim.

When you submit your payment, you will get a confirmation page like this:

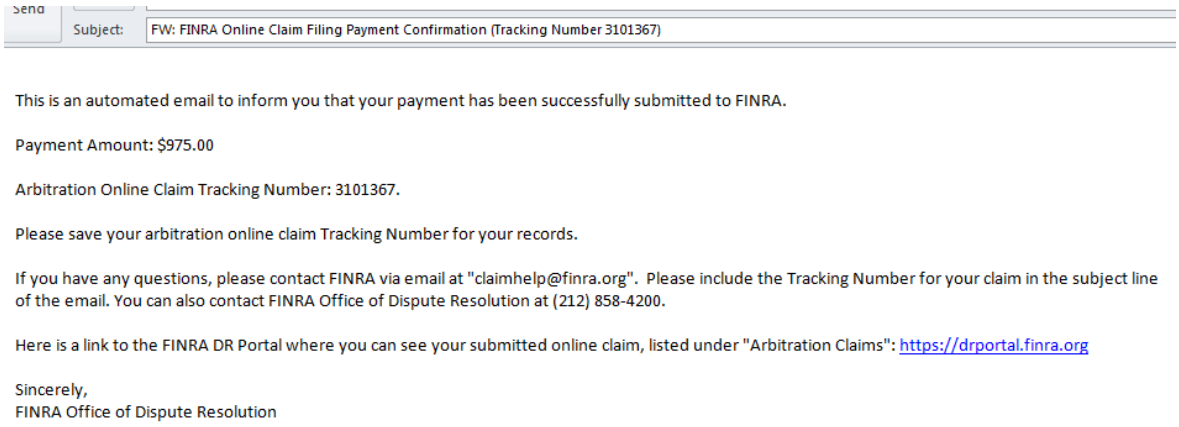


If you click where it says "**Click here to display your Claim Information Tracking Form,"** you will be returned to your Tracking Form. From there, you can click on "**Back to My Arbitration Claims**" to see your list of draft and submitted claims.

The payment status of your online payment might not be available for a few moments and you will still see the "**Pay**" link associated with your claim. If you decide to click the "**Pay**" again, the confirmation page will again be displayed. The system will not permit you to accidentally pay the fee twice. Once the funds have been captured successfully, you will see the status of your online payment.



You will also receive an email confirmation (to the email address that you entered on the payment page of the claim form) that your payment information was received. If you requested a fee waiver, you will not receive this email.



TIP: If you do not receive the email confirmation, it is possible that it was caught in your email spam filter. Check the mail folder on your computer where potential spam mail is placed.

Processing Your Submitted Claim

After your claim is successfully submitted, FINRA staff will process your claim and assign a Case ID to the case. When this occurs, you will receive an email invitation from FINRA to register with the DR Portal for access to this case. See “Accessing Case Information – Email Invitation from FINRA” for more information on using the email invitation.

Once you are registered for the case, you will find a formatted PDF copy of your Claim Information Form, along with your submitted attachments in the Documents tab of the associated case.

If you have any issues or concerns regarding your online claim submission, contact FINRA Dispute Resolution by emailing claimhelp@finra.org or calling 800-700-7065.

New York State Bar Association
Securities Arbitration and Mediation 2017:
The Courage to Simplify
April 6, 2017

Materials for

Special Considerations for Elderly Claimants

Speaker: Martin L. Feinberg

Expedited Proceedings for Seniors & Seriously Ill

Various state statutes provide for speedy trials in civil actions involving seniors or seriously ill parties. FINRA recognized a need for expedited hearings in arbitrations involving such parties in its dispute resolution forum. Thus, on June 7, 2004, FINRA implemented various measures to expedite arbitration proceedings in matters involving seniors or seriously ill parties.

Under these proceedings, FINRA Dispute Resolution staff (staff) will endeavor to do the following on an expedited basis:

- Complete the arbitrator selection process;
- Schedule the initial pre-hearing conference;
- Serve the final award; and
- Determine whether the parties are interested in mediation.

Arbitrators are encouraged to consider the health and age of a party when:

- Scheduling hearing dates;
- Considering postponement requests; and
- Setting discovery deadlines.

FINRA Dispute Resolution Staff Actions

Although staff cannot shorten the time requirements set forth in the Customer Code, upon a party's request, staff will expedite the administration of arbitration proceedings in matters involving seniors or seriously ill parties. In such situations, staff will begin the arbitrator selection process, schedule the Initial Prehearing Conference (IPHC), and serve the final award as quickly as possible. By mutual agreement, parties are also free to reduce the time requirements contained in the Customer Code. Staff will also determine promptly whether the parties are interested in mediation, which could further expedite resolution of the dispute.

Arbitrator Sensitivity

FINRA encourages its arbitrators to be sensitive to the needs of seniors or seriously ill parties when scheduling hearing dates, resolving discovery disputes, and determining the reasonableness of postponements.

At the IPHC, counsel for a senior or seriously ill party should advise the arbitration panel of the party's desire for expedited hearings. When a party makes such a request, the arbitration panel is expected to press for hearing dates and discovery deadlines that will expedite the process, yet still provide a fair amount of time for case preparation.

Financial Industry Regulatory Authority

Expedited Procedures Stipulation*

Case Number:

Case Name:

The undersigned parties acknowledge their understanding that some of the time requirements set forth in the Code of Arbitration Procedure ("the Code") may be reduced by mutual agreement of the parties as set forth below. FINRA will proceed with any shortened deadlines agreed to by all parties. The parties may agree to any or all of the following stipulations. Please check each box to indicate your agreement and return the completed Stipulation to FINRA. The parties may return the Stipulation separately. FINRA will review all returned Stipulations to determine which, if any, provisions have been agreed to.

☐ **Answer Extensions:**
Any agreed upon extensions to answer will not delay the case, specifically the arbitrator selection process, unless FINRA is advised otherwise by the parties in writing.

☐ **Arbitrator Ranking Deadline:**
Pursuant to the Code, rankings are due 20 days after lists have been sent to the parties. The parties agree to reduce this 20 day deadline to ___ days.

☐ ***Preferred Hearing Dates:***
The parties will provide agreed upon evidentiary hearing dates at the time rankings are due. However, FINRA cannot guarantee the parties' preferred hearing dates. Evidentiary hearing dates will be subject to the availability of the appointed arbitrators.

☐ **Appointment of Non-Ranked Arbitrators:**
The parties direct FINRA to appoint arbitrators who are available for the agreed upon hearing dates and understand that by doing so the parties' ranked arbitrators may not be appointed to this case. FINRA will provide the parties' preferred hearing dates to the appointed arbitrators at the time of paneling and ask that they hold these dates on their calendars.

☐ **IPHC Notice:**
The Code requires that the parties must be notified of the time and place of the Initial Pre-hearing Conference (IPHC) at least 20 days before it takes place. The parties hereby waive the 20 day notice so that the IPHC may be scheduled with at least ____ days notice. An Initial Pre-Hearing Conference will be scheduled, even if the parties provide FINRA with agreed upon hearing dates, unless the parties agree to opt out and provide all required information pursuant to Rules 12500(c) and/or 13500(c) of the Code.

Please discuss this Stipulation with all parties before submitting this form. FINRA will only move forward with agreed upon provisions as demonstrated by all parties checking a provision. If the parties do not agree, the case will proceed under the Code. ***If there are any additional agreements by the parties, they must notify FINRA in writing***. This Stipulation can be signed electronically by entering your name and initials, preceded and followed by the forward slash symbol (/) (e.g., /Jane Q. Public jqp/).

_____

Signature Name of Party Date

*This Stipulation only applies to cases involving senior or seriously ill parties.

FINRA & DRTF: Making Statistics Tell Us More About Practice in Securities Arbitration
by Richard P. Ryder

INTRODUCTION

For many years now, the FINRA Office of Dispute Resolution has published monthly statistics about its arbitration and mediation operations. The reported data has offered current and historic information about case inflow and outflow, the types of allegations and securities behind customer disputes, the number of cases going to hearing and their proportion to the rest, the outcomes for customers, and the state of the neutral roster.

I follow the trends and developments reflected in these changing statistics and write a monthly column analyzing the figures provided by FINRA. We learn a lot from FINRA's Public Awards Program about arbitrator thinking and case dispositions; the published statistics on FINRA's operations tells us what is coming through the front of the dispute resolution pipeline, what is being currently processed and what we can learn from closed cases in the aggregate. So many of the tactical matters an arbitration practitioner will have to address during the life of a case with FINRA will be informed by the general knowledge available in these statistics.

Let me just give a few examples. FINRA reports data on average turnaround time, the percentage of settlements and the customer win rate. This data allows one to calculate the probability of a long or short wait for hearing, of going to hearing at all, of winning if one proceeds or of settling through mediation. You can even figure out from these statistics the probability that the settlement process will take as long as or longer than the route to hearing. If one is representing a customer, the client will want to know how long the process will take; the branch client on the defense side will want to know the amounts to budget, the likelihood of success and how your case fits into the averages.

Thus, the reported statistics not only afford the nervous and suspicious a sense of the transparency and impartiality of the forum; they also provide needed intelligence about the whole theater of activity and its relation to one's own skirmishes and legal battles. In 2016, FINRA-ODR upgraded and re-designed the monthly statistical report, adding features that enhance the sense of transparency and improving the tactical value of the data and its usefulness to counsel on both sides. This article describes and analyzes those changes and explains how the changes better prepare the arbitration practitioner to navigate her case through the shoals of arbitration.

IMPETUS FOR CHANGE

Among the 51 recommendations made by the Dispute Resolution Task Force in its December 2015 Report was the recommendation to enhance the information imparted to the public in the monthly statistics published by FINRA on the Office of Dispute Resolution's Website (www.finra.org/arbitration-and-mediation). The DRTF was tasked by the FINRA Board with coming up with ways to improve the transparency, integrity and efficiency of the FINRA forum. With regard to the monthly statistical report posted by FINRA-ODR on the organization's Website, DRTF had this to say on page 44 of the Report:

"Publication of Additional Information on FINRA's Website. The task force considered a suggestion that additional statistical information be posted on FINRA's website, specifically:

a. A roster breakdown of active arbitrators by hearing location,
b. Pending cases by hearing location,
c. Average Turnaround Time for closed cases by hearing location.

It was suggested that this information would be useful to parties to determine if there were particular bottlenecks or delays regarding arbitrations in particular locations and would also assist FINRA to determine where additional arbitrators may be needed for recruiting purposes."

The Task Force later withdrew the proposal to provide average turnaround times by hearing location, for reasons we can explore later in this article. Because this recommendation did not require rulemaking or major deliberation, the FINRA-ODR staff set to work on it immediately and incorporated these and numerous other changes into the monthly format -- and did so even before the DRTF Report was released. We'll next review some of those improvements and why they aid our understanding of the operations and procedures behind the arbitration process at FINRA.

BIG CHANGES TO THE FINRA-ODR REPORT

At the top of the new Report is a topical link list of ten choices that will take the viewer, without scrolling, to the place in the Report that interests them. The case-filing statistics that formerly gave a binary look at the new submissions (up; down) now break down new filings by those that are customer-related and those that are industry-related. Historically, intra-industry cases form about 30-40% of FINRA's open cases. Historically, too, the number of intra-industry cases from year-to-year remains quite stable. Customer cases account for much of the ebb and flow on the intake side. With this new division, one gets a more precise sense of tidal shifts. That information can be helpful to those handling customer claims, particularly. It can impact marketing and staffing decisions and, on a higher level, where to aim one's practice.

The new Report also collapses three prior charts on new filings, closed cases, and average turnaround times into one chart. In the past, we have often tried to judge where the pending docket at FINRA stood (*ed: what's in the pipeline?)* through an aggregation of the new submissions figures with the accumulated closed-case figures. Now, FINRA just puts it out there. Comparable figures for the prior two years appear below the most current year's numbers. The pending number -- in FINRA parlance, the "open cases" -- tells users just how backlogged FINRA is, so one can anticipate either smooth sailing or a more protracted path ahead.

Having the average turnaround times (ATT) in the same chart allows confirmation of suspected backlogs and ATTs have fluctuated quite widely at FINRA over the years. These ATT figures revealed an apparent anomaly recently: In 2016, the ATT for <u>all</u> cases closed has been going up (i.e., worsening), while, measured separately, the ATTs for decided cases (Hearing Decisions and Simplified Decisions) have been going down (i.e., improving). Decided cases account for only about 20-25% of dispositions and most of the rest are settlements. That the overall average would be rising, while the decided averages are decreasing, indicates that the time to settlement is getting closer to the commencement of hearings.

For customer claimants, in particular, such a development, if verified, reduces the virtues of settling, versus taking the risk of a hearing decision. Generally, customer claimants pay on contingency, so the hearing costs are much diminished from what the defense must absorb. The threat of hearing, though, carries with it the stress of the process itself, but, most importantly, the risk of a total loss. The FINRA Report advises that only 14% of customers are trusting to the wisdom of arbitrators today, as compared to 20% of parties overall. That's not good news, no matter what the reason (and we can think of four or five), but the data provide the key to discovering the possible explanations and expose the need to inquire.

Whereas, FINRA reports in the past have supplied per-item charts offering statistics for a particular topic, FINRA-ODR has now juxtaposed the charts to show the interrelationship of one statistic to another. For instance, the historical (2001-2017) chart of cases filed and cases closed, previously separate, are now presented together. One can see, at a glance, the buildup in case filings after the Tech-Wreck, as the Millennium began and, again, in 2008 and 2009 with the financial crisis. Parallel to those figures are the closed-case figures, which struggled during the years of heavy volume and caught up in years of slackening volume. In 2014-2016, with several straight years of stable and historically low volume, the closed cases are running in parallel with new matters.

Controversies and Security Types: Customers

The Controversy (allegations) and Security Type (product) Charts have also been revamped, so that more items (15 vs. 10 or 11) are presented, and they are presented in order of numerical importance. One can now easily discern that “Breach of Fiduciary Duty” claims dominate the “Controversy” chart, followed by “Negligence” and “Failure to Supervise." The new “claims” on the Chart are “Violations of Blue Sky Laws,” “Manipulation,” “Errors-Charges” and “Fraud.” In January 2017, the FINRA Report reveals a doubling of blue sky claims (50 vs. 21 in January 2016) and big increases in claims of fraud and omission of facts.

On the product side, the Chart for "Security Types" now shows "Common Stocks," "Mutual Funds" and “Municipal Bonds” at the top of the Chart. Mutual Funds regained second position after trailing Municipal Bonds for three years. We could not see the impact of the Puerto Rico bond fund cases on FINRA’s product chart in the past. Now it is plain! In addition to the previous category, Municipal Bond Funds have occupied a more prominent position, but is now also slipping. Additional new categories in the early phase were “Real Estate Investment Trust (REITs),” “Exchange-Traded Funds,” “Private Equities” and “Structured Products.” Now, we see, instead or in addition, "Unit Investment Trust" and " 401(k)," Perhaps, FINRA is following trends here, too, as there were 27 "401(k)" cases for all of 2016, while 8 were filed in January alone. Unit Investment Trust claims numbered 4 in January, but up from 3 all of last year.

Controversies: Intra-Industry

The new Report opens a whole new dimension in reporting with the inclusion of a “Controversy” chart for Intra-Industry Arbitrations. All-new are the 15 categories of disputes, running from "Breach of Contract" and “Promissory Notes” at the top to “Compensation” disputes in the third slot and “Raiding Disputes,” a small, but important group (32), as we move to the bottom. Raiding Disputes are down dramatically; one can see this confirmed in the "Transfer" category on the customer "Controversies" list, which is also drying up. One might think that "Defamation" claims would be dropping, if brokers are staying put, but that's not the case. Both the Form U5

category of defamation claim and the "other" category are rising and have been in recent years. "Discrimination" claims, another important intra-industry category, are far fewer in number than Defamation and "Compensation" claims, and have remained relatively stable in number.

Big Change: Arbitrators by Hearing Location

Perhaps, the most significant change to the new statistical Report -- certainly the most colorful -- is the addition of an interactive map of the United States, with each hearing location on the map embedded with information about the number of pending cases and the arbitrators available for service in that specific hearing location. In the text above the map, the words "table format" link the user to a chart that provides the same information, but for all hearing locations in alpha order. This chart makes it easier to compare numerous hearing locations and it can be saved as a PDF, enabling month-to-month comparisons by return visitors, like ourselves.

The Table lists each hearing location, the number of cases pending in that location (updated monthly), and the number of Public Arbitrators, Non-Public Arbitrators, and Public Chairs. FINRA basically gave the DRTF everything it asked for. Those contemplating bringing a claim that will be heard by arbitrators in Albany, NY will easily see that this situs has ample arbitrator capacity in all classifications and that only seven cases will be competing for those resources. FINRA did not supply the average turnaround time for Albany in this new listing, as the DRTF originally asked. The staff did not need the information for its own needs (identifying trouble spots and recruitment deficiencies). The Task Force withdrew the recommendation, saying it "did not see any data suggesting that certain districts were more delayed than others in their ability to facilitate arbitration cases." The Report also notes that "hearing locations are generally determined by the residence of the claimant, unless otherwise agreed to by the parties."

Recommendations: Hearing Location

Parties can agree on a change in hearing location, if the available information suggests it would be practical. What the new hearing location list does not tell the user considering Albany is that, in the past three years, five cases have been decided in that situs with an ATT of 953 days! The ATT for Hearing Decisions is currently at an enviable low of 13.7 months (about 400 days), but, for reasons that do not appear to be affected by ample arbitrator capacity, Albany has a bottleneck. If the customer considering Albany resided there when the claim arose, but now lives in California, where the Respondent broker-dealer is also based, ATT data for Albany, Los Angeles (572 days) and San Francisco (619 days) could be material in persuading the parties to agree mutually on a situs change.

A further modification we think prudent and helpful was not one the Task Force was able to consider. FINRA apparently lists the number of arbitrators *available for service* in the hearing location, as opposed to the number who were originally admitted or who reside there. We say this, only because, when one adds up the listed arbitrators, the number equals far more than the 7,000 arbitrators on the FINRA Neutral Roster. While the number of available arbitrators seems the correct figure for purposes of weighing bottleneck potentials, many practitioners, particularly on the Claimant side, do not like the use of "itinerant" or "traveling" arbitrators.

In a comment letter, submitted by PIABA to the SEC in 2016, in connection with a rule proposal on chairperson eligibility (SR-FINRA-2016-033), then-President Hugh Berkson wrote: "PIABA does not want to see the quality of the pools watered down or have an increase in 'traveling arbitrators' to attain a greater number of chair-qualified arbitrators." PIABA members are encountering the same out-of-state arbitrators more frequently, he wrote, and the problem is exacerbated in the small and mid-size hearing locations. Besides causing delays, out-of-state arbitrators may have lower "win" rates than local chairpersons, he claimed. The delays relate to the need for traveling arbitrators to adhere to a travel schedule, to the delays that result from traveling, and the difficulties of scheduling back-to-back hearing days.

Conclusion

Practitioners would be greatly aided, we think, were FINRA to supply two more columns on the "Hearing Location Statistics" chart: one for average turnaround time for past Awards in the specific hearing locations; and, another for the number of "traveling" arbitrators who have the relevant hearing location as their secondary base. As for other recommendations, we have some, but FINRA has truly amplified the utility and transparency of its statistical reports with the changes it has already undertaken. Further change and continued improvement lie ahead, one can tell from FINRA's open approach on this subject. The information already available provides much data for refining observations, polishing probabilities, and making more informed judgments in one's arbitration practice.

Topic 2:
Telling Your Story Simply from Intake to Closing Statements

DRAFTING THE ANSWER

by Jonathan L. Hochman
and Lena J. Wong

INTRODUCTION

A few years ago, a federal judge remarked that the "answer is the least important piece of paper in the courthouse." Not so in arbitration. The form and substance of the answer are among the greatest differences between litigation and arbitration. Whereas the answer in litigation is a dry, formulaic paragraph-by-paragraph response to the complaint that rarely reveals the defendant's story or strategy, the answer in a securities arbitration can be – and should be – a dynamic advocacy piece. Respondents' counsel in an arbitration has the opportunity through his or her answer to tell respondents' story, to identify, provide and discuss crucial evidence, to introduce major themes and thus generally to set the stage for respondents' entire case.

PURPOSES OF THE ANSWER

Persuasion of the arbitration panel is of course the primary purpose of the answer. But a well-prepared answer does more than simply attempt to persuade the arbitration panel of the merits of respondents' case. The process of preparing the answer itself provides an important opportunity to investigate the merits of the claim, gather evidence, and perform early case evaluation. The demands of assembling a persuasive answer necessitate a careful factual investigation. Compared to litigation, this requires a front-

loading of defense counsel's factual investigation, which in turn often yields a clear view of the merits early in the case. As a result, resolutions are sometimes possible at a time when neither party has expended great resources on the arbitration process.

A related purpose is to alert the claimant and the claimant's counsel to the strength of respondents' defenses. It is not uncommon that the claimant, claimant's counsel, or both are unaware of important evidence rebutting some or all of the claims at issue. Receipt of a well-crafted answer, laying out facts that the claimant was unaware of, or forgot about (or forgot to mention to counsel) can lead to an early settlement and sometimes even a voluntary dismissal.

THE RULES GOVERNING ARBITRATION ANSWERS

Timing

The FINRA rules provide forty-five days from the receipt of the statement of claim for the respondents to serve an answer on claimant. (FINRA Rule 12303(a).) Nevertheless, the parties may agree in writing to extend or modify any deadlines for serving an answer. (FINRA Rule 12207.) Under the American Arbitration Association ("AAA") Supplementary Procedures for Securities Arbitrations, the respondents have twenty days in which to submit an answer. (AAA Supplementary Procedures for Securities Arbitrations, Rule 2.)

Waiver of Defenses

The FINRA rules require that answers set forth all available factual and legal defenses. (FINRA Rule 12303(a).) In fact, if respondents fail to specify a factual or legal defense, upon a parties' objection, particular claims or defenses may be excluded by

the panel at the hearing. (FINRA Rule 12308(b).) Furthermore, failure to answer within the time frames prescribed can also lead to the respondents' being barred from presenting *any* defenses. (FINRA Rule 12308(a).) [1] The AAA has a similar rule in the event that the claimant has requested an answering statement. (AAA Supplementary Procedures for Securities Arbitrations, Rule 2.) Accordingly, respondents' failure to identify their defenses prior to answering, and the failure to include those defenses in their answer, can lead to serious adverse consequences.

Answering Amended Claims[2]

FINRA Rule 12310 governs the deadlines for serving an answer where a claim has been amended. If a claim is amended before an answer has been served, then the respondents' original time to answer is extended by twenty days. Where a claim is amended after it has been answered, but before a panel has been appointed, the respondents must serve their amended answer within twenty days of receiving the amended claim. Finally, where a claim is amended after a panel has been appointed, the respondents have twenty days to serve an amended answer from receipt of the notice that the panel has granted the motion to amend the claim. As stated above, the parties may agree in writing to extend or modify the deadline for serving an answer. (FINRA Rule 12207).

[1] Under the AAA Supplementary Procedures for Securities Arbitrations, respondents' failure to answer will be deemed a general denial. If, however, the claimant then demands an answer and respondent still fails to provide one within ten days of such request, defenses may thereafter be barred by the panel upon the claimants' request. (AAA Supplementary Procedures for Securities Arbitrations, Rule 2.)

[2] A new version of FINRA Rule 12310, which comes into effect on April 3, 2017, does not change the current deadlines for serving an answer.

PRE-ANSWER INVESTIGATION

The opportunity to tell respondents' story and the requirement that factual or legal defenses not be omitted compels respondents' counsel to thoroughly investigate claims and defenses prior to answering. The forty-five (45) day time period afforded under the FINRA rules and the extensions of that deadline that can often be obtained, as well as the shorter deadlines under the AAA rules, generally provide ample time for a reasonable investigation.

As soon as possible after receipt of the statement of claim, it is particularly important that inside and/or outside counsel take steps to ensure both that no documents are destroyed and that all relevant documents are collected for review from all possible file sources. The SROs and panels can be vigilant about punctilious compliance with discovery obligations and may award sanctions against parties failing to meet those obligations. (*See, e.g.,* NASD Reminds Members of their Duty to Cooperate in Arbitration Discovery Process, 03-70 NASD NTM 761 (2003).)[3]

The pre-answer investigation should begin in earnest with a review of the basic account documents, including new account forms and agreements, monthly statements, confirmations, the broker's CRD, any notes and correspondence and research and analytical materials about the relevant product, transaction or strategy sent to or

[3] Once the Director serves the statement of claim, the Director will notify the parties of the location of the FINRA Discovery Guide and Document Production Lists on FINRA's website, which at the time of this writing is located at: http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13786&element_id=10084&highlight=FINRA+Discovery+GuidE#r13786. (FINRA Rule 12506.)

otherwise available to claimant. In most cases, Respondents will also want to obtain a profit and loss analysis of the account or accounts at issue.[4]

After gaining an understanding of the activity in the account and becoming familiar with the core documents, counsel should interview the broker, branch manager and anyone else who had any significant contact with the claimant. These interviews will hopefully yield facts rebutting some or all of the story presented in the statement of claim and possibly point to additional documents for review. Information that can be crucial flowing from interviews of the broker and branch manager includes the claimant's personal and investment history, explanations of any disciplinary history of the broker or branch manager, the course of dealing between the broker and the claimant and contacts between supervisory personnel and the claimant.

Finally, any other means that can be used to investigate the claimant should be used. At a minimum, counsel should perform Google searches and Westlaw or Lexis searches. Such searches may reveal, among other things, prior litigations involving claimant, the claimant's business dealings and finances or other useful details of claimant's personal history.

[4] These analyses, prepared by various independent firms, "slice-and-dice" the information culled from the account statements in a variety of useful ways, making analysis of the account activity far easier than it would be from the raw data on the monthly statements. For example, such p&l's usually include: (1) a snapshot of the overall account activity, showing the cash in, cash out and over-all profit or loss; (2) a chronological listing of all trades; (3) a chronological listing of all cash transactions; (4) an analysis of the turnover in the account; and (5) a table showing the profit and loss, as well as deposits, withdrawals and transfers, on a month-by-month basis.

FORMAT OF THE ANSWER

There is no reason that an answer in an arbitration proceeding must look like an answer in litigation. It is neither necessary nor helpful to respond to each paragraph of the statement of claim. Rather, the answer should be a cogent narrative broken down into clear, well organized sections. We generally include a prefatory statement indicating that the answer is not intended to rebut each allegation of the statement of claim and that therefore any allegations not specifically addressed should be deemed denied.

Each answer, of course, varies depending on the specifics of the case. However, ours generally consist of:

- a preliminary statement, a roughly chronological rendition of the relationship between the parties, focusing on the facts constituting respondents' defenses;
- an explanation of the respondents' legal defenses if appropriate;
- a section setting forth affirmative defenses; and
- a prayer for relief.

The preliminary statements should be a tight summary of the respondents' basic story and defenses. The following sections discussing factual and legal defenses should be organized as clearly as possible. We do not always separate the "fact" sections from sections dealing with the legal defenses. Where possible, we prefer to integrate the two seamlessly.

For the sake of clarity, we favor the use of argumentative (though not hyperbolic) section headings that highlight respondents' themes or key arguments. For example:

- "Claimant Is A Sophisticated And Aggressive Investor";

- "Claimant Was Well Aware Of The Transactions At Issue";
- "Claimant Repeatedly Ratified the Transactions At Issue";
- "Respondents Are Well-Respected, Experienced Professionals With Unblemished Records"; and
- "Claimant Suffered No Damages."

While the answer does not generally need to resemble a litigation-style answer, it is probably a good idea to include a section setting forth affirmative defenses, due to the FINRA waiver rules discussed above. Affirmative defenses you may want to consider using where appropriate (but by no means an exhaustive list) include:

- Failure to state a claim;
- Failure to mitigate damages;
- Ratification;
- Statute of limitations;
- Laches;
- Lack of a private right of action for violation of SRO rules;
- The transactions complained of in the statement of claim were duly authorized by claimant;
- Claimant was in control of the assets in the account;
- Respondents acted in good faith and exercised the degree of care, diligence, and skill which a prudent person would exercise in similar circumstances and like positions;
- Respondent's conduct was not the proximate cause of Claimant's losses; and

- Respondents had adequate supervisory systems in place and adhered to them in a reasonable and appropriate manner.

Following the affirmative defenses, the prayer for relief should include at least requests for dismissal of the statement of claim, for expungement of the claim from the broker's CRD records (where applicable), for costs of the proceeding and for such other and further relief as the panel may deem just and proper.

COMMON DEFENSE THEMES AND TYPICALLY HELPFUL FACTS

1. **Claimant Was A Sophisticated Investor.** Claimant's sophistication can often be demonstrated by one or more of the following: (1) information on new account forms indicating years of investing experience; (2) account activity at other firms; (3) subscriptions to financial periodicals; (4) claimant's business activities; or (5) claimants' high net worth.
2. **Claimant Was Warned That He Or She May Lose Money.** Refer to the account agreements and other documents that claimant signed in opening the account stating that he received, read and understood the risks associated with the account or strategy. In addition, often interviews of the broker and review of e-mail communications will reveal extensive warnings about a particular strategy or securities. There are sometimes strikingly explicit warnings given to, or even signed by, the customer upon opening an options account, which are very useful in an options case. Similarly, prospectuses or offering materials received by the claimant typically contain extensive disclosures of the risks of an investment. Some firms

also transmit or otherwise make available to clients "product guides" describing the nature and characteristics of a particular product.

3. **Claimant Acknowledged The Risks Of Investing In The Product At Issue.** Investors sometimes are required to execute subscription agreements before committing to a product in which they acknowledge that they are sophisticated investors and have read and reviewed the relevant offering material. There are sometimes strikingly explicit warnings given to, or even signed by, the customer upon opening an options account, which are very useful in an options case.

4. **Claimant Cannot Justifiably Rely On Oral Representation Made By The Broker Outside Of The Written Offering Materials.** Where investors sign subscription agreements or similar documents acknowledging receipt and review of written offering materials (particularly the fund prospectus), courts have held that such investors cannot demonstrate reasonable or justifiable reliance on a brokers' alleged oral misrepresentation actions. *See, e.g.*, *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020 (2d Cir. 1993).

5. **The Investments At Issue Were Directed By The Claimant.** Whether the claim is for unauthorized trading, unsuitability or churning, evidence that the claimant directed the investments at issue is generally helpful. Where this is the case, ideally, the broker will have marked the order tickets "unsolicited." The monthly statements and trade confirmations should also reflect the unsolicited nature of the transactions. But, even if the documentation does not indicate that the transactions at issue were

marked unsolicited, often testimonial evidence from the broker, sales assistant or others will so indicate.

6. **There Were Frequent Communications Between The Claimant And The Broker.** Evidence that the broker and the claimant communicated frequently is often helpful. These communications can sometimes be established with actual phone records, but may also be proven with broker notes, e-mail or information garnered from interviews.

7. **Claimant Subscribed To Financial Periodicals And/Or Computer Services.** It is similarly helpful to demonstrate the claimant's sophistication and level of involvement with the management of his or her account by showing that the claimant subscribed to various financial periodicals and/or computer services. It is wonderfully persuasive to demonstrate, for example, that a claimant who professes complete naiveté as to financial matters and total dependence on the broker subscribes to the Wall Street Journal, Barons, Forbes and monitors her account daily on respondents' online service.

8. **Claimant Had Aggressive Account Objectives.** Many is the claimant who files an unsuitability claim despite having indicated on the new account forms speculative and aggressive account objectives. New account forms are often actually signed by the claimant and therefore tend to rebut rather powerfully the claim that the claimant wished to invest conservatively.

9. **Claimant Received Monthly Statements And Confirmations.** Because claimants almost invariably have received statements and confirmations clearly revealing the

transactions at issue, this fact is available in almost every case. Nonetheless, it is well worth pointing out. Monthly statements can be helpful in unauthorized trading and churning claims for the additional reason that they generally contain a statement that they become final or binding if not objected to within a specified amount of time, which can buttress a ratification defense.

10. **Claimant Witnessed Volatility In His Or Her Account.** Related is the situation in which the claimant's account rose and fell dramatically several times prior to whatever losses are the subject of the claim. Having witnessed such volatility – as would be revealed to claimant from even the most casual glance at the account statements – is seriously inconsistent with any claim that the claimant believed his or her account to have been conservatively invested.

11. **Claimant Ratified The Management Of The Account.** Often times, claimants discover unauthorized trades or other purportedly improper behavior in connection with their account and take no action for substantial periods of time. Not only do claimants have a duty to mitigate damages but there is specific case law in the area of broker-customer disputes making clear that claimants are not allowed to "ride the market" to see if their investments will recover after discovering purportedly improper conduct. (*See, e.g., Tripi v. Prudential Sec., Inc.*, 303 F.Supp. 2d 349, 356 (S.D.N.Y. 2003) (remanding damages awarded because panel could have found that evidence of investor's receipt of written confirmation of all trades constituted either ratification of the transactions or failure to mitigate damages); *Jaksich v. Thompson McKinnon Securities, Inc*., 582 F.Supp. 485, 497 (S.D.N.Y. 1984) (by not objecting

to trades, customer waived her right to object; instead, she elected to "ride the market" when the price of the stock went up*); see also Richardson Greenshields Securities Inc. v. Lau*, 819 F.Supp. 1246, 1259 (S.D.N.Y 1993) ("[a] failure [by a customer] to object over a long period of time is evidence of acquiescence in the unauthorized activity"); *Grey v. Gruntal & Co., Inc*., 1987 Fed. Sec. L. Rep. (CCH) P93, 262 (S.D.N.Y. 1987) (securities investor ratified transactions where she admitted receiving confirmation slips and monthly account statements without objecting and where she paid for the stocks purchased); *Carr v. Warner*, 137 F.Supp. 611, 614-15 (D. Mass. 1955) (plaintiff waived any right to recovery for churning by "repeatedly accepting confirmations and accounts, which fully disclosed all aspects of the transactions").)

12. **Respondents Had No Duty.** Claimants sometimes attempt to hold brokers liable for acts or omissions – particularly omissions – where the law simply imposes no duty on the brokers or firms. For example, it is the law in most jurisdictions that brokers and firms do not owe fiduciary duties in connection with nondiscretionary accounts. More specifically, as made clear by the Second Circuit in *De Kwiatkowski v. Bear Stearns & Co.*, 306 F.3d 1293 (2d Cir. 2002), brokers and firms owe no duties to investors with discretionary accounts to advise them regarding their positions in between transactions. Rather, their duties are limited to the advice they actually give and their execution of particular transactions.

13. **Claimant's Claims Are Barred By Statutes Of Limitation/Eligibility Rules.** As a matter of law, statutes of limitations can apply to bar various claims. While not a

defense that often meets with success before arbitration panels, a statute of limitations defense can be asserted in New York State Court pursuant to CPLR § 7502(b), despite the arbitration clause in an account agreement.[5] The eligibility period under SRO rules – which is six years for FINRA (FINRA Rule 12206)[6] – is a compelling defense and should prevail in arbitration where claimant has waited that long before filing a statement of claim.

14. **Claimant Suffered No Damages.** Claimants sometimes seek damages on one investment or aspect of their portfolio, while similar investments or the entire portfolio was profitable. Identifying a claimant's "cherry-picking" of losses – typically done through a profit and loss analysis – can be a powerful way to undermine a claimant's credibility.

CITING LEGAL AUTHORITIES

While the answer is predominantly a narrative, there is no reason that helpful case law cannot be cited and/or quoted. Certain defenses, such as ratification and failure to mitigate, are particularly amenable to legal citations. An explanation of the applicable legal principle along with citations indicating that respondents' defenses are richly supported by case law can be very persuasive and instructive – particularly because some members of the panel might not be litigators, or even lawyers.

[5] An application to the New York State Supreme Court to stay arbitration pursuant to this provision must be made within twenty days after service of the statement of claim or it is precluded. CPLR § 7503(c).

[6] FINRA's six-year limitations period is tolled if a party submits a claim to a court of competent jurisdiction and so long as the court retains jurisdiction of the claim matter. (FINRA Rule 12206(b).)

CREDIBILITY AND EXHIBITS

It has become a workplace maxim that one should "under-promise and over-deliver." Without selling respondents' case short, or in any way failing to make the most of the defenses at respondents' disposal, this is a fine principle to keep in mind when preparing an answer. Certainly, doing the opposite can be fatal. The answer often provides opportunities to demonstrate respondents' credibility to the panel while undermining the claimant's. Counsel should therefore take particular pains to make sure that he or she will be able to deliver everything at the hearing that is promised in the answer. Similarly, the answer should avoid overblown rhetoric and flights of righteous indignation. (Nonetheless, truly egregious or outrageous claims should – in a low-keyed and sober fashion – be identified as such.)

An important way of bolstering respondents' credibility while eroding claimant's is the judicious use of exhibits. Exhibits that crisply contradict significant aspects of the statement of claim should certainly be attached. Similarly, key documents supporting defense claims should also be attached. By being scrupulously accurate in the answer about what the attached documents demonstrate, counsel enhances his or her credibility with the panel, as the panel members learn that statements in the answer invariably correspond with exactly what the evidence shows. For ease of reference, we like to literally highlight with a colored marker the salient features of any exhibits on the actual copies of the answer.

MOTIONS TO DISMISS

FINRA rules all but prohibit motions to dismiss. FINRA Code of Arbitration Procedure Rule 12504, first adopted in April 2007, permits motions to dismiss in the following limited circumstances:

(A) the non-moving party previously released the claim(s) in dispute by a signed settlement agreement and/or written release;

(B) the moving party was not associated with the account(s), security(ies), or conduct at issue; or

(C)the non-moving party previously brought a claim regarding the same dispute against the same party that was fully and finally adjudicated on the merits and memorialized in an order, judgment, award, or decision.

Further, such motions must be made in writing and be separate from, and made only after the filing of, the answer. Notably, the panel has the discretion to award reasonable costs and attorneys' fees where motions to dismiss have been deemed frivolous and to issue sanctions where motions to dismiss have been made in bad faith. (FINRA Rule 12504(a)(11).)

In contrast, the AAA Commercial Arbitration Rules do not provide a specific provision on motions to dismiss. Rather, the AAA Rules allow dispositive motions on a case-to-case basis and ***only*** if the arbitrator determines that the moving party has shown

that the motion is likely to succeed and dispose of or narrow the issues in the case. (AAA Commercial Arbitration Rules, Rule 33.)[7]

COUNTERCLAIMS AND THIRD-PARTY CLAIMS

Counsel should consider in preparing the answer whether or not the claimant may be liable to respondents or whether some third-party may bear responsibility for the transactions at issue. While grounds for counterclaims against claimants are infrequent, on occasion the claimant has, for example, unpaid outstanding loans to the firm or some other source of liability to it. More frequent is the circumstance in which the harm complained of by the claimant may be the responsibility of a third-party, as where the transactions in the securities at issue were executed at a different firm or by a trustee or other individual with trading authority over the claimant's accounts.

CONCLUSION

The key to a successful and effective answer is thorough preparation early on. If this requirement is treated as an opportunity, it will stand counsel in good stead throughout all of the phases of an arbitration proceeding and also any mediation or settlement negotiations. Furthermore, by the time they arrive in the hearing room armed with the well-crafted answer, the panel will clearly understand respondents' position and even, perhaps, be favorably disposed toward it.

[7] Following this flexible approach, the AAA Commercial Arbitration Rules do not set forth any deadlines for the filing of dispositive motions.

What Behavioral Psychology Can Teach Us About Effective Advocacy

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When I was an economics major in college, I learned a lot of classical economic theory. Much of that became obsolete with the election of Ronald Reagan and the ascendancy of what then came to be called "supply-side" economics (or "voodoo economics," as the first President Bush called it). But that was nothing. Since then, behavioral economists have swallowed up much of what Reagan, Bush and I thought we knew about the subject. That is because traditional economic theory rests on the assumption that people are fundamentally rational. New research in psychology casts major doubt on that assumption, and so has turned economics on its head.

We should care about this because when we as advocates frame a presentation for an arbitration panel, we also think we are dealing with rational actors. To compound the problem, securities cases lend themselves all too easily to a presentation based on logical syllogism, the epitome of rational thinking and too often a crutch for lawyers, that creates dense and complex presentations aimed at rational decision-makers. That being so, advocates would do well to consider some of the lessons of modern behavioral economics and adopt them towards framing more effective presentations.

It is apt that the theme of this conference is *The Courage to Simplify*, because how the mind deals with simplicity is one of the key lessons to be learned. Nobel laureate Daniel

Kahneman, in his masterwork *Thinking, Fast and Slow*,[1] posits a most useful model for considering how we think. Kahneman hypothesizes that we evolved two distinct modes of thought, which he labels System 1 and System 2.

System 1 is our older brain. It is basically lazy. It favors easy answers. It is gullible. It jumps to conclusions. It favors solutions that it can grasp intuitively, without heavy mental lifting, to those that require analysis or calculation. It is attracted to "shiny objects" and it is the natural order of our minds.

System 2, on the other hand, has to be engaged, usually by conscious effort. It will use logic, calculation, analysis and all the other tools of rationality, to cast doubt—to throw shade, if you will—upon a conclusion that System 1 would otherwise be all too ready to accept. System 2 is powered by training and education, and feeds on hard-to-digest information and data. Thus, it requires willpower and mental effort, which is to say, work. And because it requires work, resort to it will be avoided whenever possible. It usually will be engaged only when and only to the extent that System 1's conclusion feels viscerally wrong.

So, System 1 is our primary mode of thinking, and we need to come to grips with it. Here are a few important concepts that research has shown are important to understanding how System 1 works:

1. Basic Assessments. "System 1 continuously monitors what is going on outside and inside the mind, and continuously generates assessments of various aspects of the situation without specific intention and with little or no effort."[2] In other words, System 1 is starting to form lazy conclusions about you and your case from the moment it is engaged.

[1] Daniel J. Kahneman, THINKING, FAST & SLOW (2011) ["TF&S"].
[2] TF&S at p. 89.

2. Cognitive Ease. System 1 takes in various effects and produces good feelings (not rational conclusions) from them. For example,
    a. Repeated exposure of facts makes those facts "feel" familiar, even without having any real prior experience of them.
    b. Clear display of facts makes those facts "feel" true, even without any evidence of their truth or falsity.
    c. Ideas of which one is primed in advance give a "good feeling" about them when heard about again later, even without having any real information about them.
    d. Ideas that evoke a good mood feel easier to follow than those that generate bad moods, regardless how difficult those ideas actually are.[3]
3. Anchoring. System 1 is very susceptible to suggestions. Merely suggesting an outcome will cause it to gravitate towards that outcome more than is warranted by actual facts.
4. Confirmation Bias. System 1 is very credulous, will make determinations on the basis of faulty evidence, and will be likely to interpret all new information so as to support the determination it has already made. Three mechanisms by which this happens are:
    a. Substitution of Easier Questions—When faced with a harder analytical question, System 1 will tend to substitute an easier question as a proxy, but the easier question will typically emerge from, and so will favor, the basic assessment that System 1 is in the process of making. This creates a feedback

[3] TF&S at 60.

loop, where a tentative conclusion generates a proxy question whose answer is likely to support the very conclusion from which it emerged.

b. The Halo Effect—the credibility of one aspect of a presentation will spill over to augment the credibility of another aspect, even if there is no rational connection between the two.

c. WYSIATI—Or, "What You See Is All There Is." System 1 tends to reach general conclusions based only on the facts it has in front of it, regardless how unrepresentative those facts might really be.

5. Knowledge Sharing. System 1 has a tendency to believe facts of which it has no knowledge if someone else in the group believes it who, we believe, does have knowledge. This is a form of knowledge sharing, wherein what I know and what you know can coalesce into a shared conclusion, even though I don't know what you know and you don't know what I know. The key to this being effective, of course, is that each of us really does know what others think we know. The way we judge that is by trusting those who we perceive belong to our own group.[4]

What to make of all this for arbitrating cases could fill a book. All we can do here is scratch the surface with some tentative ideas. We all have to cope with our System 1 and System 2 minds every day, and arbitrators are no different than us. Knowing how these two mental systems are at play in the minds of the arbitrators cannot but help us to frame our advocacy more effectively. The basic goal for any advocate must be to win over each arbitrator's System 1, and to ensure that if his or her System 2 is engaged, it at best supports System 1's conclusions, or at worst is unable cast sufficient doubt to dislodge System 1's conclusion. Understanding System

[4] Phillip Fernbach and Steven Sloman, *Why We Believe Obvious Untruths*, THE NEW YORK TIMES (Mar. 3, 2017).

1, however, is crucial. These observations come to mind:

First, this suggests that it is important to have arbitrators with whom both you and your client will have a natural credibility, by virtue of you and they being members of the same "group." So, pick one arbitrator who is like yourself, and one who is like your client. Then you can hope that your credibility with your arbitrator and your client's credibility with his, will cause the both of them to believe both you and your client (since the two of them are also members of the another common "group," that of being arbitrators). This affinity also primes their System 1s to be at least neutral if not favorably disposed towards you.

Second, your mother (grandmother?) was right: First impressions count, and they count a lot. The first thing the arbitrator encounters about your case—be it the pleading or your own demeanor—starts his or her System 1 in forming a basic assessment. From that point on, everything that you and your adversary do gets processed in the context of that basic assessment. The basic assessment is molded by the evidence—with the easiest evidence to absorb taking pride of place. Once an arbitrator's basic assessment reaches the tipping point of concluding that one side or the other should win, then confirmation bias will cause every new fact will to be interpreted in a way that supports that result, until by the end of the case that result will seem to the arbitrator to be a foregone conclusion.

Third, given the non-analytical nature of System 1—given its emphasis on moods and feelings—and given System 1's tendency not to want to work too hard, it seems obvious that it will relish being told stories, and stories with pictures most of all. This is primal. All children want to be told stories, and all authority figures are at bottom story-tellers. Arbitrators, like all of us, are children in that regard. Their System 1 minds will not be able to resist a good story, and that story lends itself easily to be the foundation of the basic assessment that then starts to form.

But what of System 2, the analytical side of our minds? That has been the subject of its own interesting research. That research is concluding that reason itself—the province of System 2—evolved for only one purpose, and that is to help humans maintain social cohesiveness in prehistoric groups by providing a mechanism to win arguments. "Skilled arguers . . . are not after the truth but after arguments supporting their views."[5] Indeed, the value both of arguments and of conclusions seem to be circular—we favor arguments that support the conclusions we like, and we favor conclusions for which we can find arguments we like, but the external question of "truth" seems almost beside the point. In the cave, "There was little advantage in reasoning clearly, while much was to be gained from winning arguments."[6] Not surprisingly, then, we tend to be more accepting of arguments against other people's positions than against our own.

All of which calls into question the role of legal argument in advocacy, at least at a trial level. If it is used merely as window dressing to support a case that already has System 1's attention, then it does not need to do that much. Only if System 2 is invoked in an attempt to dislodge a basic assessment formed or in the process of being formed by System 1 does legal argument become important. But then, whose mind are we trying to influence with legal arguments? Not your adversary's, surely. And not that of any arbitrator whose System 1 assessment is firmly against you. All who's left upon whom to aim a legal argument are the arbitrator whose System 1 assessment has not yet been fully formed, and the arbitrator whose System 1 assessment is already on your side—the former to influence, and the latter to reuse your legal argument to persuade the former to accept his (your) side. The problem for us as

[5] Hugo Mercier and Dan Sperber, *Why do humans reason? Arguments for an argumentative theory.* 34 BEHAVIORAL AND BRAIN SCIENCES 57 (2011), at 57.
[6] Elizabeth Kolbert, *That's What You Think*, THE NEW YORKER (Feb. 27, 2017) at p. 69 [Book Review].

advocates, of course, is that we don't know who our target is in advance, so we are forced to cast a wide and often blind net.

As I said, we've only scratched the surface. I find it interesting, though, how much of what the new research shows was known intuitively by the great trial lawyers of old. That we now try so few jury cases has, I fear, numbed our collective sense of how to try cases well, and the casualness of arbitration has itself tended to make us sloppy and a little lazy too. The modern research is indeed very interesting and even instructive in a System 2 sort of way. But pick up an old volume by Lloyd Stryker, Louis Nizer or Herbert Stern and you would learn pretty much the same thing.

The Importance of Storytelling in Arbitration[*]

Professor Paul Radvany[†]

There are two aspects of telling a story. The first, which this article will focus on, is the substance of the story. The second, nearly as important, is how to deliver the story. Stories must convince the arbitrator(s) to rule in your favor. Thus they must be persuasive. They must be engaging lest you lose the arbitrators' attention. If the story you tell, beginning with the Statement of Claim and ending with your summation is not interesting and convincing, it will be more difficult for the arbitrators to listen to your arguments let alone remember them when they deliberate.

Obviously, one can't tell a story until one knows what happened. But simply telling the story is insufficient. One must be able to tell a persuasive story and one can't accomplish this without learning as many details as possible. Thus, an attorney must first develop a strong understanding of all of the relevant and material facts, along with the applicable regulations and legal precedents before telling a compelling story at an arbitration.

Master the Facts

In order to develop a clear understanding of the facts, you must be sure to spend sufficient time with your client to have a complete grasp of the facts as he/she recalls them. The more familiar you are regarding what happened, the more effective you will be in advocating for, and counseling, your client.

 Parts of this article is based, on Paul Radvany and Michael W.

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Presumably, before drafting the Statement of Claim you interviewed your client extensive detail. At the arbitration you will tell the story during your opening and closing but your client will also play a crucial role in bringing the story to life. In preparing your client to testify at an arbitration, you will have to meet many times and often will discover some additional facts you may not have learned earlier in the case.

First and foremost, an attorney must inquire into any conversations and correspondence the client had with the broker and any other individuals at the broker dealer, as their interactions will often be crucial to analyzing the strength of the case. For example, if a broker convinced your client to purchase an illiquid REIT, you would want to know how the broker represented the investment to your client. What, if anything, did the broker tell your client about the liquidity of the investment? Did the broker talk about the risks of the investment? Did your client make his investment objectives clear to the broker? Did your client understand the investment before purchasing it? The discussions between your client and the broker will undoubtedly come into play during the arbitration.

To craft a convincing story, the facts you must elicit from your client are not limited to the specific facts of the case. Thus, your inquiry into your client's discussions with the broker and others at the broker dealer should not be limited to the transaction(s) at issue. Your client should explain to you any previous contact he/she had with them in any context. Had he/she invested with the firm previously? Did he/she known the broker before investing? Did anyone else from the firm, *e.g.* a supervisor or someone from compliance, ever contact him/her? You do not want to discover during the arbitration that there were additional interactions and investments you did not know about. You must also interview any other potential witnesses you might call.

Because opposing counsel will often attempt to portray an investor as sophisticated and well versed in investments, you must inquire thoroughly into the claimant's investment background. These include any previous investments your client has made, as well as how knowledgeable in general he/she is about investing. Of course, much of this information will already be known to your adversary. During discovery, your client will have had to disclose much of his/her previous investment history. In addition, your client may have told the broker about his previous investments as well as other information relating to his investment knowledge. Thus, it will be crucial to include in the story how experienced and sophisticated your client may be.

Moreover, it is crucial to understand the facts surrounding the previous investments as the documents cannot tell the whole story, such as why your client chose to make certain previous investments and who, if anyone, advised him/her regarding them. If your client has made investments in the past, knowing this at an early stage will allow you to develop a response, whether it is to distinguish the previous investments or to demonstrate that somebody else advised your client to make the investments and he/she was simply following their advice. If your client has no previous investment experience whatsoever, an attorney can use this fact to prove your client's lack of sophistication. On the other hand, if your client has extensive experience investing then this must factor into how you analyze his/her case.

While it is crucial to attempt to understand the facts by speaking with your client, it is equally important to thoroughly analyze the key documents in the case. You must not only know what is written on them, but, if your client signed any documents, you must understand both what your client understood the documents to mean and why he/she signed them. For instance, if you have an unsuitability claim, the account opening document may reflect a risk tolerance

consistent with the investment at issue. However, in discussing the document with your client, you might discover that the broker and not your client completed the form and either your client never reviewed it before signing it and/or never received a copy. Thus, it is crucial to discuss important documents with your client and determine what your client knows about them.

You must also strive to understand and anticipate your adversary's story. You should be able to get a sense of this from their answer, the conversations your client had with the broker, and any discussions you have had with your adversary in an effort to settle the case.

Understand the Investment

Next, you must develop a strong understanding of the investment(s) at issue. This is especially true in a products case. Among other things, you must understand the type of investment(s) (*e.g.* stocks, bonds, annuities, REITs, Mutual Funds), how much your client invested, how long your client owned the investment(s), and how the investments performed over time. Obviously, depending on your claim, certain information relating to the investment will be more or less important. For example, in a suitability claim you must understand the nature and risk of the investment. If you have a claim involving churning, each individual stock purchased will be less important than the overall effect of the commissions earned by the broker as a result of his excessive trading.

Developing a timeline can be particularly helpful in organizing the "lifespan" of the investment. This is especially true if your client made several investments based on different interactions with the broker or if the investment fluctuated in value over time and the respondent may argue that the claimant should have mitigated damages at some point. If the case revolves around a complex or unique investment product, it may be necessary to consult with an expert.

An expert will assist you in analyzing the risks and problems inherent in the product and can often determine what the broker and broker dealer should have known about the investment from publicly available documents before recommending it to your client.

While expert analysis may not be considered part of the story, where possible, you should try to weave it into the narrative to emphasize why the broker's investment advice was improper.

Analyze the Case

After you have obtained a clear picture of what happened and understand all of the key documents, you must analyze the claims. In other words, you have to determine what your strength and weaknesses. This will depend on many factors, including the:

- Client's background and demeanor (How likeable and/or sympathetic will they appear?)
- Credibility of the broker (Does he/she have any complaints or judgments against him/her?);
- Type of investment;
- Strength of your claim(s) (*e.g.* if claiming unsuitability, how unsuitable were the investments?; if claiming churning what was the turnover ratio?);
- Egregiousness of the broker's conduct (*i.e.* was it negligence or more willful behavior which is often the case if churning is alleged);
- Adequacy of the supervisory procedures of the broker dealer;
- Broker dealer's implementation of their supervisory procedures;
- Broker's history of complaints; and
- Arbitrator (*e.g.* award history, background, comments from attorney's who have appeared before the arbitrator); and

Carefully analyzing the case, researching the arbitrators' previous awards, discussing the case's strengths and weaknesses with colleagues, and reviewing your results in past cases are

effective ways to determine which facts and arguments to emphasize in your story. Keep in mind that if there is more than one claim, you should analyze each one separately. For example, if your client has an unauthorized trading claim, along with a suitability claim, analyze each claim separately.

Inevitably certain claims will be stronger than others. Analyzing and presenting the claims separately will be important when telling the story as it will increase your credibility and force your adversary to respond specifically to each of your claims. It is often the case that one claim is stronger than another. To maintain your credibility, it is crucial that you do not argue each claim is equally strong when that clearly is not the case. This is also true when your client has claims against both his/her broker and the broker dealer. If the claim against the broker is plainly stronger than the claim against the company, you should not attempt to portray them as equal. Of course in some instances if they are both represented by the same counsel this may, as a practical matter, not be important.

That being said, you must obviously advocate strongly for your client and not give the impression that a relatively weaker claim is therefore inherently weak. The respondent must still respond to all of your claims, and you should be prepared to argue the strengths of each claim and reasons why you believe you can prevail on all of them. Being both firm and reasonable regarding your claims will preserve your credibility and increase your chances of obtaining a favorable judgment.

Presenting your Story to the Panel

Once you have martialed the facts, researched the applicable law and regulations, and analyzed the strength of your claim(s), you are ready to convey your story to the panel. Once the

arbitration begins, you must decide how best to present the case theory to the arbitrators. The key here is to bring your case theory to life through storytelling. A detailed story is crucial for convincing the arbitrators that they should rule for you in your favor. Moreover, stories are more easily remembered which will help your case when the arbitrators deliberate. Finally, especially if your arbitrators are very experienced, telling a riveting story will keep them interested. "Fact finders like stories — tales with beginnings and ends, drama and climax, victims and villains, and heroes and justice seekers. In short, the best way to say interesting things is via the story construct." Radvany, Trial Practice at 18.

Here are seven ways you can ensure that your story will influence the arbitrators' decision making.

1. Support your Story with Non-Testimonial Evidence.

A pure he-said-she-said case is hard to win. Thus, your story should rely on undisputed evidence as much as possible and you should corroborate your client's and witnesses' testimony when you can. The "power of the story, corroborated by evidence less prone to the vagaries of recollection — *i.e.*, documents, audio and video recordings, physical evidence, etc. — will help blunt the uncertainty of how recollections affect the case." Radvany, Trial Practice at 21.

2. Begin Storytelling in your Statement of Claim

You should take advantage of every opportunity to tell your story to the arbitrator. Because the first time an arbitrator learns about your case is when he/she reads the Statement of Claim, it is crucial that you tell a coherent and persuasive story in your pleading.

3. Explain how your Client's Life has been Affected.

Although an advocate may think that appealing to the trier of facts' emotions is more important in jury trials, it is often true at arbitrations. Thus, you need to humanize your client

and focus on how the matter has affected her life. Thus, it is important to determine how your client will appear to an arbitrator. Will they seem sympathetic? Likeable? While many if not most arbitrators will not take this into account consciously, it can only help if you can tell the story in a manner that makes your client appear sympathetic. Similarly, you should ask your client enough about the broker so that you can attempt to determine how the broker may appear to an arbitrator so that you can paint them as unsympathetic if appropriate.

4. Be Concise

By the time the arbitration has begun, the panel will have some sense of the case from reading the Statement of Claim and any written submissions or oral arguments which have occurred before arbitration. Thus, you need to ensure that the story you tell at the arbitration is not overly repetitive.

> The story must be lean throughout, retaining only the evidence that moves the case forward — *i.e.*, focusing on people, their actions and the injustice that befell your client from start to finish. . . . Evidence should be parsed to yield that which clarifies your case for [the arbitrators], evokes visceral reactions in your favor, and fits within the experience [of the panel].

Radvany, Trial Practice at 22-23.

5. If possible, Explain the Broker's Motive

In many cases, the wrong alleged is mere negligence (e.g. in an unsuitability case). However, where the broker's conduct is more egregious such as where the broker acts to the investor's detriment but to the broker's financial gain (e.g. a churning claim), then you must include in your story the motive behind the broker's actions. Motive is powerful evidence. That's why in criminal cases prosecutors always seek to explain a motive even though it's not an element of the crime.

6. Use Themes

Case themes can be powerful organizing devices. They are "emotionally based phrases or sentences that evoke your case theory and trigger emotional images and responses. They capture why the jurors should be sympathizing with your case in short, pithy statements or questions that resonate with them." Radvany, Trial Practice at 23.

> One you understand the facts, you should begin to think about case themes.
>
> They should be (i) emotionally compelling, appealing to a[n arbitrator's] sense of justice, and their power to right a wrong; (ii) drawn from shared values, civic virtues, or common motivations; (iii) easy to remember (short, snappy, and alliterate); and (iv) carefully constructed — if you do not think them through thoroughly, the other side may devastate your client's case by turning your case theme on you. If well conceived, they should be used repeatedly, in ... opening, examinations, and closing.

Radvany, Trial Practice at 23.

7. Present Your Story Visually

Whether using a PowerPoint or charts, you should strive to engage the arbitrators visually. This will serve a number of purposes. It will keep them more interested during your opening, summation and witness examinations. It will also help you present your story in a clear and concise manner. Finally, it will help the arbitrators remember your story as studies have shown that one is more likely to remember something one sees and hears.

8. Deliver the Story with Credibility and Conviction

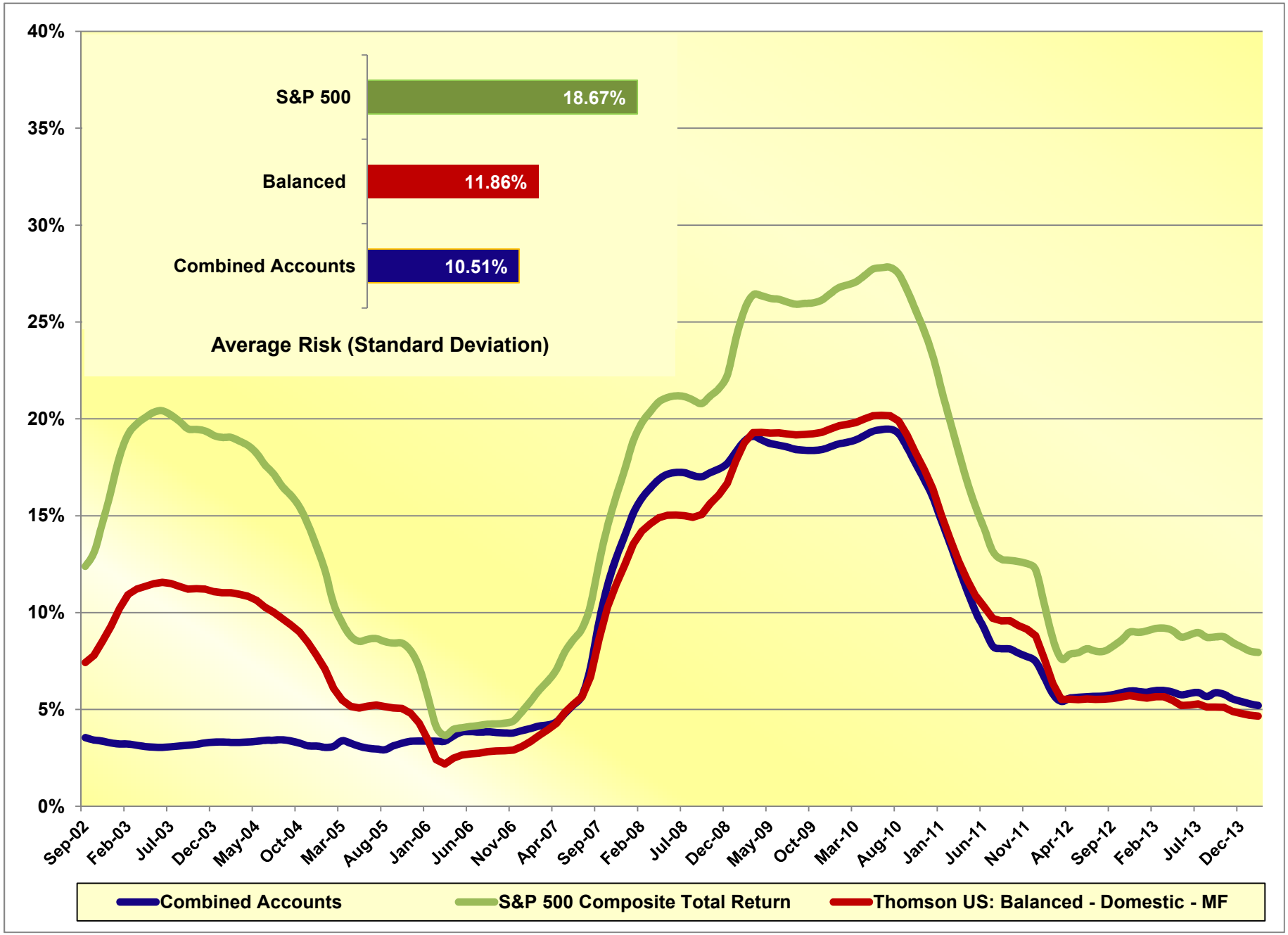
You and your client's credibility are crucial. Thus, when making arguments to the panel you must make sure to refer accurately to the facts and the law and not exaggerate. Through skillful witness preparation and the introduction of corroborating evidence, your client will be able to demonstrate to the panel that their story is credible.

Conclusion

Storytelling is crucial to obtaining a favorable judgment at an arbitration. The more effort you put into understanding and developing the story during trial preparation, the more convincing the story will be. In the end, the better the storyteller, the more likely your client will obtain the relief she is seeking.

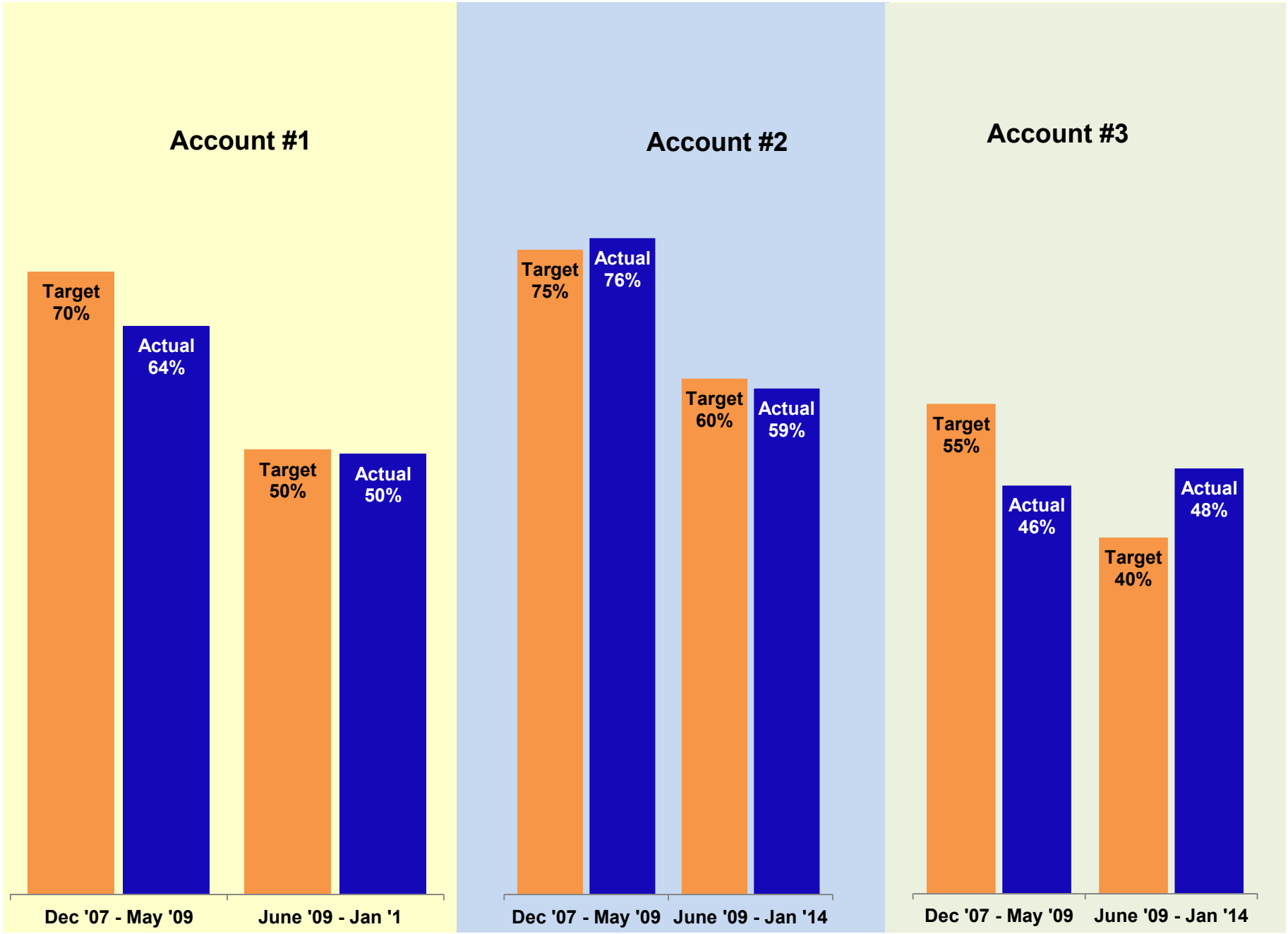
Topic 3:
Securities Industry Experts' Perspective on Securities Arbitration

*Change in Risk - Claimant Accounts at Firm***



***Rolling standard deviation analysis.*

*Average Month End Equity** Allocation Compared to Target*



***Data source: Brokerage Firm Month End Statements*

Claimant v. Respondent Chronology

#	Date	Event
1	12/14/07	Event #1
2	03/16/08	Event #2
3	05/20/08	Event #3
4	09/15/08	Event #4
5	09/26/08	Event #5
6	06/08/09	Event #6
7	06/30/09	Event #7
8	07/08/09	Event #8
9	07/13/10	Event #9
10	05/17/12	Event #10
11	09/09/12	Event #11
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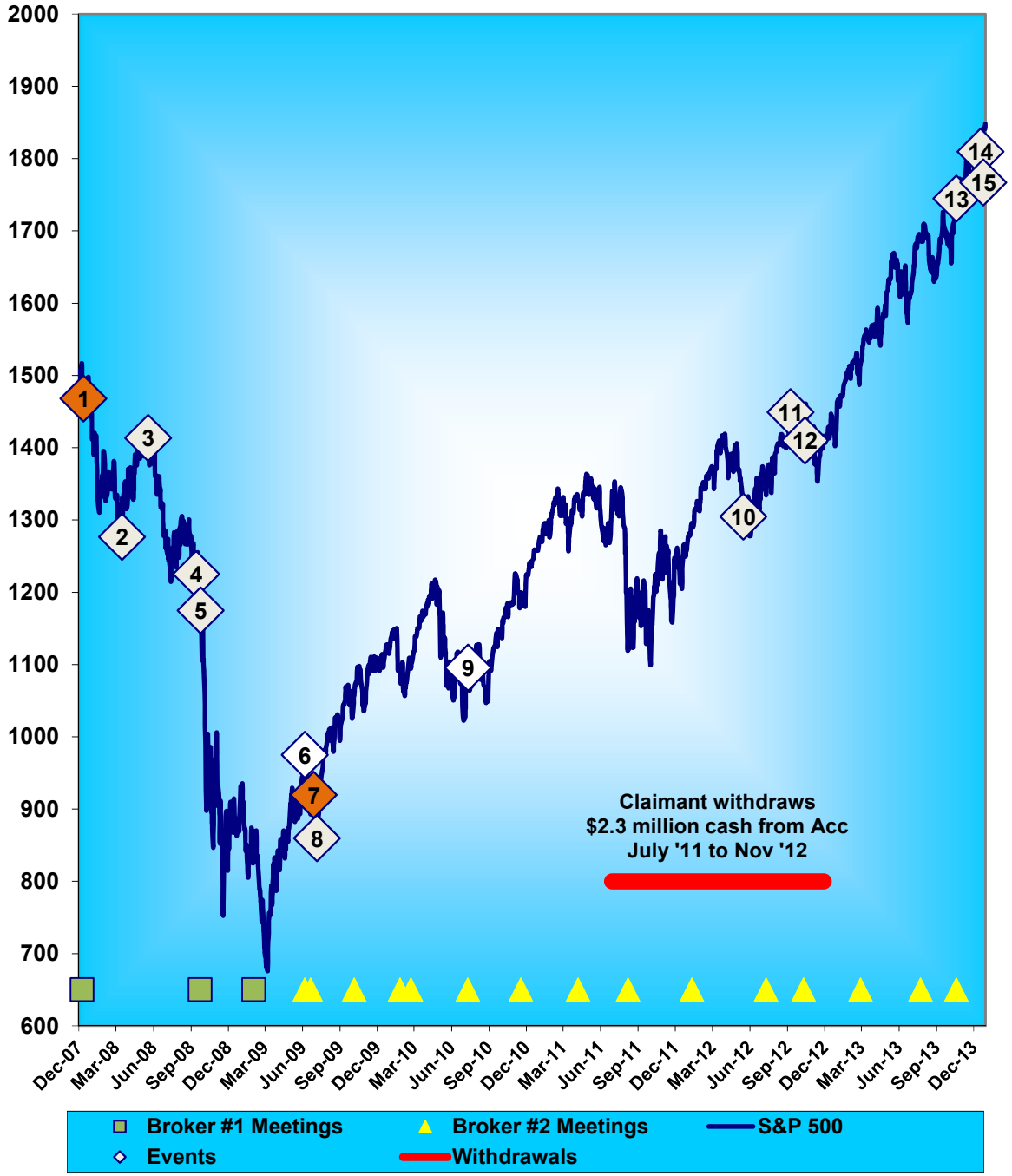
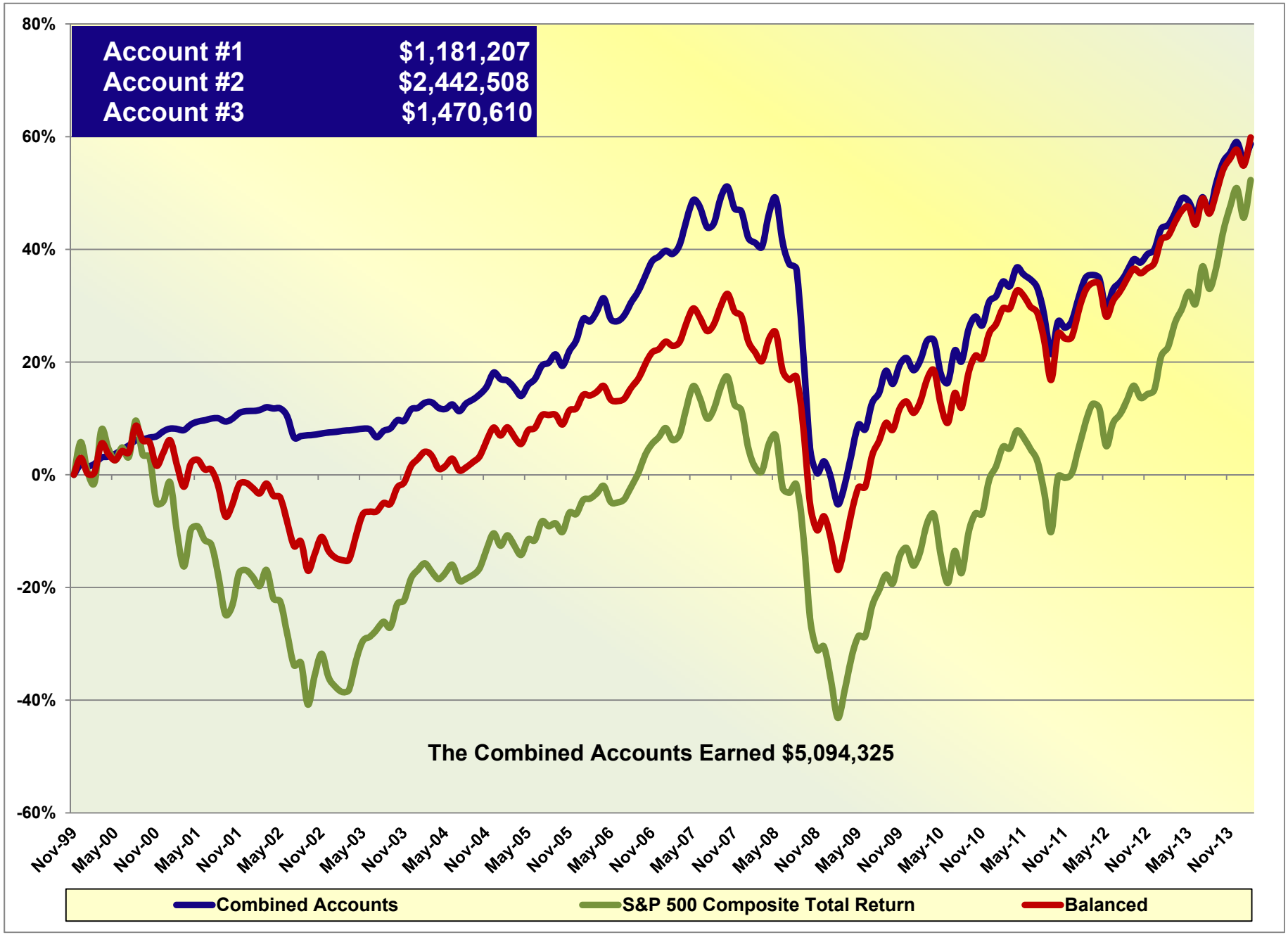
14	12/19/13	Event #14
15	12/26/13	Event #15



*Claimant** Performance Compared to Benchmarks*



*** Combined Accounts - Does not include Claimants' Initital Position in Concentrated Position*

Topic 4:
Supervisory and Clearing Firm Liability

SECURITIES ARBITRATION AND MEDIATION 2017: THE COURAGE TO SIMPLIFY, DAVID E. ROBBINS, ESQ. AND JAMES D. YELLEN, ESQ., CO-CHAIRS
New York Bar Association Continuing Legal Education Series,
New York City, April 6, 2017

TRENDS IN SUPERVISORY AND CLEARING FIRM LIABILITY

By: Timothy J. O'Connor and Paul C. Carroll

INTRODUCTION

As suggested in the agenda for this program "wrongdoing rarely takes place without the assistance or acquiescence of others". This pertains to both liability claims in the supervisory context of major wirehouses, brokerage firms, introducing firms and independent broker dealers, as well as in the case of clearing firm liability. With the emergence of mandatory custom arbitration in the case of Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), virtually all retail customer claims are currently resolved under the auspices of the self-regulatory Financial Industry Regulatory Authority (FINRA) Office of Dispute Resolution. With this change of 30 years ago, there is very little controlling court precedent in this arena, but rather, arbitrators are afforded considerable leeway to make decisions in accordance with the guidelines of the authority pursuant to the directives of the FINRA Arbitrator's Manual, as well as any statutory and common law the arbitrators deem applicable. Further, in the context of supervision and FINRA rules encompassing supervisory responsibilities, no distinction is made in these rules which serve to immunize clearing firms from liability.

The Equitable Authority of FINRA Arbitration Panels

The guiding principal of equity espoused by the FINRA Arbitrator's Manual and other pronouncements of FINRA afford arbitrators latitude to make decisions without being wholly bound to any particular court decisions involving clearing firm liability which may have issued from one of the various state or federal courts.

> "Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail." – Domke on Aristotle, from the FINRA Dispute Resolution Arbitrator's Guide, at page 8 (July 2013 Edition).

In addition to those FINRA rules applicable to all FINRA members, this article will also touch upon certain court related precedent, particularly in the context of clearing firm related claims.

A. Supervisory Liability

Supervision

FINRA Rule 3110 (Supervision)

FINRA Rule 3110 mandates that brokerage firms must establish and maintain an organizational structure to assure the supervision of the activities of its associated persons in such a manner to assure compliance with the securities laws, regulations and FINRA rules. The hallmark of Rule 3110 is the requirement that firms have written supervisory procedures including those involving its supervisory personnel – in other words, how are the supervisors going to be supervised? These supervisory rules include the firm's investment banking and securities businesses, as well as correspondence, internal communications, customer complaints, etc. The rule also requires the implementation of hierarchical structure to achieve these ends with specificity to include all supervisory activities of individuals working in the supervisory hierarchy, how supervisory reviews are conducted and in-house supervisory.[1]

FINRA Rule 3120 (Supervisory Control System)

This rule requires firms to have in place supervisory control policies (SCP's) and procedures. This includes a requirement for testing and verification of these procedures,

[1] Rule 3110 also defines the concept of branch offices and Offices of Supervisory Jurisdiction (OSJ's), setting forth the respective designation and registration aspects of these offices, as well as provisions requiring office inspections and transaction reviews.

differentiating these requirements from those requirements of written supervisory procedures required by FINRA Rule 3110. Supervisory control policies and procedures are required to test and verify the written supervisory procedures of Rule 3110 at least annually. This rule also requires the designation of principals, positions which include a heightened level of securities industry licensure within the FINRA examination scheme, and these principals are required to establish, maintain and enforce supervisory control policies.[2]

FINRA Rule 3130 (Annual Certification of Compliance and Supervisory Processes)

In addition to the principal designation procedures required by FINRA Rule 3120 (above), Rule 3130 requires firms to formally designate, identify and make filings to identify the principals who will be serving as Chief Compliance Officers (CCO). The rule also requires that the firm's Chief Executive Officers certify that the firm has in place sufficient processes to establish, maintain, review, test and modify policies and procedures to assure compliance of applicable laws and regulations. In turn, these processes are required to be reported to a firm's board of directors and audit committee on an annual basis.

Under the rule, CEO's are required to certify that they have met with their Chief Compliance Officers within the past 12 months and have engaged in a meaningful in person exchange regarding the compliance and supervisory processes, including those required by Rule 3110 and 3120. In other words, the executive officers of the firm and the firm's compliance officers are required to engage in a meaningful and effective course of interaction in a face-to-face context and not merely rely on paper flows and signatures.

[2] These principals are also required to report annually, particularizing their firm's supervisory control systems in a report known as a Rule 3120 Report.

FINRA Rules 2090 and 2111 – The Know Your Customer Rule and The Suitability Rule

FINRA Rule 2090, the latest version of FINRA's Know Your Customer Rule, states that "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…". This dovetails with FINRA Rule 2111, the Suitability Rule, which states that "a member or 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…".

FINRA Rule 2210 – Communications with the Public

In this day and age of cell phones (texting), e-mails,[3] chat rooms, PDF document scans, cloud stored information, blogging, Google alerts, photocopying/scanning, a comprehensive review of a brokerage communications with the public requires hands-on day-to-day vigilance. In addition to the obvious easily detectable modes of communication, other means of assessment includes a periodic review of office photocopier for documents photocopied, to detect the copying of contraband/unauthorized materials relating to securities, unauthorized correspondence or even cut and paste bogus account statements misrepresenting account valuations. Photocopier storage conventions and protocols have included embedded storage capabilities of all documents copied and scanned on photocopiers. Transfers between accounts, as well as transfers outside of a firm's account structure would beg for periodic review and confirmation of third party withdrawals requests.

FINRA Rule 3270 – Outside Business Activities

FINRA Rule 3270 requires that associated persons of member firms make full disclosure of their outside business activities to their FINRA member firms prior to participating in such

[3] FINRA Regulatory Notice 07-59, as well as follow-up guidance, addresses the need for thorough review of electronic correspondence.

activities. Hundreds of customer claims have been filed over the years against firms whose brokers have operated side businesses involving prohibited selling away activity involving pitching of interests in these separate business enterprises to firm customers. FINRA Rule 3270 requires that firms supervise these activities with an eye on detecting improper conduct.

These FINRA Rules form the bulwark of the supervisory and compliance obligations of introducing brokerage firms relative to the activities of their brokers.[4] In this context, FINRA arbitration panels have the equitable authority, as well as the common law authority, to render decisions and fashion awards, where merited, in furtherance of their equitable powers.

Supervision of Brokers with a History of Prior Complaints

Supervision of brokers with a history of customer complaints statistics show that approximately one percent (1%) of associated persons have had more than one complaint lodged by a customer within the preceding five years. Given this, it is clear in this day and age of technological capabilities heightened supervisory review of accounts under management of this small percentage of brokers are a no brainer.

B. Clearing Firm Liability Trends

The majority of all stock and bond transactions in the New York securities markets are cleared through clearing brokers, with trades often initially entered by introducing brokers or their customers. What's the difference between introducing brokers and clearing brokers and why do we need clearing brokers? There are over six thousand brokerage firms licensed with the Financial Industry Regulatory Authority and over ninety percent (90%) of them, independent broker-dealers, have no trade clearing facilities of their own given the logistics, as well as the regulatory and infrastructural costs of maintaining securities trade clearing and custody

[4] FINRA Rules 3110, 3120, 3130, 2090, 2111, 2210, 3270

facilities.[5] Large, household name brokerage firms (also known as wirehouses) still remain self-clearing, that is to say they have their own facilities for clearing trades and overseeing any purchases of sale of stocks and bonds through their own facilities.

What is a Clearing Firm?

At the outset, the definition of what constitutes a clearing broker, including the variants of financial services related firms providing clearing services is essential. Traditionally, clearing firms performed services limited primarily to effectuating the purchase and sale of securities for introducing brokers and generally having no direct in-person exchanges with retail customers. Just as there are a number of large, self-clearing, major brand name brokerage firms who are self-clearing, there are likewise several large clearing firms which oversee, facilitate and finalize securities trades, while also maintaining the back office, operational infrastructure for the issuance of monthly account statements, trade confirmation reports, cash and custodian account coordination and the issuance of tax reporting statements. Clearing firms are compensated in a number of ways for their involvement with trading activity directed in the first instance by introducing brokers. For example, payment for order flow, transaction fees, margin interest spreads and custody float are modes of compensation which brings millions of dollars in revenues to clearing firms.

Clearing Firms Extend Margin Leverage

In all instances the carrying clearing firm as creditor extending margin leverage has the obligation to ensure compliance with the margin rules and the overall management of the attendant risk to the carrying firm represented by a customer's portfolio. Clearing brokers may

[5] Top clearing firms include Apex Clearing Corp, COR Clearing, First Clearing, Goldman Sachs Execution and Clearing, LPL Financial, Merrill Lynch Professional Clearing Corp and Broad Court, National Financial Services Fidelity Clearing and Custody Source, Pershing, Raymond James & Associates, Inc., RBC Correspondent Services, Sterne Agee Clearing, Inc., Southwest Securities Inc. and Wedbush Securities Inc.

allocate to an introducing broker, the role of communicating the existence of a margin call to the client and require the IB to take an active role in monitoring the actions taken to meet the call. However, FRB Regulation-T and FINRA Rule 4210 do not permit the abdication of the creditors compliance responsibility to an introducing broker or investment advisor regardless of any written agreement between the parties to the contrary. This prohibition also applies to the Day Trading provisions under FINRA 4210(f)(8)(B).

Clearing Firm Duties Under FINRA Rule 4210(f)(8)(B)

Under 4210(f)(8)(B), clearing brokers are required to monitor all accounts for intra-day exposure in instances when a position is acquired during the trading day and close out prior to the close of business of the same day. Since Reg-T and FINRA 4210 calculate margin as of the close of business each day, the day trading rule was designed to capture the market risk which is no longer present at the close. In effect, it prevents an account from trading on the creditor's dime without ever having to put up a nickel.

Clearing Firm's Changing Rules with Broker Migration

The past decade has seen the migration of hundreds of thousands of FINRA licensed brokers from self-clearing, household name, wirehouse firms to small independent FINRA member brokerage firms, for more reliant upon the services of clearing brokers to perform various tasks. The past decade has also seen an explosion in the number of brokers leaving large brokerage firms, transferring their business platforms to non-FINRA licensed Registered Investment Advisory model.[6] With these two trends, clearing brokers have also taken on additional tasks given their emerging interface with private banking business models, investment

[6] Top custodians for Registered Investment Advisory custody clients include Folio Institutional, Interactive Brokers, LPL Financial, National Advisors Trust Co., National Financial Services Fidelity Clearing and Custody, Pershing Advisors Solutions, RBC Advisor Services, Schwab Advisors Services, Scottrade Advisor Services, Shareholder Services Group, Trade-PMR Inc., TD Ameritrade Institutional, U.S. Bank Trust Company of America, ("Custodian and Clearing Firms Ranked by Number of Clients", Investment News, as of June 30, 2015).

advisory platforms, money management relationships, ancillary credit and lending services, and the check writing and credit card interface with banks.

Clearing Firms and the Banking Interface

Clearing brokers now interface with and perform a considerable number of additional tasks and functions that they did not perform a generation ago. With the integration of bank products linked directly with the brokerage account, clearing firms have added a layer of complexity when calculating the availability of client assets held and how the assets are captured and treated under the Net Capital rules, segregation calculations and funds available for margin trading. Clearing firms are now performing a steadily increasing percentage of the trade clearing in the American securities markets, commensurate with the deadline previously performed by self-clearing wirehouses.

FINRA Rule 4311(h)(2) Clearing Firm Reporting Requirements

FINRA Rule 4311(h)(2) requires a clearing member to notify the introducing broker and FINRA of the reports offered to the introducing member firm. These reports include exception and surveillance focused information related to the transactions in and performance of the accounts cleared on their behalf. Clearing firms cannot turn a blind eye to patterns of suspicious or improper activity captured by these reports and occurring in the introduced accounts i.e. late trade bookings, cherry picking, unusual banking activity or order routing abnormalities.

SEC Regulation SHO

Compliance with Regulation SHO went into effect in January, 2005. A significant concern which drove the adoption of this rule was the persistence of fail to deliver and potentially abusive short selling practices. Regulation SHO Rule 204 contains provisions which require broker dealers to take action to close out failure to deliver positions within prescribed

timeframes. Although some of the responsibility for compliance can be shared with introducing brokers, clearing brokers must have robust monitoring and close-out procedures in place to make every reasonable effort to prevent the aging of fail to deliver positions. Under certain circumstances, failure to resolve an ongoing fail to deliver can prevent the broker from effecting additional short sales in the same security on behalf of any customer carried on the books of the clearing broker until such time as the aged fails have been satisfied. Naked short selling by introducing brokers can result in liability for the clearing broker and affect the clearing broker's ability to service other introducing brokers and their clients. Clearing brokers can also be a party to lawsuits involving issuing companies and shareholders alleging illegal short selling violations.

New Technologies Heightening Clearing Firm Responsibility

Clearing firms now employ various types of software, scanning technology, forensic capabilities and other systems and methodologies designed to detect aberrant trading activity including defalcation, unauthorized withdrawals, unauthorized transfers, suspicious trading volumes, factoring, and criminal activity. With suspicious day trading and margin related strategies becoming all the more prevalent in these days of algorithmic and computerized trading, it is important to keep in mind that the primary creditor is the clearing firm. With these extensions of credit to suspicious or known wrongful actors clearing firms can clearly be involved with not only facilitating but aiding and abetting any number of civil, common law, regulatory and criminal wrongdoing.

Pattern recognition procedures, software and computer processes, algorithms, Anti-Money Laundering Regulations, Suspicious Activity Reports SARS and the interface of clearing firms with the Financial Crimes Enforcement (FinCEN), all come to the fore, making it very

difficult for clearing firms to turn a blind eye to the clear indication of wrongdoing and customer victimization.

Emerging Problem Areas for Clearing Firms

Consider the emerging trend involving an increase in non-FINRA licensed Registered Investment Advisors, working alone or in small independent offices, without any meaningful compliance or supervisory review or oversight. Given their lack of FINRA licensure and registration, it will be invariably argued that they are not subject to the aforementioned FINRA rules set forth earlier in this article. Clearing firms who custody and transfer the beneficial account owner's assets, however, must insure that the activity which they facilitate is in accordance with FINRA rules.

In addition to the increase in non-FINRA licensed RIA's is the trend involving smaller introducing brokerage firms specializing in boutique and niche services including speculative, low-priced and illiquid securities, high yield bonds, options and margin trading strategies and private placements; present trading scenarios exposing investors to considerable losses if not properly executed, monitored and supervised.[7] Examples of types of transactions which can involve a more hands-on/intertwining relationship between an introducing firm and a clearing broker include the following:

1. Outsized trades by in or dollar amount or number of shares versus the equity on deposit.

2. Accumulation of large positions and positions involving an outsized percentage of the public float of a public company.

[7] Top independent broker-dealer firms include LPL Financial, AIG Advisor Group, ING Advisors Network, NFP Securities, Inc., AXA Advisors, LLC, National Planning Holdings, Inc., Securities America Inc., Commonwealth Financial Network, Northwestern Mutual Investment Services and MML Investor Services, with LPL Financial and Primevest Financial Services, Inc., a subsidiary of ING Advisors Network, Inc.

3. Thinly traded and/or illiquid securities

4. Cross-selling transactions involving the sale of securities from one customer's account to another customer's account within the same firm.

5. Regulation T or Portfolio margin violations and non-marginable securities

6. Discrepancies involving client account information on new account forms, margin trading forms, trading authorization forms and cash and securities transfer authorization forms.

7. Embezzlement schemes.

8. Direct Market Access – clearing brokers which provide direct access to external parties using a trading acronym or Market Participant Identification Number (MPH) assigned to the clearing member are required to surveil all trading activity for compliance with exchange based rules and SEC 15c3-5.

9. Improper trading strategies engaged in by non-FINRA licensed Registered Investment Advisors.

Clearing Firm Responsibility for Affording Wrongdoers Market Access

One of the central concepts when considering a case of clearing firm liability is the extent to which the clearing firm has afforded market access to wrongdoers. By merit of the contractual relationship between clearing broker and introducing broker or registered investment advisor utilizing the market access afforded by the clearing broker with all the intended possibilities to engage in wrongdoing, the regulatory responsibilities of the clearing broker for what is going on because of this access can't be overlooked.

Clearing brokers have developed a potpourri of digital services offered to allow introducing brokers and their clients immediate access to market data, sophisticated trade routing tools and complex derivative securities. While introducing brokers may hold the primary

responsibility for suitability, clearing brokers can be held responsible to unintended consequences which result from the systems lack of proper controls covering order violations, suspicious trading activity or ineffective risk management. These tools may end up in the hands of neophyte investors or bad actors intent on gaming the system.

The clearing broker is the entity accountable for regulatory compliance of the rules of the exchanges and clearing organizations for all activities effectuated over these systems. Since introducing brokers are often thinly capitalized, clearing brokers cannot rely on the introducing broker to manage the capital or regulatory risk to the clearing broker or to have in place sophisticated tools to monitor compliance.

FINRA Rules Relating to Market Access and SEC Rule 15.3-5

The interplay of the FINRA, Rules SEC Rule 15c3-5 and other federal securities regulations, serve to highlight the regulatory responsibility of clearing firms and highlight the requirement of clearing firms to monitor the activities of introduced customers and to take action once they discovery regulatory violations and illicit conduct being engaged in by their contractual partners.[8] Clearing firms affording nanosecond access to trading capabilities providing the opportunity for all sorts of gamesmanship including spoofing, intraday trading access and trading in excess of an introducing firm's or Registered Investment Advisor's capacity, away trading and gaming of share price and share price bid/ask spread discrepancies resulting in investment victimization, are all examples of conduct that can be facilitated by clearing brokers. The blue-chip name recognition and street credibility which establish clearing firms afford introducing brokers and registered investment advisors is something which these firms routinely tout in their marketing materials.

[8] For example, see FINRA Rules 5210 and 6410 and 17 CFR § 242.200 – 204; 17 CFR § 240.15c3-5 and 17 CFR § 242.600 – 613.

Duty to Monitor the Net Capital and Compliance Culture of Introducing Brokers

Clearing brokers must also have procedures in place which monitor the introducing broker's net capital, compliance culture and the potential impact on the clearing broker's capital, funding needs and associated reputational and operational risk of partnering with what could be an unsophisticated broker with no more than rudimentary tools to manage its customer. As the tools marketed to introducing brokers continues to expand to a one stop shop model designed to provide a comprehensive array of financial products, trading tools and cash management solutions to all clients, clearing brokers open themselves up to liability should they fail to monitor the effectiveness of the products and the ability of the introducing brokers and their clients to utilize them in a responsible manner.

The Erosion of Clearing Firm Claims of Immunity from Civil Liability

Up until the past decade, clearing firms have cited case law going back several decades to claim immunity from civil liability in customer claims, from trading activity or conduct directed, in the first instance, by introducing brokers. Claiming that they perform solely administrative tasks for their introducing brokerage firms, they have contended they are not liable for the wrongful conduct of introducing firm's which clear through them. These statements are often gratuitous misstatements in instances when the introducing broker is solely reliant on the clearing broker to provide market access, margin funding, stock borrowing, equity research, advanced trading tools, IB Focus calculations and a myriad of exception reports to identify trade allocation issues, suspicious order routing practices, AML surveillance, income and expense analytics and asset movement irregularity pattern recognition.[9] The clearing broker

[9] One need only look at the recent initiatives with its SEC and Market Data capabilities (SEC.gov/data) to see how billions of bits of data can be organized to help discover possible fraud involving trading and possible fraud, and possible regulatory violations, improper trading and fraud.

cannot just turn a blind eye to red flag information known to them, as well as their introducing broker without requiring a reasonable explanation from the introducing broker regarding any potential questionable activity identified.

Clearing firms have been held liable in varying degrees for facilitating the fraudulent activity of the introducing brokerage firms which clear through them.[10] Examples of clearing firm liability include arbitration claims including allegations of fraud, constructive fraud, breach of fiduciary duty, conversion and misrepresentation. A number of decisions have issued out of the various State and Federal Courts of New York over the past decade, including the following:

1. Goldman Sachs Execution & Clearing LP v. The Official Unsecured Creditors Comm. of Bayou Group, LLC, et al. (2nd Cir. 2012). The Second Circuit refused to vacate a $20.6 million arbitration award against Goldman Sachs Execution & Clearing, LP where it argued that it was a "mere conduit", in a claim in which the firm was an initial transferee of fraudulently transferred property.

2. In Bear Stearns Securities Corp v. Gredd, 397 B.R. 1 (SDNY 2007) District Court noting the control which Bear Stearns exercised by merit of its clearing contract, held that Bear Stearns was liable to the victimized customers there as an "initial transferee" of Ponzi Scheme proceeds.

3. McDaniel v. Bear Stearns & Co., Inc., 196 F. Supp. 2d 343 (SDNY 2002). This case contains a comprehensive review of the then extant law in the area of clearing firm liability. The underlying claims included aiding and abetting liability claims as against Bear Stearns as well as claims also alleging primary securities fraud by the introducing broker dealer. The court noted that where a clearing firm "moves beyond performing mere ministerial or routine clearing functions and becomes actively and directly involved in the introductory broker's actions, it may expose itself to liability with respect to the introductory broker's misdeeds. (Citing *inter alia* Berwecky v. Bear Stearns & Co., 197 FRD 65 (S.D.N.Y. 2000), Koruga v. Fiserv Correspondent Services, 183 F. Supp. 2d

[10] See *Levitt v. Bear Stearns & Co*., 340 F.3d 94, 97 (2d Cir. 2003); *Koruga v. Fiserv Correspondent Services, Inc*., 40 Fed. Appx. 364 (9th Cir. 2002); *McDaniel v. Bear Stearns & Co.*, 196 F. Supp. 2d 343 (S.D.N.Y. 2002); *Berwecky v. Bear Stearns & Co*., 197 F.R.D. 65 (S.D.N.Y. 2000); see also *McDaniel v. Michael Davis, Bear, Stearns & Co*., NASD Case No. 97-00497, 2001 NASD Arb. LEXIS 668 (July 31, 2001) (NASD arbitration panel award against clearing firm*; In re Arbitration Between Peers v. Saydein*, NASD Case No. 00-00027, 2001 NASD Arb. LEXIS 1347 (Nov. 21, 2001) (NASD panel award against clearing firm, including attorney fees); *In re Arbitration Between Hamszeh v. Bear Stearns Secs. Corp*., NASD Case No. 99-00959, 2001 NASD Arb. LEXIS 253 (Jan. 29, 2001) (breach of fiduciary and failure to supervise, and unsuitability against Respondent clearing firm. NASD awarded claimants $127, 511 in compensatory damages); *Kostoff v. Fleet Secs., Inc*., 2007 U.S. Dist. LEXIS 25444 (M.D. Fl. 2007) (Clearing firm was liable, as "a conduit that provided the introducing firms the ability to engage in the proscribed activity which damaged [the customer's] account."

1245, 1247 (D.Or. 2001) *interalia* and In Re Blech Securities Litigation, 961 F. Supp. 569, 584 (S.D.N.Y. 1997) and Michael G. Shannon "Clearing Firm Liability Has the Dam Really Cracked?", 1196 PLI/Corp 677, 690-697.

The FINRA Office of Dispute Resolution maintains a public online repository of the decisional history of all arbitration awards, including decisions involving clearing firms. A mere sampling of these recent cases includes the following:

- Aimes v. RedRidge Securities, Inc., et al., FINRA Case No. 15-02212 diversion of funds by investment advisor involving wire transfers of funds.
- Schroeder v. Wells Fargo Advisors, LLC, et al, FINRA Case No. 15-00074 (claim involving unauthorized change of address of record, forged signatures and unauthorized cash withdrawals – award for clearing firm.
- Pershing, LLC v. Rochdale Securities, LLC, N.Y. Sup. Ct. Index No. 651604/2016 per Honorable S. Scarpulla (lengthy decision containing detailed analysis of interrelationship between introducing broker and clearing broker, motion to vacate award against clearing broker denied, also including analysis of indemnification provision, attorney's fees.
- John Carris Investments, LLC v. Cor Clearing, LLC, FINRA Case No. 14-03457 (dispute between introducing broker and clearing broker with allegations of breach of contract, conversion, theft and breach of fiduciary duty, award for claimant introducing firm.
- Richard G.A. Forde, Jr., et al. v. TD Ameritrade Clearing, Inc., et al., FINRA Case No. 15-00598 case involving claims of negligence, negligent supervision, breach of contract, etc. Award in favor of claimant customer.
- Grace Financial Group, LLC v. Penson Financial Services, Inc., FINRA Case No. 12-020002 (industry case in favor of member firm against clearing broker in claims involving breach of clearing agreement.

Additionally, a number of arbitration support vendors have published observations regarding trends associated with causes of action asserted and the types of firms against which such claims have been filed (i.e., wirehouses, introducing broker dealers, clearing firms, platform firms, registered investment advisors and individual FINRA associated person brokers), and other emerging trends.[11]

FINRA Regulation and Enforcement

FINRA Regulation and Enforcement have addressed the various emerging problems facing clearing firms in these times of rapidly increasing technological capacities and the emergence of trading entities formed solely for the purpose to qualify for better preferred treatment of the margin rules and for risk treatment considerations. Such entities use the market access afforded to them by clearing firms to configure portfolios presenting with risk exposure perhaps beyond the capabilities and tolerances of individual or separate parties or partners to these trading entities. Recent FINRA pronouncements suggest that clearing firms may have an ongoing obligation to monitor and calculate the risk of these portfolios and trading activity of these entities in furtherance of their regulatory responsibilities and also highlight the need for clearing firms who maintain supervisory procedures to address these concerns and scenarios including the issuance of exception reports and to their contractual partners and communicating their concerns about possible violations seeking feedback from these partners of these concerns.[12]

[11] The award/decisional history of the FINRA Office of Dispute Resolution has also been addressed by several vendors and publications, vendors and legal support service providers offering varying degrees of a editorialization, summaries, search capacities and arbitrator vetting services (i.e., The Securities Arbitration Commentator). Dana Pescosolido of Pescosolido, Florida has authored a number of articles, including annual summaries of arbitration awards rendered by the FINRA Office of Dispute Resolution, including commentary regarding trends, patterns, pitfalls, practical advice and statistics.

[12] In circumstances involving fraudulent wire transfers of customer funds facilitated by weak supervisory systems clearing firms have also been held liable. Notably, Brad Bennett, FINRA Executive Vice President and Chief of

Applicability of the Anti-Waiver Provisions of the Federal Securities Laws

Investors having an account with an introducing broker utilizes the services of a clearing broker to clear its trades initiate their account relationships by signing new account forms forming contractual relationships with both the introducing broker and the clearing broker. These agreements oftentimes contain various hold harmless, as well as indemnification provisions with which clearing brokers have been known to raise as defenses to investor claims – but are they enforceable? The Anti-Waiver provisions of the Federal securities laws may tend to militate against such defenses.[13]

Counsel for Investors Should Thoroughly Review Their Clients' Potential Clearing Firm Claims

Far too often, counsel for victimized investors assume that clearing firms are one and the same with the introducing brokers and registered investment advisors that they serve. While they are oftentimes named as parties as respondent and FINRA arbitration claims formulating a picture of establishing a case of liability requires a detailed assessment of the underlying facts and circumstances of the case of alleged victimization. An understanding of the relationship between clearing brokers and introducing brokers, as well as an understanding of the relationship between registered investment advisors and/or registered representative/stockbrokers on the one side and clearing firms on the other side is essential to assessing a case of liability. Clearing firms have been successful in many claims brought against them and an assessment with an

Enforcement noted "Ameriprise and its affiliated clearing firm missed numerous supervisory red flags, including the fact that two of the wired transfers went to accounts in Guelinas' (the brokers) in Maine. Firms must have robust supervisory systems to monitor and protect the movement of customer funds." (FINRA Fines Ameriprise and Clearing Firm $750,000 for Failing to Supervise Transmittal of Customer Funds to Third Party Accounts, FINRA Press Release March 4, 2013).

[13] The Anti-Waiver Provisions of the Federal Securities Laws render void any clause or contract purporting to constitute a waiver of compliance with the Federal Securities Laws (see Section 29(a) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78cc(a) "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void."

experienced securities professional and expert witness can be crucial in making a determination as to whether or not a clearing broker should be a named party in a customer claim.

Clearing Firms and the New Fiduciary Rule

As of this writing, it is not known whether or not the Fiduciary Rule will become effective relative to the obligation of broker dealers carrying IRA and other retirement type accounts.[14] With the looming onset of the Fiduciary Rule, however, a number of large self-clearing brokerage firms have made known that they will be moving various retirement-type accounts to mandatory wrap-fee arrangements. With customers who only transact one or two purchase or sale transactions in any given year in their retirement accounts be willing to pay wrap fees? Probably not. If fully implemented and enacted, the Fiduciary Rule could well see a favorable business opportunity for clearing firms serving smaller independent broker dealers who will continue with the transactional fees as opposed to mandatory wrap fees. In this environment, clearing brokers may well be positioned to afford these small investors cost effective access to the financial markets.

Clearing Firms and the New Paradigm

What is the future of clearing firms given their increasing interaction with the independent broker model brokers, registered investment advisors and trading partnerships, balanced against emerging technologies such as high frequency and block trading technology and newly emerging trading platforms and nascent competing entities? Trends in technology and transactions have served to commoditize the services provided by clearing firms, particularly in light of the cutthroat competition for trading and credit associated fees, charges and expenses and narrowing profit margins. Clearing firms are also facing competition from emerging trading

[14] The Department of Labor Fiduciary Rule which was originally scheduled to be phased in April 10, 2017 through January 1, 2018, expanding the "Investment Advice Fiduciary" term as set forth under the Employee Retirement Income Security Act of 1974 (ERISA).

modalities and platforms including Alternate Trading Systems, Electronic Communications Networks and dark pools. These emerging economic and financial considerations notwithstanding, they do nothing to alter the simple fact of the human element and the ongoing responsibility of clearing firms to monitor the activities of their trading partners to whom they provide trading and credit access.

One could argue that the accelerating pace of change requiring greater sophistication and expense in developing and maintaining order routing software, integrated bank and security accounts, interfaces into the growing list of alternate trading facilities and a full complement of central clearing counterparties to clear and custody the cash and securities will continue the consolidation of specialized clearing brokers. This allows the introducing brokers to utilize their intellectual and capital resources into focusing on profit making opportunities, while leaving the bookkeeping details to someone else. These developments, however, do not permit clearing firms to advocate their supervisory and compliance responsibilities.

The clearing business has and continues to evolve into a complex matrix of seemingly routine steps. Clearing brokers cannot rely on the traditional view that they just issue monthly statements and provide bookkeeping. They have become an integral part of and partner with the introducing brokers they service. The intertwining of the services open up new areas of exposure to clearing brokers requiring increased vigilance and potential liability to the actions of an introducing broker and by extension the potential harm caused to a public customer. All of these considerations aside, clearing firms are still required to exhaust their supervisory and compliance obligations pursuant to FINRA guidelines and SEC rules and regulations.

C. In Closing

The overriding guiding principle for FINRA member firms as set forth in the Duties and Conflicts chapter of the FINRA Manual is set forth in Rule 2010 entitled Standards of Commercial Honor and Principles of Trade, a mere one sentence rule which states

> "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade".

Within this same chapter is Rule 2020 entitled "Use of Manipulative, Deceptive or Other Fraudulent Devices" which states:

> "No member shall affect any transaction, or induce the purchase or sale of, any security by means of any manipulation, deceptive or other fraudulent device or contrivance.

These rules, in addition to the aforementioned FINRA rules regarding supervisory and compliance obligations of all FINRA member firms, as well as the additional provisions specific to clearing firms, provide guidance to FINRA arbitration panels in fashioning a just and proper equitable award in claims of retail customers.

In the final analysis, FINRA arbitration panels are not wholly bound by law or rules formalistic of evidence (Lentine v. Fundaro, 29 N.Y.2d 382, 328 N.Y.S.2d 418, 278 N.E.2d 633). Panels may apply these concepts, as well as the concept of equity, to the cases they decide (Matter of Sprinzen [Nomberg], 46 N.Y.2d 623, 631, 415 N.Y.S.2d 974, 389 N.E.2d 456; Matter of Port Washington Union Free School Dist. v. Port Washington Teachers Assn., 45 N.Y.2d 411, 418, 408 N.Y.S.2d 453, 380 N.E.2d 280; Matter of Raisler Corp. [New York City Housing Auth.], 32 N.Y.2d 274, 283, 34 N.Y.S.2d 917, 298 N.E.2d 91).

As noted by FINRA President Linda D. Fienberg:

PUBLIC STATEMENT BY LINDA D. FIENBERG
President of NASD (now FINRA) Dispute Resolution July 20, 2004

> "In SRO NASD arbitration, unlike in court, you get an equitable result. ***You do not have to have a claim that is cognizable under state or federal law; it can be cognizable under NASD rules***… The rules that are applied by arbitrators looking for equitable relief are much broader than if they had to strictly follow the law.*"[15]

Towards this end, FINRA arbitration panels are exhorted to pursue an equitable result in the claims they are presented with.

[15]* Speech by Linda D. Fienberg presented to the North American Securities Administrators Association Arbitration Forum (NAASA) on July 20, 2004 in Washington, D.C.

President Fienberg retired as President of FINRA Dispute Resolution in November, 2014

VICARIOUS LIABILITY OF CLEARING FIRMS – THE CONTINUED GRAB AT THE DEEP POCKET

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I. Introduction[1]

Clearing firms do not enjoy "blanket immunity" against claims brought by customers of the introducing or correspondent firms for which they clear. However, clearing firms should not be held liable to the customers for the wrongful conduct of their introducing firms, even if the clearing firm knew or "should have known" about the misconduct. Through regulatory rule-making and a significant body of case law, a line of demarcation has emerged which limits the exposure of clearing firms in cases where they do no more than act as clearing firms. Despite efforts to use various legal theories and to press customer claims against the presumptively deeper pockets of clearing firms, the history, the rule amendments and the case law have been quite consistent where a clearing firm merely performs clearing services for its introducing or correspondent firms, it is not liable for the misconduct of those firms. Only when it "crosses the line" and does more than those ministerial and allocated functions will a clearing firm's exposure be amplified.

The issue is to find where that "line" lies. To do so requires consideration of clearing firms' functions in the securities market. Clearing firms not only provide an indispensable vital service to the trading market, but they create and distribute critical tools to their introducing firms to better enable those firms to conduct their businesses in a regulatory compliant manner and enhance their ability to supervise their own activities. The clearing firms also do this with transparency to the regulators and thereby improve the abilities of the regulators to oversee the

[1] Michael Shannon is a trial attorney and a partner in the New York office of Thompson Hine LLP. He has more than 40 years' experience as a commercial litigator and concentrates his practice in the representation of brokerage firms, clearing firms and brokers in securities' arbitration and disciplinary matters. He has authored several previous pieces on securities arbitrations and broker dealer and clearing firm liability and is a member of the Securities Industry Financial Markets Association, Compliance and Legal Division.

Riccardo DeBari is an associate in Thompson Hine's New York office and a member of the firm's Business Litigation practice group. Mr. DeBari works alongside Mr. Shannon on behalf of the firm's brokerage and clearing firm clients and also represents domestic and international financial services firms and banks in a variety of commercial litigation and investigatory matters.

operations of the introducing firms. But—and very importantly—clearing firms are not the "watchdogs" or the "gatekeepers" for introducing firms. Through new due diligence and continued reporting requirements, regulators are more informed and better equipped than ever to combat fraud or other malfeasance in introducing firms and to better protect the investor customers. At the same time, rule changes over the years have reaffirmed the underlying allocation of duties and commensurate liabilities that may accrue to the introducing and clearing firms.

This Article examines the origin and basis of this area of the law, attempts to provide guidance on where that dividing "line" is between a clearing firm's conduct that should not subject it to liability and when it might, and provides commentary on where we stand and where we might be headed in coming years.

II. Background

Pinpointing just where the dividing line of clearing firm liability lies is most often triggered by an end customer's claim. Usually, a customer of the introducing firm alleges some misconduct within the introducing firm and asserts that the clearing firm should be held liable alongside the introducing broker. The claim against the introducing broker may allege just one claim of wrongdoing, e.g., that the broker engaged in unauthorized trading, that the trades were blatantly unsuitable or that the broker committed outright fraud or theft. Sometimes, the customer's claims of wrongdoing go beyond a single wrongful act and claim more systemic malfeasance across the introducing firm, such as a Ponzi scheme or stock manipulation claims.

The claimant's playbook in such cases is no secret. In cases where the introducing broker is reputable, or at least solvent, the customer claimant will usually proceed just against that broker and the introducing firm that employs him. This is especially so in cases where a single, miscreant employee of the firm is the culprit of the alleged wrongdoing. Theories of *respondeat*

superior, supervisory liability and other common agency principles generally permit the claimant to recover from the introducing firm with enough capital to pay out on an award.

In the larger dollar cases where the introducing firm might not maintain sufficient capital to cover all adverse claims or awards, the clearing firm is often targeted as the most direct path to a deep pocket. Where the alleged conduct involves broader claims of boiler operations, Ponzi schemes, patterns of conduct such as market manipulation or other systemic activities, the introducing firm may collapse under the weight of regulatory investigations and fines and numerous claims or lawsuits. In these circumstances, the clearing firm may be the best—or perhaps only—source to compensate the injured customer.

Over the years, customer claims against clearing firms frequently have shown either a confusion about the relationship between clearing firms and introducing firms or have been a concerted attack seeking to move the "line" of allocation of their respective responsibilities or, at least, blur it. In that vein, claims have been brought against clearing firms for the misconduct of an introducing firm on little more than the fact that the clearing firm's name appeared on account statements and confirmations. Other claimants have tried to assert that by its routine and ministerial clearing activities alone, the clearing firm "aided," "abetted," "controlled," or otherwise was complicit in the wrongful conduct by the introducing firm so as to render it jointly liable.

Other claimants advance the theory that the clearing firm "knew or should have known" of the wrongdoing by the introducing firm and that the clearing firm failed to take some action to stop it. Through this "knew or should have known" theory, the claimants seek to link up the failure to act by the clearing firm to the alleged injury to the claimant. Typically, these claimants still do not allege any direct contact between the customer and the clearing firm, nor do they

point to a basis for a *duty* owed by the clearing firm requiring it to take the actions claimants allege should have been taken. Such claimants invariably try to allege "red flags" of wrongdoing which "should have" alerted the clearing firm to the misconduct. They can be such things as account opening documents containing suitability data which "should have" put the clearing firm on notice that certain trades made in the accounts were improper, or it could be an unusually high level of trading irregularities that "should have" been discoverable in reports or data that are regularly prepared or assessed by the clearing firm in the course of its operations. Even in those cases, however, claimants rarely allege any *personal* actions or human knowledge (as opposed to data maintained by the firms) on the part of the clearing firm officers or employees, much less that they "knowingly participated" in the wrongdoing. Instead, these claims appear to be based on the assumption that databases of clearing firms provide enough information from which the clearing firm "should have" unearthed that the wrongful conduct was happening. From those facts, the assertion is that the clearing firm—on a systemic level—"knew or should have known" of the conduct and, therefore, "should have" done something to stop it. Still, even in those cases, the only actual "conduct" that is alleged is usually nothing more than the clearing firm's raison d'être. That is, the processing of trades, extending margin credit, issuing statements or other confirmations or other tasks which are the routine, common and ministerial functions of every clearing broker. In other words, it is not so much that the clearing firm did something wrong, but that it did not stop doing its routine job of clearing. Because the clearing firm did not stop clearing for the miscreant introducing firm, it should be liable because it cleared—without more. As we shall see, this is not, and has never been, the law.

As we set forth in this Article, attempts to skirt the fundamental allocation of duties to impose liability upon clearing firms for non-performance of duties allocated to introducing firms

have not fared well. At their core, these claims conflict with several legal principles, including agency law. They are also at odds with the basic and regulated division of labor as between a clearing firm and the introducing firm. Finally, from a legal sense, these claims presume or seek to impose upon the clearing firm an affirmative duty to speak or to act, where the law dictates that no such duty exists.

Unfortunately, fraudulent conduct by introducing firms or a few bad apple brokers continues to plague the industry and causes significant monetary damages to investors. But, with the evolution of the rule changes and the enhancement of the tools given to the introducing firms and regulators, which we will discuss here, oversight has never been greater. While clearing firms should (and must) do their part to adhere to industry regulations on compliance and reporting, clearing firms are not the industry's policemen and when doing their job, are simply not liable for the acts of their correspondents.

III. The Historical Setting – 1982 to Today

A. Rule 382 and Courts' Recognition of the Allocation of Duties

Most of modern day case law governing clearing firm liability stems from the adoption of New York Stock Exchange (NYSE) Rule 382 in 1982, and the clarification and guidance on the Rule issued by NYSE Memo 82-18. On a broad level, Rule 382 provided for the *allocation* of responsibilities, not a *delegation*, as between the clearing firm and the introducing or correspondent firm. Rule 382 established a process for filing, and regulatory approval of, clearing agreements and mandated that all clearing agreements specify the allocation of certain functions as between the firms.

Specifically, NYSE Rule 382 (and its counterpart National Association of Securities Dealers (NASD) Rule 3230) required that all clearing agreements be submitted to, and approved by, the NYSE, thus taking them out of the realm of purely private understandings. It mandated

that all agreements must address the allocation of at least seven specified functions—(1) opening, approving and monitoring accounts …; (2) extension of credit (Reg T, margin, etc.); (3) maintenance of books and records; (4) receipt and delivery of funds and securities; (5) safeguarding of funds and securities; (6) confirmations and statements; and (7) acceptance and execution of transactions. The Rule further provided that each of these functions "where applicable, be specifically allocated with a clear indication of the extent of responsibility assumed by each party to the agreement" and that "to the extent that a particular function is allocated to one of the parties, the other party is to supply that firm with all appropriate data in its possession pertinent to the proper performance and supervision of that function." In addition, end customers were to be notified of the allocation of responsibilities.

1. 1982 – Adoption of Rule 382

In its NYSE Information Memo 82-18, the NYSE issued critical guidance on Rule 382. It explained that the purpose of the Rule is to "clarify the relationship" between the brokers involved. The allocation of responsibilities would be predicated on many factors including the size and nature of the businesses and their data processing facilities. It further observed that parties had freedom of contract to allocate the functions themselves, but must do so in "a manner consistent with the responsibilities of the organizations involved to protect the public interest as well as their own."

The guidance also reiterated that certain enumerated functions must be addressed in the allocation and, perhaps most importantly, addressed the impact of the allocation of responsibilities. The allocations would "*relieve a party to the contract from duties and responsibilities which, under the framework of Exchange regulation, otherwise would be imposed upon the party*" and to the extent a function is allocated to one party, the other party "is to supply that firm with all appropriate data in its possession pertinent to the proper performance

and supervision of that function and the agreement should acknowledge this obligation." (emphasis added)

2. 1982 to 1999 – Relatively Consistent Case Law and Arbitration Awards

Since the adoption of NYSE Rule 382, courts and arbitration panels overwhelmingly rejected customer claims against clearing firms where the underlying conduct or wrong alleged was that of the introducing firm and its employees—in essence affirming the allocation of responsibilities. Because the functions of a clearing firm are limited, courts have held, so are its responsibilities to the customers and hence its liability exposure.[2]

The *Blech* cases provide a useful guide to what, if any, actions by a clearing firm could give rise to liability to the end customer. In *In Re Blech Securities Litigation*, 925 F. Supp. 1279 (S.D.N.Y. 1996) (*Blech I*), the district court granted the clearing firm's (Bear Stearns) motion to dismiss despite allegations that Bear Stearns "knew of and participated in sham transactions." It held simply that "a clearing broker owes no duty of disclosure to the clients of the introducing broker … Silence, absent a duty to disclose, is not actionable under federal securities laws."

[2] Examples of this principle are included in the holdings of: *Katz v. Financial Clearing & Services Corp.*, 794 F. Supp. 88, 90 (S.D.N.Y. 1992) ("neither primary nor aiding or abetting liability under the securities laws attaches to a clearing broker who merely clears trades for an introducing broker."); *Riggs v. Schappell*, 939 F. Supp. 321 (D.N.J. 1996) ("negligence," "agency," "fiduciary duty" and "respondent superior" claims dismissed on motion); *Carlson v. Bear, Stearns & Co.*, 906 F.2d 315 (7th Cir. 1990) (since the firm had nothing to do with actual buying and selling decisions, it is not jointly liable for actions of the introducing firm); *Baum v. Phillips, Appel & Walden, Inc.*, 648 F. Supp. 1518 (S.D.N.Y. 1986), *aff'd*, 867 F.2d 776 (2d Cir. 1989) (no control person liability); *Schober v. Department of Labor*, 1999 U.S. Dist. LEXIS 6844 (S.D.N.Y. 1999) (not liable for introducing firm's misrepresentations); *Marshall Mars v. Wedbush Morgan Securities, Inc.*, 231 Cal. App.3d 1608 (Cal. Ct. App. 1991) (clearing firm does not owe a fiduciary duty to the customer); *Stander v. Financial Clearing & Serv. Corp.*, 730 F. Supp. 1282 (S.D.N.Y. 1990) (no fiduciary duty—no liability for churning or unauthorized trading and to hold otherwise would "be taking paternalism to an extreme"); *Antinoph v. Loverell Reynolds Securities, Inc.*, 703 F. Supp. 1185 (E.D. Pa. 1989) (absent a fiduciary duty, there was no obligation to disclose the broker's misconduct—"Mere bystanders, even if aware of the fraud, cannot be held liable for inaction").

The district court permitted the plaintiffs to amend their complaint and in the following year in *Blech III*, 961 F. Supp. 569 (S.D.N.Y. 1997), it once more considered a Bear Stearns dismissal motion.[3] The plaintiffs' second attempt fared better. The court found that the amendments had overcome some of the earlier complaint's deficiencies and declined to dismiss some of the claims asserted. In the amended complaint, the plaintiffs alleged a series of facts in support of their claim that Bear Stearns had acted as a "direct participant" in the alleged securities fraud. In denying the motion to dismiss the re-pleaded 10b-5 and common law fraud claims, the court held that the facts alleged were sufficient to state a claim for primary liability insofar as Bear Stearns was alleged to have *itself* engaged in conduct aimed at artificially inflating or maintaining the price of the securities at issue.[4] Critically, the court observed that liability could be imposed because Bear Stearns' conduct went beyond that of the normal activities of a clearing broker. Relying on its earlier ruling, and doubling down on its reasoning, the court noted that it was Bear Stearns' alleged *direct* actions[5]—and not its knowledge of the fraud or routine clearing activities—that made the claim viable:

[3] *Blech II*, 1997 U.S. Dist. LEXIS 404 (S.D.N.Y. 1997), involved the district court's denial of defendants' motion for entry of a final judgment pursuant to Rule 54(b).

[4] *Id.* at 583

[5] Among the allegations cited by the court were: (1) Bear Stearns had demanded that Blech sell the subject securities to reduce margin debt; (2) Bear Stearns knew that the prices of the securities must remain at artificially high levels for liquidation to be successful; (3) Bear Stearns knowingly executed sham transactions; (4) Bear Stearns knew that Blech had pledged the securities at issue and that Blech's ability to borrow (and to meet Bear Stearns' margin calls) necessitated that the high prices be maintained; (5) Bear Sterns had access to confidential records regarding Blech's financial condition and the power to impact it; (6) Bear Stearns "arranged," "funded" and "contrived" sham transactions; (7) Bear Stearns knew that it was executing manipulative and unlawful transactions; (8) Bear Stearns warned Blech to cease its parking, but nevertheless allowed it to persist; (9) Bear Stearns closely monitored Blech's trades and finally, and perhaps most significantly; and (10) Bear Stearns ***directed*** and executed sham transactions and ***agreed to fund them.***

> Even assuming that Bear Stearns had knowledge of the Blech scheme, primary liability cannot attach when the fraudulent conduct that is alleged is no more than the performance of routine clearing functions. In other words, under Section 10(b), the act of clearing sham trades is not equivalent to causing or directing sham trades for the purpose of soliciting or inducing a plaintiff to purchase securities. The act of clearing sham trades alone, even with scienter, is not enough to show an attempt to unlawfully affect the price of such securities within the meaning of Section 10(b).

Id. at 584 (internal citation omitted).

Elsewhere in the opinion, the court reiterated that "primary liability cannot attach when the fraudulent conduct that is alleged is no more than the performance of routine clearing functions." Indeed, even where a plaintiff pleads around this rule by including "[c]onclusory allegations [such as "engaging in," "executing," "entering into" fraudulent trades], they do not suffice when the factual allegations underlying those assertions are consistent with the normal activity of a clearing broker."

Thus, while *Blech* remains unusual insofar as it actually permitted a claim against a clearing firm to proceed under 10b-5 as one for primary liability, the case provides a still helpful rubric on where to draw the line. But *Blech* also reaffirms that a clearing firm cannot be liable for the bad acts of the introducing firms—even if the clearing firm knew of the underlying fraud and continued to process trades. In this vein, following the promulgation of Rule 382, courts almost uniformly rejected claims for failure to "monitor" theories, in various contexts.[6]

[6] *Carlson v. Bear, Stearns & Co*., 906 F.2d 315 (7th Cir. 1990) (breach of fiduciary duty; state law "material aid"); *Dillon v. Militano*, 731 F. Supp. 634 (S.D.N.Y 1990) ("reckless" failure to discover); *Stander v. Financial Clearing & Services Corp*., 730 F. Supp. 1282 (S.D.N.Y. 1990) (breach of fiduciary duty); *Connolly v. Havens*, 763 F. Supp. 6 (S.D.N.Y. 1991) (breach of fiduciary duty); *Katz v. Financial Clearing & Services Corp*., 794 F. Supp. 88 (S.D.N.Y. 1992) (neither primary, nor aiding and abetting liability under federal securities' laws); *Riggs v. Schappell*, 939 F. Supp. 321 (D.N.J. 1996) (no duty to investigate, monitor, negligence, no industry practice); *Rivera v. Clark Melvin Secs. Corp.*, 59 F. Supp. 2d 297 (D.P.R. 1999) (duties

3. 1999 – Amendments to Rule 382: More Tools for the Introducing Firms, More Oversight by the Regulators, but Legal Obligations Remain Unchanged

In 1999, Rule 382 was amended. Generally, these amendments reaffirmed the allocation of responsibilities, enhanced the capabilities of the introducing firms to perform and supervise their own regulatory functions and improved regulatory policing and claim reporting. What did not change was the legal paradigm which gave clearing firms protection from liability for claims stemming from introducing brokers' misconduct. If anything, the Rule amendments made those protections more formidable.

First, Rule 382's amendments required that the clearing firm provide meaningful tools for a correspondent firm's self-policing and regulatory compliance. The amendments mandated clearing firms to forward promptly any written customer complaint about the correspondent firm not only to the firm itself, but *also* to the correspondent firm's primary regulator. Second, and more substantively, the clearing firm had to provide each correspondent firm with an annual list of all reports (i.e., exception and other types of reports) that the clearing firm could make available to assist the correspondent firm in supervising and monitoring its customer accounts. The introducing firm, in turn, was required to select from that list and specify in writing which reports it wished to receive, and a copy of its written specifications had to be provided to that firm's primary regulator.

Through these changes, the introducing firms were given a comprehensive menu of the reports—sometimes in the hundreds—which might assist them in the performance of their functions and from which they would make their selections. The regulator also would be notified of the selections and thus be better poised to determine if the introducing firm was thorough in

limited by contract to those in clearing agreement); *Schwarz v. Bear, Stearns & Co.*, 1998 N.Y. Misc. LEXIS 751 (N.Y. Sup. Ct. 1998) (no negligence claim).

the reports it selected for its compliance needs. But there was no requirement that the clearing firm provide reports not requested or that the clearing firm delve into the substance of any reports it generated for the introducing firm.

B. The Blip That Was Bear Stearns

The landscape appeared to change when the Securities and Exchange Commission (SEC) brought a civil suit against Bear Stearns in 1999, stemming from Bear's clearing services provided to A.R. Baron (Baron), which turned out to be a bucket shop whose customers lost $75 million. Ultimately, this suit lead to a Settlement and Consent Decree with the SEC. Although a *settlement* without any admission of liability, Bear's payment of $30 million toward customers' losses and a $5 million penalty suggested that the "line" had moved. On close scrutiny, this was not the case.

1. Bear Stearns-Baron SEC Spawned More Claims

The Bear Stearns/Barron debacle and Bear's settlement with the SEC spawned many claims in both the courts and arbitration forums.

One such case, *Berwecky v. Bear, Stearns & Co.*, 197 F.R.D. 65 (S.D.N.Y. 2000), provides a good example of how claimants began to frame their claims of liability as against clearing firms in the wake of the Bear-Barron settlement. In that case, the district court granted class certification in a suit brought by investors against clearing broker Bear Stearns for its role in the introducing firm Baron's scheme to defraud investors. The *Berwecky* plaintiffs alleged that Bear "asserted control over Baron's trading operations by, *inter alia*, placing Bear Stearns' employees at Baron's offices to observe Baron's trading activities, approving or declining to execute certain trades, imposing restrictions on Baron's inventory, and loaning funds to Baron."[7]

[7] *Id.* at 67.

The plaintiffs further alleged that Bear Stearns exercised control over Baron's activities "in order to keep A.R. Baron a viable concern while Bear, Stearns … continued to reap the large profits they received from their activities with A.R. Baron."[8] Although *Berwecky* pertained to a Rule 23 class certification decision, and the court credited the allegations underlying Bear's "control" of the stock scheme to satisfy the class rule's "predominance" requirement[9], the allegations against Bear prove helpful here on whether the "line" had moved or whether Bear had just gone too far and crossed it.

The facts show the latter to be the case. Bear's exposure arose from things it did that transcended the tasks of routine and ministerial clearing functions. Bear invested in Baron. Bear placed its employees on site at Baron. Bear refused to process Automated Customer Account Transfer (ACAT) forms. Bear monitored and supervised trading. Bear failed to report commissions and markups. Bear knowingly processed unauthorized trades. Bear was in direct contact with the end customers regarding their complaints and did not respond to them. These circumstances were sufficient to transform Bear's ministerial clearing acts into something more and now provide factual guideposts that have been used in subsequent years to assess just what acts by a clearing firm could "cross the line" and give rise to liability.

2. The Fallout: McDaniels v. Bear Stearns & Co. and the Use of "Red Flag" and "Material Aid" Theories of Clearing Firm Liability

Following *Baron*, plaintiffs attempted new theories to hold clearing firms liable. Despite broad adherence to the established rule, three outlier decisions in the wake of *Baron*, for a time, pressed the limits of clearing firm liability. In *Koruga* (Fiserv); *Klein* (Oppenheimer); and *McDaniel* (Bear Stearns), the "red flag" and "material aid" theories of liability were first

[8] *Id.*

[9] *Id.* at 68-69.

introduced. At bottom, these cases each exhibit extraordinary acts by the clearing firm or deeply flawed legal decisions. In any event, while they did not alter the clearing firm liability landscape, they require re-visiting.

Koruga v. Wang (NASD 2000) was an NASD arbitration in which the panel opted to issue a lengthy reasoned award. In *Koruga*, claimants were victims of micro-cap stock fraud conducted by employees of Duke & Company (Duke) for which Hanifen Imhoff Clearing Corp. (Hanifen), later known as Fiserv Correspondent Services, cleared. Claimants alleged violations of state (uniform) securities statutes. The Panel found Hanifen enabled a boiler room (Duke) operation to begin and continue in business. The Panel also found Hanifen's clearing house functions "materially aided" Duke in completing each transaction. On that score, it determined that Hanifen's clearing functions were an "indispensable," "material" and "substantial" part of every transaction because, without a clearing broker, the title could not pass and consideration could not be exchanged—both prerequisites to trade. The clearing firm was found to be in violation of the implied obligation of good faith found to have been established in the Clearing Agreement. Notably, the Panel found that Duke's promotion of Hanifen on Duke letterhead and use of the Hanifen name on statements were factors and awarded the Claimants $1,840,363 plus interest, attorneys' fees and forum fees.

Klein v. Oppenheimer, 281 Kan. 330 (2006) is truly an outlier and difficult to square with the vast body of clearing firm law. In *Klein*, Kansas residents sued correspondent (LT Lawrence) and the clearing firm (Oppenheimer) in Kansas state court, alleging they bought securities not properly registered in Kansas. The parties stipulated that:

- Oppenheimer reasonably believed that Lawrence was maintaining procedures adequate to assure compliance with all federal and state securities laws (particularly as it was Lawrence's obligation to do so under the clearing agreement, NASD rules, and applicable law);

- Oppenheimer had no obligation under the clearing agreement or applicable law to determine whether the specific securities were registered with the State of Kansas and, therefore, took no actions to do so; and
- While Oppenheimer was not required to review the registration status of securities sold by Lawrence, the clearing agreement reserved to Oppenheimer the right to refuse to execute any transactions entered for a customer account.

The trial court initially granted summary judgment to Oppenheimer on the grounds that under New York law a clearing firm was not liable for the sale of unregistered securities by an introducing firm. The holding was reversed with the appellate court. It found that the choice of law provision was unenforceable, determined that Kansas law had to be applied and sent the case back to trial court.

In the trial court's second ruling, it again ruled in favor of Oppenheimer, this time under Kansas law, finding that although Oppenheimer was a "broker dealer" within the meaning of the state statute, it had not "materially aided" Lawrence. The trial court held that "material aid" means "that the clearing broker exercised some degree of control, influence and participation in the transaction" and relied on the holding in *Carlson v. Bear, Sterns & Co., Inc.*, 906 F.2d 315 (7th Cir. 1990) and the Official Comments to the Uniform Securities Act of 2002, § 509(g)(4), which state that "the performance by a clearing broker of the clearing broker's contractual functions—even though necessary to the processing of a transaction—without more would not constitute material aid or result in liability under this subsection."

Once again, the Kansas Supreme Court reversed. The Court cited to *Koruga* and drew heavily from a student law review article, reasoning that (a) the signs of securities fraud by the introducing broker should have been apparent to the clearing firm; (b) the defrauded investors have little recourse to recover losses where introducing brokers go out of business or are otherwise insolvent; (c) the clearing firms are in an ideal position to spread the costs of due diligence to their customers—which may be preferable to imposing the cost of noncompliance

on the individual victims of securities fraud; (d) clearing firms profit from the processing of the trades for the brokers engaged in fraudulent activities; and (e) by continuing to extend credit and/or failing to report securities violations, the clearing firms permit the introducing broker to continue its activities.

As a takeaway from *Klein*, the "conduct" considered to be the requisite "material aid" for liability was as follows:

- "Maintaining records of transactions," "receiving payments," "delivering securities," "printing and mailing confirmations and statements," and "receiving a flat fee on trades," and
- Extending and maintaining margin credit to Lawrence customers (regardless of whether margin was used to purchase the unregistered securities).

The Kansas Supreme Court concluded: "Examination of the clearing broker's services in the present case shows that they included activities that required the exercise of professional expertise and judgment and, thus, cannot accurately be called merely clerical or ministerial."[10] Yet, in this author's view, the clearing firm "conduct" in *Klein* was typical routine tasks of a clearing firm and the Court's "rationale" for finding otherwise was not fact based, but reflected policy differences at odds with well-established law.

In *McDaniel v. Bear Stearns*, 196 F. Supp. 2d 343 (S.D.N.Y. 2002), the implied duty of "good faith and fair dealing" was at issue. As set forth in *McDaniel*, NYSE Rule 401 and NASD Rule 2310 require all members to: "adhere to the principles of good business practice in the conduct of [their] business affair[s]," honor a "fundamental responsibility for fair dealing" with

[10] In addition to the "material aid" strand of clearing firm liability, other theories were advanced as well. Aiding and abetting the breach of fiduciary duty was established in *Lesavoy v. Lane* (S.D.N.Y, 2004) (2d Cir. 2006). Making out such a claim requires four elements: a) fiduciary duty owed by another; b) breach; c) actual knowledge of the duty and its breach; and d) aid, inducement or participation. Here again, the test would most often come down to whether the clearing firm is performing its routine ministerial tasks or going further to participate in the misconduct of the introducing firm.

customers and others; "deal fairly with the public"; and recognize that "brokers and dealers have an obligation of fair dealing in actions under the general anti-fraud provisions of the federal securities laws."[11]

In assessing whether Bear Stearns violated these principles, an NASD panel found against Bear Stearns, assessing $1 million in punitive damages. The Panel held that the customer agreements between Bear and claimants created duties of "fair dealing and good faith." In terms of Bear's conduct, the Court noted that the arbitrators had found that Bear personnel were aware of, or on notice of, Baron's fraudulent conduct based in part on their discussions about the claimants' accounts; Bear was "inefficient, negligent, and purposely evasive in dealing with claimants; Bear helped conceal some of the fraudulent conduct; and Bears' account statements were materially inaccurate and misleading." Bear had also given Baron 30-day termination notices twice, yet withdrew both to recover debts owed by Baron, and at the same time provided assistance to Baron in the form of loans.

The district court in the Southern District of New York confirmed the Award which an NASD panel had issued by holding, "where a clearing firm moves beyond performing mere ministerial or routine clearing functions and becomes actively and directly involved in the introducing broker's actions, it may expose itself to liability with respect to the introductory broker's misdeeds."[12] But the *McDaniel* court reaffirmed the bedrock rule of clearing firm law:

> [W]hen a clearing firm acts merely as a clearing agent, it owes no fiduciary duty to the customers of its introducing broker and cannot be held liable for the acts of an introducing firm. … Moreover, courts have refused to hold clearing firms liable for the practices of introducing brokers even where the clearing firm

[11] *McDaniel*, 196 F. Supp. 2d at 360.
[12] *McDaniel*, 196 F. Supp. 2d at 353.

> continued to provide clearing services after it knew or should have known of the introducing broker's fraudulent scheme.[13]

Thus, even in the wake of *McDaniel*, the general rule that has been applied since 1982 and was used in that case, did not change. *McDaniel* and the weight of authority since still hold that simply providing normal clearing services to an introducing firm which is acting in violation of the law does not make out a case of aiding and abetting against the clearing broker.[14]

Klein, on the other hand, should be shelved as a parochial driven outlier. It is a deeply flawed opinion which casts aside fundamental precepts of clearing firm liability. First, the court significantly misread the case law it cited in purported support of its opinion or in an attempt to distinguish contrary holdings. Second, the court deduced (erroneously) that margin lending is beyond a clearing firm's routine, ministerial function. Third, the court abandoned any serious case for statutory construction and adopted an explicit deep pocket policy for its reasoning. Fourth, the court weaved whole cloth for new definitions of "ministerial" and "material" because the tasks entailed the "exercise of professional experience and judgment" even though the claims in *Klein* involved the sale of unregistered securities, and it appears clear from the discussion that Oppenheimer did no more than process the transactions as directed. Having concluded by its

[13] *McDaniel*, 196 F. Supp. 2d at 352.

[14] *See also Greenberg v. Bear Stearns & Co., Inc*., 220 F.3d (2d Cir. 2000), *abrogated on other grounds by Vaden v. Discover Bank*, 556 U.S. 49 (2009); *accord SFM Holdings, Ltd. v. Banc of Am. Sec., LLC*, 600 F.3d 1334 (11th Cir. 2010), *rehearing en banc, denied by SFM Holdings, Inc. v. Banc of Am. Secs, LLC*, 402 F. App'x. 513, 2010 U.S. App. LEXIS 27281 (11th Cir., June 3, 2010) (investor's fiduciary duty and constructive fraud claims against a broker were properly dismissed pursuant to Fed. R. Civ. P. 12(b)(6) because the parties' agreement stated that the broker was not an adviser or fiduciary, it had no direct contact with the investor, and it made no decisions about the investor's account but only executed transactions); *Goldberger v. Bear Stearns & Co., Inc.*, 2000 U.S. Dist. LEXIS 18714, at *13-14 (S.D.N.Y. 2000) ("With respect to the Introducing Brokers, the complaint does no more than allege that Bear Stearns performed the normal function of a clearing broker. Even if one accepts that the complaint sufficiently alleges that Bear Stearns did this with knowledge that these brokers were manipulating the securities at issue, the complaint does not establish Bear Stearns' primary liability under § 10(b)").

"scrutiny" of *Koruga* that engaging in activities such as margin lending was not ministerial action and noting that Oppenheimer engaged in margin lending, the *Klein* court appears to have determined that Oppenheimer's relationship with Lawrence could not have been merely ministerial.

Nonetheless, the "line" of clearing firm liability has survived and indeed has been painted more clearly in more recent opinions and in the Financial Industry Regulatory Authority's (FINRA) adoption of Rule 4311.

C. FINRA Rule 4311 and More Recent Case Law

In 2011, the role of the clearing firm—and its attendant duties—was even more fully delineated. FINRA Rule 4311, as explained by FINRA Notice 11-26, controlled the registration and requirements associated with any new service agreement as between clearing firms and their introducing broker.

1. FINRA Adopts Rule 4311

Rule 4311 continued the requirement that all clearing agreements and any changes to them must be submitted to FINRA for approval before they become effective. But, it also added a due diligence requirement. Before clearing for a new introducing firm, the clearing firm must submit a written notice to FINRA identifying the firm and providing certain required information. The clearing firm also must conduct due diligence with respect to any new introducing firm relationship "to assess the financial, operational, credit and reputational risk that such arrangement will have on the carrying firm."[15] Due diligence might include inquiry about

[15] FINRA Notice 11-26 provides the following about the Rule's due diligence requirement:

> FINRA Rule 4311(b)(4) expressly requires each carrying firm to conduct appropriate due diligence with respect to any new introducing firm relationship. Such due diligence is expected to be conducted prior to the commencement of the relationship. The rule provides that such due diligence must assess the financial,

the firm's business model, product mix, proprietary and customer positions, Financial and Operational Combined Uniform Single (FOCUS) reports, audited financials, complaint and disciplinary history.

The purpose is clear—FINRA Rule 4311 mandates that clearing firms provide the regulators with the necessary tools to monitor and investigate potential misconduct. As FINRA Notice 11-26 explains "FINRA Rule 4311(b)(3) codifies the current practice under NYSE Rule 382 of requiring that as early as possible, but not later than 10 business days, prior to the carrying of any accounts of a new introducing firm (including the accounts of any piggyback or intermediary introducing firm(s)), the carrying firm must submit to FINRA a notice identifying each such introducing firm by name and (Central Registration Depository (CRD) number and include such additional information as FINRA may require." FINRA Rule 4311.02 provides that, for purposes of the notice requirement of paragraph (b)(3) of the Rule, the carrying firm must also submit a questionnaire put out by FINRA. Clearing firms are thus on notice that its initial evaluation on whether to enter into a clearing agreement with an introducing broker carries with it reporting requirements to the regulators. Importantly, the primary purpose of the analysis is to ensure that the clearing firm adequately "assess the . . . risk that such arrangement will have on the carrying [i.e., clearing] firm." In other words, the focus is on the *protection* of the clearing firm; not an expansion of its duties to end customers.

> operational, credit and reputational risk that such arrangements will have upon the carrying firm. The rule provides that FINRA, in its review of any arrangement, may in its discretion require specific items to be addressed by the carrying firm as part of the firm's due diligence requirement under the rule. The rule further provides that the carrying firm must maintain a record, in accord with the time frames prescribed by the U.S. Securities Exchange Act of 1934 (SEA) Rule 17a-4(b), of the due diligence conducted for each new introducing firm.

Rule 4311 also continues the industry allocation of responsibilities. The clearing broker is responsible for written notification requirements and FINRA Rule 4311(d) requires that each customer account must be notified in writing upon the opening of the account of the existence of the clearing agreement and which responsibilities are allocated to the introducing broker versus the clearing firm. Finally, the provisions of FINRA Rule 4311(g)(1) and (h) generally addressed and imposed obligations on clearing firms to provide information, such as any written customer complaints and exception reports, to the introducing broker ***and/or*** to FINRA. Thus, through the due diligence reporting to FINRA at the outset, FINRA is provided with additional information by which it—as the regulator—can oversee the operations of the introducing firm.

2. Current State of the Law—The "Crossing the Line Theory" is Re-affirmed

Since the enactment of Rule 382 and most recently FINRA Rule 4311, clearing firms have been generally insulated from liability for a correspondent firm's misconduct. Despite certain aberrations through the past few decades of relevant decisions, courts have almost uniformly respected this structure. The reasons for this are several. First, following the issuance of a Rule 382 letter to the customer, the functions of each broker servicing the customer are allocated and disclosed. In the normal circumstance, the customer is informed that the clearing firm will simply perform ministerial tasks for the correspondent. Second, as a corollary to this allocation of responsibilities, no general fiduciary duties are owed by the clearing firm to correspondent customers who might override the allocation. Third, and similarly, there is no duty to monitor the activities of the correspondent and to disclose detected problem to the correspondent and customers. The clearing firm is not the client-facing service provider; the correspondent is. Fourth, correspondent brokers are not employees or agents of the clearing firm

and, accordingly, and there is no duty (or right) to supervise or control them. This structure has long been respected by the courts in determining liability when things go wrong.

In *Levitt v. J.P. Morgan*, 710 F.3d 454 (2d Cir. 2013), the Second Circuit provided a detailed and oft-cited explanation of the current state of clearing firm law. In reversing and vacating a class action certification, the court credited the separation of roles and disparate duties owed by clearing firms and their introducing broker dealers. In *Levitt*, Bear cleared for Sterling Foster and was alleged to have participated in Sterling Foster's market manipulation scheme. It was alleged that Bear continued to clear transactions despite actual knowledge of an ongoing manipulative scheme; failed to cancel trades in violation of Reg T; extended credit; and even sent out false confirmations. In assessing these claims, the court observed that "a clearing agent is generally under no fiduciary duty to the owners of the securities that pass through its hands" and that the "simple providing of normal clearing services to a primary broker who is acting in violation of the law … [does not] make out a case of aiding and abetting against the clearing broker."[16]

Generally, the court continued, there are two types of cases: First, where a clearing broker was simply providing normal clearing services—there is no liability for the transgressions of the introducing broker and mere clearance of the trades is not "substantial assistance" or "participation" in the fraud—even if the clearing firm is alleged to have known of the fraud and even if it failed to enforce margin requirements which allowed the fraud to continue. Second, there are some limited cases where the clearing firm "is alleged effectively to have shed its role as clearing broker and assumed direct control of the introducing firm's operations and its

[16] *Id.* at 465-66.

manipulative scheme" or "directed" the fraudulent trades.[17] The Second Circuit adopted this dividing line and found the test to be dispositive:

> We think that the distinctions drawn by these district courts properly implement Rule 382's scheme, which allows clearing and introducing brokers to contractually allocate functions amongst themselves. As noted above, this scheme permits clearing brokers to place the burden of monitoring trades on the introducing broker. In return, the introducing broker has access to the services of the clearing broker and thus avoids the overhead costs associated with providing clearing services in-house.[18]

Accordingly, the court held: "In view of the importance of not holding clearing brokers liable for conduct for which the *introducing* broker assumed responsibility pursuant to NYSE Rule 382, we here adopt the approach thus far taken by the district courts of this Circuit in § 10(b) suits against clearing brokers governed by Rule 382."[19] Ultimately, the court held that the complaint's allegations that Bear "allowed" putatively sham or manipulative trades did not meet the requirement that the clearing firm have "direct[ed] or instigat[ed]" such trades before it's considered to have "shed" its role as clearing firm and subjected itself to primary liability.

In addition to Section 10(b) violations, the Second Circuit has also applied the same rationale to dismiss claims against clearing firms for liability under the Commodities Exchange Act (CEA), 7 U.S.C.S. § 25. In *Gracey v. J.P. Morgan Chase & Co. (In re Amaranth Natural Gas Commodities Litig.)*, 730 F.3d 170, 185 (2d Cir. 2013), the Second Circuit held that the standard for aiding and abetting liability under the CEA was the same as for criminal aiding and abetting and required evaluation of the relationship between a defendant's knowledge, intent, and actions. More specifically, the "substantial assistance" prong of aiding and abetting requires that

[17] *Id.* at 466.

[18] *Id.* at 467.

[19] *Id.* (emphasis added).

the defendant associated himself with a violation of the Act, participated in it as something that he wished to bring about, and sought by his actions to make the violation succeed.

Accordingly, on the facts before it, the Second Circuit affirmed the district court's dismissal of claims by traders who bought and sold natural gas futures contracts because they failed to state a claim under § 25(a)(1) of the CEA against a clearing broker for aiding and abetting market manipulations. The court reached this holding by reasoning that large positions taken by the broker's client in natural gas futures and swaps did not necessarily imply manipulation, and the broker was not alleged to have done more than provide routine services in connection with "slamming the close" trades. It reasoned:

> The amended complaint does not allege that J.P. Futures did anything more to assist Amaranth in these trades than to provide routine clearing firm services. As previous decisions from this Circuit recognize, such allegations provide only weak evidence that J.P. Futures associated itself with Amaranth's manipulation and "participate[d] in it as in something that [it] wishe[d] to bring about."
>
> …
>
> It suffices to conclude that in the circumstances presented here, the provision of routine clearing services, when combined only with allegations that the clearing firm knew of trading activity that was highly suggestive but not dispositive of manipulation, is not enough to state a claim for aiding and abetting under Section 22 of the CEA.[20]

Contrasting these cases are three that constitute deviations from the norm since FINRA Rule 4311 was issued in 2011. In *Overstock.com*, *Alaron Trading*, and *Turk v. Pershing LLC*, courts employed the traditional test of assessing whether the clearing firm "crossed the line" and acted as more than just a clearing firm, but did so in a broader manner. These three cases,

[20] *Gracey*, 730 F.3d at 185.

distinguishable on their facts from traditional clearing firm liability law; however, are worthy of examination because they buck the weight of authority.

In *Overstock.com, Inc. v. Goldman Sachs & Co.*, 180 Cal. Rpts. 3d 269 (Cal. Ct. App. 2014) the California court denied a motion for summary judgment by one of several firms in a naked short selling case brought against a clearing firm by the issuer and several shareholders because there was "slight" evidence that the firm did more than provide normal clearing services and did more than knowingly clear its client's manipulative trades and sham "reset" transactions.[21] In reaching this conclusion, however, the court applied the traditional tenets of clearing firm law. It noted that § 10(b) does not provide for a private right of action for claims for aiding and abetting and that a clearing firm to be exposed to liability it must "cross the line" to being a primary violator.[22] Further, it echoed that mere knowledge of the fraud and clearance of the fraudulent trades would not be enough for a claim; but some "intimate" "hands on involvement" or participation in key decisions about the trades could trigger liability as a primary violator.[23] Finally, citing to *Levitt*, the court acknowledged that a clearing firm did not have a duty to disclose a known fraud to the clients of the introducing firm and could continue to clear and extend credit for the trading. *Id.* at 288-89.

Nevertheless, the court found that plaintiffs had cleared the low hurdle of putting forth triable issues of facts with respect to one clearing firm, Merrill Clearing, that showed it could be subjected to liability. The court held, in a "close call," that "there is a triable issue as Merrill took an active, direct role in [the introducing brokers'] trading schemes to cause, and to profit from, ongoing failures to deliver shares in short sales of Overstock, as well as other hard-to-borrow

[21] *Overstock*, 180 Cal. Rpts. 3d at 296.
[22] *Id.* at 287-88.

[23] *Id.* at 289.

securities."[24] As evidence of this, the court credited proofs that one of the introducing brokers "effectively asked Merrill Clearing to review and approve [an] exotic 'test trade' he had concocted to flagrantly violate the securities laws."[25] Following this, Merrill gave its "stamp of approval" of this trading technique and "continued to clear [the broker's] unlawful trades even after compliance personnel made clear this was 'not ok.'"[26] Because these trades were arguably part of a clearing firms normal activities, the court further noted that "it is arguable" that Merrill Clearing "went beyond giving routine notice and knowingly coached [the introducing brokers]" on how to facilitate their scheme.[27] In sum, the court held, "Merrill Clearing . . . did more than provide normal clearing services, and did more than knowingly clear its clients' manipulative trades and sham reset transactions."[28]

Two decisions issued out of *DeDavid v. Alaron Trading Corp*. also provide guidance on what constitutes "crossing the line."[29] The Northern District of Illinois issued two rulings, one denying a motion to dismiss and the other denying summary judgment for the clearing firm. In *Alaron*, the clearing firm (ATC) established a new office (ALA) with some of the individual defendants and that office agreed to act as the clearing broker for customers of a Guatemalan broker dealer (MDF) which introduced customers and to execute trades, issue account statements and hold funds for them. ALA and ATC maintained a "tight relationship" with MDF; ALA sent its employees to train MDF's trading group in Guatemala; and provided trading equipment and

[24] *Id.* at 295.

[25] *Id.* at 296.

[26] *Id.*

[27] *Overstock*, 180 Cal. Rpts. 3d at 296.

[28] *Id.*

[29] 814 F. Supp. 2d 822 (N.D. Ill. 2011) (Rule 12(b)(6) motions); 2015 U.S. Dist. LEXIS 60403 (N.D. Ill. May 7, 2015) (Summary judgment motions),

software to MDF. ALA and MDF also hosted joint marketing events in Guatemala that gave MDF credibility. ALA praised MDF's principal—stating he was "one of the best" and giving him three awards as the top foreign introducing broker—when, in fact, MDF was a Ponzi scheme.

The court denied the Rule 12(b)(6) and then summary judgment motions on most of the counts finding that ALA's and ATC's endorsement of MDS was material because there was evidence that they knew the trading was suspicious and had been warned it was a Ponzi scheme. Further, by expending significant resources to train and support MDF and promoting MDF with joint marketing events, they had aided and abetted MDF's activities and allowed "MDF to not only remain in business, but also grow larger by attracting new clients."[30]

On summary judgment, the court rejected the clearing defense to the fiduciary duty claim because of the evidence that the defendants "actually took part in perpetrating" the fraud and, citing its own Rule 12(b)(6) decision and *McDaniel*, stated "courts will impose liability when the clearing firm goes beyond ministerial or routine clearing functions and directs or contrives in the fraudulent trades" and further, "passive silence is enough to trigger the fraudulent concealment doctrine when the defendants are in a continuing fiduciary relationship with the plaintiff."[31]

Finally, in *Turk v. Pershing LLC*, 2014 U.S. Dist. LEXIS 190624, *3-4 (N.D. Tex. Dec. 8, 2014), the court sustained claims against Pershing stemming from the Ponzi scheme run by R. Allen Stanford, his associates, and various entities under his control (collectively, Stanford). Plaintiffs brought an action against Pershing, which served as custodian and clearing broker for

[30] 2015 U.S. Dist. LEXIS 60403, at *18.

[31] *Alaron*, 2015 U.S. Dist. LEXIS 60403at *20. The latter observation regarding "passive silence" appears to be a novel spin on clearing liability—insofar as it appears to be in tension with the "mere knowledge" is not enough tenet—but is one that has not gained traction. The *Alaron* summary judgment decision has not been cited or relied upon for this proposition by any court.

the Stanford Group Company (SGC). Essentially, plaintiffs argued that, in providing these services to SGC, and thus facilitating SGC's sale of fraudulent certificates of deposit, Pershing incurred liability stemming from Stanford's own wrongdoing. Pershing moved to dismiss, positing that, as a clearing broker, it is too far removed from the underlying wrongdoing to be held liable, and that plaintiffs inadequately pled their claims. The court agreed in part, but allowed claims to proceed against Pershing.

The court held that the plaintiffs' allegations of misconduct by Pershing allowed them to "avoid Pershing's assertion of blanket immunity" for clearing firms. [32] Relying on *McDaniel* and *Klein*, and eschewing reference to the body of law rejecting essentially identical allegations as insufficient, the court credited plaintiffs' allegation that Pershing had "discretion over 'whether or not to accept an order for processing, whether to execute a transaction in a customer account,' and was responsible for 'ensuring that the introducing broker was meeting net capital and other regulatory requirements.'"[33] Without addressing *Levitt* or any of the body of law stating that such conduct qualifies as routine clearing functions, the *Pershing* court held that the plaintiffs thus presented "sufficient allegations that, when accepted as true, establish Pershing provided services to SGC that were more than routine or ministerial" and accordingly found "Pershing's role as a clearing broker is no impediment to imposing liability."[34]

Despite the *Overstock*, *Alaron*, and *Pershing* decisions, the traditional clearing firm liability test remains alive and well in the Second Circuit. Since *Levitt*, the Second Circuit has re-affirmed its holding, this time in the context of a motion to dismiss pursuant to Rule 12(b)(6). In *Fezzani v. Bear, Stearn's & Co*., 777 F.3d 566, 569 (2d Cir. 2015), the court adopted its analysis

[32] *Pershing LLC*, 2014 U.S. Dist. LEXIS 190624, at *6.

[33] *Id.* at *5.

[34] *Id.* at *6.

in *Levitt* and applied it to its decision re-affirming a dismissal of a complaint pursuant to 12(b)(6) that appellants had sought a re-hearing on. The Second Circuit began by re-articulating its holding in *Levitt* and stressing that the procedural context of that motion—a Rule 23 class certification hearing—was ***not*** geared to the merits and that any *dicta* crediting allegations of "control" and "direction" of trades to make out a case against the clearing firm did not control. In that regard, the Second Circuit noted, if the merits of the complaint had been examined in *Levitt*, it would have gone a step further. Accordingly, and once again, the Second Circuit affirmed the dismissal of the claims against Bear for its clearing activities in *Fezzani* with ease.

The court began by noting the plaintiffs' argument that because the complaint in *Fezzani* contained allegations that "Bear Stearns assumed control over and sent Bear employees to Baron to 'enforce that control'" and required that every trade ticket be checked and "reviewed every order at this discretion [to] determine whether to execute the trade"—which were "substantially identical" to the factual allegations found sufficient in *Berwecky* and cited in *Levitt*—the court was compelled to sustain the complaint. However, the court noted the difference in the procedural posture of *Levitt* and *Berwecky* from that in the case before it. Neither of those went to the merits of the claim, the motion to dismiss in *Fezzani* did.[35]

[35] The Court observed:

> [*Levitt*] was decided entirely in the context of determining only whether a class was properly certified under Fed. R. Civ. P. 23(b)(3) and not whether the factual allegations were sufficient under Rule 12(b)(6). Indeed, *Berwecky* was itself a district court decision under Rule 23(b), and the issues regarding the legal sufficiency of the allegations were never finally determined. …
>
> The issues regarding the sufficiency of the pleadings under Rule 12(b)(6) are quite different from those regarding certification of a class pursuant to Rule 23(b)(3). Whereas the Rule 12(b)(6) inquiry goes to the merits, the Rule 23(b)(3) issue is whether "law or fact questions common to the class predominate over questions affecting individual members." *In re Initial Pub. Offerings Sec. Litig.*, 471 F.3d 24, 32 (2d Cir. 2006). … "Rule 23 grants courts no license to engage in free-ranging merits inquiries at the certification stage. Merits questions may be considered to the extent —but only to the extent—that they are relevant to determining whether the Rule 23 prerequisites for class certification are satisfied."

Turning to the substantive allegations in the complaint before it, the Second Circuit held that Bear Stearns' conduct as alleged in the Amended Complaint in *Fezzani* was not sufficient to state a claim for relief under Section 10(b) and Rule 10(b)-5. While the Amended Complaint alleged in "conclusory fashion that Bear Stearns asserted 'control' over Baron's trading activity, it fail[ed] to allege facts showing how this 'control' related to fabricating 'market' prices of particular securities and communicating them to customers or to manipulating prices with regard to any particular securities."[36] The Second Circuit also rejected the plaintiffs' contention that Bear's alleged knowledge of the wrongdoing required Bear to cease clearing. "Appellants allege that Bear Stearns was aware of the manipulations, knew that these manipulations were leading to a crisis, but continued to clear trades that did not involve unnecessary exposure to itself. ***Knowledge alone, however, is not enough to attach liability to a clearing broker under Section 10(b)***."[37]

The weight of authority from the past few years adheres to the now well-established principle of law: a clearing broker, engaged in its routine clearing functions, is performing merely ministerial tasks and may not be found liable for the wrongdoing of an introducing broker. In *Frezzani*, the Second Circuit again confirmed that the law respects the allocation of duties provided for in the clearing agreement.

IV. Commentary on What's Next

In today's landscape, industry regulators are more informed than ever. Under the changes to the clearing firm rules, regulators are involved in the due diligence reports when a new

> Therefore, *Levitt*'s comment on *Berwecky* ***at most*** held that Bear Stearns' alleged "control" of Baron was "sufficient to satisfy Rule 23(b)(3)'s predominance requirement."

Id. at 569-70 (emphasis added).

[36] 777 F.3d at 570.

[37] *Id.* (emphasis added here) (citing *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 102 (2d Cir. 2007)).

correspondent is brought on board and are provided with the proposed clearing agreement, which then requires their approval. Regulators are also given the list of reports annually chosen by the introducing firms from the menu offered by the clearing firm. From that data, regulators can assess whether the introducing firms are asking for the reports they should be reviewing and then, from their examinations, can test whether the introducing firms are properly using the data they receive. Also, by receiving customer complaints from the clearing firms, the regulators can cross-check them with reports from the introducing firms for completeness and to ensure that the complaints are addressed.

Similarly, the introducing firm is provided with tools to do its job. The variety of reports offered—and the capabilities of generating customized reports for the particular needs of an introducing firm—have improved the in-house compliance efforts of the introducing firms immensely. The proper entities are equipped to ferret out wrongdoing.

These developments are consistent with the law, the business structures and relationships of clearing firms and introducing firms. Indeed, in *Fezzani*, the Second Circuit expounded on the policy reasons supporting Rule 382's allocation, and not mere delegation, of duties imposed on each party and the end customers—and the attendant limitations of liability on clearing firms for introducing brokers' misconduct. The Second Circuit aptly reasoned that even though the regulatory scheme and the law refuses to hold clearing brokers liable for the trading activities of its introducing firms, there are safeguards still in place. "Moreover, there are legitimate reasons for clearing brokers to monitor the trading activities of some introducing brokers. A clearing broker guarantees the performance of buyers and sellers of the securities being traded and often extends credit to clearing brokers. Indeed, the complaint states that Baron was in deep debt to

Bear Stearns, reason enough to monitor Baron's activities."[38] In other words, clearing firms will be looking at certain activities of introducing firms, not because the law requires that they do so, but because they have their *own* economic, reputational or other risks at issue. This business-driving perspective provides an added layer of oversight—albeit, from a different perspective. But, it is not one based on a duty to third parties.

Unless the clearing firm is directing or initiating it, a customer-facing introducing firm's conduct is not the responsibility of the clearing firm. Clearing firms are not the monitors of their introducing broker dealers. The Second Circuit in *Fezzani* accurately captured the serious ramifications that would be felt in the financial services industry should clearing firms be deemed the overseer of their introducing firms—and exposed to liability for failure to satisfy these heightened duties—even where they did not "direct" or "instruct" the fraud at issue:

> There is a real danger of harm to the financial industry in allowing such allegations to suffice to subject clearing brokers to the cost of discovery and perhaps a trial even though there is no evidence of participation by the brokers in the fraud or manipulation. The potential of such litigation would deter clearing brokers from engaging in normal business activities—guaranteeing performance, extending credit, and therefore often monitoring the financial condition of introducing brokers—and drive up costs of trading generally. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlant*a, 552 U.S. 148, 163-64, 128 S. Ct. 761, 169 L. Ed. 2d 627 (2008) ("extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies," and because "contracting parties might find it necessary to protect against these threats, [this may] rais[e] the costs of doing business" and "[o]verseas firms … could be deterred from doing business" in United States security markets.).[39]

Accordingly, despite a few outlier cases, a disciplined and careful application of the test regarding whether a clearing firm "crosses the line" and "sheds its clearing firm role" should yield predictable results. Furthermore, with the additional tools given to both the regulators and to the introducing firms themselves to help the introducing firms perform properly and the

[38] *Fezzani*, 777 F.3d at 570.
[39] *Id.*

regulators to monitor more effectively, there are less reasons to push the envelope for expansion of the duties of clearing firms.

In any event, so long as the courts continue to respect and recognize the industry's self-regulation and the parties' allocation of duties—and do not impose new duties, with wide-ranging ramifications—there should be clarity and uniformity. Where a clearing firm is performing its normal, ministerial tasks, it is both clear—and just—that it should not be liable for the misconduct of its correspondents. And that is as it ought to be.

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Clearing Arrangements - Revisited

By *Henry F. Minnerop**

Introduction

Clearing brokers are subject to a uniform standard of conduct, a standard rooted in a framework of SEC rules and SEC approved industry (SRO) rules issued in 1982. In deference to this federal regulatory framework, the drafters of the Uniform Securities Act of 2002 (USA 2002)[1] sought to harmonize federal and state norms of clearing broker liability, stating that "the performance by a clearing broker of the clearing broker's contractual functions - - even though necessary to the processing of a transaction - - without more would not constitute material aid or result in in liability…."[2] However, in 2006, the Kansas Supreme Court in *Klein v. Oppenheimer*[3], rejected this harmonization under the Kansas Securities Act (K.S.A.), ruling that the clearing broker, performing ordinary and routine functions under a standard clearing agreement,"materially aids" its introducing broker's primary violation of selling unregistered securities to its introduced customers [4] The court further held that the clearing broker may escape liability only under the K.S.A. by proving that it "did not know, and in the exercise of reasonable care could not have known of the existence of the facts" constituting the primary violation of its

1 Uniform Securities Act of 2002.
2 Official Comment 11 to USA (2002), section 509(g)(4). This section corresponds to the Uniform Securities Act of 1956, section 410(b) on which K.S.A. 17-1268(b) is based.
3 130 P. 3d 569 (Kan. 2006).
4 *Klein*, 130 P. 3d at 588.

introducing firm.[5] As will be discussed in this article, the decision of the Kansas Supreme Court in *Klein* undermines the uniform regulation and liability of clearing brokers within the federal regulatory framework and presents the securities clearing industry with a significant risk management dilemma.

- A -

An Overview of Clearing Relationships[6]

Clearing arrangements and clearing brokers are integral parts of the securities industry and the national securities markets. Approximately 90% of all broker-dealers registered with the SEC engage clearing brokers.[7] Although these broker-dealers, called "introducing brokers," are often small in size, they represent collectively a significant percentage of daily trading volume.[8] The total number of introducing brokers in the United States has risen from 564 firms in 1975[9] - a seminal year in the development of the clearance and settlement system in the United States - to 4,664 in 2008[10], the last year for which relevant SEC data appears to have been published.

This large increase in the number of introducing firms - more than 800% over 30 years - was the direct result of Congressional legislation and SEC regulation designed to facilitate the establishment of a robust and efficient clearing and settlement system in the wake of the so-called "Paper Crunch" of 1967-70, a crisis caused by an increase in trading volume that over-

5 *Id.*

6 This section of this article is largely based on the author's article, *Clearing Arrangements*, 58 Bus. Law 917, 917 - 925. (2003).

7 According to the SEC's "Select SEC and Market Data, Fiscal 2009" (which appears to be the most recent data available) there were in 2008 a total of 4,708 broker-dealers doing business with the public and registered with the SEC, 514 of which were self-clearing and (by inference) the balance, 4,664, utilized clearing brokers. *See* SEC Website: http://www.sec.gov./about.shtml.

8 Bear, Stearns Securities Corp. a clearing broker acquired by J.P. Morgan Securities, reported an estimated 12% share of NYSE trading volume in 2000. See *The Bank of New York Acquires SG Cowen's Clearing Business*, Sec..Wk. Feb. 7, 2000 at 3.

9 Henry F. Minnerop & Hans R. Stoll, *Technological Change in the Back Office: Implications for Structure and Regulation of the Securities Industry*, *in* Technology and Regulation of Financial Markets 31 at 40 (Anthony Saunders & Lawrence J. White, eds. 1986).

10 *See supra* note 7.

whelmed the largely manual clearance and settlement system of the time, causing numerous NYSE member firms to go under and resulting in massive customer losses.

(i)

Before describing the respective roles of clearing and introducing firms it is be helpful to identify the functions generally involved in the operation of a typical securities account:

1. Soliciting, opening, approving, and monitoring of customer accounts;
2. Providing investment recommendations or accepting customer orders;
3. Executing customer orders;
4. Extending credit to customers in margin accounts;
5. Providing written confirmations of executed orders to customers;
6. Receiving or delivering funds or securities from or to customers;
7. Maintaining books and records that reflect executed transactions, including rendering monthly or periodic statements of account to customers;
8. Providing custody of customer funds and securities; and
9. Clearing and settling transactions effected in customer accounts.[11]

A brokerage firm that performs each of these functions *within its own organization* is called a "self-clearing" firm. Large broker-dealers, such as Morgan Stanley, Goldman Sachs and Merrill Lynch—to mention but a few—tend to be self-clearing firms. Other brokerage firms, often small in size and called "introducing" brokers, often outsource to "clearing brokers" those functions which they themselves are operationally or financially unwilling or incapable of performing within their own organizations.

In entering into clearing agreements, introducing brokers uniformly retain all customer contact and sales related functions (Functions 1 and 2) and often execute their customers' orders

[11] Most of these functions were enumerated in New York Stock Exchange ("NYSE") Rule 382, and NASD Conduct Rule 3230.Since the merger of the respective regulations departments of the NYSE and the NASD into the Financial Industry Regulatory Authority ("FINRA") in 2007, these NYSE and NASD Rules have been merged into FINRA Rule 4311, effective as of August 1, 2011.

themselves ("away" from their clearing firm) (Function 3),[12] and out-source the balance of all necessary functions (*e.g.*, Functions 4-9) to their clearing brokers. These out-sourced functions, performed by their clearing broker, are collectively called "back-office" functions to distinguish them from customer contact "front-office" functions performed by introducing brokers.

Out-sourcing back-office functions offers substantial economic advantages to introducing brokers. Specifically, out-sourcing avoids the need of introducing brokers to invest in and maintain expensive back-office operations to process their customers' transactions. Out-sourcing also enables introducing brokers to pay for back-office services out of their current revenue stream, allowing them to manage their cost of doing business in line with prevailing business conditions.[13]

The specific allocation of functions between an introducing broker and its clearing broker is largely determined by the business needs of the introducing firm and the scope of services offered by the clearing firm,[14] although customer-contact functions are uniformly retained by the introducing firm.[15] The party, be it the introducing firm or its clearing broker, to whom a specific function has been allocated in their clearing agreement, has full and exclusive regulatory responsibility for its performance and supervision.[16] Thus, the retention of all customer-contact

[12] With advances in electronic communication, the trend has been for introducing firms to execute their own and their customers' orders directly ("away") from their clearing firm.

[13] Introducing firms also benefit from lenient net capital requirements. See, discussion *infra* at pp. 19-20.

[14] The terms "introducing broker" and "introducing firm" are used interchangeably in this article. Similarly, the terms "clearing broker" and "clearing firm" are also used interchangeably.

[15] NYSE Rule 382 listed the functions and responsibilities that clearing agreements were required "at a minimum" to address and allocate between the introducing and clearing firms. See, NYSE Rule 382(b). NASD Rule 3230, which was substantially identical with NYSE Rule 382, applied to the clearing agreements of clearing firms that were only NASD members. Both rules were merged and harmonized into FINRA Rule 4311 in 2011, following the merger of NYSE and NASD in 2007.

[16] NYSE Interpretation Handbook, Rule 382/03 provides:

EACH ORGANIZATION WILL BE ACCOUNTABLE FOR ACTUAL PERFORMANCE OF ALL FUNCTIONS PERFORMED BY EMPLOYEES AND OTHER ASSOCIATED PERSONS AS WELL AS FOR OVERALL SUPERVISION OF FUNCTIONS AND ACTIVITIES PERFORMED BY IT PURSUANT TO ANY CARRYING AGREEMENT.

TO THE EXTENT THAT A PARTICULAR FUNCTION IS ALLOCATED TO ONE OF THE PARTIES, THE OTHER PARTY IS

functions by the introducing firm (*e.g.* soliciting customer accounts, determining the customer's investment objectives, and recommending transactions in accord with such objectives) gives it full and exclusive regulatory responsibility for the sales practices of its brokers. Conversely, the clearing firm has no regulatory duty to supervise its introducing firms or monitor the sales practices of the brokers employed by them..

There are two types of clearing agreements, namely, "fully disclosed" and "omnibus", the former being by far the more common form of agreement. The clearing firm is required to submit its standard form of clearing agreement, in both categories, to FINRA for approval and may enter into subsequent clearing arrangements "without the re-submission and re-approval of its template form of agreement."[17] The clearing firm is required "to submit to FINRA for approval any material changes to an approved [clearing] agreement before such changes may become effective."[18]

Under a fully disclosed clearing agreement, the introducing firm discloses to its clearing broker the identity of each of its customers whom it wishes to introduce.[19]. The clearing firm establishes on its books and records an account in the name of the introduced customer and "carries"—a term of art—the customer's account with its own net capital under the agreement.[20]

TO SUPPLY THAT FIRM WITH ALL APPROPRIATE DATA IN ITS POSSESSION PERTINENT TO THE PROPER PERFORMANCE AND SUPERVISION OF THAT FUNCTION. THE AGREEMENT SHOULD ACKNOWLEDGE THIS OBLIGATION.

17 FINRA Rule 4311(b)(2*).* Prior to the merger of NYSE and NASD Regulation in 2007 each individual clearing agreement was required to be filed with and approved by the NYSE or NASD under former NYSE Rule 382 or former NASD Rule 3230.

18 FINRA Rule 4311 (b)(1).

19 An introducing firm is free to hire more than one clearing broker or engage in business activities directly with their customers, introduced or not, that do not require the services of a clearing broker. A clearing broker should be aware of all business activities of the introducing firm at the outset of the clearing relationship, including those activities that will not be covered by the clearing agreement and as to which the clearing firm provides no or only incidental services.

20 "Carrying" is a term of art under SEC regulations. A broker-dealer, whether self-clearing or clearing for others, is said to "carry" all customer accounts subject to SEC net capital and financial responsibility rules. In a nutshell, a "carrying" broker is required to possess specified levels of net capital in relation to the value

All introduced customers are required to be notified in writing at the account opening stage of "the existence of the carrying [clearing] agreement and the responsibilities allocated to each respective party" and , thereafter ,"of any material change … to the allocation of responsibilities" under the agreement.[21]

(ii)

Customers

Introduced customers are solicited and serviced by the financial advisers of the introducing firm. All introduced customers are provided with notice at the opening of their accounts that their accounts will be introduced to a designated clearing firm and that certain responsibilities with respect to the operation of their accounts have been allocated between the introducing and clearing firms. The notice also typically states that "the customer authorizes the clearing firm to accept instructions and orders from the introducing firm for the customer's account without inquiry or investigation, unless the clearing firm receives written prior notice from the customer to the contrary."[22] Any customer who does not wish to have its account introduced to the designated clearing broker may decline to open an account or request that the account be transferred to another brokerage firm the customer's choice.[23]

of customer assets in its custody. *See* Securities and Exchange Commission Net Capital Rules, 17 C.F.R. § 240.15c3-l.

21 FINRA Rule 4311(d).

22 *In re Bear, Stearns Secs. Corp*., Exchange Act Release No. 41,707, 1999 SEC LEXIS 1551, at *15–16 (Aug. 5, 1999)(emphasis added). The quoted language may also be part of an agreement between the introduced customer and the clearing firm relating, for example, to any cash or margin account in the customer's name.

23 When an introducing firm changes clearing firms, its customer accounts are transferred as a group ("tape-to-tape") to the new clearing firm. This transfer does not require the affirmative consent of introduced customers, but each introduced customer, upon notice of the impending transfer, may affirmatively opt out of the transfer and direct the current clearing firm to transfer her account to another brokerage firm of her personal choosing. All customers who do not affirmatively object are deemed to have given their "negative" consent to the transfer. The current clearing firm itself has no right, contractual or otherwise, to retain any of the introducing firm's customers.

There are two regulatory exceptions to the general proposition that introduced customers are the customers of the introducing firm:

- First, introduced customers are deemed to be customers of the clearing firm under the Securities Investors Protection Act of 1970 (SIPA).[24] That Act provides insurance with respect to the funds and securities in customer accounts in the event of the clearing firm's insolvency.[25]

- Second, introduced customers are deemed to be the customers of the clearing firm under SEC financial responsibility and net capital rules. Under those rules, all clearing brokers are required (1) to maintain certain minimum levels of net capital in relation to the market value of securities and funds held in introduced accounts[26] and (2) to segregate funds in introduced customer accounts from funds in the clearing firm's proprietary accounts.[27]

(iii)

Introducing Firms

Introducing firms come in many shapes and sizes, covering a wide spectrum of business activities, extending from retail brokerage to underwriting newly issued securities and making over-the-counter markets in such securities.[28]

[24] 15 U.S.C. §§ 78aaa *et seq*.

[25] The SEC Division of Market Regulations has noted that:
[IT] HAS INTERPRETED THE NET CAPITAL RULE AND RULE 15C3-3 TO REQUIRE THAT, FOR THE PURPOSES OF THE COMMISSION'S FINANCIAL RESPONSIBILITY RULES AND SIPC, THE INTRODUCING FIRM'S CUSTOMERS SHOULD BE TREATED AS CUSTOMERS OF THE CLEARING FIRM. . . FURTHERMORE, THE CLEARING FIRM MUST ISSUE ACCOUNT STATEMENTS DIRECTLY TO CUSTOMERS. EACH STATEMENT MUST CONTAIN THE NAME AND TELEPHONE NUMBER OF A RESPONSIBLE INDIVIDUAL AT THE CLEARING FIRM WHOM A CUSTOMER CAN CONTACT WITH INQUIRIES REGARDING THE CUSTOMER'S ACCOUNT. FINALLY, THE ACCOUNT STATEMENT MUST DISCLOSE THAT CUSTOMER FUNDS OR SECURITIES ARE LOCATED AT THE CLEARING BROKER-DEALER, AND NOT THE INTRODUCING FIRM. Exchange Act Release No. 31,511, 1992 Fed. Sec. L. Rep. (CCH) ¶ 85,064 at 83,571 (footnote omitted).

[26] 17 C.F.R. § 240.15c3-1. (This requirement applies equally to accounts carried by self-clearing firms.)

[27] 17 C.F.R. section 15c3-3. (This requirement also applies equally to accounts carried by self-clearing firms.)

[28] The SEC Division of Market Regulation has described introducing firms as follows:
AN INTRODUCING BROKER-DEALER IS ONE THAT HAS A CONTRACTUAL ARRANGEMENT WITH ANOTHER FIRM,

Introducing firms solicit prospective customers, approve the opening of new accounts, determine their customers' investment objectives, and make recommendations based on those objectives. All customer-related data (*e.g.*, name, address, social security number, investment experience, investment objectives, age, income, and net worth) are gathered by personnel of the introducing firm.[29]

Introducing firms are registered as broker-dealers with the SEC and are required to be members of the Financial Industry Regulatory Authority ("FINRA"). They are required to register with FINRA all senior members of their management as "principals" and all of their financial advisers as "registered representatives." In addition, introducing firms and their registered representatives are required to be registered with each state in which they do business. As registered SEC broker-dealers and FINRA members, introducing firms are required to maintain written compliance procedures and employ compliance staff to monitor and supervise the conduct of their registered representatives and are subject to regulatory examination and inspection by the SEC and FINRA.

(iv)

Clearing Firms

Clearing firms are hired by introducing firms to provide "back-office" services, a term that encompasses all functions performed in connection with a securities transaction *after* an or-

> KNOWN AS THE CARRYING OR CLEARING FIRM, UNDER WHICH THE CARRYING FIRM AGREES TO PERFORM CERTAIN SERVICES FOR THE INTRODUCING FIRM. USUALLY, THE INTRODUCING FIRM SUBMITS ITS CUSTOMER ACCOUNTS AND CUSTOMER ORDERS TO THE CARRYING FIRM, WHICH EXECUTES THE ORDERS AND CARRIES THE ACCOUNT. THE CARRYING FIRM'S DUTIES INCLUDE THE PROPER DISPOSITION OF THE CUSTOMER FUNDS AND SECURITIES AFTER TRADE DATE, THE CUSTODY OF CUSTOMER SECURITIES AND FUNDS, AND THE RECORDKEEPING ASSOCIATED WITH CARRYING CUSTOMER ACCOUNTS.
>
> EXCHANGE ACT RELEASE NO. 31,511, 1992 FED. SEC. L. REP. (CCH) ¶ 85,064 AT 83,569 (NOV. 24, 1992).

[29] A clearing firm may store - usually electronically - customer data as custodian of records for the introducing firm. The clearing firm's role as custodian does not require it to examine the records or monitor or supervise the introducing firm's conduct with respect to any customer account. See, discussion, *infra*, at note **[..]**

der to buy or sell a security has been authorized by an introduced customer and accepted and entered for execution by the introducing firm. Clearing firms do not recommend the purchase or sale of any security, nor do clearing firms participate with their introducing firms or otherwise in determining the suitability of any recommendations to any introduced customer.[30]

Back-office functions involve the execution of orders to buy or sell securities per instructions of the introducing firm and the clearance and settlement of the transactions "street-side" at the National Securities Clearing Corporation (NSCC). Back-office functions also may include the financing of purchases of securities for customer margin accounts[31] and conclude generally with the clearing firm's issuance of trade confirmations and the receipt of customer funds by the clearing broker for "customer-side" settlement of all executed trades.[32] At the end of each month, the clearing firm issues a monthly statement of account to each introduced customer, summarizing all transactions effected in the customer's account during that month.[33]

Back-office functions generally fully automated and computerized and conducted or performed electronically. For example: upon being entered ("key-stroked") into an order entry system by the introducing firm, an order to buy or sell a security is transmitted to a designated secu-

30 As part of the services, clearing firms may offer to distribute securities research reports to their introducing firms. Such reports, usually prepared by third-party research firms, are generic in nature and are not intended to furnish investment advice to any particular introduced customer. In addition, clearing firms may [**add**

31 The terms of the margin account, including a schedule of interest charges, are reflected in the margin agreement between the clearing firm and the customer. Margin accounts are electronically coded to determine in how much margin credit may be extended initially at the time of a margin transaction and thereafter while the a margin loan is in place and may generate a margin maintenance call in the account. Margin account terms are generally not negotiated or determined at the time of the trade, but, rather, in advance when the account is established.

32 While clearing firms always prepare trade confirmations, introducing firms may transmit them to their customers to facilitate the prompt delivery of confirmations to customers so as to enable them to meet their settlement obligations by settlement date. All confirmations reflect the names of both the clearing firm and the introducing firm.

33 Clearing firms are required to transmit monthly statements to customers directly - - not via their introducing firms. Monthly statements are required to provide the clearing firm's conduct information to enable introduced customers to inquire as to the data reported in the statement. However, any customer inquiry , for example, as to the reasons for a particular trade reported in the statement, are generally referred to the customer's introducing firm.

rities exchange or market for execution. Immediately upon execution, the trade details of the (now) executed order (*e.g.*, execution price, number of shares bought or sold) are forwarded to the NSCC for "street-side" clearance and settlement. Similarly, the trade details of the executed order are routed back to the clearing firm, which forwards the data to its introducing firm. The clearing firm then generates a confirmation for "customer-side" settlement with the introduced customer. The details of the completed transaction are recorded and stored in the books and records of the clearing firm. The introducing firm has "remote" electronic access to these records at all times.

The steps involved in the execution, clearance and settlement of a particular trade take only seconds to complete from the time the order is entered into the order entry system to the time that the clearing firm is able to generate the confirmation of the trade. These steps are repeated in rapid succession thousands upon thousands of times for each separate transaction throughout the trading day. No order - once entered into the order entry system - is touched by human hands or subjected to personal scrutiny by the clearing firm. Nor could it be otherwise in the context of trading volumes of millions of shares per clearing firm per day.[34] Any restrictions or limitations on transactions in any introduced account - such as the amount of margin credit available to the account - are imposed by the clearing firm in advance of the entry of any order as part of the clearing firm's risk management policy.[35]

[34] Bear, Stearns, one of the largest clearing brokers in its day, reportedly cleared "an estimated 12% of all NYSE trades". *The Bank of New York Acquires SG Cowen's Clearing Business.* Sec. Wk. Feb. 7, 2000 at 3.

[35] The Risk Management Functions of the Automated Confirmation Transaction Service ("ACT") provide for a 15 minute halt in the processing of transactions executed by an introducing firm "away" from its clearing firm in Nasdaq National Market and Nasdaq SmallCap securities and other OTC securities if the market value of the transaction exceeds $1million or exceeds the daily credit limit established by the clearing firm for the introducing firm that executed the trade. Upon being notified of the $1 million trade or the violation of the credit limit, the clearing firm has a 15 minute window to decline to clear the trade. If the clearing firm does not act within the allotted 15 minutes, it is required to clear the trade "street-side."NASD Rule 6150(f) and (g). ACT does not apply to transactions on the NYSE or any other securities ex-

(v)

Risk Management Practices of Clearing Firms

A clearing firm faces financial risk in all transactions that it clears. Even in customer cash accounts, the clearing firm incurs financial risk because its settlement obligations "street-side" are independent of its receipt of funds or securities "customer-side" with respect to any particular transaction. In the context of margin lending, the clearing firm's risk lies in the potential decline of the market value of the margin collateral in the customer's account below the amount of the margin loan. Similarly, in the context of short sales, the clearing firm's risk is in the potential limitless increase in market value of the security sold short for a customer's account because the security sold short may have to re-purchased by the clearing firm to cover the short position. To guard against these risks, the clearing firm monitors all open short securities positions and may demand additional margin collateral (i.e., margin maintenance) from introduced customers to protect against any heightened risk.

Although a clearing firm's various financial risks are conceptually addressed by its introducing firm's promise of indemnification in the event of a customer's default or losses suffered because of the introducing firm's own conduct or omission, that promise is only as good as the continuing financial strength of the introducing firm.[36] As a result, the clearing firm engages in substantial due diligence of the introducing firm before entering into a clearing agreement and during the term of the agreement. In addition, clearing agreements generally provide for a substantial cash deposit by the introducing firm to assure payment under the indemnification provision. This deposit may be adjusted - up or down - during the term of the clearing agreement.

change.Moreover, clearing firms frequently permit all or some of their introducing firms to by-pass the ACT system.

[36] Clearing agreements generally provide that the introducing firm shall indemnify the clearing firm for all losses resulting from the introducing firm's own conduct or omissions and from its customers' defaults in, for example, meeting their payment or other obligations to the clearing firm as introduced customers.

Further, as a condition of entering into a clearing agreement, a clearing firm may require its introducing firms to maintain net capital at a level higher than the minimum required by the SEC's net capital rule. Clearing agreements usually provide that a clearing firm may reject a particular account[37] or decline to execute a particular customer order.[38] These contractual safeguards are intended to protect the clearing firm from introduced customers with a history of failed payment obligations (e.g., "wooden tickets"). Finally, a clearing firm may terminate the clearing agreement for cause. Such termination may be the clearing firm's ultimate and last measure of risk management[39].

Clearing firms are required to conduct due diligence of introducing firms as a matter of industry regulation before entering into a clearing agreement with them[40]. The focus of this due diligence is two-fold:

[37] A clearing firm will generally check the credit history of a proposed new account.

[38] The contractual right to decline a particular trade, found in many standard clearing agreements, is of little practical value to the clearing firm where its introducing firm to permitted to execute transactions "away" from the clearing firm. Once the trade is executed, the clearing firm is generally in no position to cancel its "street-side" settlement obligations.

Where, in the unusual case, the clearing firm has no "street-side" settlement obligations with respect to an executed trade, it may cancel the entire trade. See *In re Adler, Coleman Clearing Corp.*, 218 B.R. 689, 708–09 (Bankr. S.D.N.Y. 1998). There, the clearing firm was able to cancel trades between its introducing firm and the latter's customers. The introducing firm had sold the securities as principal from its own proprietary account at the clearing firm directly to its customers. The customers alleged fraud and refused to pay for their purchases. No "street-side" counter-parties being involved in any of the trades, the clearing firm was able to cancel the trades rather than pay its introducing firm in the absence of funds received from the customers.

[39] Standard clearing agreements permit either party to terminate the agreement for cause. In considering whether to terminate the agreement for cause, a clearing broker typically reviews all available potential evidence supporting termination provable in court or before an arbitration panel, rather than act on mere suspicion or vague and uncertain "red flags" that, in hind sight, may prove to to be "false positives." This careful consideration is advisable so as to successfully defend against any potential claim for breach of contract by the introducing firm which may have been put out of business or had its reputation impaired by the clearing broker's decision to terminate the clearing agreement.

[40] FINRA Rule 4311(b)(4) requires clearing firms to conduct due diligence of prospective introducing firms. All clearing firms also perform due diligence of their introducing firms during the term of their clearing agreements as a matter of prudent risk management.

- First, it requires clearing firms to familiarize themselves with securities product mix of prospective introducing firms to determine that they are operationally capable of clearing all contemplated transactions.
- Second, it requires clearing firms to assess whether the prospective introducing firm is likely to honor its financial commitments to the clearing firm. In that context the clearing firm generally reviews the financial statements of the introducing firm as well as the disciplinary history of the firm and its principals.

Both prongs of due diligence are designed to protect the financial and operational viability of the clearing firm and the seamless and uninterrupted operation of the clearing and settlement system as a whole. Any failure on the part of any particular clearing firm - whether the result of inadequate due diligence or for any other reason - has the potential of cascading failures of settlement obligations by other clearing firms[41]. While introduced customers may incidentally benefit from due diligence conducted by a clearing firm - whether conducted prior to or during the term of a clearing agreement - the sole focus of the clearing broker's due diligence is to protect its own capital and financial vitality.[42]

[41] Clearing firms have been forced into SIPA liquidation when one of their introducing firms defaulted on its commitments to them. See *Mishkin v. Ensminger (In re Adler Coleman Clearing Corp*.) 218 B.R.689 (Bankr. S.D.N.Y. 1998) and *Maple USA, Inc. v. Stephenson (In re MJK Clearing*) 286 B.R. 862 (Bankr. D. Minn 2002).

[42] Clearing firms owe no fiduciary duty to introduced customers and, thus, are under no obligation to introduced customers to (i) conduct due diligence of their introducing firms or (ii) to disclose to introduced customers any information or "red flags" or internal concerns they may have as a result of their due diligence efforts or otherwise or (iii) to take any action or to omit to take any action in response to the above for the benefit of introduced customers.While certain due diligence is required of clearing firms under FINRA R. 4311(b)(4), customer do not have a private right of action against clearing firms their breach of that or any other SRO rule. Similarly, a clearing broker, conducting an anti-money laundering inquiry pursuant to its obligation under various bank secrecy or anti-money laundering laws and regulations, has no duty to share any suspicious activities that it may become aware of with anyone other than the U.S. Government. **[Cite]** Along the same lines,while a clearing broker is required to adhere to the various margin requirements of the Federal Reserve Board when extending credit to introduced customers in margin accounts, a breach of

Clearing firms are links in a chain of participant/members of the NSCC, the central clearing house of the securities markets in the United States.. The rules of the NSCC provide that the NSCC shall become the principal of every transaction submitted to it, that is to say, it becomes (i) the buyer to every seller and (ii) the seller to every buyer.[43] This assumption of counter-party risk in every transaction submitted to NSCC is designed to prevent the potential domino effect of failed settlement commitments by one or more participant/members of NSCC. Such settlement failures could destabilize the entire clearance and settlement system. NSCC rules provide that all participant/members are required, *pro rata*, to make NSCC whole in the event that a participant/member becomes insolvent or is otherwise defaults on its commitments within NSCC

- B -

Regulatory Framework of Clearing Brokers[44]

The evolution of the modern clearing industry may be traced to Congress' response to the "Paper Crunch" crisis of 1967-1970, a period that was described by the SEC at the time as "the most prolonged and severe crisis in the securities industry in forty years."[*i.e.*, since the 1929 stock market crash].[45] At the heart of the crisis was the nearly total failure of the clearance and settlement system in use at the time, a system that was decentralized and largely manual, and that proved to be incapable of processing an increase in trading volume starting in 1967. This was a time when "[b]rokers still exchanged physical certificates and checks for each trade, while hun-

that duty is not actionable by the margin account holder. See, *e.g. Cromer Finance Ltd. v. Berger,* 137 F. Supp. 2d 452, 471-472 (S.D.N.Y. 20011).

43 NSCC Rule 11, Secs. I(b), (c), (e); Procedure VII(A). *See,* also, *Mishkin v. Ensminger (In re Adler Coleman Clearing Corp.*), 247 Bankr. S.D.N.Y 1999).

44 This section of this article is based in part on the author's prior article, *The Role and Regulation of Clearing Brokers,* 48 Bus. Law.841 (1993)

45 Letter of SEC Chairman to Congress, December 28, 1971 (transmitting and summarizing the SEC's Study of Unsafe and Unsound Practices of Brokers and Dealers). House Doc. No.92-231, 92 Cong.,1st Sess [Dec. 1971], p. 1.

dreds of messengers scurried through Wall Street clutching bags of securities and checks."[46] During the height of the crisis, the NYSE was forced to curtail its trading hours and close the exchange entirely on Wednesdays as brokerage firms struggled to process an increase in trading volume. The severity of the crisis, now a distant memory, is hard to exaggerate. Approximately 160 NYSE member firms closed their doors, 80 through merger and another 80 permanently.[47] The impact on the investing public was equally severe. Customer records were massively incomplete and inaccurate, failing to reflect customer securities and cash positions correctly, if at all.

Congress responded in 1975 by amending the Securities Exchange Act of 1934 (the '34 Act) after finding that "[t]he prompt and accurate clearance and settlement of securities transactions . . . are necessary for the protection of investors . . . ."[48] Congress directed the SEC "[t]o facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities. . . ."[49] Significantly, the 1975 amendments to the '34 Act marked "the first time" that Congress entered this area of inter-state commerce, charging the SEC with "regulating the securities transfer and clearing process, a subject previously left to state law."[50]

Mandated by Congress, the SEC took a number of steps that led to the development of the clearance and settlement system now in place. The success of this effort was and continues to be dramatic. While an increase in trading volume from an average of 10 *million* to 12 *million* shares per day to 14 *million* to 15 *million* shares per day had thrown Wall Street into crisis in

46 *How We Serve the Financial Services Industry,* The Depository Tr. & Clearing Corp. Capabilities Brochure (DTCC, New York, N.Y.) 2000, at 9

47 *See* Loss & Seligman, VI Securities Regulation 2897-907 (3d ed. 1999). The Congress created the Securities Investors Protection Corporation ("SIPC") in 1970 to afford some protections against loss by investors resulting from broker-dealer failures.

48 Exchange Act of 1934, § 17A(a)(i).

49 Exchange Act of 1934, § 17A(a)(2)(A) (i).

50 Loss & Seligman, VI Securities Regulations p. 2897 (3d ed. 1990) (emphasis added).

1967[51], the securities clearing industry today settles and clears over 2 *billion* (with a "b") shares per day and does so routinely and accurately during a shorter settlement cycle.[52]

The cap-stones of the new clearance and settlement system were set under the guidance of the SEC shortly before the 1975 amendments, they are: (i) the Depository Trust Company (DTC) established in 1973 and (ii) the NSCC) formed in 1974.[53] The DTC provided, for the first time, a central depository for virtually all securities traded in the United States and developed a system to immobilize the transfer of securities which ended the need for the physical transfer of certificates from seller to buyer after each trade. Working in tandem with DTC, the NSCC instituted its Continuous Net Settlement (CNS) System in 1974 which allowed for the multilateral (rather than the formerly bi-lateral) netting of securities transactions during trading hours. Under the CNS Systems, all *purchase* transactions submitted to NSCC during the trading day are aggregated and netted against all *sale* transactions submitted to NSCC in the same securities during the course of the same trading day, thus eliminating the need for one-on-one bilateral "street-side" settlements between opposite clearing brokers after each trading day. With multilateral netting completed by NSCC at the end of the trading day, the data was transferred electronically to DTC which then adjusted the accounts of its participant/members to reflect their respective new net positions.Each participant/member maintained its own books and records for its own customers(including introduced accounts) and is able to correlate the aggregate positions in its DTC account with the securities positions in the accounts of its customers.

While the NSCC and DTC became the cap-stones of the new clearance and settlement system, clearing and self-clearing brokers - all of whom were required to become partici-

51 Joel Seligman, *The Transformation of Wall Street* p. 451 (3d Edition2003).

52 The NYSE and NASDQ reported a combined trading volume of over 2.5 billion shares for February 24, 2017. *See* Wall Street Journal, Section B-8 (Feb. 25, 2017).

53 DTC and NSCC are now the operating subsidiaries of the Depository Trust Clearing Corporation (DTCC).

pant/members of NSCC and DTC - provide the supporting walls of this system, their operational structure and standard business model being shaped decisively by three key SEC initiatives, each undertaken in response to Congress' mandate to facilitate the establishment of a new clearance and settlement system in the wake of the "Paper Crunch" crisis.. These initiatives were:

(1) The elimination of fixed brokerage commissions on May 1, 1975;[54]

(2) The adoption of the first industry-wide net capital rule on June 26, 1975;[55] and

(3) The approval of amendments to NYSE Rule 382 (clearing agreements) and NYSE Rule 405 (know -your-customer) on February 19, 1982.[56]

(i)

The Elimination of Fixed Commissions

On May 1, 1975, the SEC ordered the end of fixed brokerage commissions on the securities markets of the United States. To underscore the importance of this order, the date of the SEC's order, May 1st, became known as "May Day"[57], the international distress signal, to mark the beginning of the end for inefficient and sinking exchange member firms that had previously been shielded from competition by fixed commissions.

Prior to May Day, all exchange members, including members acting as clearing brokers for others, were required to charge fixed minimum commissions for all but the largest transactions involving public customers and non-member firms.[58] This requirement placed introducing firms—which were usually not exchange members—at a competitive disadvantage. To realize a

54 Exchange Act Release No. 11,203 (Jan. 23, 1975).

55 In 1972, the NYSE amended its Constitution to permit its clearing members to rebate up to 40% of the minimum commission required to be generally charged by NYSE members. NYSE Const. art. XV, § 2(h) (rescinded).

56 17 C.F.R. § 240.l5c3-1 (1992).

57 Loss & Seligman, Fundamentals of Securities Regulation 745 (2001).

58 Prior to the SEC's elimination of all fixed commissions on "May Day," the NYSE had gradually permitted its members to negotiate commissions for large transactions.

profit, these firms needed to charge an extra commission to their customers in addition to the exchange-mandated minimum charged by their clearing firms. [59]

The elimination of fixed commissions had two immediate consequences directly impacting the development of clearing arrangements: (i) non-exchange firms were now able to clear their trades through those exchange members that agreed to charge lower commissions and (ii) exchange members were now able to compete for the business of non-member firms by charging clearing fees that reflected their actual cost of processing trades rather than some fixed amount. In due course, a number of exchange member firms began to specialize in providing clearance and settlement services for non-member firms.

(ii)

Net Capital Rule

While the end of fixed commissions enabled exchange member firms to offer clearance and settlement services to non-members at competitive rates, the SEC's new uniform net capital rule, promulgated on June 26, 1975[60] encouraged the formation of new introducing firms and their entry into fully disclosed clearing agreements. It did so (i) by requiring only modest net capital for broker-dealers that introduced their customer accounts to a clearing firm and (ii) by requiring firms which wished to clear for other firms to have substantial net capital.[61] The in-

[59] Being unable to compete on the basis of commissions, NYSE member firms competed for the business of non-member firms via various work-around schemes involving reciprocal business arrangements with members of different exchanges and so-called "give-ups" that compensated non-members with the flow of other business.

[60] Exchange Act Release No. 11,497, 1975 Fed. Sec. L. Rep. (CCH) ¶ 80,212 (June 26, 1975) (codified at 17 C.F.R. § 240.15c3-1).

[61] The Net Capital Rule has been amended since its original adoption in 1975, but continues to provide for lenient net capital treatment of introducing firms. *See*, 17 C.F.R. § 240.15c3-1(a)(2). The current regulatory minimum net capital of introducing firms is, effectively, $50,000 although it is still possible to operate as an introducing firm with only $5,000 in net capital if the firm has no involvement with the receipt or delivery of customer assets at any point. Clearing firms may - and often do - contractually require higher amounts in their clearing agreements with introducing firms. The current minimum net capital for clearing firms is $250,000. The operative minimum net capital for any given clearing firm is computed by reference

centives offered by the new net capital rule led to the formation of numerous new brokerage firms throughout the country, their total number growing dramatically from 564 in 1975 to 4,664 in 2008.

(iii)

NYSE Rules 382 and 405

On February 19, 1982, the SEC approved amendments to NYSE Rule 382,[62] permitting clearing and introducing firms to contractually allocate between themselves responsibilities for the performance and supervision of functions related to transactions in introduced customer accounts. The Rule 382 amendments were approved by the SEC simultaneously with changes to NYSE Rule 405, the "know-your-customer" rule. Rule 405 had previously required NYSE member clearing firms to supervise their introducing firms as if they were branch offices of the clearing firm.[63] The continuation of that requirement could no longer be justified economically after May Day as exchange member clearing firms were no longer receiving the generous fixed

to the value of the assets (funds and securities) actually carried by the clearing firm for its introduced customers. Virtually all clearing firms have well in excess of the required minimum of $250,000 in net capital. The size of a clearing firm's net capital is critical to its ability to absorb and survive losses in the event of large customer defaults or massive fraud on the part of its introducing firms or their introduced customers. Thus, two mid-tier clearing firms, Adler Coleman Clearing Corp. and MJK Clearing, were forced into SIPC liquidation in 1995 and 2001 because of net capital deficiencies caused, in Adler's case, by a massive penny stock fraud by one of its introducing firms, *In re Adler Coleman Clearing Corp*., 198 B.R. 70 (S.D.N.Y. 1996) and, in MJK's case, by a massive stock loan default by one of its introduced customers, *SIPC v. MJK Clearing*, Adv. Proc. 01-4257 (D. Minn. 2001).

62 Order Approving Proposed Rule Change, Exchange Act Release No. 18,497 (Feb. 19, 1982). Under Section 19(b) of the '34 Act, as amended in 1975, a proposed SRO rule change must be filed with the SEC, along with "a concise general statement of the basis and purpose" of the proposed rule change. The SEC publishes notice of the new rule and gives interested parties an opportunity to comment. *See* Exchange Act Rule 19b-4. The rule change may not go into effect until approved by the SEC. *See* '34 Act § 19(b)(l). Under Sections 6(b)(5) and l5A(b)(6) of the '34 Act, the SEC may approve an SRO rule only if it finds that the rule is "designed to prevent fraudulent and manipulative acts and practices."

63 NYSE Information Memo No. 82-18 (Mar. 5, 1982), announcing the SEC's approval of the amendments to Rules 382 on February 18, 1982, emphasized that Rule 405 (the "know-your-customer" rule) would no longer have any application to clearing brokers. Prior to 1982, NYSE Rule 405 was interpreted by the Exchange as requiring member clearing firms to regard their introducing firms as one of their own branch offices. *See In re Adler Coleman Clearing Corp.*, 198 B.R. 70, 73 n.4 (Bankr. S.D.N.Y. 1996), (summarizing the history of the 1982 amendments to NYSE Rules 382 and 405).

commissions that had permitted them to hire and maintain legal and compliance staff to supervise introducing firms. Under amended Rule 382, all know-your-customer responsibilities—*e.g.*, establishing a customer's investment objectives and determining the suitability of recommended investments—could now be allocated to the introducing firm, which, in any event, already had that obligation as a registered broker-dealer under existing regulations. Most significantly, under Rule 382, as amended, clearing brokers and introducing brokers became responsible *only* for the performance and supervision of those functions that were allocated to them, respectively, in their clearing agreements.[64] Each clearing agreement was required to be submitted to and approved by the NYSE prior to becoming effective.[65]

Amended Rule 382 encouraged the rational division of labor, a division in which each party profits from the strengths and business focus of its own organization. For introducing firms, this meant focusing on customer-contact functions: soliciting customers, providing investment recommendations, and, generally serving their customer accounts. It also meant being able to pay for back-office services in line with their current revenues, thus avoiding the fixed overhead costs of maintaining their own back-office operations. For clearing firms, it meant investing in sophisticated clearance and settlement platforms and personnel, employing economies of scale to process a high volume of transactions to achieve the most competitive per-trade processing cost. Last but not least, for clearing firms, it meant being shielded from potential liability to introduced customers resulting from the sales practices or other conduct of their introducing

64 "Each organization will be accountable for actual performance of all functions performed by employees and other associated persons as well as for overall supervision of functions and activities *performed by it* pursuant to any carrying agreement." 1 NYSE Interpretation Handbook, Rule 382/03 (emphasis added).

65 NYSE Rule 382(a). Currently, a clearing firm is required only to submit its template clearing agreement for FINRA approval. Individual clearing agreements are required to be filed only with FINRA for approval if they vary materially from the template. See, FINRA Rule 4311.

firms. Prior to the 1982 amendments, clearing firms were required to monitor their introducing firms under Rule 405 as if they were the clearing firm's own branch offices.

The benefits realized from this division of labor accrued not only to introducing and clearing firms, but also to introduced customers. These benefits were significant. They came first of all in the form of lower commission charges. But equally important - in the wake of the Paper Crunch crisis - benefits came in form of sound and safe custody services for their securities and funds in the hands of well-capitalized clearing firms as well as the receipt of accurate and timely account statements issued by generally well managed clearing firms.[66]

The net benefits of the efficient division of labor made possible by the amendments to Rules 382 and 405 were summarized by the SEC in its Order approving the amendments in 1982: "The proposed rule change is intended to enhance the viability of carrying [clearing] agreements to the mutual benefit of introducers [introducing firms], carriers [clearing firms] and investors by permitting the organizations the flexibility to allocate functions and responsibilities between themselves in accordance with the type and nature of their relationship and business manner that ensures continued protection to customers with introduced accounts consistent with the federal securities laws and applicable self-regulatory ("SRO") rules."[67]

(v)

With its approval of amendments to NYSE Rules 382 and 405 in 1982 - preceded by the elimination of fixed commissions and the promulgation of a new uniform net capital rule, both

[66] In 1977, the SEC initially disapprove the proposed amendments to Rule 405, stating that "it doubts that the complete or substantial elimination of the duty of the carrying firm with respect to introduced accounts … is consistent with the protection of investors and the public interest." Rel. 34 -14143, 13 SEC Docket 639 (Nov. 7, 1977). In 1982, SEC overcame its doubts and approved the proposed amendments to Rules 382 and 405, stating that the "proposed rule change is intended enhance the viability of [clearing] agreements to the mutual benefit of introducers, carriers and investors …." 24 SEC Docket 964, Rel. No. 34-18497 (Feb.19, 1982)

[67] *In re New York Stock Exchange, Inc.*, Exchange Act Release No.18,497, SEC Docket 964 (Feb. 19, 1082). Securities and Exchange Act of 1934, Section 17A(a)(i).

in 1975, and its facilitation of the formation of NSCC and DTC in 1973 and 1974 - the SEC successful implemented key elements of Congress' mandate "to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of … securities transactions … for the protection of investors."[68]

Significantly, the new clearance and settlement system was designed to prevent - and has in fact succeeded in preventing - a repetition of the disastrous consequences of the Paper Crunch crisis of the late 1960's - namely: insecure custody of investor assets, failed trade settlements, inaccurate customer records, missing or lost stock certificates and customer funds - all of which had resulted in massive customer losses and the liquidation of many NYSE member firms. Further initiatives taken by the SEC and SRO industry regulators after 1982, have built on the foundational regulatory framework established in 1982 without materially deviating from its original design.[69]

[68] Securities Exchange Act of 1934, Section 17A(a)(i).

[69] Among post-1982 developments, the 1999 amendments to NYSE Rule 382 and NASD Rule 3230 are, perhaps, the most substantive. The 1999 amendments impose two new requirements on clearing firms:

(i) Clearing firms are required to forward all introduced customer complaints they receive to the customers' introducing firms and to FINRA, and

(ii) Clearing firms are required to provide their introducing firms with "exception reports" pertaining to all transactions in introduced customer accounts within specified time periods and sorted by various categories, such as commissions generated by specific brokers at the introducing firm. The clearing firm is required to notify FINRA (a) of all exception reports offered to its introducing firms and (b) all exception reports actually requested by the introducing firm among those offered by the clearing firm.

The 1999 amendments are intended (i) to enable FINRA "to generate a regulatory response" to customer complaints, if necessary, and (ii) to "enhance[] introducing organizations' ability to supervise activities relating to customer accounts" by availing themselves of exception reports.

The amendments did not require clearing firms to investigate either any customer complaints they received or to review the exception reports provided to their introducing firms. In announcing the1999 amendments, FINRA's predecessor, the NASD, stated that the amendments, both with respect to customer complaints and the exception reports, "*are not intended to change the fundamental relationship between introducing and clearing firms or otherwise affect any existing rights, responsibilities or liabilities under law or contract.*" (emphasis added). NASD Notice to Members No. 99-57 (July 1999). The NYSE issued a similar statement. *See*, NYSE Information Memo 99-33 (July 1, 1999).

- C -

Klein v Oppenheimer & Co.

This section of this article focuses on the 2006 decision of the Kansas Supreme Court in *Klein v. Oppenheimer & Co.*[70] and the potential impact of that decision on the uniform regulation of clearing brokers and the potentially different liability standard they face under state blue sky laws.[71]

Courts have generally and overwhelmingly held that the relationship between a clearing broker and its introduced customers is not a fiduciary relationship and that, accordingly, a clearing broker, performing typical clearing broker functions, is not liable to introduced customers for

[70] 130 P. 3d 569 (Kan. 2006).

[71] For a recent comprehensive review and analysis of clearing broker case law, s*ee*, Harry S. Davis and Betty Santangelo, *Clearing Broker Liability and Responsibilities,* (Section 24:3 - *Litigation Exposure of Clearing Firm*s). Chapter 24 PLI Broker-Dealer Regulations (2nd Edition). Supplemented: Sep. 2016. Hereinafter "Davis and Santangelo."

the conduct of their introducing firms.[72] In describing the functions of clearing brokers - executing and clearing transactions, providing margin credit in margin accounts, issuing trade confirmations and monthly account statements - court's have generally used such terms as "administrative", "ministerial" or "clerical" and have held that the performance of these functions does not constitute "material aid" or "substantial participation" in the misconduct of their introducing firms. The SEC has echoed these rulings in enforcement and administrative proceedings involving clearing firms.[73]

However, in 2006, the Kansas Supreme Court, in *Klein v. Oppenheimer & Co.*,[74] held that a clearing broker "materially aid[ed]" the primary violation of its introducing broker under the Kansas Securities Act (K.S.A.), when it performed ordinary and routine clearing functions for one of its introducing firms , specifically, processing the sale of unregistered securities by the introducing firm to two of its introduced customers.[75] The trial court had held that the clearing broker had not "materially aid[ed]" in the sale of unregistered securities, within the meaning of the K.S.A. The particular statutory provisions involved in Klein were in K.S.A. 17-1268(b).[76]

This was the second appeal in this action and the second time that the Court remanded the case to the trial court. The first remand followed the trial court's decision in favor of Oppenheimer in accordance with New York law. The trial court had enforced the New York choice of law

[72] The line of decisions holding that clearing brokers have no fiduciary duty to introducing firms may be traced back to the U.S. Supreme Court decision in *Affiliated Ute Citizens.v. United States*, 406 U.S. 128 (1972), involving the duties of a transfer agent. See *Edwards & Hanly v. Wells Fargo Securities Clearing Corp.* 602 F. 2d 478, 484 (2d Cir. 1979), *cert. denied*, 444 U.S.1045 (1980). see, Davis and Santangelo.

[73] *Del Mar Financial. Services* 75 SEC Docket 1905 (August 14, 2001) and *Bear Stearns Securities Corp.* Exchange Act Release 41,707, 199 SEC LEXIS 1551 (Aug 5,) 1999

[74] 130 P.3d 571 (Kan. 2006)

[75] Id . at 588.

[76] Id. at 572

clause of in plaintiffs' customer agreements with Oppenheimer .[77] In dismissing all claims against Oppenheimer, the trial "characterized Oppenheimer's involvement as 'nothing more than ministerial' and held that since'Oppenheimer was not involved in any of the plaintiffs' decisional process' it was not liable to [plaintiffs] under New York law."[78] In reversing that decision, the Court noted that Kansas, being the first statute in the country to have enacted a blue sky statute in 1911, was dedicated to a strong public policy under its blue sky law to protect Kansas investors even though, in the action before it, only one of the two plaintiffs lived in Kansas, the other plaintiff residing in Missouri, and both defendants being located in New York, where all the conduct complained of in the action took place.[79]

In reversing the trial court's second judgement - this time entered under K.S.A. 17-1268(b) - the Court held that Oppenheimer did "materially aid" L.T. Lawrence's primary violation, even though the parties, in their joint stipulation of facts, had "agree[ed] that Oppenheimer provided *ministerial administrative services* to L.T. Laurence , including accepting instructions from L.T. Lawrence for the creation of account records in Oppenheimer's automatic data system; preparing and transmitting confirmations of trades and monthly account statements to L.T. Lawrence and/or its customers; and extending and maintaining margin credit for L.T. Lawrence customers." [80] Disregarding the parties' joint stipulation with respect to the nature of Oppenheimer's services, the Court appears to have made its own assessment and concluded that they had not been "merely clerical or ministerial." In reaching this conclusion, the Court, in effect, adopted

77 Id. at 571.

78 *Brenner v. Oppenheimer & Co*., 273 Kan.525, 532, 130 P.3d 364 (2002). Following the death of plaintiff Daniel Brenner, his co-plaintiff and nephew, Roger Klein, continued with the action. The plaintiffs had initially submitted their claims to arbitration but withdrew them prior to a decision on the merits by the arbitrators. *Brenner,* 273 Kan. at 528.

79 *Brenner v. Oppenheimer & Co*., 273 Kan.525, 44 P. 3d 364 (2002).

80 *Id*. at 573-574 (emphasis added). Court noted that the case presented "an issue of first impression" under the KSA.

the views expressed by the author of the Comment, *Clear Skies for Investors:Clearing Firm Liability Under the Uniform Securities Act*, 39 San Diego L. Rev. 1327 (Fall 2002). The author of that Comment unabashedly advocated the expansion of clearing broker liability under the blue sky laws[81] and, as the Court noted, "takes issue with " the characterization "that the activities of a clearing broker involve processing rather than selling and, thus, are ministerial in nature."[82] The Court found the Comment "to be both instructive and persuasive." [83] Indeed, so "instructive and persuasive" as to lead the Court to disregard the stipulated facts and adopt the reasoning of the Comment which contended that "[just because] a clearing firm is performing its normal professional responsibilities does not render the duties 'ministerial' and therefore outside the scope of liability."[84]

In reviewing the record created in the trial court, the Court noted that Oppenheimer had received numerous complaints from introduced customers about the sales practices of L.T. Lawrence, the introducing firm, with some charging that L.T. Lawrence was operating a "boiler room." The Court also noted that Oppenheimer had asked L.T.Lawrence to find another clearing firm.[85] Oppenheimer, while forwarding the customer complaints to L.T.Lawrence for its attention, did not alert regulators.[86] None of the customer complaints themselves related to the performance of Oppenheimer's clearing broker functions with respect to plaintiffs' transactions. It is

81 *Id*. at 587

82 *Id* at 586.

83 *Id*. at 588.

84 *Id*. at 577.

85 *Id*. at 589.

86 *Id*. at 589.. The Court did not suggest that Oppenheimer was required to alert any regulatory authority with respect to the customer complaints. In 1996-97, when Oppenheimer received the complaints, it was not required by then existing rules to forward the complaints to iL.T. Lawrence's designated examining authority. *See*, footnote 69, with respect the 1999 amendments to NYSE Rule 382 and NASD Rule 3230, requiring clearing brokers to forward customer complaints, not only, to the introducing firm complained about but also, starting in 1999, those firms' designated examining authority. That requirement is currently reflected in FINRA Rule 4311(g)(1).

unclear to what extent, if any, the Court was influenced by the history customer complaints to find that Oppenheimer had "materially aid[ed]" L.T.Lawrence with respect to plaintiffs' transactions.within the meaning of K.S.A. 17-1268(b).

The Court remanded the case to the trial court for a second time, this time to permit Oppenheimer to submit, by way of affirmative defense, "proof" - as required under K.S.A. 17-1268(b) - that [it] did not know, and in the exercise of reasonable care could not have known of the existence of the facts [constituting the introducing firm's primary violation]."[87] The Court issued this remand even though it had determined earlier in its opinion that "Oppenheimer had no knowledge or information that [the] securities [sold to plaintiffs] were not registered with the State of Kansas [and] had no duty or obligation … to determine whether these securities were registered with the State of Kansas and, therefore, took no action."[88] The Court did not indicate what other steps Oppenheimer should have taken "in the exercise of reasonable care" to escape liability under K.S.A. 17-1268(b).[89]

The Court explicitly rejected Official Comment 11 to Section 509(g)(4) of Uniform Securities Act of 2002 (USA 2002), as irrelevant, even though Section 509(g)(4) corresponded directly with K.S.A. 17-1268(b) under which the Court had found that Oppenheimer, as clearing broker, had "materially aid[ed]" L.T.Lawrence.[90] Official Comment 11 seeks to harmonize state and federal norms of clearing broker liability, stating that "the performance by a clearing broker of the clearing broker's contractual functions - - even though necessary to the processing of a transaction - - without more would *not* constitute material aid or result in liability."[91] The authors

[87] KSA 17-1268(b).
[88] 130 P. 3d at 574
[89] The send remand raises the
[90] *Id.* at 588
[91]

of Official Comment 11, most likely, aware that provisions like K.S.A.17-1268(b) in the blue sky laws of various states, did not differentiate among different types of "broker-dealers", but treated all entities registered as "broker-dealers" in the state with the same broad brush in determining their secondary liability. By noting that the performance of contractual functions by a clearing broker does *not* constitute "material aid" of a primary violation, the authors of Official Comment 11 added, in effect, a missing statutory gloss with respect to clearing brokers, as a particular type of "broker-dealer", with no fiduciary obligations to introduced customers.[92]

In rejecting Official Comment 11, as irrelevant, the Kansas Supreme Court stated that its authors, by citing *Ross v. Bolton,*[93] had relied improperly on an "aiding and abetting" standard of secondary liability in support of their position, "rather than …a statutory provision comparable to KSA 17-1268(b)."[94] The Court was correct in that K.S.A.17-1268(b) does reflect a different standard for determining secondary liability when compared with the aiding and abetting standard typically applied to the conduct of clearing brokers in cases such as *Ross v. Bolton.* The principal difference between the two standards is that a defendant clearing broker is *not* required to demonstrate that it exercised "reasonable care" to avoid liability under an aiding and abetting

Official Comment 11 has also been criticized by advocates for the expansion of clearing broker liability under the blue sky laws. *See,e.g,* Robert S. Banks, Jr., "*Clearing Firms and the 2002 Uniform Securities Act: What You Didn't Know Could Have Hurt You."* PLI. Chapter 35, Securities Arbitration 2003: Simplifying Complexity (August 2003). Mr. Banks was lead counsel for claimants in *Karuga v. Fiserve Correspondent Services* and is a former president of the Public Investors Arbitration Bar Association (PIABA), which supports expanded clearing broker liability under the blue sky laws. In addition, it is noteworthy that lead trial and appellate counsel for plaintiffs in *Klein,* Joseph C.Long, testified as claimants' expert witness in the Koruga arbitration, and is also a leading member of PIABA. The author of the present article was counsel for the Securities Industry Association (SIA), as *amicus curia*, in the proceedings seeking judicial confirmation of the arbitration award in *Karuga*. The SIA opposed the confirmation of the *Karuga* award.

92 States typically do not enact Official Comments when adopting a uniform securities act. To date, nineteen (19) states have adopted USA (2002). See, *Uniform Securities Act table of jurisdiction* (2002), pp.1-2. The Uniform Securities Act of 1956 was adopted, in whole or in part, by 37 jurisdictions. *Id.* at 2. Section 410(b) of the '56 Act corresponds to Section 509(g)(4) of USA (2002).

93 904 F. 2d 819 (2d Cir. 1990).

94 *Klein,* 130 P. 3d at 588.

standard whereas it *is* required to do so under K.S.A. 17-1268(b). While Official Comment 11 does not align perfectly with the case law developed with respect to the liability of clearing brokers, it supports the legal principle that a clearing broker, performing routine and ordinary functions necessary to the clearance and settlement of securities transactions, does not materially aid or substantially assist the primary violation of its introducing firms with respect to those transactions.[95]

In summary, the rulings of the Kansas Supreme Court in *Klein* are at odds with, not only the stipulated facts in the case, but also at odds, *in principle*, with the decisions of the vast majority of courts, faced with the same or similar facts, that have held that the routine functions of a clearing broker are "ministerial", "clerical" or "administrative" in nature and that a clearing broker's performance of those functions does not constitute material aid or substantial participation in the primary violation of its introducing firms.[96] Equally troubling is the Court's ruling that Oppenheimer, in order to escape liability under K.S.A. 17-1268(b), was required, on remand, to proof that it "did not know, and in the exercise of reasonable care could not have known of the facts [constituting the primary violation of the introducing firm]." [97] Again, as with the Court's first ruling, this ruling is troubling, not only because the Court had already found that Oppenheimer had no duty or obligation to determine whether the securities in question were registered in Kansas, but because the ruling conflicted, *in principle*, with the well settled axion that a clear-

[95] Official Comment 11 would not protect - as one commentator fears - clearing brokers who are found to have directly defrauded introduced customers by, e.g., exercising control over introducing firms or by directing introducing firms to engage in deceptive conduct. *See, In re Blech* Sec. Litigation, 961 F. Supp. 569, 584-85 (S.D.N.Y. 1997) (clearing broker was found to have directed manipulative trading by the introducing firm.). For a critique of Official Comment 11, s*ee*, Robert S Banks, Jr., *Clearing Firms and the 2002 Uniform Securities Act: What You Didn't Know Could Have Hurt You*. (PLI PLUS) Chapter 35, Securities Arbitration 2003: Simplifying Complexity.(The author of that article fears that clearing brokers could avoid liability under Official Comment 11 "simply by expanding the scope of their contractual obligations.").

[96] *See*, footnote 71.

[97] *Klein*, 130 P. 3d at 588. The above quotation is from KSA 17-1268(b)..

ing broker, having no fiduciary obligations to introduced customers, is under no obligation to monitor its introducing firms or otherwise "exercise [] reasonable care" as to the conduct of the introducing firms for the benefit of introduced customers.[98]

Conclusion

The Kansa Supreme Court opinion in 2006 in *Klein* created a new and uncertain legal landscape in which clearing firms may be held to different standards of liability depending solely on whether the action is adjudicated under state blue sky laws such as Kansas' or federal law and industry regulations. For this reason, *Klein* presents clearing firms with a significant risk management dilemma: whether to stay with or to abandon their current current business model, a model developed in compliance with specific SEC rules and SEC approved securities industry rules, that explicitly relieved clearing firms from any duty of reasonable care, as imposed by *Klein* with respect to the conduct of their introducing firms. These rules, which came into effect in 1982 and which have been refined since then, are intended (i) to encourage clearing brokers to focus their financial and human resources on the delivery of prompt and accurate clearing services at a reasonable price, while (ii) at the same time, requiring introducing brokers to focus their resources on "know-your-customer" functions to serve their customers properly. By contrast, the business model forced on clearing brokers by *Klein* would require clearing brokers to divert a substantial portion of their financial and personnel resources from (i) the single-minded performance of their clearing and settlement functions - e.g. investing in sophisticated computer-driven clearance and settlement platforms and the employment of expert personnel to run and maintain such platforms - to (ii) the monitoring and supervision of the conduct of their introduc-

[98] *See,* footnote 71

ing brokers. This type of business model would be substantially identical to the pre - 1982 model, when clearing brokers were required - under then existing industry rules - to treat the offices of their introducing brokers as their own and perform compliance functions for the benefit of their introducing brokers' customers. As discussed, *supra*, this pre-1982 model was abandoned under SEC guidance as inefficient, unreliable and unduly costly for public investors.

Proponents of the view that clearing brokers should be under an obligation of "reasonable care," generally ignore the substantial additional costs associated with requiring clearing brokers to monitor their introducing firms and that such costs would, inevitably, be passed on to *all* introduced customers in the form of higher commissions and other transaction fees. While a clearing broker's supervision of its introducing firms and its registered representatives may indeed prevent some misconduct by some introducing firm on some occasions, the aggregate passed-on-costs of supervision of all introducing firms would, without question, dwarf the uncompensated losses suffered by individual customers under prevailing current law and regulations.

The re-imposition of of the pre-1982 model of clearing broker conduct under *Klein* raises the specter of a federal conflict preemption challenge. As the U.S. Supreme Court observed in *Crosby v. National Foreign Trade Council*, [99] state laws are "naturally preempted to the extent of any conflict with a federal statute."[100] While the Securities and Exchange Act of 1934 Act does not intend to displace state law, a court will nevertheless find conflict preemption "where under the circumstances of a particular case, the challenged state law stands as an obstacle [as it does under *Klein*] to the accomplishment and execution of the full purposes and objectives of Congress." [101] (internal citations, quotation marks, and brackets omitted.) The SEC has made clear

99 530 U.S. 363, 372 (2000).
100 530 U.S. at 372.
101 *Id.*

that: "SRO rules that are approved by the SEC preempt conflicting state law".[102] *In NanoPierce Technologies v Depository Trust and Clearing Corporation*[103], the Nevada Supreme Court held that Nevada fiduciary law was preempted by SEC approved NSCC rules governing NSCC's stock borrow program. The program enables NSCC to borrow securities to make delivery of such securities as principal under its continuous net settlement system. Plaintiffs claimed that NSCC's stock barrow program encouraged the creation of "phantom" securities by naked short sellers and, as such, violated NSCC's fiduciary obligations under Nevada law by depressing the market value of plaintiffs' NanoPierce securities. The Nevada Supreme Court, however, held that Nevada's fiduciary law, as sought to be applied by plaintiffs, conflicted with the effective operation of NSCC's stock barrow program and as such was preempted as conflicting with SEC approved NSCC rules that created its stock barrow program. Similarly, NYSE Rules 382 and 405, as amended, were approved by the SEC in 1982.[104] These two SRO rules are at the heart of the federal regulatory framework governing clearing brokers and are an integral part of the overall fabric of SEC rules and SEC approved SRO rules that regulate the clearance and settlement systems in the United States.[105] The rulings of the Kansas Supreme Court in *Klein* clearly undermine and conflict with the SEC sanctioned regulatory framework that governs the conduct of clearing brokers as part of this country's overall clearance and settlement system.

102 SEC *Amicus* Brief at 19-20 filed in *NanoPierce Technologies, Inc. v The Depository Trust and Clearing Corporation*, 168 P. 3d 73 (S. Ct. Nev. 2007),"citing *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119, 1128 (9th Cir. 2005), citing *Merrill Lynch, Pierce, Fenner & Smith v. Ware*, 414 U.S. 117, 127 (1973)."

103 168 P. 3d 73 (S.Ct. Nev. 2007), *cert. den.*, 553 U.S.1031 (2008).

104 *See*, 24 SEC Docket 964, Release No. 34-18497 "Order approving proposed Rule Change." (February19,1982).

105 *See generally* Roberta S. Karmel, *Reconciling Federal and State Interest in Securities Regulation in the United States and Europe*, 28 Brook. J. Int'l L.495 (2002 - 2003) for an overview of federal preemption issues with respect to securities regulations.

Topic 5:
Whether and When to Settle
a Securities Mediation

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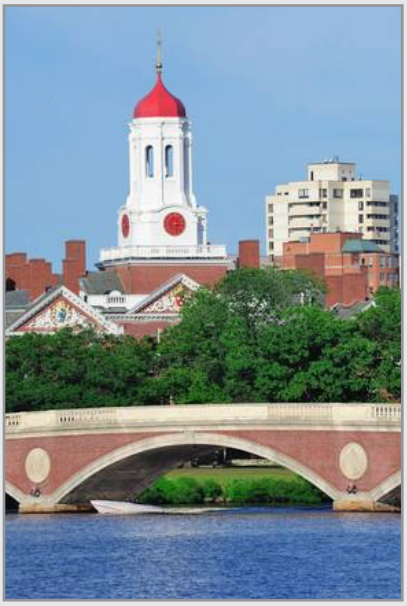

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1. Assess your BATNA using a four-step process.

Adapted from "Accept or Reject? Sometimes the Hardest Part of Negotiation Is Knowing When to Walk Away," by Deepak Malhotra (professor, Harvard Business School), first published in the *Negotiation* newsletter, August 2004.

It was a classic case of a business partnership gone awry. After building a profitable construction company together over several decades, Larry Stevenson and Jim Shapiro recognized that their differences had become irreconcilable. Stevenson wanted to buy out Shapiro, who was willing to sell for the right price. After months of haggling and legal maneuvering, Stevenson made his final offer: $8.5 million for Shapiro's shares in the company.

The company is worth about $20 million, Shapiro thought to himself. I own 49% of the shares. Heck, I helped build this company. I'm not going to accept anything less than my fair share—$10 million. I'd rather fight in court than accept $8.5 million. Shapiro rejected the offer, and each party prepared for a trial.

Shapiro's rationale for rejecting Stevenson's offer seemed reasonable enough. Furthermore, Shapiro's lawyers assured him, a court ruling very likely would be in his favor.

Yet Shapiro made the wrong choice. He could have figured this out if he had assessed his BATNA—his *best alternative to a negotiated agreement.* A negotiator's BATNA is the course of action he will pursue if the current negotiation results in an impasse. An evaluation of your best alternative to a deal is critical if you are to establish the threshold at which you will reject an offer.

Effective negotiators determine their BATNAs before talks begin. When you fail to do so, you're liable to make a costly mistake—rejecting a deal you should

have accepted or accepting one you'd have been wise to reject. In negotiation, it's important to have high aspirations and to fight hard for a good outcome. But it's just as critical to establish a walkaway point that is firmly grounded in reality.

Assessing your BATNA. To determine your BATNA in a given negotiation, follow these four steps:

List your alternatives. Think about all the alternatives available to you if the current negotiation ends in an impasse. What are your no-deal options?

Evaluate your alternatives. Examine each option and calculate the value of pursuing each one.

Establish your BATNA. Choose a course of action that would have the highest expected value for you. This is your BATNA—the course you should pursue if the current negotiation fails.

Calculate your reservation value. Now that you know your BATNA, calculate your *reservation value*—the lowest-valued deal you are willing to accept. If the value of the deal proposed to you is lower than your reservation value, you'll be better off rejecting the offer and pursuing your BATNA. If the final offer is higher than your reservation value, you should accept it.

To assess his BATNA, Shapiro first should have obtained the following information from his lawyers: estimated litigation costs, $500,000; his likelihood of winning in court, approximately 70%; and the fact that if he won, he would receive $10 million for his shares, whereas if he lost, he likely would receive only $3 million.

Next, Shapiro should have used this formula to determine the actual value of his BATNA:

(0.7 x $10MM) Value if he wins in court
+ (0.3 x $3MM) Value if he loses in court
– $500,000 Cost of litigation

$7.4MM

Shapiro should then have determined his reservation value for the negotiation with Stevenson: What is the least he would accept? It's worth noting that, after the trial was well under way, Shapiro came to believe that he should not

have rejected Stevenson's offer. "I still think the offer should have been higher," he said, "but if I could go back, I'd accept it. Righteous indignation is worth something, but it's not worth $1.1 million."

2. Take your BATNA to the next level.

Adapted from "Taking BATNA to the Next Level" by Guhan Subramanian (professor, Harvard Business School and Harvard Law School), first published in the *Negotiation* newsletter, January 2007.

If your current negotiation reaches an impasse, what's your best outside option? Most seasoned negotiators understand the value of evaluating their BATNA, or *best alternative to a negotiated agreement,* a concept that Roger Fisher, William Ury, and Bruce Patton introduced in their seminal book, *Getting to Yes: Negotiating Agreement Without Giving In* (Penguin, 1991, second edition). Even those who don't know the term probably think through their BATNA instinctively as they prepare for a negotiation. An awareness of your BATNA—particularly if it's a strong one—can give you the confidence you need to walk away from a subpar agreement.

Although BATNA is a commonsense concept in the negotiation world, achieving "best practice" in this arena is not easy. Here are three strategies to help you take the BATNA concept to the next level and gain a critical advantage in upcoming deals.

1. Translate your BATNA to the current deal. Here's a classic illustration of the BATNA concept: while haggling over a rug in a bazaar, you're aware that you can purchase an identical rug at a nearby stall for $100.Assuming that you want only one rug, you won't pay more than $100 in the negotiation at hand. Such clear-cut BATNAs tend to exist more in theory than in reality. In truth, your best alternative to agreement is rarely, if ever, apples-to-apples comparable with the deal at hand.

The implication? When negotiating, take time out for an explicit translation process to ensure that you aren't giving up a good deal in hand for a BATNA in the bush. Recently, for example, as the renewal deadline for his homeowner's insurance policy approached, Larry decided to do a "market check" to compare

prices. His existing insurer—let's call it Acme—had been raising its rates by 7% to 10% annually for the past three years, and Larry wasn't sure he was getting the best deal. He then found a carrier that offered a policy for 30% less than Acme's renewal rate.

Delighted, Larry came very close to switching to the new insurer. But after doing some digging (and receiving some self-interested guidance from Acme), Larry identified important coverages and term definitions buried deep in the legalese of the two policies. After going through a translation process to make the prices comparable, Larry realized that Acme, his current insurer, was offering him a better deal. The lesson: Rather than assuming that the deal on the table matches your BATNA point by point, translate your BATNA to fully understand what it means for the current negotiation.

2. Assess their BATNA with care. It may seem an obvious step, but even the most sophisticated negotiators often fail to think through the other party's BATNA as carefully and objectively as they think through their own. Although you can't assess someone else's BATNA as precisely as you can your own, asking "What will he do without a deal?" provides valuable insight.

Consider the case of a Mississippi farmer in the early 1990s. The state legislature had just legalized riverboat gambling, and the farmer owned land along the Mississippi River that was very attractive for the development of hotels, restaurants, and other businesses. Sure enough, an entrepreneur approached the farmer about buying his land. Before meeting to negotiate a purchase price, the farmer hired a professor of agriculture to estimate the land's value. After conducting soil tests and estimating cash flows, the professor concluded that the land was worth approximately $3 million.

As the negotiation began, the farmer kept quiet and let the entrepreneur frame the discussion. His opening offer: $7 million. Though ecstatic, the farmer kept his composure and made a counteroffer of $9.5 million. Eventually they reached a deal of $8.5 million.

You might view this tale as a success story for the farmer; after all, he got $8.5 million when he was only expecting $3 million. But what if the farmer had considered the entrepreneur's perspective, perhaps retaining an expert in the gaming industry to assess the land? He might have learned just how profitable casinos

can be and that the benefit to the entrepreneur of securing the optimal location rather than a second-best BATNA was worth much more than $8.5 million.

3. Think through two-level BATNAs. In most business negotiations, you face two counterparts: the individual across the table and the organization he represents. This means you're facing two BATNAs as well. Sophisticated deal makers think through *both* BATNAs—the organization's and the individual's.

In one real-world case, a vacation resort was seeking to have certain equipment installed on its property. The equipment manufacturer sent Frank, the CEO's newly hired lieutenant, to negotiate this major contract. The resulting deal was extremely successful for both sides.

A few years later, the manufacturer held its annual meeting of top managers at the resort to show off its installations and celebrate the deal. The two organizations held a panel discussion to reflect on the dynamics of their negotiation. At one point, the moderator asked Frank to reveal his BATNA. He responded with a textbook analysis: "Our BATNA was to look around for some other major contract in which to powerfully demonstrate our capability." When pressed, he continued, "Well, *my* BATNA, as a new hire, was probably to look around for another job if I didn't get the deal."

Most meaningful negotiations occur between organizations, not individuals—yet individuals, not organizations, negotiate deals. Thus, it's crucial to consider the incentives of the individual across the table: How is she compensated? How long has she worked for the company? What are her long-term aspirations? Only by examining both pieces of the BATNA will you gain a complete picture of the other side's walk-away alternatives.

3. Track BATNAs in multiparty negotiations.

Adapted from "How to Cope When the Table Gets Crowded," first published in the *Negotiation* newsletter, August 2011.

Negotiations between just two sides can be tough enough to manage. Add more parties to the mix, and things get a lot more complicated. Yet multiparty talks are common: think of department heads dividing up scarce resources,

family members debating the future of a business, or a group of consumers launching a class-action lawsuit.

One of the issues that makes multiparty negotiations more complex than two-party talks, according to Massachusetts Institute of Technology professor Lawrence Susskind and Harvard Law School professor Robert Mnookin, is the fluctuating nature of each party's *best alternative to a negotiated agreement* (BATNA). By preparing for this complication, you will be well positioned to thrive in your next round of multiparty negotiations.

As in a two-party negotiation, you should enter multiparty talks with a solid idea of your BATNA—that is, what you will do if a deal fails to materialize. Knowledge of your BATNA can help you stand firm in the face of offers that fall short of your goals.

Suppose that Mark, an unemployed marketing professional, is preparing to meet with his three siblings to discuss the future of their marginally profitable family business. Mark's preference is to dissolve the business and use his share of the assets to start a consulting firm. However, he knows that one or two of his siblings would prefer to keep the business running as is or sell it. If the negotiation doesn't work out as he would like, Mark decides that his BATNA is to move to a city across the country where a colleague has offered him a job.

You should also attempt to analyze the BATNAs of the other parties at the table. Roughly calculating the minimum you can offer someone to secure a commitment will help you immensely. Mark, for instance, expects that his sister Leah, who has been involved in the business, will demand a large share of the pie in exchange for agreeing to dissolve it. He estimates that she will ask for 50% of the assets but be willing to settle for about 40% and accept a position with a client.

In negotiations among a large number of parties, determining each party's BATNA can be a daunting, even impossible, undertaking. At the very least, try to foresee how parties may align and estimate the BATNA of each possible coalition.

Once discussions begin, parties' BATNAs will begin to fluctuate, according to Susskind and Mnookin. For instance, imagine that Mark persuades his sister Jaclyn and brother Tom that the business should be dissolved. At this point, because

Leah is outnumbered, her BATNA becomes a virtual nonissue. Yet to preserve their relationship with her and each other, her siblings become focused on dividing up the assets in a way that satisfies them all. A payoff matrix—a spreadsheet that lists the names of the parties in rows, the issues to be discussed in columns, and the parties' priorities on those issues in the boxes that are formed—will help you keep track of shifting BATNAs in addition to parties' preferences.

4. Anticipate hidden hazards of BATNA research.

Adapted from "Dear Negotiation Coach: Hidden Hazards of BATNA Development," by Francesca Gino (professor, Harvard Business School), first published in the *Negotiation* newsletter, May 2012.

Question: I was recently put in charge of negotiations with a supplier involved in one of our company's products. Given what I've learned in school and in negotiation books, I did my homework: I started exploring options with other suppliers to gain power and reduce risk in case the current negotiations with my preferred vendor go sour. I invested quite a bit of time (and money!) creating those options, but in the end I was not interested in pursuing them, and I let them go. Now I can't help but wonder: Was it a mistake to do so much research?

Professor Francesca Gino: Negotiators often spend time and energy pursuing alternatives to the current deal to gain more power at the bargaining table. In classic negotiation texts and research, you'll find the same advice: bargainers would be wise to invest resources in strengthening their *best alternative to a negotiated agreement* (BATNA), or their fallback alternative, in the event that the parties fail to reach an agreement.

Investing in outside alternatives enhances power by giving you other opportunities if the current negotiation cannot or will not provide the outcome you desire. Thus, outside alternatives often entail sunk costs, or irrevocable investments that keep open the possibility of pursuing other specific courses of action in the future. In a situation such as yours, investments in outside alternatives may enhance your leverage in the negotiation.

So far, so good, right? Well, there's more to the story. In addition to helping

you enhance your power, these investments in strengthening your BATNA can have other, potentially unintended consequences. Your realization that investments you made and discarded represent irrecoverable costs may affect your behavior in the current negotiation in ways you don't expect.

Specifically, research I conducted with my Harvard Business School colleague Deepak Malhotra shows that the extent to which decision makers invest directly in outside options influences how entitled they feel in the current negotiation. When you decided to forgo options that you invested time and money in creating, you may feel as though you wasted resources. This perceived loss creates a desire for a counterbalancing gain. Thus, it is likely to trigger a sense of entitlement: the feeling that you deserve a favorable outcome in the current negotiation. Our research shows that the costlier a negotiator's investment in developing a strong BATNA is, the stronger those feelings of entitlement will be.

We found that this sense of entitlement causes the negotiator to have high aspirations in the current relationship, and these aspirations fuel opportunistic behavior.

Your sunk costs—and not simply the leverage provided by the outside options you created—may lead you to exploit your counterpart in ways that could damage your relationship going forward. So, for instance, you may find yourself lying or misrepresenting information to your counterpart in an attempt to improve your outcomes. You may feel entitled to use aggressive strategies to reach a better deal for yourself. Without your realizing it, the foregone alternatives are influencing your behavior.

Since you likely are interested in maintaining a good relationship with the supplier in your current negotiation, you should consider the effect that the forgone options in which you invested might have on your expectations and behaviors as you negotiate. Namely, your prior investments may compromise your ethical standards. By remaining vigilant about negotiating in good faith and reciprocating goodwill, you should be able to emerge from the shadow cast by sunk costs.

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Alida Camp

Whether and When to Settle

Whether to settle:

BATNA = Best Alternative to a Negotiated Agreement

The stronger the BATNA, the stronger the negotiating position.

Before mediation, analyze the BATNA. A mediated agreement should be better than the alternative. Analyzing the BATNA allows the party to determine clearly the better option at any specific negotiating point.

Power in a mediation derives from knowing one's BATNA and having a strong BATNA.

Checklist for BATNA Analysis

I.

Arbitration as an alternative to mediation.

Financial Costs of arbitration:

- Forum fees
- Panel fees
- Expert witness fees and expenses
- Expenses of other witnesses
- Legal fees
- Transcript costs
- Document production costs
  - production
  - review of the other party's production
  - will party be required to pay any costs of other party's production, such as translation
- Motions

Contested subpoenas
Time until award
Appellate costs, if there is an appeal
Injunctive relief
Would party receive interest (benefit at 9% statutory rate)

Emotional and Psychological Costs of Arbitration

Cross-examination
Becomes major event to individual
Time spent preparing for and in arbitration
How will he/she/it feel if loses

Other Costs of Arbitration

Drain of resources (time, financial) that must be spent on arbitration
Would it create an internal precedent
Expungement issues

Risks of arbitration:

What are chances of prevailing at each arbitration stage
Motion goes against party (although very rare to be granted dispositive motions in FINRA)
Award goes against party
Prevailing party may receive pre- and/or post-award interest (New York State rate is 9%)
Prevailing party may receive attorney's fees where authorized
Strengths and weaknesses of each side's case
Will your expert be credible
Will arbitrators sustain objections to your witnesses or testimony
Will documents requested be produced
What will witnesses say
Will non-party witnesses appear

With whom do equities lie

II.

Other factors to weigh.

Present value of money
Will there be publicity if either party brings matter to court
Creative solutions not available through arbitration

Payment plan
Payment to charity
Creative employment solutions
Confidentiality clause
Non-disparagement clause
Apology
Certainty of and control over outcome
Are there trust issues, will agreement be performed

The other party's BATNA should, to the extent possible, be analyzed.

When to settle:

Benefits of discovery for settlement: Provides basis for BATNA analysis.

Risks of discovery: Parties dig in heels on positions, may non-verbally consider recoupment of discovery costs as necessary part of settlement (Claimant), or may non-verbally resent having incurred costs and may want to deduct from settlement (Respondent).

Suggested approach: Limited documents necessary for analyzing own case, understanding other side's case and for performing BATNA analysis should be exchanged cooperatively in controlled fashion rather than a full-blown document production.

Topic 6:
Proving and Defending Bond Cases

ASSESSING DAMAGES IN BOND CASES

by: Prof. Seth E. Lipner

AUTHOR'S NOTE – This article is a work-in-progress. A final version will appear in the Spring 2017 issue of the PIABA Law Journal.

Cases involving bond losses are different from stock loss cases because bonds are fundamentally different from stocks. From the viewpoint of the law, bonds are promissory instruments, while stock and equity investments have no promissory element.[1] From an investment standpoint, the two also have very different risk/reward characteristics.

Not only are there legal differences and risk/reward differences between the categories of investors, there are differences in the objectives of investors in these different types of securities. Bond investors seek the promise of current income and the issuer's promise to pay "par value" at maturity – a fixed amount at a fixed time. There is no hope for a meaningful capital gain, and that is fine with bond investors. Stock investors have more lofty expectations. They hope to make a capital gain at some undetermined date and, although they may even expect some dividends along the way, there are no guarantees. [2]

In arbitrations involving bond losses, these differences present challenges, especially when assessing the damages the investor suffered. The battleground issue is usually whether to deduct interest the bond paid from capital losses the investor suffered. Respondents want interest to be deducted from the principal loss because doing so will often wipe out a large capital loss on the bonds. Claimants resist such netting, but must be prepared to explain their reasons for resisting. The impact of discovery dates and prices, and whether the investor must sell the bonds in order to maintain an action, are also important issues for advocates. This Article explores each of these issues.

ASSESSING DAMAGES:
THE DIFFERENCES BETWEEN STOCKS AND BONDS

From the legal and corporate perspective, the differences between stocks and bonds are well-known. Bonds represent corporate promises with *priority* but no *equity*; stocks are all equity, without promises of any kind. Put simply, bonds are contracts and stocks are not.

This difference is critical, and it carries over to the way we assess damages in these two types of cases:

[1] See Restatement (2d) Contracts §1 ("A contract is a promise or set of promises….")

[2] This article focuses on bonds and bond investors. It does not directly address investors who buy bonds as part of an asset allocation strategy, although it can be applied to either .

(1) **Expectations -** The bondholder's contract creates what the law terms an "expectation" and contract law gives the promisee an "expectationary" remedy from the promisor.[3] Those who own stock, on the other hand, have no such expectation, right or remedy.

(2) **Promises -** The bondholder's contract – his legally enforceable "expectation" – contains two separately created and separately enforceable (i.e., severable) promises. The first promise is to pay interest. The second promise is to repay principal.

These legal differences are not so technical that investors do not understand the difference. Quite the contrary: investors either expressly or intuitively divide the right to receive periodic interest from the right to the payment of principal at maturity. They see the bond (and its return components) as comprised of these distinct issuer promises.

Since these two distinct promises constitute the basis for the bargain, mixing interest and principal together at the damages stage of a bond case, in the form of a "net-out-of-pocket loss" calculation, is contrary to the investor's understanding and the basis upon which the investor agreed to invest.

Along with these legal and investor-mindset distinctions, the economic characteristics of bonds are different from those of stocks:

1. **Non-Linear Upside -** Unlike stock investment outcomes, the outcomes of bond investments are not linear. That is, stock prices start at zero and follow a straight line to infinity. But bonds selling at or near par or at premium do not appreciate as much when rates go down as they do when interest rates go up, because they will always, some day, accrete to 100.[4] Stated differently, stocks can keep going up as profits are made or economic changes take place, but potential gains on bonds top out[5] and bond investors who buy near, at or above par have limited upside. Unlike stock investors, bond investors are not investing for capital gains.

2. **Outcome Distributions -** On the downside, stocks and bonds again face different characteristics. If a bond investor is willing and able to hold the investment to maturity, and there is no default, the bond investor realizes all of his expectation. On the other hand, if the bond defaults, the bond investor's loss tends to be catastrophic – all or nearly all the principal.[6] Stock investors, by contrast, face a

[3] See Restatement (2d) Contracts §1, Comment (g)("A promise that is a contract is 'binding'…."); §347 (…the injured party has a right to damages based on his expectationary interest….")

[4] Call features, early redemption features, sinking funds, etc. all contribute to the non-linearity of bond investment outcomes. ***cite***

[5] ***cite***

[6] Of course, bond defaults do not necessarily result in a complete wipe-out; there

much wider spectrum of downside outcomes, with catastrophic loss only one of many possible results. A very different distribution of outcomes.

3. **Investor Mindset: Loss v Gain** -- Hold-to-maturity bond investors need to focus hard on what can go wrong; their upside is limited, but their potential loss is catastrophic. Managing risk is the key element. While stock investors may be also concerned with loss, their goal is to find companies whose stock price will rise.[7] Risk management is less important to them. Stock investors want to be rewarded (at the end of their holding period) because the stock went up. Bond investors aren't looking for profit upon final sale.

Because stock investors are seeking potentially-unlimited capital gains, and the ending value is a key component, a stock investor's outcome is appropriately measured by "total return" (*i.e*. an accounting outcome that nets dividends paid and capital gains/losses). There is no rational basis for separating dividends from capital losses; both reflections of the issuer's success, and success is what the stock investor bargained for.[8]

For the bond investor, especially one who divides the promise to pay interest from the promise to return principal – usually by spending the periodic amounts earned on living expenses -- total return was not the object of the exercise.[9] Dollars received today are not fungible with the principal dollars promised – and not paid – at maturity. Indeed, often the interest was spent *in reliance on* the issuer's promise to return principal. Measuring total return (i.e., assessing damages based on net-out-of-pocket loss on a bond that paid interest for some years and then declined with a default or threat of default) may satisfy an accounting professional's urge to add

may be residual assets flowing (some day) from a bankruptcy or reorganization.

[7] A consequence of these economics is that bond managers seek to provide value to their clients by avoiding having any losers, thus achieving the returns of their management benchmarks. With limited upside and a potentially catastrophic downside, most bond managers avoid bad outcomes by being very diversified. By contrast, active equity managers must try to add value to their clients by "beating" their benchmark indexes – usually by being less widely diversified than those benchmarks. Put differently, equity investors can afford a few losers if they find some big winners. Bond investors can't find big winners – they don't exist. In such an environment, bond investors need especially to watch their downside.

[8] Both the dividends and the gain/loss are a product of the profitability of the corporation. An unprofitable corporation typically does not pay dividends; its stock price tends not to rise. But that same company's ability to make its contractual payments is subject to a very different set of factors, including its ability to obtain re-financing.

[9] Damages in cases involving unsuitable asset allocations (as opposed to unsuitable bonds within the allocation) may properly be measured by total return (and netting stock outcomes with bond outcomes), because the object was to produce a diversified total portfolio. But when the alleged wrong relates to the makeup of individual parts of an otherwise well-allocated portfolio, assessing damages based on the total return of the whole portfolio is wrong because it has the potential of excusing wrongdoing or carelessness by netting it against gains from proper or careful behavior.

columns and balance debits with credits, but it ignores the basis for (and nature of) the investment. Most of all it ignores real losses to the investor's principal.[10]

For all these reasons, assessing damages in a bond case is different from assessing damages in a stock case. Netting of dividends and capital losses – the so-called "net-of-pocket" method – is useful in many securities cases. But that measurement fails to capture the essence of bonds, bond investors and bond investing. A different assessment is thus needed – one in which there is no netting, so that the bond investor's justified expectations are actually realized.[11]

DETERMINING THE DATE ON WHICH TO MEASURE DAMAGES; OF PURCHASE DATES AND POST-PURCHASE EVENTS

Even before there were securities, there was a law of fraud. At common law, the typical measure of damages for fraud-in-the-inducement in the sale of a chattel is the (inflated) price paid for the object minus the actual value of that object on the date of the purchase.[12]

In chattel cases, damages are, under the formula, measured as of the date of the fraud.[13] The same rule applies in many investment cases. Damages, the cases say, are the "pecuniary losses" that are the "direct result" of the defendant's fraud.[14] But what does "pecuniary loss" mean? How does the law measure it? And as of what date is such a loss measured in a securities case? Is it the same as a chattel case?

The date-of-the-fraud measure, courts often say, follows from the observation that a seller's fraud is "complete and its effect exhausted at the time of the sale and transfer."[15] Under this approach, damages based on subsequent events are not compensable, because of the lack of causation associated with later occurrences. For example, in cases involving mis-reported earnings, courts require the plaintiff to prove (through economic analysis) the value of the stock – absent the fraud (i.e., the intrinsic value on the date of purchase). That calculation is designed to exclude from damages the effect of events subsequent to the purchase that caused the price to

[10] Thus, the out-of-pocket loss calculation of damages – appropriate to a stock case or other investment where total return is the object and cash flows are fungible – is inappropriate to a bond or other income-oriented investment (especially bonds).

[11] A "benefit of the bargain" calculation in a bond case might involve netting (depending on circumstances) the "risk free" rate (comparable maturity Treasuries) or some other surrogate, assuming a reliable one can be found and employed.

[12] See *Hotaling v. A.B.Leach & Co., Inc.*, 247 N.Y. 84, 87-88 (1928)("Ordinarily the actual pecuniary loss as a direct result of the fraud which induces a chattel is the difference between the amount paid and the value of the article received.")

[13] Id.

[14] See *Reno v Bull*, 226 N.Y. 546 (***)("The true measure of damages is indemnity for the actual pecuniary loss sustained as a direct result of the wrong."); *Hotaling*, *supra.*

[15] See *Hotaling*, at 88.

decline.[16]

Courts recognized early on, however, that in investment cases, the circumstance can be different. For example, in cases alleging issuer fraud -- xwhere the buyer could not discover the fraud until later -- courts have looked to the post-discovery price of the security as a surrogate for the intrinsic purchase-date value, especially if the fraudulent conduct caused an artificial inflation of price for a long duration.[17] But still, if other events unrelated to the fraud intervene, the price movements associated with those subsequent events must be accounted for and removed when assessing damages based on this discovery-date surrogate.

In cases calling for a discovery-date assessment, courts have sometime split on whether to use the date on which the public discovered the fraud, or the date on which the investor discovered the fraud.[18] In many cases, of course, the investor discovers the truth at the same time as the general public. In cases where the investor discovers before the public does, damages are assessed as of the (earlier) date of the investor's discovery; if the investor discovers the fraud after the public (and can explain why the investor failed to learn the truth at that time), damages are assessed as of the time of actual discovery.[19]

Broker cases present yet another situation, and a different exception to the date-of-purchase rule exists for these cases. When a risk is omitted or misrepresented by a broker, events subsequent to the sale can trigger price declines and losses. In such cases, the causal chain is not necessarily broken by these post-purchase events, and one thus cannot simply exclude the effects of subsequent events that turn undisclosed or misrepresented risks into investment losses.

Hotaling v. Leach & Co.,[20] a seminal broker case, is a classic and powerful example – and it involved bonds. In *Hotaling*, the defendant broker misrepresented the issuer's financial wherewithal to withstand adverse market events. When those events occurred (subsequent to the purchase), the New York Court of Appeals awarded damages for losses caused by *post-purchase* events.[21]

The New York Court of Appeals in *Hotaling* began by observing (as we did) that, in a case involving fraud in the sale of chattels, damages are ordinarily measured by the difference between the price paid and the real (intrinsic) value *on the date of purchase*.[22] The Defendant thus argued that the bond-buyer's damages should be measured by the liquidation value of the company on the date of the fraud; since the company had sufficient assets to meet its obligations

16 ***add cite***

17 See *Harris v. American Inv. Co.*, 523 F.2d 220, 226 (8th Cir. 1975)(Citing Restatement of Torts §549 Comment (c).

18 *Compare* Richardson v. MacArthur, 451 F.2d 35, 43-44 (10th Cir. 1971)(using date of public discovery) *with Harris v. American*, supra.(using the date of investor discovery).

19 See *Harris*, supra at 226-27.

20 247 N.Y. 84 (1928).

21 *Id.* at 87.

22 Citing *Smith v. Duffy*, 57 N.J.L. 679 (***).

on that date, the company argued there was no loss.

The Court of Appeals rejected that argument and any date-of-purchase measure of damages. Pointing to the long-term investment purpose of the bonds the buyer bought, the Court ruled that damages must be assessed in light of the fact that the company was an ongoing concern;[23] after all, the Court said, the bonds were bought "for investment, not speculation."[24] Damages in such a case, said the Court, "must represent the loss which the plaintiff sustained through the purchase *and continued ownership* of the bond."[25] The Court is telling us – investment cases are different from chattel cases, and bond cases are different from stock cases.

The Court explained that the buyer's loss in *Hotaling* occurred when the company's ability to meet its obligations under the bond was impaired by subsequent events in the oil business. The Court, upholding the buyer's claim to these (subsequent) losses, explained that "the[] disturbed conditions [in the oil business] would not have caused the company's failure if the enthusiastic statements ... contained in the circular had been true....[A]n expectant investor might have hesitated and drawn back...."[26] As long as the fraud "continued to operate and induce the continued holding of the bond, all losses flowing naturally from that fraud may be regarded as its proximate result," the Court held.[27]

Claimants who can satisfy *Hotaling* and show that the subsequent events triggered a bond loss that was tied to a risk that was misrepresented at the moment of purchase can recover damages for the misrepresentation even if the events leading to the decline occurred after the purchase. In such situations, the price of the date of discovery is the price to use in assessing damages.

DISCOVERY AND THE INVESTOR WHO WON'T SELL

Once discovery of the fraud occurs, the investor who decides to hold securities cannot later assert a claim for the declines that occurred after that discovery because such an investor

[23] The Court distinguished an old the English case, *Peek v. Derry*, 37 Ch.D. 541 (***explain***)

[24] While the Court does not so state, one can observe, as Part I of this Article observed, that, in a legal sense, all stocks are held for "speculation" because, by definition, there are no promises involved.

[25] *Hotaling, at 87.* Addressing the causation issue associated with using subsequent prices to assess damages, the *Hotaling* Court determined that the change in conditions in the oil business as a "subsidiary cause," rather than an "independent" one. *Cf. Nye v. Blythe Eastman Dillon & Co. Inc.* 588 F.2d 1189 (8th Cir. 1978)("the appellees had a reasonable time in which to make a 'second investment decision' to either hold the shares or sell them and reinvest the proceeds elsewhere. [citing *Harris v. American Investment Company, supra*]). The second investment decision doctrine is analyzed in Part III of this Article.

[26] *Id.* at 90.

[27] *Id.* at 93.

made a "second investment decision"-- one that is free from the original fraud. But that does not mean that an investor who discovered the fraud is under a duty to sell the securities and cannot maintain any action if he fails to do so.

Although arbitration respondents sometimes try using the argument, it has long been held that the decision to hold a security after the discovery of a broker fraud is not “ratification.”

The leading case is *Harris v. American*.[28] That federal district court decision involved a stockholder's derivative suit alleging common law fraud and the violation of federal Rule 10b-5. The defendants sought dismissal, alleging that the named plaintiffs, who held the stock after discovery of the fraud, suffered no damages because the stock price rose after the action was commenced, and their loss was thus wiped out.[29]

The Eight Circuit disagreed with the defendants, explaining that "it would be inappropriate to apply a rule requiring [plaintiff] to sell [the securities] prematurely for the benefit of the defrauding defendant."[30] Any other rule, the Court said, would give the plaintiff all the risk of further price decreases, while still giving the defendant all the benefit of any price increases. Since the plaintiffs "second investment decision" was independent of the original fraud, said the Court, "what[ever] happens after this second investment decision has no bearing whatsoever on the measure of the plaintiff’s damages."[31]

The *Harris* rule is not just equitable; it’s logical. The rule fixes a claimant's damages at the moment of discovery; it aligns risks and rewards from that point out in an equitable manner; and, it allows the law to compute damages with certainty. Any other rule would, as the *Harris* Court explained, give the wrongdoer the benefit of a heads-I-win-tails-you-lose scenario.[32]

[28] *Harris v. American Inv. Co*., 523 F.2d 220, 227 (8th Cir. 1975). See also *Pfeffer v. Cressaty*, 223 F.Supp 756, 758 (S.D.N.Y. 1963); *Hindman v. First National Bank*, 112 F. 931, 935-36 (6th Cir.), cert denied, 186 U.S. 483 (1902); *Hotaling v A.B. Leach & Co*., 247 N.Y. 84 (1928).

[29] *Harris v. American*, at 224.

[30] Id. at 228.

[31] Id. See also *Acticon v. China North East Petroleum Holdings Ltd*, 692 F.3d 34, 41 (2d Cir. 20 12)

[32] See also *Pfeffer v. Cressaty*, 223 F.Supp 756, 758 (S.D.N.Y. 1963), where the court held that the common law rule permitting an aggrieved buyer to maintain an action even though he continued to hold the securities after discovery of the fraud also applied to actions for damages claims under Section 17 of the 33 Act and Section 10b of the 34 Act.

With respect to the state securities statutes, the rule is different. Uniform Securities Act Section 410 measures the aggrieved buyer's recovery as "the consideration paid for the security, together with interest at (x) percent per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security and any income received on it, or for damages if he no longer owns the security." The statute assumes either a tender or a sale. If there is neither a tender nor a sale, the statute appears to offer no remedy.

The *Harris v. American* rule produces not just economic fairness; it offers a consistent measure of damages. As another court explained when applying the rule:

> The plaintiff will not be able to avail himself of any further decrease in the value of the security after [the discovery] date. So also the defendant should not be able to avail itself of any increase in the value of the stock after that date. This is the only method in which a consistent measure of damages can be obtained. If the defendant's contention was accepted the scale of damages would be prejudicially tipped in favor of the defendant.[33]

Hindman v. First Nat. Bank of Louisville[34] is similar. The case was an action for deceit. The plaintiff alleged he was induced to buy stock which he claimed was worthless at the time of his purchase. The defendants argued that even if the shares lacked any intrinsic value on the date of purchase, the shares subsequently acquired "market value" and the plaintiff's recovery should be limited thereby. The Court disagreed with the defendants, holding that "if the shares had ... afterwards a market value is of no importance....[T]he plaintiff was under no obligation to sell, and might hold for an investment, if he saw fit."[35]

Subsequent cases show that the second investment decision rule offers even further instruction about how to measure damages in bond cases. In *Harris v. Union Electric Company*,[36] a securities fraud defendant argued that a bond buyer's damages for fraud should be reduced by interest paid on the bond after discovery of the fund. The trial court refused to so instruct the jury, and the 8th Circuit Court of Appeals agreed. The Court wrote: "the [lower] court properly refused to instruct the jury to reduce the award by the value of any benefits received by the plaintiffs .... the recovery of the bonds two months later, and the continued receipt of interest payments have no bearing on the measure of damages ...."

Harris v. Union Electric demonstrates that the second investment decision doctrine not only applies to subsequent increases and decreases in the price of the securities, but also to interest earned on bonds after discovery of a securities fraud. Interest earned after discovery is part of the "benefit" assigned to the plaintiff who, having decided not to sell, took the "risk" of decline.

Thus, even if one were to compute damages by netting interest and capital losses, the netting must end with discovery of the fraud. All subsequent coupon payments must be excluded from the damage calculation. Those payments belong to the investor who made a "second investment decision" and took the risk they would not be made.

[33] *Cant v. Becker & Co.*, 379 F.Supp. 972, 975 (N.D.Ill. 1974).

[34] 57 L.R.A. 108 (6th Cir. 1902)

[35] *Id.* at 935-36, citing *Smith v. Bolles*, 132 U.S. 125 (1889), where the Supreme Court held that damages for common law securities fraud do not include "the expected fruits of an unrealized speculation." *Id.* at 130

[36] 787 F.2d 355 (8th Cir 1986)

CONCLUSION

Bond cases present special issues of damage assessment. Parties to a securities arbitration involving bonds that went bad after several years of ownership and coupon payments are likely to be far apart in their damage assessments. The investors will be looking for the return of lost principal, while the respondent will be looking to net the interest payments against that capital loss.

Bonds are different from stocks in all their attributes and investors who buy bonds with the intention of holding them to maturity have different expectations from those who buy equities. The measure of damages that applies to stock cases does not fit bad-bond cases. *Hotaling* shows that discovery-date prices are the right prices to use in assessing bond-case damages.

The second investment decision doctrine is another important issue to be addressed in many cases. Aggrieved bond investors face a difficult choice when they discover that the bond they were sold was misrepresented to them by their broker. The investor does not know whether the bond will recover, but he does know that selling it and replacing it will (unless he can win his arbitration) forever diminish his income and his wealth. He must make a choice. But the choice is not one-sided. If the bond continues to pay and appreciates in value, those facts do not diminish the compensable damages. Because if the bond's value goes down further, or stops paying, the loss is on him.

Topic 7:
Ethics and Expungements

BrokerCheck Expungement Cases
A Primer and Proposals[1]

David E. Robbins[2]

FINRA's rules on expunging customer complaints and customer arbitrations presents an inherent conflict between the investing public's right to know as much as possible about individuals in whom they may entrust their life savings and a financial advisor's right to clear his or her public record of false accusations of wrongdoing. While FINRA provides a means to expunge such complaints and arbitrations from a broker's record, it makes sure to stress to its arbitrators that such relief is "an extraordinary remedy." This article provides a primer on the subject and offers proposals to customer attorneys who settle cases, only to be advised that the broker now wishes to remove that case from his or her record.

1. Primer on Expungement - "An Extraordinary Remedy"

FINRA's October 2016 online Expungement Training and Exam[3] makes clear that:

> Expungement is an extraordinary remedy that arbitrators should recommend only under appropriate circumstances. Arbitrators should recommend expungement of customer dispute information only when it has no meaningful investor protection or regulatory value. Once information is expunged from the CRD[4] system, it is permanently deleted and no longer available to the investing public, regulators or prospective broker-dealer employers.[5]

Brokers seek to expunge from their CRD/BrokerCheck Report, among other things, customer complaints and customer arbitrations in which they were named as a Respondent or in which, if not named, the arbitration claim concerned their customers' accounts.[6]

[1] This article contains excerpts from a PIABA Bar Journal article by the author that will be published in 2017 entitled "Challenging Expungements After Settlements."

[2] David E. Robbins is a member of Kaufmann Gildin & Robbins, LLP in New York City, is the author of *Securities Arbitration Procedure Manual* (Lexis Matthew Bender Dec. 2016) and the *Practice Commentary* to *McKinney's Consolidated Laws of New York, Article 23-A: The New York Practitioners Guide to Securities Arbitration and Mediation.* He represents investors, brokers and firms.

[3] https://www.finra.org/file/finra-dispute-resolution-expungement-training-and-exam

[4] According to its website, "FINRA operates Web CRD®, the central licensing and registration system for the U.S. securities industry and its regulators. The system contains the registration records of more than 3,865 registered broker-dealers, and the qualification, employment and disclosure histories of more than 641,130 active registered individuals. Web CRD also facilitates the processing and payment of registration-related fees such as form filings, fingerprint submissions, qualification exams and continuing education sessions. Web CRD is a secure system for entitled users only. Firms must complete FINRA's entitlement process noted below to request access to use Web CRD by completing FINRA's entitlement process noted below." See http://www.finra.org/industry/crd

[5] *FINRA Dispute Resolution Expungement Training and Exam*, October 2016, *available at* https://www.finra.org/sites/default/files/FINRA-Expungement-Training.pdf, pg 8.

[6] For the "events" required to be disclosed on a broker's CRD and thus the BrokerCheck Report,see,http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9819

2. Frequently Asked Questions

When FINRA's process of expungement became more structured with the implementation of Rule 2080 (grounds for expungement) and Rules 12805 and 13805 (expungement procedure), it issued guidance in *FINRA Rule 2080 Frequently Asked Questions.*[7] Here are excerpts:

> *5. What affirmative finding(s) must arbitrators make for FINRA to waive participation in the court confirmation process?*
>
> *The arbitrator must, after complying with Arbitration Code Rule 12805 or 13805, make an affirmative finding that the subject matter of the claim or the information in the CRD system meets one or more of the three standards, set forth in Rule 2080. Without such an affirmative finding, FINRA would have no basis under Rule 2080 to waive the requirement that it be named as a party in the court confirmation process.*
>
> ***(1)*** *The claim, allegation, or information is factually impossible or clearly erroneous...*
>
> ***(2)*** *The registered person was not involved in the alleged investment- related sales practice violation, forgery, theft, misappropriation, or conversion of funds...*
>
> ***(3)*** *The claim, allegation, or information is false….*

Frequently Asked Question #5 then mentions, without analysis, a ground that is not addressed in *FINRA's* Expungement Training and Exam:

> *In addition, if the expungement relief is based on judicial or arbitral findings other than those described above, FINRA, in its sole discretion and under extraordinary circumstances, may waive the obligation to name FINRA as a party if it determines that*:
>
> *(1) The expungement relief and accompanying findings on which it is based are meritorious and*
>
> *(2) The expungement would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.* [8]
>
> *18. How did FINRA determine the standards for expungement of customer dispute information?*
>
> *In crafting the standards set forth in FINRA's rules regarding expungement, FINRA was guided by the interests of regulators in having accurate and relevant information to*

[7] http://www.finra.org/industry/crd/rule-2080-frequently-asked-questions. The questions and answers seek to provide guidance regarding the operation of FINRA Rule 2080, which was formerly NASD Rule 2130.
[8] *Id. Emphasis Added*.

fulfill their regulatory responsibilities, the interests of the brokerage community in having a fair process to protect their reputations where appropriate, and the interests of investors in having access to accurate and meaningful information about brokers with whom they now or in the future may engage in business.[9]

3. January 2016 Changes to Expungement Requests

In January 2016, FINRA issued the following additional guidance to parties in such proceedings:

Parties should provide FINRA with the following information for all expungement requests made in cases filed on or after January 1, 2016. This will enable FINRA staff to efficiently process expungement requests:

1. *The CRD number of the party requesting expungement;*
2. *The CRD occurrence number(s) which is the subject of the expungement request;*
3. *The case name and docket number that gave rise to the disclosure, if applicable;*
4. *Whether expungement of the same disclosure item was previously requested, and if so, an explanation of the outcome of that request.*

Parties should include all subject CRD occurrence numbers on the first page of the pleading in which they request expungement. Providing this information will ensure the accurate and timely processing of all expungement requests. NOTE: Failing to provide this information may unnecessarily delay the proceedings. Individuals with CRD numbers can access their registration and licensing information by requesting an Individual Snapshot Report. [10]

4. FINRA Expungement Training and Exam – October 2016 Update[11]

Standards Explained

FINRA's training and exam material focuses its arbitrators on what it refers to as *the three grounds* available for expungement, despite there being a fourth ground on which FINRA provides no guidance to its arbitrators. Here is what FINRA tells its arbitrators about *the three grounds*:

- "The procedures are intended to ensure that expungement occurs only after the arbitrators find and document one of the narrow grounds specified in Rule 2080: 1. The claim, allegation or information is factually impossible or clearly erroneous; 2. The registered person was not involved in the alleged investment-

[9] *Id.*
[10] https://www.finra.org/arbitration-and-mediation/changes-expungement-requests.
[11] © 2016 Financial Industry Regulatory Authority, Inc. All rights reserved. https://www.finra.org/file/finra-dispute-resolution-expungement-training-and-exam.

related sales practice violation, forgery, theft, misappropriation or conversion of funds; or 3. The claim, allegation or information is false."[12]

- "Even if the parties settle and agree to include expungement relief in a stipulated award, arbitrators must still find and document one of the grounds under Rule 2080 and satisfy all of the procedural requirements under Rules 12805 and 13805 before recommending expungement."

- "FINRA will generally participate in the court confirmation proceeding and oppose confirmation of the recommendation for expungement if it does not meet at least one of the specified standards under Rule 2080 and satisfy the procedural requirements under Rules 12805 and 13805."[13]

FINRA's 2016 Expungement Training and Exam is broken down into a number of Sections, with key excerpts included and examined below.

Section 1: Central Registration Depository

The Central Registration Depository (CRD®) has several important uses:

- Investors rely on CRD information, most of which is available to them through FINRA BrokerCheck® (as described below), when making decisions about whether to do business with a particular broker or brokerage firm.

- Regulators use CRD to fulfill their regulatory responsibilities.

- Regulators also use the CRD system as a regulatory tool (e.g., to help identify trends or potential threats to investor protection).

- Brokerage firms rely on CRD when making hiring decisions.

- Most of the information submitted to CRD is made publicly available through BrokerCheck but BrokerCheck does not provide all of the information that is available to regulators through the CRD system.[14]

Sections 2 and 3: Expungement Rules

What Is Expungement?

Brokers who seek to expunge disclosure events from their CRD records generally look to remove a customer dispute, employment termination or internal review. To protect the broker's reputation, brokers may seek to have any reference to the arbitration removed from their CRD record.

[12] https://www.finra.org/file/finra-dispute-resolution-expungement-training-and-exam, pg 8.
[13] *Id.* at 23.
[14] https://www.finra.org/file/finra-dispute-resolution-expungement-training-and-exam, p.5.

- *Expungement is an extraordinary remedy that arbitrators should recommend only under appropriate circumstances.*

- *Arbitrators should recommend expungement of customer dispute information only when it has no meaningful investor protection or regulatory value.*

- *Once information is expunged from the CRD system, it is permanently deleted and no longer available to the investing public, regulators or prospective broker-dealer employers.*[15]

Expungement Rules

- **Rule 2080:** Grounds for Expungement (examined below)

- **Rule 2081:** Prohibited Conditions Relating to Expungement

  > Neither firms nor registered representatives may condition the settlement of a customer dispute on - or otherwise compensate a customer for - the customer's agreement to consent to, or not to oppose, the firm's or representative's request to expunge such information from CRD. The rule helps ensure that negotiated customer agreements not to oppose do not influence the arbitral decision to recommend expungement. [16]

- **Rules 12805 and 13805** - The Procedure Under the Codes of Arbitration

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

1. *Hearing* - Hold a recorded hearing session (by telephone or in person) regarding the appropriateness of expungement. It is important to allow customers and their counsel to participate in the expungement hearing in settled cases if they wish to. Specifically, arbitrators should allow:

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

[15] *Id.* at 8.
[16] *Id.* at 9.

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

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

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

Rule 2080 – Grounds for Expungement

When recommending expungement of customer dispute information, FINRA's October 2016 Expungement Training and Exam states that arbitrators must indicate in the Award which of the grounds under Rule 2080 serves as the basis for expungement.

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

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

Amplification: If the evidence shows that the broker was not even employed by the securities firm during the relevant time period, the arbitrators could find that he or she was erroneously named in the arbitration claim, dismiss the claim against the individual and recommend expungement of any mention of the claim from the CRD record under this standard.

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

Amplification: This list of activities is taken from Question 14 of Form U4, which specifies the types of customer complaints that registered persons must report. It is an objective standard based on CRD reporting requirements. This standard would require an affirmative arbitral finding that the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds. Under this standard, dismissal of a claim, by itself, would not be a sufficient basis for ordering expungement.

C. The claim, allegation or information is false.

Amplification: Arbitrators should make such a finding only after considering the merits of the allegations against the broker or securities firm. For example, if the customer alleged that the broker made unauthorized trades and the broker

provided evidence contrary to this claim, such as a document signed by the customer directing the trades, arbitrators could find that the claim or allegation was false.

This is the ground customer attorneys should have the greatest trouble with this ground since it is diametrically opposed to the average Statement of Claim.[17]

Expungement-Only Cases

- To ensure that customers know about the expungement request, arbitrators should order the associated persons to provide a copy of their Statement of Claim to the customer(s) involved in the underlying arbitration.

- It is particularly important to note that without this directive from the arbitrators, the customer(s) may not even be aware that an expungement claim is pending regarding their prior dispute.

- Notice provides the customer(s) with the opportunity to advise the arbitrators and parties of their position on the expungement request, which may assist arbitrators in making the appropriate finding under Rule 2080. The position of the customer(s) can be made known in writing or through participation in the expungement hearing.

Review Settlement Documents

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

- To make sure that a recommendation for expungement comports with one of the grounds under Rule 2080 and is recommended only under appropriate circumstances, arbitrators must critically evaluate the settlement and determine whether it raises any concerns.

- Arbitrators should question whether expungement is appropriate in situations where the broker, or the firm, has agreed to pay a large monetary settlement - a settlement amount beyond a nuisance value.

- Arbitrators should evaluate this fact and consider whether a financial settlement raises questions about some culpability on the part of the broker or firm. If arbitrators nevertheless recommend expungement, they should explain in their written rationale why expungement is still appropriate despite a large settlement.[18]

[17] *Id.* at 12.
[18] *Id.* at 14.

5. Proposals for Settled Cases

After centering the Statement of Claim on allegations of such sales practice abuses as unsuitable, unauthorized or excessive trading, statistics show that few customers take part in expungement proceedings, leaving it up to the broker – whom they accused of such wrongdoing – to convince a panel of arbitrators that either:

1. The customers' allegations were factually impossible or clearly erroneous,
2. The broker was not involved in the investment-related sales practice violation or
3. The claim, allegation or information was false.

Or the fourth ground: That the expungement relief and accompanying findings on which it is based are *meritorious* and the expungement would have *no material adverse effect* on investor protection, the integrity of the CRD system or regulatory requirements.

If the case settles prior to hearing and the broker seeks to expunge the case from his/her BrokerCheck Report, the burden of proof is shifted. It is now the broker who must prove something that the broker had no burden of proving at the arbitration – that one of the Rule 2080 grounds exists so that, with a clear conscience, the arbitrators can order the deletion of that arbitration from the broker's BrokerCheck Report, as if the arbitration never occurred, as if no allegations – which resulted in a monetary settlement – were ever made.

Here are questions to consider for customer attorneys who settle cases:

1. Should you advise your client to take the money and run or should you recommend – to mix metaphors – that he/she should have his/her cake and eat it too (i.e., take the money and then object to the expungement request)?

2. Should you and your client split the settlement check in accordance with your contingency fee arrangement and go on with your lives or should you deposit the settlement check and then contest the broker's attempt to expunge the case?

3. Or, heresy – should you and your client participate in the hearing and *encourage* the arbitrators to expunge the case from the broker's record?

Recommendations

Premise – Your client has settled the arbitration prior to the hearing and has executed a settlement agreement. You receive a notice from the FINRA Case Administrator that the arbitrators who were going to hear and decide the case have been asked by the broker to conduct an in-person expungement hearing.

Question – Should your client testify at the hearing, with you as counsel, recognizing that the settlement agreement will be entered into evidence?

1. **Broker as Respondent – Intentional Misconduct -** If you named the broker as a Respondent and believe you could have met the burden of proof that intentional sales practice abuses directly resulted in your client's losses (even though now satisfied), the client should testify if the client believes the case should remain on the broker's BrokerCheck Report so that other customers and potential customers will have proper warning.

2. **Broker as Respondent - Unintentional Misconduct -** If you named the broker as a Respondent but believe the broker's misconduct was based on negligence and the brokerage firm's failure to properly train and supervise him/her, there may be a question whether your client would have met his/her burden of proof at the arbitration. If your client wants other customers and potential customers of the broker to make similar complaints and/or move their account away from the broker – even if the broker's conduct was based on negligence – the client should testify because the allegations were not, in his/her opinion, false.

3. **Product Cases -** If you named the broker as a Respondent in a "product case" (which may have been a tactical and procedural mistake) and believe the broker's misrepresentations were based on the firm's misconduct (e.g., failing to disclose to its brokers the inherent risks of the product or strategy and encouraging its brokers to nevertheless solicit the product/strategy to as many clients as possible), serious thought should be given to attending the hearing and joining the broker in the expungement request. I did this as a matter of routine – with my clients' authorization – in auction rate securities cases, even when I did not name the broker as a Respondent.

4. **Broker Not Named as a Respondent -** If you did not name the broker as a Respondent but the firm still (as is required) amended the broker's U4 and therefore his/her BrokerCheck Report, you may want to take a pass at participating in the hearing. If you did not believe the conduct justified naming the broker as a Respondent, it may be considered hypocritical of you to insist on the case remaining on the broker's record after your client agreed to settle the arbitration with the brokerage firm and possibly other brokers who were named as Respondents.

Conclusion

Having represented customers for decades in arbitrations against brokers, I believe that the purpose of such actions is twofold:[19]

1. To recover losses suffered by my clients and
2. To discourage the recurrence of the misconduct.

[19] Full disclosure: I have represented brokers in stand-alone expungement cases where customer complaints were not followed up with arbitration claims, causing such Disclosable Events to remain on the broker's record, or where the brokerage firm settled the case over the broker's objection.

Deterrence is often achieved with a significant arbitration Award. Should customers settle, rendering such an Award moot, FINRA provides customers an opportunity to discourage similar misconduct with other customers. Instead of "taking the money and running," more customers should, in appropriate circumstances, show up and be heard at expungement hearings.

Elderly Claimant Customers – Special Considerations in FINRA Arbitration[1]

David E. Robbins[2]

For many years now, FINRA has sought to implement the central precept of arbitration as an expeditious alternative to litigation for the elderly and seriously ill. This article will provide context and guidance for attorneys in such cases by considering FINRA's pronouncements on the subject, the defense bar's perspective and the laws of California and Florida. FINRA's 2007 Regulatory Notice on Senior Investors is attached for further guidance.

1. FINRA Speaks

On its website since 2004, FINRA has explained its expedited proceedings for senior and seriously ill parties:[3] For such cases, Dispute Resolution staff will endeavor, on an expedited basis, to:

- Complete the arbitrator selection process;
- Schedule the initial pre-hearing conference;
- Serve the Award; and,
- Determine whether the parties are interested in mediation.

"Arbitrators are encouraged," says FINRA, "consider the health and age of a party when:

- Scheduling hearing dates;
- Considering postponement requests; and,
- Setting discovery deadlines.

"Although FINRA Dispute Resolution staff cannot shorten the time requirements set forth in the Code of Arbitration Procedure, upon request, staff will expedite the administration of arbitration proceedings in matters involving senior or seriously ill parties. In such situations, staff will begin the arbitrator selection process, schedule the initial pre-hearing conference, and serve the final award as quickly as possible. By mutual agreement, parties are also free to reduce the time requirements contained in the Code. Staff will also determine promptly whether the parties are interested in mediation."

Arbitrator Sensitivity – "FINRA Dispute Resolution expects its arbitrators to be sensitive to the needs of senior or seriously ill parties when scheduling hearing dates, resolving discovery disputes, and determining the reasonableness of postponements. At the initial pre-hearing

[1] This article contains excerpts from the author's book *Securities Arbitration Procedure Manual* (5th Ed. Dec. 2016), and is published with the permission of his publisher, Lexis Matthew Bender.

[2] David E. Robbins is a member of Kaufmann Gildin & Robbins, LLP in New York City, is the author of *Securities Arbitration Procedure Manual* (Lexis Matthew Bender Dec. 2016) and the *Practice Commentary* to *McKinney's Consolidated Laws of New York, Article 23-A: The New York Practitioners Guide to Securities Arbitration and Mediation*. He represents investors, brokers and firms.

[3] https://www.finra.org/arbitration-and-mediation/expedited-proceedings-senior-or-seriously-ill-parties

conference, counsel for a senior or seriously ill party should advise the arbitration panel of the party's desire for expedited hearings. When such a request is made, the arbitration panel is expected to press for hearing dates and discovery deadlines that will expedite the process, yet still provide a fair amount of time for case preparation."

2. The Regulators' Senior Initiative in 2006

In 2006, the SEC, FINRA and the North American Securities Administrators Association, Inc. ("NASAA") joined in an initiative toward protecting seniors from investment fraud and sales of unsuitable securities. This Senior Initiative entailed:

(1) targeted examinations to detect abusive sales tactics aimed at seniors,
(2) aggressive enforcement of state and federal securities laws in cases involving seniors, and
(3) investor education and outreach.

The senior "sweeps" addressed: (1) "free lunch" seminars targeting the senior market; (2) professional designations or titles that use the terms "senior" or "elderly" or imply that a person has special expertise, certification, or training in advising or servicing senior citizens; (3) early retirement seminars designed to entice older workers to retire early, liquidate their retirement funds, and invest them with a particular registered representatives; (4) sales of principal only, interest only and inverse floater tranches of collateralized mortgage obligations to seniors; and (5) marketing life settlements to seniors.

3. An Appreciation of the Subject by Two Leading Defense Attorneys

In their 2008 PLI course book chapter, "*Respect Your Elders: A Survey of the Rules and Laws that Apply to Claims Brought by Senior Investors*" [4] Bradford D. Kaufman and Jon A. Jacobson, shareholders at Florida defense firm Greenberg Traurig, discussed unique issues that arise when litigating sales practice claims brought by senior investors. They examined whether the regulators' pronouncements have effectively created new or different standards when it comes to dealing with seniors. They also provided a general overview of some of the statutory laws that have been enacted specifically to protect seniors and how such laws might be applied to senior investors. They report these staggering statistics:

1) Approximately 5 million senior citizens become victims of financial abuse and fraud each year.

2) An estimated 44% of all investor complaints received by state securities regulators are made by seniors and 31% of all enforcement actions taken by state securities regulators involve senior investment fraud.

[4] Footnotes in the quoted PLI and PIABA articles are not included in this article, but can be found in Section 5-5[a] of *Securities Arbitration Procedure Manual.*

3) From January 2005 through August 2007, FINRA completed approximately 100 formal disciplinary actions involving or related to seniors. In September 2007, FINRA had approximately 70 open investigations that involve seniors or senior-related issues.

Kaufman and Jacobson then asked and answered this question: are there industry rules that apply to senior investors? No, but FINRA has implemented specific measures to expedite the administration of arbitration involving elderly or seriously ill parties.

And in September 2007, FINRA published Regulatory Notice 07-43, announcing on its first page one of its priorities "is the protection of senior investors, as well as Baby Boomers who are at or approaching retirement."[5] It looked at the suitability of recommendations to and communications aimed at older investors. They then look carefully at Footnote 5 of the Notice to Members, finding the possibility that FINRA is asking firms to pay special attention to a customer's age when recommending a security while adhering to the know your customer rule:

> A broker must refrain from making an unsuitable recommendation even if the customer expressed an interest in engaging in the inappropriate trade or asked the broker to make the recommendation." With this footnote, FINRA seems to be suggesting for the first time that "objective" criteria (e.g., net worth, age, etc.) can trump "subjective" criteria (e.g., a customer's stated investment objective or risk tolerance) when a firm conducts its uniform suitability analysis. Stated another way, notwithstanding FINRA's earlier suggestion that suitability is a relative concept that can be properly evaluated only in a context, Footnote 5 suggests that there might be some objective threshold beyond which an investment will be deemed unsuitable regardless of the context or what the customer tells the firm.

The authors then highlighted FINRA's reminder to its members that a customer's net worth alone is not determinative of whether a particular investment is suitable. "The practical effect of this observation is that FINRA Regulatory Notice 07-43 downplays one of the suitability criteria that firms are specifically required to consider under industry rules (financial status) and adds—indeed, emphasizes—two new suitability criteria that have never before been expressly singled out under industry rules for special consideration (age and life stage). In sum, while all suitability criteria are equally important, it appears that some criteria—age and life stage—might be more equally important than others."

4. State Statutes That Apply to Senior Investors

California and Florida[6] have statutes that prohibit the financial exploitation of the elderly and provide for special civil remedies.

1) Florida's Adult Protective Services Act states: "A vulnerable adult who has been abused, neglected, or exploited as specified in this chapter has a cause of action against

[5] FINRA Regulatory Notice 07-43 at 1. This Notice is attached in full to this article.

[6] Cal. Welf. & Inst. Code § 15600 et seq.; Fla. Stat. § 415.101 et seq.

any perpetrator and may recover actual and punitive damages for such abuse, neglect, or exploitation."[7]

2) California's Elder Abuse and Dependent Adult Civil Protection Act provides a private cause of action for financial abuse of a person 65 or older, [8] which can occur when a person or entity:

(1) Takes, secretes, appropriates, or retains real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.

(2) Assists in taking, secreting, appropriating, or retaining real or personal property of an elder or dependent adult to a wrongful use or with intent to defraud, or both.[9]

Bad Faith under the California Statute — An allegedly individual under this statute only has to prove bad faith; intent to defraud is unnecessary.[10] If the defendant knew or reasonably should have known that the elder had the right to have the property transferred or made readily available to the elder and nevertheless engaged in the prohibited conduct, then the bad faith requirement is met.

Attorney's Fees Under These Statutes

Florida awards attorney's fees to the prevailing party regardless of who that is.[11] Under the California statute, if the protected person proves by a preponderance of the evidence that the defendant is liable for financial abuse, the statute provides for the authority to grant attorney's fees. And, if the plaintiff proves by clear and convincing evidence that the defendant is guilty of oppression, fraud or malice, he or she may recover punitive damages.[12]

5. Protecting Clients with Diminished Capacity

One of the many advantages of being a PIABA member is attending its annual, multi-day conferences where experienced customer attorneys share their insights on critical, developing issues of investor protection. At the October 2015 conference, New York customer attorneys Jenice L. Malecki and Robert M. Van De Veire wrote a comprehensive article on representing the elderly and others with diminished mental capacity, who are greatly reliant on others, including financial professionals.

Many of the large brokerage firms have special programs and surveillance safeguards for such customers, not only to protect the firm from possible allegations of wrongdoing but because it makes good business sense. Among the comments of Ms. Malecki and Mr. Van De Veire that are of great assistance to practitioners included the following:

[7] Fla. Stat. § 415.1111.
[8] Cal. Welf. & Inst. Code §§ 15610.27, 15610.30, 15657.5.
[9] Cal. Welf. & Inst. Code § 15610.30.
[10] Cal. Welf. & Inst. Code § 15610.30.
[11] *See* Fla. Stat. § 415.1111.
[12] *See* Cal. Welf. & Inst. Code § 15657.5 and *Negrete v. Fidelity and Guaranty Life Insurance Co.*, 444 F.Supp 2d 998 (C.D.Ca. 2006).

A. Additional Training

• The industry should be required to provide their employees with diminished capacity training, such as how to spot signs of diminished capacity or elder abuse, who to report it to, and how to handle recommendations and transactions to and from persons suspected of diminished capacity or those abusing the elder whom may have powers of attorney or discretion over the account.

B. Powers of Attorney

• Since diminished capacity can affect a client's ability to make decisions concerning their investments, it is important for firms to be aware of the existence of a power of attorney ("POA"). Industry rules do not require firms to obtain information about POA. Since it would not take a lot of effort to ask this important question, it would not be unreasonable to require firms to obtain POA information.

• Firms should flag accounts that are controlled by agents acting under power of attorney. This extra level of supervision would ensure that these accounts are managed properly and would help prevent any future losses if a fraud is detected early.

C. Authorizations

• An *Investment News* survey participant stated that his/her firm was "building permission forms authorizing [them] to contact family or other professionals to discuss accounts." This is similar to a "diminished capacity letter," which would allow a firm to contact a family member to act as a fiduciary if a client shows signs of diminished capacity. Merrill Lynch created a contact authorization form that would allow brokers to ask the designated contact about "a client's whereabouts or health issues—but not about a client's investments."

• It would not require much effort on the industry's part to have clients provide the name of a trusted individual if diminished capacity becomes an issue. A simple question on an already existing new account application or the creation of a new authorization form would be easy and inexpensive to implement.

6. **Florida Elder Abuse Statute—A Model for the Nation**

Overview

As a state with vast numbers of senior citizens, Florida enacted in 1973 the Adult Protective Services Act, F.S. §§ 415.101 through 415.113. This statute creates a private cause of action for a violation of the Act and provides that "a vulnerable adult who has been abused, neglected or exploited as specified in this chapter has a cause of action against any perpetrator

and may recover actual and punitive damage for such abuse, neglect or exploitation." The statute also provides for recovery of attorney's fees and costs. Under F.S. § 415.102(7)(a), "exploitation" occurs when a person who:

> 1) Stands in a position of trust and confidence with a vulnerable adult and knowingly, by deception or intimidation, obtains or uses or endeavors to obtain for use, a vulnerable adult's funds, assets, or property with the intent to temporarily or permanently deprive a vulnerable adult of the use, benefit, or possession of the funds, assets, or property for the benefit of someone other than the vulnerable adult; or
>
> 2) Knows or should know that the vulnerable adult lacks the capacity to consent, and obtains or uses, or endeavors to obtain or use, the vulnerable adult's funds, assets, or property with the intent to temporarily or permanently deprive a vulnerable adult of the use, benefit, or possession of the funds, assets, or property for the benefit of someone other than the vulnerable adult.

More specifically, the statute states that "exploitation" includes the following conduct that could very well have occurred in your clients' brokerage accounts:

> 1. Breaches of fiduciary relationships, such as the misuse of a power of attorney or the abuse of guardianship duties, resulting in the unauthorized appropriation, sale, or transfer of property;
>
> 2. Unauthorized taking of personal assets;
>
> 3. Misappropriation, misuse, or transfer of moneys belonging to a vulnerable adult from a personal or joint account; or,
>
> 4. Intentional or negligent failure to effectively use a vulnerable adult's income and assets for the necessities required for that person's support and maintenance.

A "fiduciary relationship," states the statute, "means a relationship based upon the trust and confidence of the vulnerable adult in the caregiver, relative, household member, or other person entrusted with the use or management of the property or assets of the vulnerable adult. The relationship exists where there is a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of the vulnerable adult. …"

The PLI 2015 annual meeting course book contained an article entitled "*Diminished Capacity and Financial Exploitation of the Elderly—The Florida Elder Law Attorney's Perspective*," by C. Randolph Coleman, in which he went into some detail about the breadth and effectiveness of Florida's criminal and civil statutes seeking to protect the elderly. Here are highlights of his article and of the applicable statutes:

> • **Lack of Capacity—**In a criminal statute that became effective in Florida in 2014, the Florida legislature has defined "lacks capacity to consent" as "an impairment by reason

of mental illness, developmental disability, organic brain disorder, physical illness or disability, chronic use of drugs, chronic intoxication, short-term memory loss, or other cause, that causes an elderly person or disabled adult to lack sufficient understanding or capacity to make or communicate reasonable decisions concerning the elder person's or disabled adult's person or property."[13]

• **Elderly Person**—"A person 60 years of age or older who is suffering from the infirmities of aging as manifested by advanced age or organic brain damage, or other physical, mental, or emotional disfunctioning, to the extent that the ability of the person to provide adequately for the person' own care or protection is impaired."[14]

• **Disabled Adult**—"A person 18 years of age or older who suffers from a condition of physical or mental incapacitation due to a developmental disability, organic brain damage, or mental illness, or who has one or more physical or mental limitations that restrict the person's ability to perform the normal activities of daily living."[15]

• **Criminal Jurisdiction—**Chapter 825 of the Florida Statutes provides for criminal prosecution of those who abuse, neglect, or exploit elderly persons and disabled adults.

• **Felonious Conduct—**Florida Statutes, § 825.103, makes the financial exploitation of an elderly person or disabled adult, a first degree felony if the value of the assets taken exceed $50,000, a second degree felony if more than $10,000 but less than $50,000, and a third degree felony if the value is less than $10,000.

• **Exploitation of an Elderly Person or Disabled Adult**—This means "knowingly obtaining or using, or endeavoring to obtain or use, an elderly person's or disabled adult's funds, assets, or property with the intent to temporarily or permanently deprive the elderly person or disabled adult of the use, benefit, or possession of the funds, assets, or property, or to benefit someone other than the elderly person or disabled adult."[16]

• **Who Are the Subjects of the Statute**—Those who "stand in a position of trust and confidence with the elderly person or disabled adult" or those who have a business relationship with the elderly person or disabled adult and those who have a fiduciary relationship with the elderly person or disabled adult.

• **Definition of Violations**—Include:

➢ "Misappropriating, misusing, or transferring without authorization money belonging to an elderly person or disabled adult from an account in which the elderly person or disabled adult placed the funds, owned the funds, and was the

[13] Florida Statutes, § 826.101(7).
[14] Fla. Stat. § 825.101(4).
[15] Fla. Stat. § 825.101(3).
[16] Fla. Stat. § 825.103(1)(a).

sole contributor or payee of the funds before the misappropriation, misuse, or unauthorized transfer."[17]

➢ "Intentionally or negligently failing to effectively use an elderly person's or disabled adult's income and assets for the necessities required for that person's support and maintenance, by a caregiver or a person who stands in the position of trust and confidence with the elderly person or disabled adult."[18]

• **Florida Civil Theft Statute**

➢ The Florida Civil Theft statute[19] provides that the definition of exploitation in Chapter 825 is to be used in the Civil Theft statute. Therefore, recovery of treble damages and attorney's fees is available through the Civil Theft statute for all of the violations set forth in the exploitation statute, Chapter 825, Florida Statutes.

Conclusion

Any attorney who has represented elderly clients knows that the older they get, the more difficult it is for such clients to deal with the adversarial process. The added pressure is that because of their advanced age and likely unemployment/retirement, they are unable to return to the workforce to make back lost principal. Many are more forgetful of events that transpired with their brokers and many are "unpreparable" as witnesses since they have often lose the natural filter between thought and speech. That is why it is so important that attorneys, arbitrators and arbitration administrators be sensitive to the special issues of the elderly and those with diminished capacity. Thankfully, FINRA and some states are aware of their special needs.

[17] Fla. Stat. § 825.103(1)(d).
[18] Fla. Stat. § 825.103(1)(e).
[19] Fla. Stat. § 772.11.

Regulatory Notice 07-43

Senior Investors

FINRA Reminds Firms of Their Obligations Relating to Senior Investors and Highlights Industry Practices to Serve these Customers

September 2007

Notice Type

- Guidance

Suggested Routing

- Advertising
- Compliance
- Continuing Education
- Legal
- Registered Representatives
- Senior Management

Key Topic(s)

- Baby Boomers
- Communications with the Public
- Designations and Credentials
- Diminished Capacity
- Fraud
- Retirement
- Sales Practices
- Seniors
- Suitability

Referenced Rules & Notices

- NASD IM-2310-3
- NASD Rule 2110
- NASD Rule 2210
- NASD Rule 2310
- NTM 96-86
- NTM 99-35
- NTM 03-71
- NTM 04-30
- NTM 04-89
- NTM 05-26
- NTM 05-59
- NTM 06-38
- NYSE Information Memo 05-54
- NYSE Rule 472

Executive Summary

One of FINRA's priorities is the protection of senior investors, as well as Baby Boomers who are at or approaching retirement.[1] FINRA's efforts in this area include investor education, member education and outreach, examinations and enforcement. The purpose of this *Notice* is to urge firms to review and, where warranted, enhance their policies and procedures for complying with FINRA sales practice rules, as well as other applicable laws, regulations and ethical principles, in light of the special issues that are common to many senior investors. The *Notice* also highlights, for the consideration of FINRA's member firms, a number of practices that some firms have adopted to better serve these customers.

Questions concerning this *Notice* may be directed to:

- Laura Gansler, Associate Vice President, Office of Emerging Regulatory Issues, at (202) 728-8275;
- James Wrona, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8270; and
- John Komoroske, Vice President, Office of Investor Education, at (202) 728-8475.

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Discussion

The number of Americans who are at or nearing retirement age is growing at an unprecedented pace. The United States population aged 65 years and older is expected to double in size within the next 25 years.[2] By 2030, almost 1 out of every 5 Americans—approximately 72 million people—will be 65 years old or older.[3] Those who are 85 years old and older are now in the fastest-growing segment of the U.S. population.[4] At the same time, Americans are living longer than ever, meaning that retirement assets have to last longer than ever, too. Moreover, fewer and fewer retirees and pre-retirees can rely on traditional corporate pension plans to provide for a meaningful portion of retirement needs. Therefore, the financial decisions made by those who are at or nearing retirement are more important than ever before.

FINRA understands that, as with other investors, levels of wealth, income and financial sophistication vary among older investors. FINRA does not have special rules for senior customers. Firms owe all their customers the same obligations and duties. However, in executing those duties, age and life stage (whether pre-retired, semi-retired or retired) can be important factors, and firms should make sure that the procedures they have in place take these considerations into account where appropriate. Two areas of particular concern to FINRA are the suitability of recommendations to, and communications aimed at, older investors.

Suitability

NASD Rule 2310 requires that in recommending "the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable" for that customer, based on "the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." The rule also requires that, before executing a recommended transaction, a firm must make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and "such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."

Although the rule does not explicitly refer to a customer's age or life stage, both are important factors to consider in performing a suitability analysis. As investors age, their investment time horizons, goals, risk tolerance and tax status may change. Liquidity often takes on added importance. And, depending on their particular circumstances, seniors and retirees may have less tolerance for certain types of risk than other investors. For example, retirees living solely on fixed incomes may be more vulnerable to inflation risk than those who are still in the workforce, depending on the number of years those retirees are likely to rely on fixed incomes. Likewise, investors whose investment time horizons afford less time or opportunity to recover investment losses may be disproportionately affected by market fluctuations.

Therefore, firms cannot adequately assess the suitability of a product or transaction for a particular customer without making reasonable efforts to obtain information about the customer's age, life stage and liquidity needs. Other questions to consider include:

- Is the customer currently employed? If so, how much longer does he or she plan to work?
- What are the customer's primary expenses? For example, does the customer still have a mortgage?
- What are the customer's sources of income? Is the customer living on a fixed income or anticipate doing so in the future?
- How much income does the customer need to meet fixed or anticipated expenses?
- How much has the customer saved for retirement? How are those assets invested?
- How important is the liquidity of income-generating assets to the customer?
- What are the customer's financial and investment goals? For example, how important is generating income, preserving capital or accumulating assets for heirs?
- What health care insurance does the customer have? Will the customer be relying on investment assets for anticipated and unanticipated health costs?

Firms should carefully consider the risk of a product with the age and retirement status of the customer in mind, including its market, inflation and issuer credit risk. Investment involves varying degrees of risk and reward. For many investors who are at or nearing retirement, there can be a temptation to reach for yield to maximize retirement income without the appreciation of the concomitant risk. Moreover, it can be difficult for some investors to fully appreciate the risks of certain products or strategies, particularly if they are concerned about running out of money. Yet, especially when investments involve retirement accounts or lump-sum pension plan payments, taking undue risks with funds needed to last a lifetime can be financially disastrous.

Firms do not have an obligation to shield their customers from risks that customers want to take, but they are required to fully understand the products recommended by their registered representatives, to give their customers a fair and balanced picture of the risks, costs and benefits associated with the products or transactions they recommend and recommend only those products that are suitable in light of the customer's financial goals and needs.[5]

This does not mean that all seniors are, or should be, risk-averse, or that any particular product, per se, is unsuitable for older investors. However, certain products or strategies pose risks that may be unsuitable for many seniors, because of time horizon

considerations, liquidity, volatility or inflation risk. Therefore, FINRA's examiners are focusing on recommendations to seniors, particularly those that involve the following:

- Products that have withdrawal penalties or otherwise lack liquidity, such as deferred variable annuities, equity indexed annuities, some real estate investments and limited partnerships;
- Variable life settlements;
- Complex structured products, such as collateralized debt obligations (CDOs);
- Mortgaging home equity for investment purposes; and
- Using retirement savings, including early withdrawals from IRAs, to invest in high-risk investments.

Many of these have been the subject of separate rulemaking or other guidance from FINRA in the past. For example, FINRA has repeatedly stated that variable annuities are generally considered to be long-term investments and are therefore typically not suitable for investors who have short-term investment horizons. This is true even of some variable annuities that offer riders specifically designed for seniors, including those offering guaranteed life benefits.[6] We also have issued guidance on the suitability of variable life settlements, which are generally aimed at investors over the age of 70;[7] and the use of home equity for investment purposes.[8] FINRA also is concerned about recommendations that investors use retirement savings, in some cases by making early withdrawals from IRAs pursuant to Section 72(t) of the Internal Revenue Code, to make unsuitable alternative investments.[9]

As we have in the past, we also caution firms that a customer's net worth alone is not determinative of whether a particular product is suitable for that investor, even when the investor qualifies as an accredited investor under Regulation D of the Securities Act of 1933. Over-reliance on net worth is particularly problematic where an investor meets the accredited investor standard based largely on home values, which may represent the largest asset of many senior investors.[10] Simply put, eligibility does not equal suitability.[11]

Firms also are reminded that their suitability obligation applies to institutional customers, as well as retail customers, although the scope of that obligation varies depending on whether the institution is able to independently assess the risk associated with a particular recommendation and is in fact exercising independent judgment.[12] FINRA is concerned about the suitability of recommendations to some pension plans, particularly recommendations involving relatively new, complicated or high-risk asset classes, such as leveraged exchange-traded funds (ETFs) or the equity tranches of some collateralized mortgage obligations (CMOs). As NASD IM-2310-3 points out, even institutional customers that have the general capability to assess risk may not be able to understand a particular instrument, particularly a product that is new or that has significantly different risk and volatility characteristics than other investments made by the institution. Therefore, in making recommendations to institutional customers, including pension plans, firms should consider both the general ability of the institution to independently assess investment risk, and whether the customer understands the particular product well enough to exercise that ability with respect to the recommendation.

Communications with the Public

Senior Designations and Credentials

FINRA also is concerned about the proliferation of professional designations, particularly those that suggest an expertise in retirement planning or financial services for seniors, such as "certified senior adviser," "senior specialist," "retirement specialist" or "certified financial gerontologist." The criteria used by organizations that grant professional designations for investment professionals vary greatly. Some designations require formal certification, with procedures that include completion of a detailed and rigorous curriculum focused on financial issues, culminating with one or more examinations, as well as mandatory continuing professional education. On the other end of the spectrum, some designations can be obtained simply by paying membership dues. Nonetheless, seniors may be led to believe that these individuals are particularly qualified to assist them based on such designations. A recent FINRA Investor Education Foundation-sponsored survey found that a quarter of senior investors surveyed were told by an investment professional that the investment professional was specially accredited to advise them on senior financial issues, and a half of those investors were more likely to listen to the professional's advice because of it.

Firms that allow the use of any title or designation that conveys an expertise in senior investments or retirement planning where such expertise does not exist may violate NASD Rules 2110 and 2210, NYSE Rule 472, and possibly the antifraud provisions of the federal securities laws. In addition, some states prohibit or restrict the use of senior designations.[13]

NASD Rule 2210 and NYSE 472 prohibit firms and registered representatives from making false, exaggerated, unwarranted or misleading statements or claims in communications with the public. This prohibition includes referencing nonexistent or self-conferred degrees or designations or referencing legitimate degrees or designations in a misleading manner. Firms therefore must have adequate supervisory procedures in place to ensure that their registered representatives do not violate this requirement. As with all supervisory procedures, these procedures should be written, clearly communicated to employees, and effectively enforced. And, they should cover how approved designations may be used.

Some firms FINRA surveyed in connection with the preparation of this *Notice* ban the use of any designation that includes the word "senior" or "retirement." Others maintain a list of approved designations, and a registered representative wishing to use a designation not on the list must submit it for review by a committee consisting of principals, compliance officers and/or legal department personnel. Criteria used by committees to review proposed designations include the curriculum, examinations and continuing education components. To help investors and firms understand professional designations, FINRA maintains a database of such designations and the qualifications, if any, that are needed to obtain them at *http://apps.finra.org/DataDirectory/1/prodesignations.aspx.* Please note, however, that FINRA does not approve or endorse any professional designation, and it maintains the list solely to assist in the evaluation of the listed designations.[14]

In addition to senior designations, FINRA notes that some third-party vendors are marketing ghostwritten books on senior investing to registered representatives as tools to establish credibility. Holding oneself out as the author of a book on senior investing, and therefore an expert, could violate a number of rules, including NASD Rules 2110, 2120 and 2210, and NYSE Rule 472.

High-Pressure Sales Seminars Aimed at Seniors

Another area of concern to FINRA and other regulators is the use of aggressive or misleading sales tactics aimed at seniors, particularly the use of "free lunch" seminars that use high-pressure sales tactics to promote products that may not be suitable for all persons in attendance. Such high-pressure tactics include attempts to create an artificial or inappropriate sense of urgency around major decisions or commitments (*e.g.*, the use of phases such as "limited time offer" or "you have to sign up today") or that heighten or exaggerate typical fears of older investors (*e.g.*, the return of double-digit inflation or becoming financially dependent on family members). In response to these concerns, in May 2006, FINRA conducted a series of on-site examinations of broker-dealers that offer so-called "free lunch" sales seminars aimed at seniors. Other regulators simultaneously conducted similar examinations of investment advisers and other firms that offer such seminars.

In the course of the coordinated examinations, regulators found troubling sales practices, including the use of false or misleading sales materials used in connection with high-pressure sales seminars aimed exclusively or primarily at seniors or those at or nearing retirement. Among the most common practices were inaccurate or exaggerated claims regarding the safety, liquidity or expected returns of the investment or strategy being touted; scare tactics; misrepresentations or material omissions about the product or strategy; conflicts of interest; or misleading credentials used by persons sponsoring or participating in the seminar. The examinations also detected instances in which advertisements failed to include the firm's name, or made improper use of testimonials, in violation of NASD Rule 2210(d). The full discussion of the regulators' findings is presented in *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (Report), available at *www.finra.org/reports*.

FINRA will continue to follow up on the examination findings that relate to its members and will bring disciplinary actions where warranted. We also will continue to pay particular attention to the conduct of firms and their registered representatives in connection with sales seminars that are aimed primarily at seniors. We therefore urge firms to review their policies and procedures relating to sales seminars to make sure they are adequate. In doing so, firms should consult Appendix A of the Report, which contains detailed best practices for supervising sales seminar activities. These practices were identified by regulators in the course of the examinations as elements of effective supervisory procedures.

Diminished Capacity and Suspected Financial Abuse of Seniors

In addition to the regulatory concerns discussed above, there are other issues that firms sometimes encounter when dealing with senior investors. One of the most troubling to the firms we surveyed is that of investors who exhibit signs of diminished mental capacity. Unfortunately, this difficult and sensitive issue is likely to become more common as the ranks of older seniors grow: a recent study published by the National Institute on Aging reveals that impaired cognition affects approximately 20 percent of people aged 85 years or older.

Another troubling issue is suspected financial—and sometimes mental or physical—abuse of senior customers by their family members or caregivers. Financial abuse is difficult to define, and therefore, difficult to recognize. In general terms, it is the misuse of an older adult's money or belongings by a relative or a person in a position of trust. Red flags can include sudden, atypical or unexplained withdrawals; drastic shifts in investment style; inability to contact the senior customer; signs of intimidation or reluctance to speak in the presence of a caregiver; and isolation from friends and family.

These sensitive issues were raised repeatedly by the firms we surveyed for this *Notice*, and we include in this *Notice*, for the consideration of other FINRA members, some of the steps that firms, as a matter of sound business practice and as a way of serving their senior customers, are taking to address them. In doing so, we are not suggesting that firms are required to take these steps, including developing special written supervisory procedures for servicing senior customers. Firms and clients differ, and policies and procedures that work well for one firm may not be appropriate for another. The steps include:

- Designating a specific individual or department, such as the compliance or legal department, to serve as a central advisory contact for questions about senior issues, as well as a repository of available resources.
- Providing written guidance to employees on senior-related issues, such as how to identify and/or what to do if they suspect their customer is experiencing diminished capacity or is being abused, financially or otherwise, by a family member, caregiver or other third party.

  For example, one firm FINRA surveyed has very detailed procedures requiring its employees to immediately notify their branch manager, supervisor or another designated firm employee if they suspect abuse. Under the firm's procedures, that person in turn must notify the firm's legal department, which may decide to report the suspected abuse to the appropriate state agency; restrict activity in the account and/or take any action necessary to comply with appropriate court orders. In addition, the firm requires that the contact with the legal department be documented in the customer's file in accordance with the firm's record retention schedule. The supervisor or branch manager also is instructed to contact local emergency services if immediate physical abuse of a senior investor is suspected.
- Asking, either at account opening or at a later point, whether the customer has executed a durable power of attorney. (Some firms report that it is easier to have conversations with their customers about such sensitive issues as a matter of routine.)

- Asking, either at account opening or at a later time, whether the customer would like to designate a secondary or emergency contact for the account whom the firm could contact if it could not contact the customer or had concerns about the customer's whereabouts or health. (To avoid violating Regulation S-P, firms would have to clearly disclose to the customer the conditions under which the information would be used, and the customer would have the right to withdraw consent at any time.)
- Asking the customer if he or she would like to invite a friend or family member to accompany the customer to appointments at the firm.
- Informing the customer (where appropriate) that, in the firm's view, a particular unsolicited trade is not suitable for the customer.
- Reminding registered representatives that it is important when dealing with customers, particularly seniors, to base recommendations on current information.
- Offering training to help registered representatives understand and meet the needs of older investors, including proper asset allocation, liquidity demand and longevity needs, as well as the possible changes in their suitability profiles. Some relevant materials are available at *www.finra.org* and *www.saveandinvest.org*. Further, some firms have invited representatives from senior-related advocacy groups, the Alzheimer's Association, and state and local agencies that serve seniors to speak to their employees. Organizations that can help firms locate local experts on senior issues include the National Association of State Units on Aging (*www.nasua.org*), the National Association of Area Agencies on Aging (*www.n4a.org*) and AARP (*www.aarp.org*).

Investor Education

Finally, we urge firms to be proactive in helping to educate customers about how to avoid being victims of financial fraud, including making investor education materials, prepared by FINRA, the SEC, state regulators, the firm or another source, available to senior investors.[15] Registered representatives are often in a unique position to help customers learn about how to avoid fraudulent solicitations. We encourage our member firms and associated persons to talk with all of their customers, particularly seniors and others at high risk of being targeted, about how to spot scams and protect themselves and their families from financial fraud.[16]

Conclusion

Given the unprecedented number of investors who are at or nearing retirement age, protecting older investors is a priority for FINRA, and we urge firms to make it a priority, as well. We recognize that seniors are not all alike, and we stress that all investors are entitled to honesty and integrity from their broker-dealers. We remind firms to make sure that the policies and procedures that they do have, as well as relevant training materials, adequately take into account the special needs and concerns that are common to many investors as they age.

Endnotes

1 For ease of reference, this *Notice* refers to both categories as seniors unless the context requires a more specific reference.

2 *See* Wan He *et al*., U.S. Census Bureau, Current Population Reports, P23-209, *65+ in the United States: 2005,* U.S. Government Printing Office, Washington, D.C. (2005), available at *www.census.gov/prod/2006pubs/p23-209.pdf*.

3 *Id.*

4 *See* Wan He *et al*., U.S. Census Bureau, Current Population Reports, P23-209, *65+ in the United States: 2005,* U.S. Government Printing Office, Washington, D.C. (2005), available at *www.census.gov/prod/2006pubs/p23-209.pdf. See also* Frank B. Hobbs, U.S. Census Bureau, The Elderly Population, U.S. Government Printing Office, Washington, D.C. (2001), available at *www.census.gov/population/www/pop-profile/elderpop.html*.

5 A broker must refrain from making an unsuitable recommendation even if the customer expressed an interest in engaging in the inappropriate trade or asked the broker to make the recommendation. *See, e.g., Dane S. Faber,* Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23-24 (Feb. 10, 2004).

6 *See* NASD *Notice to Members (NTM) 96-86* (December 1996) and *NTM 99-35* (May 1999). In *NTM 99-35* and in NYSE *Information Memo 05-54* (August 11, 2005), we outlined a series of "best practices" and critical criteria relating to sales of variable annuities. While some members have voluntarily adopted many of those practices, others have not. Because some firms continue to engage in problematic sales practices in this area, and some investors continue to be confused by certain features of these products, we have adopted a rule (Rule 2821) that establishes suitability, disclosure, principal review, and supervisory and training requirements, all tailored specifically to transactions in deferred variable annuities. *See* Exchange Act Release No. 56375 (Sept. 7, 2007) (SR-NASD-2004-183). *See also www.finra.org/RulesRegulation/RuleFilings/2004RuleFilings/P012781*.

7 *See NTM 06-38* (August 2006).

8 *See NTM 04-89* (December 2004). Other relevant *Notices* include *NTM 03-71* (November 2003) (relating to non-conventional instruments); *NTM 04-30* (April 2004) (relating to bonds and bond funds); *NTM 05-26* (April 2005) (relating to vetting new products); and *NTM 05-59* (September 2005) (relating to structured products).

9 IRS Section 72(t) permits penalty-free withdrawals from IRAs before the age of 59½ pursuant to a series of substantially equal periodic payments. Some registered representatives tout Section 72(t) as a "loophole" that allows investors to retire early by withdrawing assets and investing them in products or strategies that offer higher rates of return. In some cases, the registered representative may promise that the investments will generate returns high enough to allow the investor to maintain a standard of living that is equal to or even higher than they did while working. However, the promised rate of return may be unrealistically high, and investors may not fully appreciate the potential downside to such strategies, including the potential loss of their home, or the depletion of their retirement assets.

10 On December 27, 2006, the SEC published for comment proposed changes to Regulation D that would establish a new "accredited natural person" requirement for investments in "private investment vehicles." The new standard would exclude the equity in a primary residence from the calculation of an accredited natural person's investment assets. The Commission has not yet adopted the proposal. *See* Securities Act Release No. 8766 (December 27, 2006) (SEC File No. S7-25-06).

11 *See* Securities Act Release No. 8766 (December 27, 2006) (SEC File No. S7-25-06). *See also* Securities Act Release No. 8828 (August 3, 2007) (SEC File No. S7-18-07).

Endnotes (cont'd)

12 *See* NASD IM-2310-3, which outlines certain factors that may be relevant when considering compliance with Rule 2310(a) in connection with recommendations to institutional customers. Two important considerations in determining the scope of a firm's suitability obligations to institutional customers are the customer's ability to evaluate investment risk independently, and the extent to which the customer is exercising that ability in connection with the recommendation.

13 For example, Nebraska prohibits the use of senior designations, while Massachusetts permits the use of designations only if they have been approved by an independent accreditation agency. *See Interpretative Opinion No. 26: Use of Certifications and Designations in Advertising by Investment Adviser Representatives and Broker-Dealer Agents,* Special Notice of the Nebraska Department of Banking and Finance (November 13, 2006), available at *www.ndbf.org/forms/bd-ia-special-notice.pdf.* The Massachusetts regulations became effective June 1, 2007. *See* 950 Mass. Code Regs. 12.204(2)(i) (2007) (*Registration of Broker-Dealer, Agents, Investment Adviser, Investment Adviser Representatives and Notice Filing Procedures*), and the Notice of Final Regulations, available at *www.sec.state.ma.us/sct/sctpropreg/propreg.htm.* Further, as of the date of this *Notice*, the North American Securities Administrators Association, Inc. (NASAA) is developing a model rule that would "mak[e] it a separate violation of law to use a designation or certification to mislead investors. Once the model rule has been released for public comment and ultimately approved by the NASAA membership, [NASAA] will urge its adoption in every jurisdiction." Testimony of Joseph P. Borg, Director, Alabama Securities Commission and NASAA President, Before the Special Committee on Aging, United States Senate (September 5, 2007).

14 Firms that are aware of designations that are not included in FINRA's database are invited to provide us with the relevant information so that we may include them.

15 For relevant materials, visit the FINRA Investor Education Foundation's Web site, *www.saveandinvest.org*.

Endnotes (cont'd)

16 To better understand why older investors fall prey to investment fraud, the FINRA Investor Education Foundation funded researchers that analyzed undercover tapes of fraud pitches and surveyed victims and non-victims to determine how they differ. Some of the key research findings include:

- Investment fraud victims are more financially literate than non-victims;
- Investment fraud criminals use a wide array of different influence tactics—from friendship to fear and intimidation tactics—to defraud the victim;
- Fraud pitches are tailored to match the psychological needs of the victim;
- Investment fraud victims are more likely to listen to sales pitches;
- Investment fraud victims are more likely to rely on their own experience and knowledge when making investment decisions;
- Investment fraud victims experience more difficulties from negative life events than non-victims;
- Investment fraud victims are more optimistic about the future; and
- Investment fraud victims dramatically under-report fraud.

See Off the Hook Again: Understanding Why the Elderly Are Victimized by Economic Fraud Crimes, survey results and analysis prepared for WISE Senior Services by The Consumer Fraud Research Group (2006), available at *www.finrafoundation.org/WISE_Investor_Fraud_Study_Final_Report.pdf.*

PERSPECTIVES

NEW CYBER SECURITY REGULATIONS PROMULGATED BY NEW YORK'S DEPARTMENT OF FINANCIAL SERVICES

BY **BARRY R TEMKIN / ROBERT USINGER**
> MOUND COTTON WOLLAN & GREENGRASS LLP / ONEBEACON INSURANCE GROUP

Effective 1 January 2017, the New York State Department of Financial Services (DFS) is expected to implement new cyber security requirements which require regulated financial companies doing business in New York to adopt comprehensive written programmes and procedures to prevent data breaches and other cyber security events. The new cyber security regulations affect any licensed entity doing business under the New York Banking Law, Insurance Law, or Financial Service Law, including insurance carriers, banks, insurance agents, consumer lenders, mortgage brokers and other entities under DFS jurisdiction. This regulation may signal a potential wave of cyber security requirements imposed by financial industry regulators. Since most financial firms do business in New York, the implications of the DFS cyber security regulations can be expected to be broad-reaching.

And while Massachusetts has recently enacted a law requiring all businesses to encrypt confidential personal information stored on portable devices or transmitted electronically where technically feasible, New York's regulations are directed specifically toward the financial services industry.

Under the new cyber security regulations, each financial services company operating in New York "shall establish and maintain a cybersecurity program to ensure the confidentiality, integrity and availability of the covered entity's information systems". The DFS regulations further require each cyber security programme to identify internal and external cyber risks, develop and implement defensive infrastructure to protect the company's information system, detect cyber security events and fulfil regulatory reporting obligations.

The DFS issued the proposed rules on 28 September 2016 for a 45-day public comment period, which ended on 14 November 2016. The final rules are expected to be issued before the end of 2016 with an effective date of 1 January 2017. The proposed effective date of 1 January 2017 is subject to a 180 day grace period. Covered entities are required to prepare and submit a certificate of compliance to the DFS, starting 15 January 2018.

The new rules apply to "any person operating under or required to operate under a license, registration, charter, certificate, permit, accreditation or similar authorization under the banking law, the insurance law or the financial services law." A

limited exception to the regulations is carved out for otherwise covered entities with fewer than 1000 customers, fewer than $5m in gross annual revenue and less than $10m in year-end total assets.

The proposed regulations require each covered company to establish a comprehensive written cyber security policy addressing 14 specific areas, including information security, data governance and classification, a business continuity and disaster recovery plan, systems operations and availability concerns, network security, customer data privacy, risk assessment and related topics. The written cyber security policy should also contain a proposed plan of response to a potential data breach or other cyber event, which must be reviewed and approved by the board of directors and chief executive on an annual basis.

Each covered entity is required to designate a chief information security officer (CISO) to implement the firm's cyber security programme and to report, on a biannual basis, to the board of directors or CEO regarding major issues affecting the company's cyber security programme. The CISO's biannual report should identify cyber risks, evaluate the effectiveness of the company's cyber security programme and propose to remediate any inadequacies. In addition, the regulations require penetration testing on an annual basis and the maintenance of an audit trail sufficient to identify persons who accessed the entity's information systems. The audit trail records must be maintained for at least six years.

The regulations require the covered entity certify its compliance in an annual report, certified by the chair of its board or a comparable senior manager. In addition, a covered entity must promptly notify DFS of a cyber event "that has a reasonable likelihood of materially affecting the normal operation of the covered entity or that affects non-public information".

> "Financial services companies doing business with vendors such as law firms will be required to affirm that these vendors maintain minimum cyber security practices, including encryption of electronic data."

Of particular note for law firms representing financial service companies, Section 500.11 of the DFS regulations requires each covered entity to implement written policies and procedures designed to ensure the security of information systems and non-public information "that are accessible to or held by third parties doing business with the covered entities". These policies must identify

third parties with access to sensitive data, and require minimum cyber security practices to be maintained by them. According to Section 500.11, each covered entity shall implement written policies and procedures designed to ensure the security of information systems and non-public information that are accessible to, or held by, third parties doing business with the covered entity. Such policies and procedures shall address, at a minimum, the following areas: (i) the identification and risk assessment of third parties with access to such information systems or such non-public information; (ii) minimum cyber security practices required to be met by such third parties in order for them to do business with the covered entity; (iii) due diligence processes used to evaluate the adequacy of cyber security practices of such third parties; and (iv) periodic assessment, at least annually, of such third parties and the continued adequacy of their cyber security practices.

Financial services companies doing business with vendors such as law firms will be required to affirm that these vendors maintain minimum cyber security practices, including encryption of electronic data.

Encryption is a key part of the new regulations, which require each covered entity to "encrypt all non-public information held or transmitted by the covered entity both in transit and at rest". Non-public information which cannot be feasibly encrypted must be secured with alternative controls. The DFS regulations require encryption of non-public information, which includes personal identifying information (PII), competitively sensitive information and any information that would be considered non-public under the Gramm-Leach Bliley Act of 1999. In addition, the regulated entity must prepare a written incident response plan designed to respond, to and recover from, a potential data breach. The encryption requirement is delayed until "one year from the effective date of the regulation."

The new regulations will also require multi-factor authentication for privileged access to database servers of covered entities or for individuals accessing systems from an external network. Such authentication would entail the use of two of the three following sensors: (i) knowledge factor, such as a password; (ii) possession factor, such as a token or text message on a mobile phone; or (iii) inherent factor, such as a biometric characteristic like a fingerprint. Thus, regulated financial entities now need more than just a password to access sensitive computer data.

The new regulations also propose "limitations on data retention", mandating the destruction of non-public information that is no longer necessary. This requirement could place these regulations, and the covered entities that follow them, in potential conflict with a body of case law about electronically-stored information, spoliation and maintenance of electronically stored data, as required by financial industry regulations and court rules. The regulations

also provide a carve-out for information required to be maintained by law or regulation.

Conclusion

Lawyers who represent covered entities regulated by DFS should advise their clients regarding compliance with the new DFS cyber security regulations. In addition, law firms transmitting data to and from financial service companies in New York would be well-advised to ensure that their own information systems are adequately encrypted in order to facilitate their clients' compliance with the new regulations.

Financial industry regulators, such as the US Securities and Exchange Commission and Financial Industry Regulatory Authority, have reported investigations and audits of firms for cyber security deficiencies. Given New York's prominence as an international financial centre, it is likely that the new DFS regulations will accelerate the trend toward further regulation of cyber security by government agencies and self-regulatory organisations. CD

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BY BARRY R. TEMKIN

Ethical Issues in Settlement Negotiations

While most practitioners are generally aware of the ethical limitations on making factual and legal representations to a tribunal, there is less consensus on the ethical constraints on an attorney during the course of settlement negotiations.

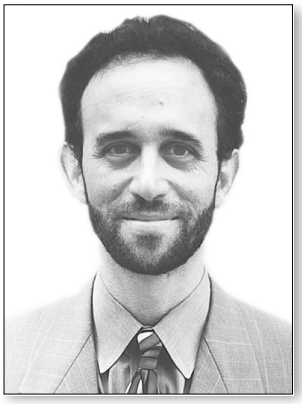
Settlement negotiations frequently take place in the absence of judicial supervision and are subject to few explicit rules or guidelines, prompting some ethicists to refer to settlement negotiations as the "no-man's land" of attorney ethics.[1]

While the Lawyer's Code of Professional Responsibility (code)[2] generally proscribes outright misrepresentations, it is less clear in what circumstances an attorney's omission can constitute a misrepresentation.

Professional Responsibility

The code, while not explicitly addressing the settlement process, does contain general provisions proscribing fraud or misrepresentations by attorneys. For example, Disciplinary Rule (DR) 1-102(A)(4) prohibits "conduct involving dishonesty, fraud, deceit or misrepresentation." DR 7-102(A)(5) provides that a lawyer may not, in representing a client, knowingly make a false statement of law or fact. The code further provides that a lawyer may not "[c]onceal or knowingly fail to disclose that which the lawyer is required by law to reveal." DR 7-102(A)(3). Subsection (B) of the same rule requires a lawyer to reveal a client's fraud committed in the course of the representation:

A lawyer who receives information clearly establishing that: (1) The client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon the client to rectify the same, and if the client refuses or is unable to do so, the lawyer shall reveal the fraud to the affected person or tribunal, except when the information is protected as a confidence or secret.



A lawyer who intentionally omits material information from discovery may be personally sued for money damages by a defrauded adversary. — 'Cresswell v. Sullivan & Cromwell'

Thus, the code requires a lawyer to reveal a fraud occurring in the course of the representation, subject to the confidentiality provisions of DR 4-101. However, as Professor Roy Simon of Hofstra University School of Law has observed, the "secret or confidence" exception to DR 7-102(B) has virtually consumed the rule: "In virtually no circumstances will a lawyer have information about a client's fraud that will escape DR 4-101(A)'s definition of 'confidence' or 'secret.'"[3]

Cases on Misrepresentation

Some authorities have examined an attorney's obligation to refrain from both affirmative misrepresentations and omissions in the course of settlement negotiations. In practice, misrepresentations sometimes contain elements of affirmative statements and material omissions.

A leading illustration is *Slotkin v. Citizens Casualty Co.*, 614 F2d 301 (2d Cir. 1979), in which a lawyer was held liable in fraud for misrepresenting the existence and extent of a client's insurance coverage. In *Slotkin*, the lawyer defending a hospital affirmatively stated in settlement negotiations that the full extent of insurance coverage was $200,000, prompting the guardian of a brain-damaged baby to settle the case within the perceived policy limits.

Upon learning of the existence of a $1 million excess policy, the infant's guardian successfully sued the attorney for fraud. The trial court set aside a verdict in favor of the plaintiffs, reasoning that the settlement of the underlying malpractice case had never been reduced to writing, and that the plaintiffs could not simultaneously affirm the settlement and obtain additional damages. The U.S. Court of Appeals for the Second Circuit reversed, holding that the victims of intentional fraud may elect either to rescind the settlement, or to ratify it and sue for any additional damages caused by the fraud. In addition, the attorney making the misrepresentation about insurance was disciplined.[4]

Cresswell v. Sullivan & Cromwell, 668 FSupp 166 (SDNY 1987), held that a lawyer who intentionally omits material information from discovery may be personally sued for money damages by a defrauded adversary. The defendant in *Cresswell* was a law firm that had previously defended a securities broker-dealer in a securities fraud action. In discovery responses, the lawyers denied that their client was being investigated by any regulators for the same conduct which formed the basis for the civil suit. The law firm withheld from production a recently received letter from the New York Stock Exchange concerning an investigation of its client for the same conduct alleged in the

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civil case. After settling the case for a fraction of its value, the underlying plaintiffs in the securities fraud action came to learn of the investigation and sued the lawyers, claiming that they were deceived by the nondisclosure. In denying the law firm's motion to dismiss, the court held that the plaintiffs could affirm the earlier settlement and still seek further damages for the additional losses they incurred in reliance upon the misrepresentation.

An even more interesting situation arises when a lawyer, in settlement negotiations, conceals from an adversary the intent to take adverse future action.

Consider a lawyer who, unlike the attorneys in *Cresswell,* was not asked any question at all in settlement negotiations, but concealed information that the adversary never requested. The question posed in *Pendleton v. Central New Mexico Correctional Facility,* 184 FRD 637 (DNM 1999), was whether a lawyer, in settling a case, was obligated to reveal a client's intention to bring a related action arising out of the same facts.

In that case, the plaintiff settled an employment discrimination action against his employer, explicitly releasing the defendant only for conduct up through the date of a settlement conference. After the settlement agreement was executed and the plaintiff had cashed his settlement check, the plaintiff filed a new charge with the Equal Employment Opportunity Commission, alleging retaliatory discharge. The defendant employer complained to the federal court that had approved the settlement that the plaintiff had intentionally withheld from settlement discussions his plan to bring a retaliation suit for the same conduct.

The district court, while declining to award sanctions against the plaintiff, wrote that "a half truth may be as misleading as a statement wholly false" and that "the failure to disclose a fact may be a misrepresentation in certain circumstances." 184 FRD at 641 (citations omitted).

A classic illustration of misrepresentation by omission is when an attorney accepts a settlement offer without disclosing the death of the plaintiff.

The seminal case concerning the duty to disclose the death of one's client in settlement negotiations is *Virzi v. Grand Trunk Warehouse & Cold Storage Co.,* 571 FSupp 507 (EDMich 1983). In that case, the court set aside a settlement agreement due to the plaintiff's attorney's failure to disclose the death of his client. In a ruling based in part on DR 7-102, the court wrote:

> Here, plaintiff's attorney did not make a false statement regarding the death of plaintiff. He was never placed in a position to do so because during the two weeks of settlement negotiations, defendant's attorney never thought to ask if plaintiff was still alive. Instead, in hopes of inducing settlement, plaintiff's attorney chose not to disclose plaintiff's death, as he was well aware that defendants believed that plaintiff would make an excellent witness on his own behalf if the case were to proceed to trial by jury.[5]

The ABA Committee on Professional Ethics, in Formal Opinion 95-397, concluded that a personal injury lawyer must disclose the death of the plaintiff before accepting a settlement offer. The ABA Ethics Committee reasoned that the death of a client terminates or at least changes the attorney's authority to act, and that "a failure to disclose that occurrence is tantamount to making a false statement of material fact" within the meaning of ABA Model Rule 4.1.[6] The ABA committee concluded that the client's death means that "the lawyer, at least for the moment, no longer has a client, and, if she does thereafter continue in the matter, it will be on behalf of a different client."

The court set aside a settlement agreement due to the plaintiff's attorney's failure to disclose the death of his client. — 'Virzi v. Grand Trunk Warehouse …'

New York practitioners should take note that the rules of court may require an attorney to take action, including notifying the court, in the event of a party's death. CPLR 1015 requires the court to order substitution of a representative for the estate of a deceased party, and the rules of the Appellate Division, Second Department require immediate notification in the event of a party's death. See 22 NYCRR 670 (g). An attorney who fails to comply with this provision can be subject to sanctions. *McCormack v. County of Westchester,* 258 AD2d 567, 685 NYS2d 738 (2d Dept. 1999). And an attorney who engaged in prolonged and persistent settlement negotiations, tried to avoid a defense medical examination and engaged in an arbitration without revealing the death of his client was suspended. *In re Forrest,* 265 AD2d 12, 706 NYS2d 15 (1st Dept. 2000).

Omitting Insurance Coverage

What about the situation in which an attorney makes a literally correct factual representation to an adversary in unsupervised settlement negotiations, which, nevertheless, is materially misleading? For example, assume that an attorney accurately informs an adversary that a corporate client is in severe financial distress and is on the verge of insolvency which could threaten its ability to continue in business. However, the attorney chooses not to reveal the existence of a substantial insurance policy that could fully satisfy the adversary's claims. The case is not in litigation, the corporation has not filed for bankruptcy and there is no statutory obligation to disclose the insurance coverage.

The New York County Lawyers' Association Committee on Professional Ethics considered these principles in Ethics Opinion 731[7] and concluded that "while the lawyer has no affirmative obligation to make factual representations in settlement negotiations, once the topic is introduced the lawyer may not intentionally mislead." The NYCLA Ethics Committee distinguished between a factual representation introduced by the lawyer and a representation derived from an outside source. The committee reasoned that while an attorney may not intentionally mislead an adversary, there is no need to enlighten an adversary who is laboring under a self-inflicted misperception of fact.

Thus, while a lawyer may not directly convey or perpetuate false information to an adversary about insurance, there is no duty to correct an adversary who is laboring under a misimpression derived from another source.

Conclusion

Although most settlement negotiations take place in the absence of judicial supervision, an attorney is still bound by the requirement of DR 7-102 to refrain from making false statements of law or fact. A lawyer is further prohibited from concealing or knowingly failing to disclose that which the lawyer is required by law to reveal. While a lawyer is not obligated to prevent an adversary from proceeding on an erroneous assumption of the adversary's own making, a lawyer is not permitted affirmatively to contribute to an adversary's misconception, either by misrepresentation or omission.

1. Michael H. Rubin, "The Ethics of Negotiations: Are There Any?," 56 La. L. Rev. 447 (1995).
2. Disciplinary Rules of the Code of Professional Responsibility, 22 NYCRR §1200 et seq.
3. Simon's New York Code of Professional Responsibility Annotated (Thompson West 2003) at 721.
4. *In re McGrath,* 96 AD2d 267, 468 N.Y.S.2d 349 (1st Dept. 1983).
5. 571 FSupp at 511.
6. The ABA Model Rules of Professional Conduct are different in some significant respects from the New York Code. New York is currently contemplating adopting a version of the Model Rules.
7. NYCLA Ethics Op. 731, www.nycla.org.

Protecting Senior Investors

by Jack Duval[1]

Introduction[2]

The United States is a rapidly aging society. As our population lives longer, the numbers of those who will suffer from declining mental capacities and dementia will increase. Since most investors are older, if not retired, broker-dealers and their Registered Representatives are on the front line of facing the rising levels of dementia.

Training, vigilance and close supervision are required to address these trends and to protect senior investors and the broker-dealers themselves. While no system is fail-safe, if Registered Representatives truly know their clients, and supervisors closely monitor the activity in senior investors accounts, most abuses can be detected and prevented.

This paper gives an overview of the problem of dementia, a basic understanding of what dementia is and how regulators - particularly FINRA - have addressed it.

Background

A recent article in *Nature* entitled "The Dementia Time Bomb" estimated that by 2050 over 130 million people worldwide could be affected by dementia.[3] The article estimated the costs in the U.S. alone to reach $1 trillion in today's dollars.[4]

However, a more immediate financial threat exists from dementia: financial fraud and abuse. Investors 50 years and older hold 77% of all U.S. financial assets.[5] Of course, they are also the most at risk of dementia. This makes them easy targets for financial abuse.

Apparently, the criminally inclined have figured this out. Some statistics summarized by the Securities Industry and Financial Markets Association ("SIFMA") are sobering:

[1] Jack Duval is the managing partner and an expert witness at Accelerant, a securities litigation consulting boutique. For further information see: www.accelerant.biz.

[2] Parts of this paper appeared as blog posts on the Accelerant blog: blog.accelerant.biz/blog.

[3] Elie Dolgin, *Nature*, "The Dementia Time Bomb," November 10, 2016, P. 156.

[4] *Id*.

[5] Yuka Hayaski, *The Wall Street Journal*, "FINRA Proposes Steps to Prevent Abuse of Senior Investors," October 20, 2016; Available at: http://www.wsj.com/articles/finra-proposes-protections-for-seniors-against-exploitation-1476977937. Accessed January 4, 2017.

> Senior financial exploitation is a problem that costs senior investors an estimated $2.9 billion annually – funds that many were relying on to support them in retirement. Moreover, with 10,000 Americans turning 65 every day and an estimated 1 in 5 Americans aged 65 or older being victimized by financial fraud, this problem will continue to grow. Complicating these protection efforts is the fact that only an estimated 1 in 44 cases of financial elder abuse is reported and the fact that 55% of financial abuse in the United States is committed by family members, caregivers and friends.[6]

Regulatory, Law Enforcement and Government Response

These facts have not gone unnoticed by financial regulators, law enforcement and government agencies, including:

- The Securities Exchange Commission ("SEC");
- The Financial Industry Regulatory Association ("FINRA");
- The Office of Compliance Inspections and Examinations ("OCIE");
- The North American Securities Administrators Association ("NASAA");
- The Federal Bureau of Investigation ("FBI");
- The Government Accountability Office ("GAO"); and,
- The U.S. Senate Special Committee on Aging.

These regulators and government agencies have been focused on financial fraud targeting seniors for at least the past 15 years. For instance, in a speech the day before September 11, 2001, Dennis M. Lormel (then the FBI Financial Crimes Section Chief), stated:

> … the FBI has identified elder fraud and fraud against those suffering from serious illness as two of the most insidious of all white-collar crimes being perpetrated by today's modern and high tech con-man.[7]

The problem appears to have gotten worse. FINRA established a special hotline dedicated to seniors in April 2015 and since then it has fielded approximately 6,700 calls – about 353 calls per month. Callers to the hotline have recovered $2.4 million in voluntary reimbursements.[8]

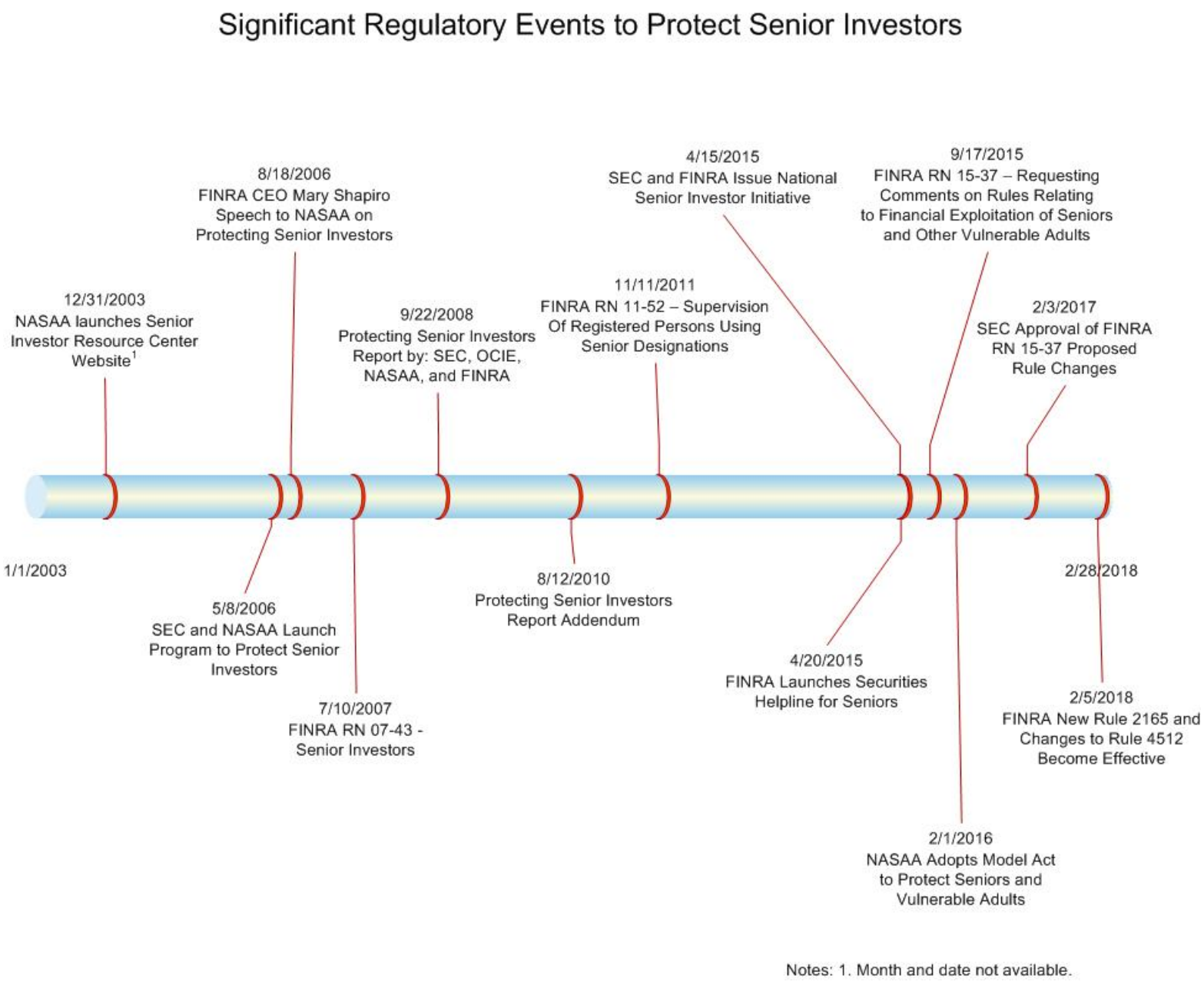
[6] Lisa Bleier, SIFMA, Comments regarding FINRA Regulatory Notice 15-37, Financial Exploitation of Seniors and Other Vulnerable Adults; December 1, 2015. Notes omitted.

[7] Dennis M. Lormel, Chief, Financial Crimes Section, FBI, September 10, 2001; Available at: https://archives.fbi.gov/archives/news/testimony/fraud-against-the-elderly. Accessed January 6, 2017.

[8] Yuka Hayashi, *The Wall Street Journal*, "FINRA Proposes Steps to Prevent Abuse of Senior Investors"; October 20, 2016. Available at: http://www.wsj.com/articles/finra-proposes-protections-for-seniors-against-exploitation-1476977937. Accessed January 6, 2017.

Timeline

Since at least 2006, there has been a concerted effort by financial regulators to protect senior investors from financial fraud and abuse. The timeline below highlights some of those efforts.



Defining a "Senior Investor"

An obvious question anyone considering how to protect senior investors is who qualifies as a senior. Most states and regulators define "senior" or "vulnerable" adult as one who is age 60 or 65 and older. I have summarized some state and regulatory definitions in the table below.

Table 1: Age of a "Senior"

Entity	Document	Senior Age	Notes
FINRA	NTM 07-43 - Senior Investors	65	Age referred to but not defined.
FINRA	RN 15-37	65	
SEC	National Senior Investor Initiative	65	
NASAA	Model Legislation	65	
Missouri	Sweep Report Findings	60	Age of "elderly persons".
Washington State	Title 74, Chapter 74.34	60	Age of "vulnerable adult".
Delaware	Title 11, Section 222	62	Age of "elderly person".
Illinois	720 ILCS 5/17-56	60	Age of "elderly person".
Alabama	Title 38, Chapter 9E, Section 38-9E-2	60	Age of "elderly person".
Louisiana	Elder Law Task Force 2014 Update	60	
Congress	Senior$afe Act, S.2216	65	Age of "senior citizen".
Senate	The Elder Protection and Abuse Prevention Act, S.3270	60	Age of "elder".

Who Perpetrates Financial Fraud on Senior Investors?

One of the most heartbreaking facts about financial fraud and abuse of senior investors is that it is most likely to be perpetrated by family members. The National Center on Elder Abuse reports that:[9]

> Perpetrators are most likely to be adult children or spouses, more likely to be male, to have history of past or current substance abuse, to have mental or physical health problems, to have history of trouble with the police, to be socially isolated, to be unemployed or have financial problems, and to be experiencing major stress.
>
> In a study of 4,156 older adults, **family members were the most common perpetrators of financial exploitation of older adults (FEOA) (57.9%), followed by friends and neighbors (16.9%), followed by home care aides (14.9%).** (Emphasis added)

[9] National Center on Elder Abuse; Available at: https://ncea.acl.gov/whatwedo/research/statistics.html#perpetrators. Accessed February 27, 2017. (Notes omitted.)

These statistics should focus Registered Representative attention on family members and others who are closest to their senior clients. However, supervisors are tasked with not only watching for abuse by family members, but also their own Registered Representatives possibly exerting undue influence, fraud and abuse upon their senior clients. As will be discussed below, there are a number of red flags for supervisors to watch for.

Knowing Your Customer, and Dementia

Registered Representatives are tasked to "know your customer." FINRA Rule 2090 states:[10]

> 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. (Emphasis added)

Of particular importance is the phrase "opening and maintenance." This means the duty to know the customer is not a one-time obligation to be met at the beginning of a financial relationship. Instead, it is an ongoing duty that must be maintained throughout the relationship. It is a diligence-based rule, as opposed to FINRA Rule 2111 – Suitability, which is a recommendation-based rule.

In industry parlance, FINRA Rule 2090 imposes a duty upon financial advisors to continually inquire (or "profile") clients in order to be up to date on any changes in their "essential facts." Not only is this common sense, it is standard industry practice.

Furthermore, it is a long-standing rule with antecedence in NYSE Rule 405 – Diligence as to Accounts:[11]

> Every member organization is required through a principal executive or a person or persons designated under the provisions of Rule 342(b) (1) to
>
> (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account **accepted or carried** by such organization and every person holding power of attorney over any account accepted or carried by such organization. (Emphasis added)

[10] FINRA Rule 2090 – Know Your Customer; Available at: http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13389&element_id=9858&highlight=2090#r13389. Accessed January 26, 2017.

[11] FINRA Rule 405 – Diligence as to Accounts. Rule 405 is no longer in force, having been replaced by FINRA Rule 2111 – Suitability and FINRA Rule 2090 – Know Your Customer. NYSE rules were subsumed into FINRA rules on November 11, 2008. See FINRA RN 08-64 – Transitional Rulebook. Available at: http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=12773&element_id=9319&highlight=405#r12773. Accessed January 26, 2017.

Like the “opening and maintenance” language above, the phase “accepted or carried” is critical. It means that the obligation to know the client is ongoing.

Knowing Dementia

While no Registered Representative should be held to a standard of diagnosing dementia, they must be extra vigilant to know their senior clients and to watch for signs of mental decline. Any indications of decline should be immediately escalated for supervisory review.

Dementia can take many forms and has many levels of severity; frequently, those who are experiencing it are unaware of their mental decline. Registered Representatives and their supervisors should be familiar with the signs of dementia. What follows is a general description of dementia and its stages.

Definitions of Dementia

The Alzheimer’s Association gives this description of dementia:[12]

> Dementia is a general term for a decline in mental ability severe enough to interfere with daily life. Memory loss is an example. Alzheimer’s is the most common type of dementia.
>
> Dementia is not a specific disease. It's an overall term that describes a wide range of symptoms associated with a decline in memory or other thinking skills severe enough to reduce a person's ability to perform everyday activities. Alzheimer's disease accounts for 60 to 80 percent of cases. Vascular dementia, which occurs after a stroke, is the second most common dementia type. But there are many other conditions that can cause symptoms of dementia, including some that are reversible, such as thyroid problems and vitamin deficiencies.
>
> Dementia is often incorrectly referred to as "senility" or "senile dementia," which reflects the formerly widespread but incorrect belief that serious mental decline is a normal part of aging.

Common problems experienced by those with dementia include:[13]

[12] Alzheimer’s Organization, “What is Dementia?”. Available at: http://www.alz.org/what-is-dementia.asp. Accessed January 24, 2017.

[13] Alzheimer’s Association. “About Dementia | Assessment and Diagnosis.” Available at: https://www.alzheimers.org.uk/site/scripts/documents_info.php?documentID=260. Accessed January 24, 2017.

- Day-to-day memory;
- Concentrating, planning or organizing;
- Language (e.g., struggling to find the right word);
- Judging distances and seeing objects properly (not caused by poor eyesight); and,
- Orientation (e.g., confusion about the day or month, or where they are).

Health professionals have created a number of scales to judge the level of dementia. One of the most commonly used is the Global Deterioration Scale for Assessment of Primary Degenerative Dementia ("GDS").[14] The table below summarizes the seven stages of the GDS:

Table 2: Global Deterioration Scale for Assessment of Primary Degenerative Dementia

Stage of Cognitive Decline	Dementia Diagnosis	Signs	Average Duration (Years)
1: None	No dementia	Normal functioning, no memory loss.	-
2: Very mild	No dementia	Normal forgetfulness associated with aging.	-
3: Mild	No dementia	Increased forgetfulness, slight difficulty concentrating, and decreased work performance.	7
4: Moderate	Early-stage	Difficulty concentrating, decreased memory of recent events, **difficulties managing finances** or traveling alone to new locations.	2
5: Moderately severe	Mid-stage	Major memory deficiencies and need of assistance to complete daily activities (dressing, bathing, preparing meals).	1.5
6: Severe	Mid-stage	Requirement of extensive assistance to carry out daily activities. Forgetting names of close family members.	2.5
7: Very severe	Late-stage	Essentially no ability to speak or communicate.	2.5

Testing for Dementia

While there is no cure for the disease, there are many sophisticated tests that medical professionals can administer for gauging dementia. However, the first test typically

[14] Dementia Care Central, "Seven Stages of Dementia | Symptoms & Progression." Available at: https://www.dementiacarecentral.com/aboutdementia/facts/stages/. Accessed January 25, 2017. (Emphasis added)

administered is the Mini Mental State Examination ("MMSE"). The Alzheimer's Society describes the MMSE as:[15]

> The Mini Mental State Examination (MMSE) is the most commonly used test for complaints of problems with memory or other mental abilities. **It can be used by clinicians to help diagnose dementia and to help assess its progression and severity.** It consists of a series of questions and tests, each of which scores points if answered correctly. The MMSE tests a number of different mental abilities, including a person's memory, attention and language.
>
> **MMSE is only one part of assessment for dementia.** Clinicians will consider a person's MMSE score alongside their history, symptoms, a physical exam and the results of other tests, possibly including brain scans.
>
> **The MMSE can also be used to assess changes in a person who has already been diagnosed with dementia. It can help to give an indication of how severe a person's symptoms are and how quickly their dementia is progressing.** Again, results should be considered alongside other measures of how the person is coping together with clinical judgment. (Emphasis added)

The MMSE asks questions that non-dementia sufferers would find fairly trivial, such as:[16]

- What is the year? Season? Date? Day? Month?;
- Where are we now? State? County? Town/City? Hospital? Floor?;
- Repeat the phrase: "No ifs, ands, or buts.";

Obviously, incorrect answers to such questions are indicative of diminished capacities. It is up to medical professionals to determine whether the diminished capacities are due to normal aging or dementia. However, from the Registered Representative's perspective, the question of the *cause* of diminished capacities is less important. For Registered Representatives, it is the fact that a client's capacities are declining that is important.

While Registered Representatives are not expected to administer the MMSE to their clients, they must be vigilant for signs of decline when dealing with senior investors. When a client begins showing signs of diminished capacities that is the time for a Registered Representative to escalate their observations to their supervisors. Even if there are no suspicions of financial fraud or abuse, accounts of such clients deserve heightened supervision.

New FINRA Rules, the Report and Hold Framework

[15] The Alzheimer's Society – The MMSE Test; Available at: http://www.alzheimers.org.uk/info/20071/diagnosis/97/the_mmse_test. Accessed February 27, 2017.

[16] Dementia Today – MMSE Test; Available at: www.dementiatoday.com/wp-content/uploads/2012/06/MiniMentalStateExamination.pdf. Accessed February 27, 2017.

On February 3, 2017, the SEC approved the proposed change to FINRA Rule 4512 and the adoption of FINRA Rule 2165 that were set forth in FINRA Regulatory Notice 15-37 – Financial Exploitation of Seniors and Other Vulnerable Adults.[17] These rule changes are designed to protect senior investors from financial fraud and abuse and are built on what is known as a "report and hold" framework.

The changes to, and amendment of, the rules will become effective on February 5, 2018. Each of the rules is examined below.

FINRA Rule 4512 – Customer Account Information

The additions to Rule 4512 add a pre-identified trusted contact person for broker-dealers to reach out to in the event of suspicious activity. While contacting the authorities has been and remains an option, this adds another contact to "report" to, the first part of the report and hold framework.

The rule currently requires Registered Representatives to gather information about any person or entity opening an account. Gathering information is part of the profiling process and one of the ways in which the broker-dealer can demonstrate that it knows the client. While new account forms used to be one or two page documents in the 1980s and 90s, under the heightened requirements of The Patriot Act, OFAC and FinCEN, many new account forms extend to four or five pages.

The new parts of FINRA Rule 4512 – Customer Account Information, state:[18]

> (a)(1)(F) subject to Supplementary Material .06, name of and contact information for a trusted contact person age 18 or older who may be contacted about the customer's account; provided, however, that this requirement shall not apply to an institutional account.
>
> **.06 Trusted Contact Person**
>
> (a) With respect to paragraph (a)(1)(F) of this Rule, **at the time of account opening a member shall disclose in writing, which may be electronic, to the customer that the member or an associated person of the member is authorized to contact the trusted contact person and disclose information about the customer's account to address possible financial exploitation, to**

[17] SEC Release No. 34-79964, File No. SR-FINRA-2016-039; Available at: https://www.gpo.gov/fdsys/pkg/FR-2017-02-09/pdf/2017-02645.pdf. Accessed February 25, 2017, at 10059.

[18] FINRA Rule 4512 – Customer Account Information. Available at: http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=17537&element_id=9958&highlight=4512#r17537. Accessed February 25, 2017.

confirm the specifics of the customer's current contact information, health status, or the identity of any legal guardian, executor, trustee or holder of a power of attorney, or as otherwise permitted by Rule 2165. With respect to any account that was opened pursuant to a prior FINRA rule, a member shall provide this disclosure in writing, which may be electronic, when updating the information for the account pursuant to paragraph (b) of this Rule either in the course of the member's routine and customary business or as otherwise required by applicable laws or rules.

(b) **The absence of the name of or contact information for a trusted contact person shall not prevent a member from opening or maintaining an account for a customer, provided that the member makes reasonable efforts to obtain the name of and contact information for a trusted contact person.**

(c) With respect to any account subject to the requirements of SEA Rule 17a-3(a)(17) to periodically update customer records**, a member shall make reasonable efforts to obtain or, if previously obtained, to update where appropriate the name of and contact information for a trusted contact person** consistent with the requirements of SEA Rule 17a-3(a)(17). (Emphasis added)

FINRA Rule 2165 – Financial Exploitation of Specified Adults

This new rule addresses the "hold" part of the report and hold framework. It works in tandem with the amendments to Rule 4512. Rule 2165 states, in part:[19]

(a)(1) **For purposes of this Rule, the term "Specified Adult" shall mean: (A) a natural person age 65 and older**; or (B) a natural person age 18 and older who the member reasonably believes has a mental or physical impairment that renders the individual unable to protect his or her own interests.

(b)(1) A member may place a temporary hold on a disbursement of funds or securities from the Account of a Specified Adult if:

(A) The member reasonably believes that financial exploitation of the Specified Adult has occurred, is occurring, has been attempted, or will be attempted; and

(b)(2) The temporary hold authorized by this Rule will expire not later than 15 business days after the date that the member first placed the temporary hold on the disbursement of funds or securities, unless otherwise terminated or extended by a state regulator or agency of competent jurisdiction or a court of competent jurisdiction, or extended pursuant to paragraph (b)(3) of this Rule. (Emphasis added)

Together, FINRA Rules 4512 and 2165 will provide a non-authority to report to and a safe harbor for member firms to temporarily hold distributions of cash and/or securities.

[19] FINRA Rule 2165 – Financial Exploitation of Specified Adults, Available at: http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=17538&element_id=12784&highlight=2165#r17538. Accessed February 25, 2017.

Supervision

As with all FINRA rules, each firm must design and implement supervisory policies and procedures that are tailored to their business and reasonably designed to achieve compliance. While the changes to Rule 4512 do not specifically address supervision, Rule 2165 states:[20]

> (c)(1) In addition to the general supervisory and recordkeeping requirements of Rules 3110, 3120, 3130, 3150, and Rule 4510 Series, **a member relying on this Rule shall establish and maintain written supervisory procedures reasonably designed to achieve compliance with this Rule**, including, but not limited to, procedures related to the identification, escalation and reporting of matters related to the financial exploitation of Specified Adults.
>
> (2) **A member's written supervisory procedures also shall identify the title of each person authorized to place, terminate or extend a temporary hold on behalf of the member pursuant to this Rule**. Any such person shall be an associated person of the member who serves in a supervisory, compliance or legal capacity for the member. (Emphasis added)

Red Flags

As discussed above, supervisors must be vigilant to potential abuses by relatives and others around senior investors, as well as their own Registered Representatives possibly exerting undue influence or other forms of fraud and abuse.

Some obvious red flags include (but are not limited to):

- A change in a long-standing investment strategy, especially one that has adverse tax consequences and/or increased costs;
- Increases in the size and/or frequency of withdrawals, especially those incurring penalties and/or taxes;
- Changes to the titling of accounts and/or other assets;
- Securities and/or cash transfers from an individual to a joint account (or vice versa), especially when there is a second transfer or withdrawal from the receiving account; and,
- Changing communications patterns, such as:
    - A client who used to come into the office changes to only phone calls;
    - A client who used to deal with the Registered Representative by herself changes to always being accompanied by someone else.

Best Practices

[20] *Id*.

There are a number of best practices that broker-dealers can implement to protect senior investors and the firm. Some of them include:

- Getting the trusted contact person involved as early as possible with any signs of dementia or suspected fraud or abuse;
- Escalating early: for Registered Representatives to their supervisors and supervisors to their legal department;
- If the senior investor is always accompanied by someone, get them one-on-one to confirm that their true instructions are being followed;
- Videotaping of meetings with senior investors (and their trusted advisor, if possible) that appear to have, or are confirmed to have diminished capacities;
- Printing the age of clients on trade reviews, exception reports and other supervisory documents;
- Implementing heightened supervision for any clients who have been flagged for possible or actual dementia; and,
- Creating red flag triggers that generate exception reports for suspicious activity in senior investors' accounts.

Conclusion

Broker-dealers must train their Registered Representatives and supervisors to the signs of declining capabilities and dementia. Registered Representatives must know their clients and continually profile them as their life circumstances change. For clients who are senior investors, Registered Representatives must continually evaluate their capacities for any signs of deterioration or dementia.

A culture of escalation should be cultivated to get second and third opinions about any suspected deterioration or suspected fraud or abuse. Finally, supervisors must also review the activity in senior investors' accounts to ensure that their own Registered Representatives are not exerting any undue influence, fraud or abuse.

Speaker Biographies

Richard W. Berry, Esq.

FINRA Dispute Resolution

Richard W. Berry is Executive Vice President and Director of Dispute Resolution.

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

Mr. Berry joined FINRA, then NASD, in 1995 as head of Dispute Resolution's Los Angeles office. In 2001, he was named Director of Case Administration in the New York City office.

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

William D. Briendel, Esq.

Greenberg Traurig LLP

William Briendel is a litigator who represents broker-dealers and their employees in virtually all aspects of their business. He is experienced in arbitrations and mediations before the Financial Industry Regulatory Authority (FINRA) (which combined the arbitration and enforcement functions of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE)) and the American Arbitration Association (AAA), and in regulatory and enforcement proceedings before the Securities and Exchange Commission (SEC), FINRA and other regulatory and self-regulatory organizations. Bill also conducts internal investigations for his broker-dealer clients. He has a wide-ranging experience in a broad range of commercial litigation matters as well.

Alida Camp, Esq.

ADR Offices of Alida Camp

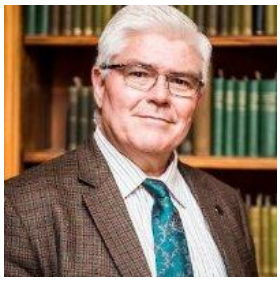
Alida Camp is a full-time mediator and arbitrator. She specializes in mediating and arbitrating disputes in a wide variety of industries including entertainment, construction, securities, fashion and general commercial. With over 100 hours of training, she has mediated more than 300 disputes including multi-party commercial and construction disputes. Mediated issues include breach of contract, breach of distribution agreements, breach of agreement between gallery and artist, breach of fiduciary duty, employment (both EEO and wrongful termination claims), construction defect, construction disputes between owner/architect, owner/contractor, contractor/sub-contractor, damage to adjacent property, mechanic liens, and customer claims against broker/dealers.

Alida is on the roster of the American Arbitration Association, the CPR Institute, the EEOC, federal and state courts, FINRA, and Volunteer Lawyers for the Arts.

Prior to her work as a neutral, Alida produced seven feature films, served as General Counsel and Vice-President of Business Affairs at Concorde-New Horizons Corp, an independent motion picture production and distribution company, production counsel on two independent features and Assistant Professor of Business Law at the University of Michigan School of Business. She began her career after graduating from the Columbia University School of Law as a litigator.

Paul Carroll

Sententia LLC



Paul has over 30 years of experience in the Financial Services Industry. He is an expert in operational controls, processes and procedures. Primary areas of focus include trade capture, settlement, custody and margin lending practices involving FRB Reg T, Portfolio and SPAN margin inclusive of the IT support systems designed to process, control and archive these critical business activities. Coverage includes the design and testing of intra-departmental data process flows, regulatory & house margin calculations and global portfolio reporting tools utilized by employees, clients and as a basis for regulatory reporting.

Since 2011 he has been engaged in providing operational risk management review, process improvement enhancements and supervisory control system recommendations to broker/dealers, market makers, and registered member firms in support of listed SEC and CFTC regulated products. Additional services include expert consulting, expert witness and testimony on behalf of regulators, broker dealers, attorneys and private parties in connection with investigations, trials, arbitration and mediation.

Paul served as Vice President in Global Operations for Goldman Sachs Execution & Clearing, Limited Partner at Spear Leeds & Kellogg and past-President of SIFMA's Credit and Margin Society. Paul was also a member of the following regulatory sponsored committees:

- NYSE 431 Margin Committee – 1999 – 2007
- NASD Margin Day Trading Committee – 2000
- FINRA 4210 Margin Committee – 2007 – 2011
- FINRA Portfolio Margin Sub-Committee (pre-adoption) 2005 – 2007
- SEC/FINRA Portfolio Margin Sub-Committee (post adoption) 2007 - 2011

Mark Conner

Corporate Treasury Investment Consulting LLC

- More than 30 years experience as a fixed income securities professional
- Extensive experience assisting U.S. corporations in the investment of cash assets (>$16B US)
- Consultant to over 150 securities litigation actions, testified in more than 50 proceedings
- Admitted as an expert witness in the subject areas of:
    - Broker duties and obligations
    - Suitability (Institutional and non-institutional accounts)
    - Sales practices
    - Fixed income securities and investment
    - Fixed income securities valuation
    - Damages
- Engaged by financial industry regulator (FINRA) to assist in investigation
- Extensive contacts throughout the securities and investment services industry
- Broad and detailed understanding of U.S. capital markets, securities origination, underwriting and trading, asset management, investment banking and finance, and investor needs
- Direct and extensive experience working with treasury professionals (CFOs, treasurers, etc.) of small and very large U.S. public companies
- FINRA arbitration expert witness experience
- Extensive experience consulting to counsel for FINRA claimants
- MSRB Municipal Finance Professional, 1994 to 2008

Philip S. Cottone, Esq.

Philip S. Cottone

Mr. Cottone is a lawyer by background and has extensive experience in dispute resolution, real estate and securities.

He is member of the arbitration and mediation commercial and real estate panels of the American Arbitration Association (AAA), and of the neutral panels of the Financial Industry Regulatory Authority (FINRA), the U.S. Bankruptcy Court for the Southern District of NY and The Counselors of Real Estate (CRE). He is certified by the International Mediation Institute (IMI) at The Hague. He is an educator, trainer and lecturer in dispute resolution. His substantive experience in real estate, securities and business informs his dispute resolution work in those fields.

Mr. Cottone's real estate experience includes property acquisition, sale, management, debt and equity financing, and development of all types of property - residential, commercial, office, retail, industrial and hotel - as well as right of way work. In real estate, he has been principal, Chairman and CEO of a national company, a senior executive in both government and the private sector, and a director of both publicly listed and private companies.

His securities experience includes being the founding principal of a broker dealer and raising capital as an issuer in over thirty Regulation D real estate private placements involving assets in fourteen different states. He also has broad experience in the disciplinary side of the business, working with the NASD (now FINRA) as Chair of both the Philadelphia and then the National Business Conduct Committee, and as Vice Chair of the national Board of Governors. He authored and taught a real estate securities course for ten years on the faculty of the Real Estate Institute of New York University. In 2014 he was appointed to a FINRA national Dispute Resolution Task Force of thirteen to consider possible enhancements to the arbitration and mediation forum. In 2015 the Task Force made over fifty recommendations for change which are now being considered.

Mr. Cottone is a graduate of Columbia College, Columbia University (1961) where he received the Burdette I. Kinne Prize for Humanities, and New York University School of Law (1966) where he received the Administrative Law Prize. He was admitted to practice law in New York State in 1967.

Kenneth G. Crowley, Esq.

UBS Wealth Management Americas

Ken Crowley is an Executive Director at UBS Wealth Management Americas, where he has worked since 2001. As the head of the WMA retail litigation group Ken oversees the Firm's defenses in a wide range of securities litigations, including class actions, complex court matters and hundreds of sales practice arbitrations. Prior to joining UBS Ken was a senior litigator at the Simpson Thacher & Bartlett law firm, where he handled large complex commercial litigations and internal investigations. Ken began his legal career in 1988 as an Assistant District Attorney in the New York County District Attorney's Office under Robert M. Morgenthau, where he was lead counsel in several felony jury trials and also argued over a dozen appeals in the New York Appellate Division, First Department. He received a JD from the NYU School of Law in 1988, and a BA from Yale in 1983.

Jerry DeNigris

Riverside Financial Group, LLC

Jerry DeNigris has over 25 years of experience in the securities industry. Besides managing the overall operations of the firm, he provides security/trading analysis, suitability reviews, compliance-style active account reviews and expert testimony for our clients. He also consults with our clients regarding their ongoing compliance and litigation support requirements. Jerry gained his compliance experience as a Compliance Officer in the Capital Markets Compliance group at UBS/PaineWebber. In this position he created and oversaw the implementation of surveillance and suitability procedures for large retail and institutional accounts and was involved in mark-up analysis and retail fixed income suitability approvals. In addition, Jerry ensured compliance with SRO regulations by maintaining constant contact with the capital markets trading desks and drafted policies and procedures in response to new SRO requirements all with the goal of reducing the firm's compliance exposure in new product areas.

Before serving as Compliance Officer, Jerry DeNigris was a trading analyst in the legal department. In this capacity, he prepared detailed analysis of trading activity and testified as an expert witness at NASD, NYSE and AAA arbitration hearings and mediations. He met regularly with staff attorneys to discuss the firm’s exposure to customer trading activity. In addition, he was responsible for computing damage calculations, turnover and commission/equity ratios and mark-up reviews.

Prior to working at UBS/PaineWebber, Jerry DeNigris was a mortgaged-backed securities trader for Security Pacific Merchant Bank. In this position, he made markets and took arbitrage positions in various sectors of the mortgage-backed securities market. He also worked with fixed income and mortgage-backed products and performed mortgage-treasury spread analysis, seasoned pool analysis, and calculated daily profit and loss reports for the trading desk. Jerry also worked on the mortgage-backed securities desk at EF Hutton, Merrill Lynch and AG Becker.

Jerry DeNigris has a BA in Economics from Rutgers University and held several NASD series registrations. Jerry is currently an active NASD arbitrator.

Martin L. Feinberg, Esq.

Martin L. Feinberg, Esq.

Martin L. Feinberg is a solo practitioner. He represents victims of securities fraud and those who are under investigation or being sued by the U.S. Securities and Exchange Commission. He also represents parties engaged in attorney–client fee disputes.

He is a graduate of Harpur College (B.A.), George Washington University (M.B.A.), Catholic University (J.D.), and New York University (LL.M.). He is a member of the bar of New York and is admitted to practice in the United States Court of Appeals for the Second Circuit and the United States District Courts for the Southern and Eastern Districts of New York.

In law school, he was an editor of the Catholic University Law Review, a recipient of the American Jurisprudence Award for Corporations, and a co-winner of the Sutherland and Miller moot court competitions.

After graduating from Catholic University's law school, he joined the Wall Street law firm of Mudge Rose Guthrie Alexander & Ferdon as an associate. Following his Mudge Rose experience, he served in the Enforcement Division of the United States Securities and Exchange Commission, and following his SEC service, he started his own practice.

In addition to his regular legal practice, he arbitrates securities and employment disputes for the Financial Industry Regulatory Authority ("FINRA") and mediates commercial disputes for the New York State Supreme Court. He is the coauthor of the chapter on Depositions in the treatise Federal Civil Practice (published by the New York State Bar Association) and its three supplements. He has appeared on panels to discuss "Representing your client in an SEC investigation." He has moderated and taught securities arbitration courses for lawyers, and he moderates the annual securities arbitration program "FINRA Listens . . . and Speaks" presented by the New York County Lawyers' Association ("NYCLA"). He teaches lawyers about their obligations and rights regarding retainer agreements, fees, and the Courts' Part 137 fee dispute arbitration program. He is the former chair of the Joint Committee on Fee Disputes and Conciliation, which administers arbitrations and mediations of fee disputes between lawyers and clients. The Joint Committee is a joint project of NYCLA, the New York City Bar, and the Bronx Bar Association. He now serves as an arbitrator for the Joint Committee.

He is a member of the American Bar Association (Section of Litigation, Committee on Securities Litigation, Subcommittee on Securities Arbitration), NYCLA (Committees:

Securities and Exchanges; Federal Courts; and ADR (Chair 2000 - 2003)), and the Public Investors Arbitration Bar Association. He ran the 2006 New York City Marathon.

Aegis J. Frumento, Esq.

Stern Tannenbaum & Bell LLP

Aegis J. Frumento joined Stern Tannenbaum & Bell LLP in 2012. Mr. Frumento had been a Managing Director of Morgan Stanley Smith Barney, a partner and the co-head of the Financial Markets and Securities Litigation Groups of Duane Morris, LLP, and the managing partner of Singer Frumento LLP. Mr. Frumento began his career at Schulte, Roth & Zabel.

Mr. Frumento concentrates his practice in representing senior executives of public companies, private companies planning for initial public offerings, and SEC-regulated entities and persons. He has over 25-years' experience litigating and arbitrating complex corporate, commercial and securities disputes, including extensive practice before the SEC, FINRA and other regulatory bodies. At Morgan Stanley, he headed the Executive Financial Services Department, which was responsible for legal compliance of sales of stock by all clients of the firm who were corporate insiders.

Mr. Frumento has tried jury and non-jury cases in all New York state and federal trial courts. He is a member of the United States Courts of Appeal for the 2d and 3d Circuits and the United States Supreme Court.

Mr. Frumento is a graduate of Harvard College and New York University Law School, and has an AV® Preeminent™ Peer Review Rating, the highest rating awarded, by Martindale Hubbell. He has published over a dozen law review and other articles and has often appeared on professional panels speaking on securities law issues. He chaired the American Conference Institute's Annual Forum on Broker-Dealer Arbitration in 2004, 2005 and 2006.

Darya Geetter, Esq.

LPL Financial

Darya Geetter is an Executive Vice President, Deputy General Counsel, reporting to the General Counsel at LPL Financial. She is responsible for managing all litigation and arbitration matters ii impacting the company and its advisors; representing LPL Financial and its advisors in FINRA arbitration proceedings and regulatory inquiries; and serving on various internal committees.

Ms. Geetter has been practicing for 25 years and was formerly at MF Global Holdings Ltd., where she served as Global Head of Litigation and Deputy General Counsel with responsibility for coordinating all litigation globally, managing all U.S. regulatory relationships, and leading internal investigations. Thereafter, she was a senior counsel to the Chapter 11 Trustee regarding strategy and coordination for litigation and insurance coverage in the Chapter 11 bankruptcy matters. In earlier roles, Ms. Geetter served as Deputy General Counsel and Executive Director at UBS Financial Services; Managing Director/Principal at Bear, Stearns & Co. Inc.; Counsel at Hogan & Hartson LLP; and held several roles at the U.S. Department of Justice, including Senior Trial Attorney in the Civil Rights Division and Assistant U.S. Attorney for the District of Columbia.

Ms. Geetter clerked for a U.S. District Court judge in New Orleans, LA and is admitted to practice in the District of Columbia, New York, and various U.S. district and appellate courts.

Ms. Geetter earned her J.D. from New York University School of Law and her B.A., with Honors, from the University of Chicago.

Jonathan L. Hochman, Esq.

Schindler Cohen & Hochman LLP

Jon Hochman is one of the firm's founders. After learning to litigate at a prominent international firm, Jon imagined building a firm where he could continue his sophisticated financial litigation practice in a responsive and efficient boutique setting. Today, SCH is exactly that firm. With clients including major financial institutions and investment funds, Jon's complex litigation and arbitration practice focuses on securities, private equity, hedge funds, structured finance, investment banking, commercial fraud, contract disputes, and class action defense.

An active trial lawyer, Jon has tried cases in federal court and numerous arbitral forums. As part of his focus on financial-sector litigation, Jon serves as Co-Chairman of the New York State Bar Association Securities Litigation and Arbitration Committee and is a member of the New York State Bar Association Hedge Fund and Capital Markets Litigation Committee. He served as a member of the Securities Litigation Committee of the Association of the Bar of the City of New York from 2010-2012. Jon regularly speaks on panels about securities litigation and arbitration.

For each year from 2007 through 2015, Jon has been named a New York Super Lawyer by Law & Politics Magazine. Before founding SCH, he practiced at Kaye Scholer LLP.

Professor Seth E. Lipner

Deutsch & Lipner

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LL.M.. 1981, New York University School of Law, Trade Regulation
J.D., 1980, Albany Law School of Union University
B.S., 1978, Rensselaer Polytechnic Institute (with Honors), Business Management

Employment History
Professor, Zicklin School Of Business, Baruch College, CUNY, 1982 - Present (Asst. Prof. 1982 - 85; Assoc. Prof. 1985 - 1991)
Adjunct Professor, Adelphi University School of Management, 1981 – 82
Attorney, Deutsch & Lipner, 1985 – Present

Areas of Expertise
State and Federal Securities Law
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Jenice L. Malecki, Esq.

Malecki Law

JENICE L. MALECKI, ESQ. is a well-known securities attorney and has a uniquely diverse background with experience representing a wide range of clients in securities and commercial litigation matters, both investors and industry professionals. She has successfully recovered tens of millions of dollars in securities related settlements and awards for her clients. An aggressive litigator, her unique background enables her to see both sides of the dispute and anticipate the opposition. Ms. Malecki has handled thousands of investor, intra-industry and employment matters, including arbitrations, whistleblower complaints and contested governmental, regulatory and self-regulatory investigations and hearings, as well as mediations, settlements, Acceptance, Waiver and Consent Orders ("AWC"s), litigation proceedings and appeals. She has also represented investor and industry witnesses and cooperators in various governmental, regulatory and self-regulatory bodies in hearings settlements.

Ms. Malecki has been a FINRA arbitrator and Chairperson. She has been qualified as an Expert Witness by FINRA arbitrators and is a trained mediator. She was recently appointed to FINRA's advisory committee, the National Arbitration and Mediation Committee (NAMC), which advises FINRA's Board of Directors. Ms. Malecki is a frequent bar association and law school speaker, as well as a seasoned authority on New York law, who frequently files official comments for consideration on new rules and laws. In 2014 and 2015, she visited Senators and House of Representatives members' offices to garner support for the Investor Choice Act of 2013, currently on the floor of the House of Representatives, and to persuade the Senate to pass similar legislation to the Department of Labor's "Fiduciary Rule."

Ms. Malecki is currently the VP on the Board of Directors of the PIABA Foundation, an investor educational non-profit group with a mission to educate investors and provide the public with information about abuses in the financial services industry and the securities dispute resolution process. Ms. Malecki is a member of and has been on the Board of Directors (and an Officer of) the Public Investors Arbitration Bar Association (PIABA) and been a member of the Securities and Exchanges Committee (SEC) at the New York City Bar Association and the New York State Bar Association, having spoken many times at the Practising Law Institute (PLI), the New York City Bar Association and the New York County Lawyers Association, Brooklyn Law School, St. John's Law School and New York Law School, as well as participating annually in PIABA's year-end conference.

Ms. Malecki's speaking engagements extend to appearing as an expert for the Wall Street Journal Live, NBC's Today Show, Fox Business News, ABC's Eyewitness News, Bloomberg Television, China TV, EBR TV and several other syndicated shows and networks. She has also appeared on Steve Forbes' in-flight radio show "America's Most Influential Women in Government, Technology, Business, and the Law", as well as other nationally syndicated radio programs. She and her cases have been and continue to be cited in numerous industry publications, including The Wall Street Journal, The New York Times, Forbes and Newsweek. The Wall Street Journal featured Ms. Malecki in a permanent educational video clip on its website about the arbitration process at FINRA.

Ms. Malecki's experience as a New York securities attorney began in class action litigation, having worked on the famed class action case In re Crazy Eddie in the counsel's office of the lead plaintiffs. Throughout the 1990's she represented numerous broker dealers and was instrumental in regulatory matters involving well-known "boiler room" stock fraud characteristic of the era and actually represented the progeny of the real-life "Wolf of Wall Street", that was the subject of a Hollywood blockbuster. In 1999, Ms. Malecki founded her own practice, Malecki Law, in Manhattan, which today employs a staff of securities arbitration, litigation and employment lawyers.

A natural fit and compliment to her securities work, Ms. Malecki has successfully represented clients in State, Federal and Appellate courts in various type of commercial and business disputes, including breach of partnership and contract disputes, against major and well-funded adversaries.

Henry F. Minnerop, Esq.

Henry F. Minnerop is a member of the NY bar and a recently retired partner of the law firm of Sidley Austin LLP in New York City. Mr. Minnerop specializes in the law and regulation of clearing brokers. He is a former member of the Clearing Firms Committee of the Securities and Futures Industry Association and author of a number of publications on clearing Brokers, including "The Role and Regulation of Clearing Brokers", 48 Bus.Law. 841 (1993) and "Clearing Arrangements", 58 Bus. Law. 917 (2003). Mr. Minnerop is a graduate of City College of New York and Columbia Law School.

Timothy J. O'Connor, Esq.

The Law Offices of Timothy J. O'Connor

Timothy J. O'Connor maintains a private practice of law in Albany, New York and is licensed in New York and Florida. He has been representing investors in securities brokerage customer claims since 1985.

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

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

Matthew C. Plant, Esq.

Bressler, Amery & Ross, P.C.

Matt Plant focuses in securities litigation and regulatory law. He has appeared on behalf of corporate and institutional clients in federal and state courts in New York and New Jersey, and at arbitrations before various self-regulatory organizations. He also represents individual registered representatives and corporate clients in connection with self-regulatory organizations and state investigations and inquiries.

Over the past years, Matt has personally witnessed product failures that have resulted in complex litigation for his clients. These failures have included hedge funds and structured products, among other examples. Matt is highly adept in guiding his clients beyond such obstacles and in overcoming financial product specific litigation claims.

Because Matt understands how financial products and services are structured and managed, his ability to work with witnesses involved in litigation claims is highly developed, and frequently a competitive edge for his clients. Often in partnership with in-house counsel, Matt has worked with his clients to ensure that such matters are handled in a consistent fashion and as efficiently as possible, never losing sight of achieving a positive result.

Currently, Matt lives in Norwood, NJ with his wife, daughter and cocker spaniel. A sports enthusiast, he enjoys training for and competing in triathlons and playing golf.

Michael Pysno, Esq.

Attorney and Mediator

Michael Pysno is a mediator of securities, banking, personal and corporate trust, and employment disputes.

Prior to opening his mediation practice in 2013, Michael was Managing Director and Senior Associate General Counsel at RBC Wealth Management (formerly RBC Dain Rauscher) in Minneapolis. In that role Michael led a group responsible for all of RBC Wealth Management's dispute resolution activities, including litigation, arbitration, customer complaints, and broker note collections. He also supervised the RBC Wealth Management employment law team and handled regulatory enforcement matters. Prior to joining RBC, Michael was Vice President and Associate General Counsel at U. S. Bancorp. There he was in charge of the bank's defense litigation and supervised the employment, consumer banking, and trust legal groups. He began his legal career as a litigator with Dorsey & Whitney in Minneapolis, where he dealt with securities, construction, products liability, and employment matters.

Michael has lectured and participated in CLE panels on a variety of topics including securities litigation, broker-dealer customer complaints, deferred compensation plans, employee handbooks, mediation practice, in-house staffing, attorney-client privilege, multi-jurisdictional practice, litigation risk assessment, and in-house litigation management. He has also presented education programs to clients on employment discrimination, sexual harassment, wrongful discharge, and defamation.

Michael is a FINRA arbitrator and mediator and is a qualified neutral under Rule 114 of the Minnesota General Rules of Practice. He received his Bachelor of Arts from the University of Minnesota and his Juris Doctor, cum laude, from Brooklyn Law School, where he was Articles Editor of the Brooklyn Law Review.

Professor Paul Radvany

Fordham University School of Law

Paul Radvany teaches the Securities Arbitration Clinic, as well as Trial and Arbitration Advocacy and the Criminal Justice Externship Seminar. He previously was a Deputy Chief of the Criminal Division for the United States Attorney's Office in the Southern District of New York. While working there, he was a Lecturer-in-Law at Columbia Law School, where he taught Trial Practice, the Federal Court Clerk Externship class, and the Profession of Law class and also was the founder and instructor of the Disability Law Project. Before joining the U.S. Attorney's Office, Prof. Radvany worked at Debevoise & Plimpton as a litigation associate. Prior to working at Debevoise, Prof. Radvany clerked for the Hon. Michael H. Dolinger in the Southern District of New York, and received his JD from Columbia Law School, where he was a Harlan Fiske Stone Scholar.

Alan S. Rafterman, Esq.

Wells Fargo & Company

Alan Rafterman is a Senior Counsel in the Wells Fargo Litigation Group. Since 2008, he has been representing Financial Advisors and the Firm, as well as overseeing outside counsel in predominately sales practice arbitrations before FINRA. In addition to his litigation responsibilities Alan has partnered with the Subpoena and Garnishment Unit providing legal advice and assisted in several regulatory investigations. Alan has also been invited to communicate with the field on hot topics in securities law and offering advice to Financial Advisors as to how they can protect their practices. Prior to coming to Wells Fargo, Alan was part of Merrill Lynch's National Arbitration Practice Group for five years where he represented registered representatives and Merrill Lynch in sales practice arbitrations and in connection with State and other regulatory investigations. In addition to his work in the securities field, in private practice he has represented clients in various commercial litigation matters before State and Federal courts. Prior to entering private practice, Alan was an Assistant District Attorney for the Bronx District Attorney's Office and clerked for Judge Bernard Newman in the United States District Court for the Southern District of New York. He earned a J.D. from Fordham University School of Law and a BA from the State University of New York at Albany.

David E. Robbins, Esq.

Kaufmann Gildin & Robbins LLP

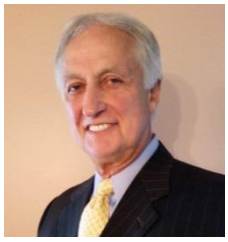
Mr. Robbins is a partner in the New York City law firm of Kaufmann Gildin & Robbins LLP and specializes in commercial arbitration, mediation and the representation of parties before regulatory agencies[1]. He represents investors, brokers and firms and is a mediator and arbitrator. He is also an expert witness in malpractice cases arising out of securities arbitrations. Mr. Robbins served as Special Deputy Attorney General of New York, responsible for the civil and criminal prosecution of securities fraud cases. He was the American Stock Exchange Director of the Compliance Department and later its Drector of the Legal and Regulatory Policy Division, where his responsibilities included being Director of Arbitration and Director of Disciplinary Hearings. He has the highest Peer Review Rating (AV) from Martindale-Hubbell.

Mr. Robbins is the author of *Securities Arbitration Procedure Manual* (Dec. 2014 Matthew Bender, a division of Lexis Publishing[2]), the primary text in this area of the law. This two volume book presents pragmatic, balanced guides to the practice of securities arbitration and mediation. He has updated the book annually since its initial publication in 1990. It is used nationwide by law firms, brokerage firms and law schools. He regularly lectures at law schools that use the book in their courses. Mr. Robbins writes the annual *Practice Commentaries* to McKinney's Consolidated Laws of New York, in Article 23-A of the General Business Law, on securities arbitration and mediation for New York attorneys[3].

From 1986 through 2009, Mr. Robbins was the Chairperson for all of the annual Practicing Law Institute (PLI) continuing education programs on securities arbitration and mediation. He edited and contributed to the program's 23 course books. He is the recipient of the Public Investors Arbitration Bar Association (PIABA) lifetime achievement *Golden Bow Tie Award* in memory of its former president who stood for integrity, the highest standards of professionalism and fairness in arbitration. He was a member of FINRA Dispute Resolution's *National Arbitration and Mediation Committee*, where he chaired the Neutral Roster Subcommittee. He is an arbitrator and mediator and is a member of the New York City Bar Association, PIABA, the Compliance and Legal Division of the Securities Industry and Financial Markets Association (SIFMA) and the Board of Editors of *Securities Arbitration Commentator*. The AAA has published his chapter "Calling All Arbitrators: Reclaim Control of the Arbitration Process – The Courts Let You" for its *Handbook on Arbitration Practice*. In 2014, he co-chaired the New York State Bar Association program on securities arbitration and mediation, was a speaker at the New York City Bar Association and New York County Lawyers Association programs on the subject and was on a panel at the annual PIABA convention in California: "The Arbitrator's Perspective."

Richard P. Ryder, Esq.

Securities Arbitration Commentator, Inc.



Richard P. Ryder is the founder and owner of SAC, and the editor/publisher of three newsletters, Securities Arbitration Commentator, Securities Arbitration Alert and SAC's Online Litigation Alert. Mr. Ryder earned his J.D. degree from New York University School of Law; he served with the NASD for seven years as New York District Counsel among other positions, and later as Director of Arbitration in charge of the NASD's nationwide arbitration program. From 1982 through 1988, he was head of litigation and Associate General Counsel for PaineWebber, Inc. Mr. Ryder also participates in the arbitration process as an arbitrator and mediator and appears as a speaker on the subjects of securities arbitration and litigation from time to time.

Michael G. Shannon, Esq.

Thompson Hine LLP

Mike is a partner in the firm's Business Litigation practice group. He focuses his practice on the defense of broker dealers, brokers and clearing firms and the representation of members of the financial services industry in litigations, arbitrations, mediations and regulatory matters.

Mike has extensive experience with hundreds of SRO securities arbitration claims (including more than 60 clearing firm cases) involving the full array of substantive issues including fraud, suitability, margin, unauthorized trading, regulatory violations, marketing and sales, churning, raiding, SIPC and other issues.

Mike also has more than 30 years of experience as a commercial litigator and has worked on diverse substantive related matters, including employment discrimination, antitrust (including civil, criminal, and class action), white collar defense, trademark, copyright, bankruptcy, hospitality, RICO, real estate and estates.

Barry Temkin, Esq.

Mound Cotton Wollah & Greengrass LLP

Barry Temkin is a partner at Mound Cotton Wollan & Greengrass LLP. His practice includes securities arbitration and litigation, commodities and securities regulation, legal ethics, professional liability defense, employment and commercial litigation. Mr. Temkin represents broker dealers, financial advisors, insurance brokers and registered representatives in litigation, arbitration and regulatory investigations. He also represents lawyers and law firms in disciplinary investigations, legal malpractice claims and conflict disputes.

Mr. Temkin is an adjunct professor at Fordham University School of Law, where he teaches Professional Responsibility. As an Assistant District Attorney in Brooklyn, he tried dozens of jury cases and served as a Senior Trial Attorney in the Homicide Bureau. Mr. Temkin has published articles on securities law and attorney professionalism in the Georgetown Journal of Legal Ethics, The Securities Regulation Law Journal, Seattle University Law Review, Securities Arbitration Commentator, and the New York Law Journal. Mr. Temkin has been a member of the FINRA (Financial Industry Regulatory Authority) Board of Arbitrators since 1999, and served for nine years as co-chair of the New York Country Lawyers' Association Professional Ethics Committee. Mr. Temkin has participated in panels on securities, commodities and legal ethics at the New York State Bar Association, the New York County Lawyers' Association, the Association of the Bar of the City of New York, the Practicing Law Institute, the Futures Industry Association and The Defense Association of New York, along with numerous corporations and insurance companies. He has been quoted in the ABA Journal, the New York Law Journal, The Economist, The Wall Street Journal.com, Law360.com, The National Law Journal, Lawyers U.S.A. and other publications. He is a graduate of the University of Pennsylvania Law School and the University of Rochester.

William P. Thornton Jr., Esq.

Stevens & Lee

Bill chairs the firm's securities litigation practice and represents broker-dealers and insurance companies nationwide in all manner of claims related to the purchase and sale of securities and insurance products. He represents a broad array of clients in customer litigation, FINRA broker-dealer claims, intra-industry claims, insurance product disputes (including annuity and life insurance claims), and SEC, FINRA and state securities commission investigations and enforcement actions. Bill also represents parties in auditor liability disputes, corporate and fiduciary duty claims, shareholder litigation and intra-company disputes.

Bill's clients include large broker-dealers, banks, Fortune 100 insurance companies, directors and officers of public companies, registered investment advisors, professionals in the financial services industry, institutional and private investors, and individuals charged with violating federal or state securities laws.

Bill frequently defends suitability, trading away, unauthorized trading and other sales-practice cases for broker-dealers. He represents insurance companies in misrepresentation and policy suitability matters, including IRS Section 412(i) and 419 related claims. He also handles all manner of regulatory investigations before the SEC and FINRA, including insider trading investigations and other enforcement matters. Bill leads corporate investigations for broker-dealers, insurance companies and public companies, and prosecutes and defends related litigation.

Bill has litigated FINRA arbitrations, life insurance product disputes and state and federal securities-related claims in multiple jurisdictions, including Massachusetts, California, New York, Washington, Utah, Arizona, Texas, Illinois, Michigan, Ohio, Pennsylvania, New Jersey, Maryland, Virginia, West Virginia, North Carolina, Tennessee, Florida, Alabama, Hawaii, Louisiana and Connecticut.

Bill holds a Series 7 license from FINRA and has directed and spoken at financial services seminars, addressing topics such as sales practice claims, FINRA arbitration practice, and mediation.

Ross Tulman

Trade Investment Analysis Group

Trade Investment Analysis Group was formed in 1985 to manage securities portfolios of high net worth individuals, small businesses and retirement plans. The current focus of our practice is to provide expert witness consulting services to counsel engaged in securities arbitration and litigation matters.

Employment
Registered Investment Advisor. 1985 – Current

Principal - Trade Investment Analysis Group (formerly Tulman Investment Advisory), Columbus, Ohio. Manage fixed income, equity, partnership & venture capital investments. Litigation consulting - securities and investment disputes. Series 65.

AudiPac/North American Logistics, Inc. 1993 - 2003.
Columbus, Ohio. Portfolio Manager of Fixed Income & Equity Investments, Board of Directors.

Investment Broker. J. C. Bradford & Co. 1982 - 1985.
Columbus, Ohio. Series 7 and Series 63 Licensed.

Angela A. Turiano, Esq.

Bressler, Amery & Ross, P.C.

Angela Turiano focuses in the representation of brokerage firms and individual registered representatives in customer and employment arbitrations and litigation. Angela has worked as in-house counsel for two major securities firms, so she understands, from an internal perspective, the highly specific needs of her clients. Known for her composure and her commitment to achieving results, Angela's clients also value that she serves as a FINRA Arbitrator. On many occasions, her experience in this capacity has benefited them greatly in terms of navigating beyond FINRA related obstacles.

Angela is a practiced trial lawyer who has appeared on behalf of corporate clients in New York federal and state courts and in arbitrations before various self-regulatory organizations. In addition to her extensive work in the securities arena, Angela has also represented individuals in both state and federal criminal prosecutions, from inception through trial. Prior to entering private practice, Angela served as an Assistant District Attorney in the Kings County District Attorney's Office, where she prosecuted and successfully brought to trial multiple felony cases including Burglary, Narcotics Sale, Robbery and Kidnapping.

Highly respected throughout the financial services industry, Angela is an active speaker in the securities community, including speaking engagements at the renowned NYU Stern School of Business and client firm roundtables and compliance conferences. She also served as a panelist for the American Conference Institute, where she has lectured on the latest trends in securities litigation.

Angela partners with corporate clients to provide free legal advice at the Neighborhood Entrepreneur Law Project (NELP) small business legal clinic, as well as volunteers annually as a mock arbitrator/trial judge in various law school competitions. Angela also speaks annually at the Lincoln High School Career Day in Yonkers, NY. When Angela is not practicing law, she enjoys cooking, running, golf and skiing. With her infant son in hand, you can find Angela at the Jersey Shore, whether at the beach in the summer, picking pumpkins in the fall or sitting by the fire in the winter months.

Robert Usinger, Esq.

One Beacon Insurance Group

Rob Usinger is Assistant Vice President of Financial Institutions Claims at One Beacon Insurance Group in New York City. Previously, Rob spent nearly ten years between insurance carriers and a coverage law firm focusing on various types of claims and related coverage litigation.

James D. Yellen, Esq.

Yellen Arbitration and Mediation Services

Jim Yellen, founder of Yellen Arbitration and Mediation Services, has over twenty-five years of experience in securities law, is Co-Chair of the N.Y.S.B.A. Securities Law and Arbitration Committee and serves on the Board of Editors of the Securities Arbitration Commentator. Mr. Yellen is also an Adjunct Professor of Law at Fordham University School of Law and frequently lectures on securities arbitration, mediation and securities law.

Securities Mediation

Having founded his practice in January 2006, Jim Yellen has completed over two hundred security and employment mediations and has settled over 90 percent of his cases. In the securities and commodities areas, he has resolved cases involving virtually every cause of action and every defense asserted in the past decade. Having tried almost one hundred arbitrations, sat on numerous panels for FINRA, NASD, NYSE, NFA AND AAA, trained arbitrators and spoken at or chaired numerous arbitration seminars, he brings a wealth of experience to the mediation arena.

Employment Mediation

In employment matters, Jim Yellen has represented both account executives and management. As a mediator, he has a finely honed sensitivity to the issues debated in wrongful discharge, discrimination, retaliatory actions, promissory note claims and wage and hour cases.

Commercial Disputes

Finally, as a mediator of general commercial disputes, Jim Yellen endeavors to bring practical, smart solutions to the parties in order to avoid the expenditure of significant fees and expenses and make settlement a "win-win" for the parties. Yellen Arbitration and Mediation Services has one goal - to provide the best, most effective and efficient mediation services.