Online/Internet Trading
Gambling, BD's No Duties, Third-Party Accounts

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Introduction

Online broker-dealers who offer a trading platform for self-directed trading claim that they make no recommendations, therefore, they have no duties or extremely limited duties to their customers - simply to properly execute unsolicited trades. This article will prove this position is a fallacy.

This article addresses three of the problems and concerns for investors and regulators that relate to trading/investing at online broker-dealers (BDs) such as Charles Schwab[2], TD Ameritrade, Interactive Brokers, E*Trade, and Robinhood.[3] The three issues are:

- Is online/internet trading nothing more than legalized, casino gambling?
- Do online broker-dealers really have no duties for self-directed platforms/online accounts?
- Are broker-dealers properly opening, managing, and monitoring third-party accounts?

In 2000, I authored an article titled, "No Duty – Does Suitability Apply to Internet Brokerage Firms?"[4] In 2016, I co-authored an article titled, "Supervision of Third-Party/Power of Attorney

[2] Though TD Ameritrade is mentioned extensively in this article, Schwab completed its $22 billion acquisition of TD Ameritrade in October 2020.

[3] Larger Wall Street broker-dealers tend not to make the "no duty" argument. "Unlike their discount-online competitors, who generally say they aren't responsible for their customers' trading decisions, Merrill Lynch & Co. and other big firms are being more watchful. In new accounts combining traditional-brokerage services with online access, brokers can monitor customer activity and, in some cases, may even stop what they consider excessive or inappropriate trading." "Brokerage Firms Have Different Plans to Protect Investors from Themselves" by Ruth Simon and Rebecca Buckman, The Wall Street Journal, June 7, 1999.

[4] "No Duty – Does Suitability Apply to Internet Brokerage Firms?" Published and presented at Public Investor's Arbitration Bar Association Meeting, PIABA October 2000. The article addresses the position of internet firms that say they have no duties as it relates to "suitability" and the "Know Your Customer Rule". The article quotes FINRA Notice to Members, 96-32, 96-60, and 99-11 which make it quite clear broker-dealers do have duties relating to suitability and supervision, even when the trades are unsolicited.

Accounts".[5] After years of FINRA issuing Notice to Members (NTMs) and Regulatory Notices (RNs) addressing many of the issues I raised in my articles, in combination with my being involved as an expert witness in numerous FINRA arbitrations on these subjects, I felt it important to update the articles. Additionally, it is more apparent than ever that online broker-dealers, in many instances, are nothing more than casino gambling houses for many Americans.

Online, Legalized Gambling

The United States has been slow to adopt online or internet gambling. Although 85 countries allow online gambling, for many years the United States has made it illegal to conduct financial transactions online for the purpose of placing a bet or wager with the Interstate Wire Act of 1961.[6] Things changed in 2011, though, when the U.S. Department of Justice limited the Wire Act's applicability to sports betting. This decision gave license to states to regulate other games of chance on the Internet. Indeed, pursuant to the Constitution, 10th Amendment, the regulation of gambling should be reserved to the States. In my 2013 article entitled "Swimming Naked When the Tide Goes Out; Naked/Short Options"[7], I wrote, "Perhaps within the next decade, online gambling will be legalized across the country." That has not happened. To date, only six states – Connecticut, Delaware, Michigan, New Jersey, Pennsylvania, and West Virginia – allow online/internet gambling.[8] In these states to varying degrees, residents are permitted to wager over the internet on poker, sports, fantasy sports, lotteries, and horse racing.

With the vast majority of states not embracing online gambling, investors shouldn't feel left out, because the public can simply open an online brokerage account and gamble their life savings away even more easily. Wall Street broker-dealers would have you believe that Las Vegas-style casinos are for gambling, whereas opening a brokerage account is for investing. I can agree with only half of this statement; casinos are purely for gambling, though many bets can be made where the odds of losing are reduced. But it is a complete falsehood, perpetrated by Wall Street, that brokerage accounts are purely for investing.

INVESTING V. GAMBLING

Investing is the process of using money and investment capital to seek positive returns; to utilize an asset or money with the goal of generating income and appreciation; to distribute resources in an attempt to generate income and gain profits; to buy assets that increase in value over time and provide returns in the form of income payments or capital gains; to build wealth and outpace

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[5] "Supervision of Third-Party/Power of Attorney Accounts" 2016 PIABA Bar Journal, Vol. 23. No.2. This article details the serious problems that can arise in brokerage accounts when a power of attorney is given to a third party, especially at internet/online brokerage firms.

[6] 18 U.S. Code §1084

[7] "Swimming Naked When the Tide Goes Out: Naked/Short Options" 2013 PIABA Bar Journal, Volume 20, No. 1 2013.

[8] https://www.bettingusa.com/states/#:~:text=How%20many%20states%20have%20legal,%2C%20Pennsylvania%2C%20and%20West%20Virginia.

inflation; to create a structured plan that includes protection of assets, diversification and long-term goals of a positive return above inflation and taxes.

Gambling is wagering money in an event that has an uncertain outcome in hopes of winning more money; the expected return for gambling is negative for the player—even though some people may get lucky and win.[9] In gambling, people do it mostly for the emotional high they receive from the excitement as opposed to the possible return; the probability of losing an investment is usually higher than the probability of winning more than the wager.

Broker-dealers offer more ways to gamble and speculate than Las Vegas. There are long options, short naked options, options strangles and straddles, commodities, commodities options, futures, margin trading, shorting, day trading, high-frequency trading, scalping, unregistered securities, cryptocurrencies, junk bonds, leveraged funds, penny stocks, derivatives, private placements, hedge and private equity funds, trendy securities, and momentum trading. Online broker-dealers such as TD Ameritrade, Charles Schwab, E*Trade, Interactive Brokers, and Robinhood offer a similar gambling platform as Las Vegas, but with 10 times the offerings, bells and whistles, and risks.

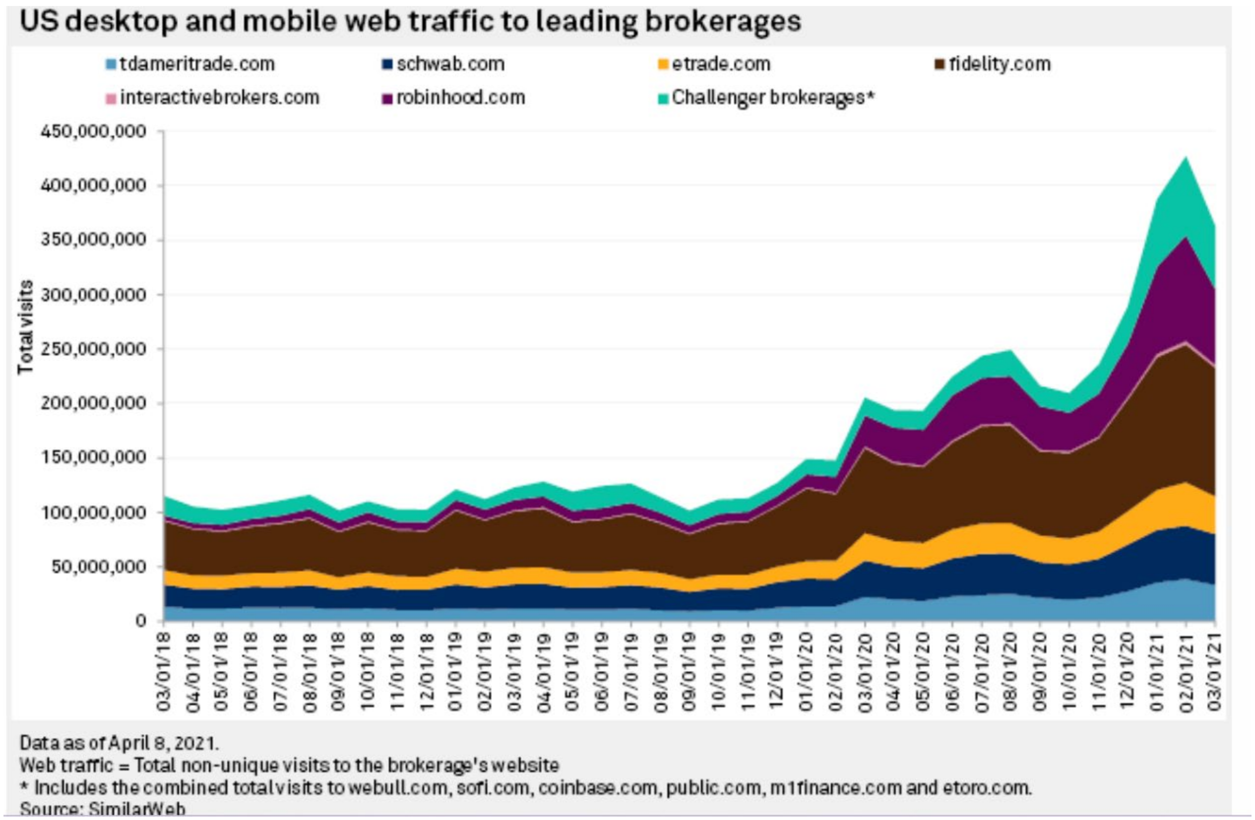
In an online brokerage account investors can, in a matter of literally minutes, lose tens of millions of dollars, their entire account value, more than their account value, or their entire net worth and life savings. That's possible in a casino but very hard to accomplish. In an online brokerage account, though, it can be accomplished with a few clicks of a button, all while reclining on the sofa at home in your pajamas. Wall Street can call it what it wants and what it wants Americans to believe, but it is often rank speculation and gambling to the extreme.

Online Broker-Dealers' Growth Numbers

The pandemic fueled online trading at firms such as E*trade, TD Ameritrade, Charles Schwab, Interactive Brokers, and Robinhood.[10] These firms experienced significant increases in customer base and assets managed during 2020 and 2021. After completing its purchase of TD Ameritrade, Charles Schwab's customer base grew by 127% between 2020 and 2021.[11] New brokerage accounts at Schwab hit 1.2 million in February 2021, more than 93% higher than the 626,000 new accounts it added in December 2020.[12] And Schwab's net income for the fourth quarter of 2022 increased 25% from the fourth quarter of 2021.[13] Robinhood also prospered, increasing its assets by 311% from $19 million in 2020 to $81 million in 2021 and nearly doubling its

[9] Investopedia, Speculation vs. Gambling: What's the Difference? By Steven Nickolas, Updated September 25, 2021
[10] Scottrade Financial was one of the bigger online BDs, but it was purchased by T.D. Ameritrade in September 2017
[11] https://www.fool.com/the-ascent/research/largest-stock-brokerage-firms
[12] https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/pandemic-retail-trading-boom-remakes-brokerage-landscape-63482952
[13] https://www.financial-planning.com/news/schwab-event-brings-td-ameritrade-updates-and-a-restated-promise-to-incoming-advisors

customer base.[14] Interactive Brokers saw daily average trades on its platform spike 53% in March 2021 from the same month of 2020.[15] The following chart shows these dramatic increases[16]:



A May 2022 analysis stated, "Though high inflation has hit some stocks very hard, it seems it has hardly blunted investors' enthusiasm. Analysis from Vanda Research…indicated that retail investors' sentiment had remained 'resilient' and that there had only been a slight dip in activity compared to 2021 when markets were far healthier."[17]

Like Vegas, Online Broker-Dealers Lure the Public

Casinos in Las Vegas, Atlantic City and other places learned long ago that providing high-dollar, regular gamblers with comps was a win-win situation for both parties. Casino whales receive such perks as private jets and limousine travel, penthouse suites, higher limits, top-shelf liquor and a dedicated VIP host.

[14] https://investors.robinhood.com/news/news-details/2022/Robinhood-Reports-Fourth-Quarter-and-Full-Year-2021-Results
[15] https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/pandemic-retail-trading-boom-remakes-brokerage-landscape-63482952
[16] https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/pandemic-retail-trading-boom-remakes-brokerage-landscape-63482952
[17] https://www.prnewswire.com/news-releases/trading-platforms-capitalizing-on-the-investing-boom-301577617.html

Online broker-dealers offer their own ways of luring investors to their sites, not unlike the tactics employed by casinos. Robinhood made waves back in 2013 by offering zero-commission trading, but today free trading is the norm in the online industry. Online broker-dealers attract new investors with such things as free research, news, trading tools, and education; credit cards, 24/7 and mobile trading, no minimum deposits, higher margin limits, and comprehensive trading reports. On December 6, 2022, Robinhood made retirement accounts available to its investors, guaranteeing a 1% match with no employer.[18] That's quite an incentive for the ever-growing entrepreneurial field.

Most states set the legal age for gambling at 21 years of age, but most brokerage firms allow anyone 18 years or older to open an online brokerage account. And whereas it used to be that one would not think about opening a brokerage account without a certain amount of money, now many firms have no minimum deposits. The introduction years ago of fractional trades ushered in a new wave of inexperienced, naive investors. At Robinhood's website, the reader is emblazoned with "Investing doesn't have to be that hard."[19] Interactive Brokers counsels, "Our award-winning platforms are powerful enough for professional traders but designed for everyone."[20] Schwab offers to help you manage not only your investments but your financial life, declaring it "Easy". Anyone can do it. Literally.

Online broker-dealers flood their clients with opportunities to be educated. As the U.S.'s digital prowess has grown, online broker-dealers have kept pace, introducing webinars, podcasts, articles, and a host of digital tools designed to increase client accounts. This is not unlike the tactics employed at casinos. In Las Vegas, many casinos offer daily "gaming classes" on craps, poker, and blackjack. Interactive Brokers advertises its "Student Training Lab" designed for educators to send invitations to their high school students to open paper accounts.[21] The firm also boasts of an online "Campus" which "offers an extensive course catalog to help traders and investors make more informed investment decisions - from equities, fixed-income, and options…"[22] TD Ameritrade has an Education Center for investors to expand their investing knowledge and "then solidify your new skills with practice assessments."[23]

Options are particularly complex, but all online firms have developed option training and education platforms, much of which is free. Robinhood launched its "Option Trading Hub" in 2021, a dedicated site on "Robinhood Learn" providing education on the ins and outs of option trading.[24] Interactive Broker's "Trader's Academy" provides numerous classes on option trading, as does Schwab.[25] TD Ameritrade offers a "Four-Part Options Strategies Virtual

[18] https://blog.robinhood.com/news/introducing-robinhood-retirement
[19] https://robinhood.com/us/en/invest/
[20] https://www.interactivebrokers.com/en/trading/trading-platforms.php
[21] https://www.interactivebrokers.com/en/accounts/educator.php
[22] https://www.interactivebrokers.com/en/education/tradersu/ibkr-campus.php
[23] https://www.tdameritrade.com/tools-and-platforms/investing-stock-trading-platforms/online-stock-trading-features.html
[24] https://learn.robinhood.com/
[25] https://tradersacademy.online/

Workshop."[26] It is no longer an excuse to "not understand investing", as the online broker-dealers will tell you all that you need to know.

The Broker-Dealer Defense of FINRA Rule 2111, 2111, 2111

File a claim against one of the online broker-dealers that even hints that the trading in the claimant's account was inappropriate or unsuitable and prepare yourself for a barrage of FINRA Rule 2111 on Suitability. The rule will be posted, plastered, blown up, and repeated ad nauseam throughout not only the Answer but in the pre-hearing brief and at the arbitration. It's a well-rehearsed defense tactic: because FINRA Rule 2111 has language that the rule applies only when there is a recommendation and the online firms claim they make no recommendations[27], the rule doesn't apply.

The problem is, though, that the firms use FINRA Rule 2111 to go even further – they attempt to shoehorn the claimed inapplicability of FINRA Rule 2111 to the laundry list of every other potentially applicable FINRA rule! They in essence claim that since FINRA Rule 2111 doesn't apply to them, neither do any of the other rules, hence, they have no duties. They act as if the arbitration panel should grant a motion to dismiss or a directed verdict based merely on FINRA Rule 2111.

Wrong, wrong, wrong! Do not allow these online broker-dealers to hold up FINRA Rule 2111 as some sort of holy grail that can absolve them of all wrongdoing. There is nothing in the FINRA rules to support the argument that if Rule 2111 doesn't apply, **then other FINRA rules don't apply, too.** That is an unsupportable jump in logic. The fact that FINRA Rule 2111 makes clear that the suitability rule only applies when a recommendation is made reinforces that the absence of such restrictive language in other rules means the other rules are free to apply. Likewise, the absence of a FINRA Rule 2111 violation does not doom the case when misconduct can be found to have violated a host of other FINRA Rules, as addressed in this article.

We Don't Make Recommendations, So We Have No Duties

In a 2021 FINRA arbitration, one online firm's Answer and Brief claimed it had no duties to the Claimant dozens of times. Some examples:

- *[BD] did not have any duty of care beyond the execution of the transactions upon Claimant's instruction…*
- *A broker ordinarily has no duty to monitor a nondiscretionary[28] self-directed account…*

[26] https://www.tdameritrade.com/education.html
[27] See in this article the section We Don't Make Recommendations…We Merely Educate, discussing how online firms' communications with investors may rise to the level of a recommendation.
[28] One of the tactics of the defense lawyers is in their answers and mainly in their briefs, they quote all kinds of case law that refers to "non-discretionary accounts." This is an irrelevant deflection. The vast majority, if not all of the accounts at online

- *[BD] also had no duty to assess the suitability of Claimant's trades in his self-directed brokerage account.*
- *A broker or dealer that lacks discretionary control over investment decisions usually has no duty of care that extends beyond the execution of transactions.*
- *[BD] had no duty to monitor Claimant's account.*
- *The Client Agreement expressly disclaims any of the duties...*

A different online firm made similar arguments in another 2021 FINRA arbitration. Again, between its Answer and Brief, the firm claimed:

- "*[BD] has no duty to supervise or monitor trading …"*
- *"…it was not [BD's] duty to monitor or oversee these accounts."*
- *"…custodial firms like [BD] have no independent duty to supervise transactions…"*
- *"…[BD] does not have an independent duty to oversee" the investments made for clients by an independent investment advisor."*
- *"…[BD] and [broker] had no duty to monitor or prevent unsuitable trading in nondiscretionary accounts";*
- *"no duty beyond executing the requested transactions where the broker did not exercise control over the account;"*
- *"The agreements expressly provide that [BD's] role as custodian does not include the duty to investigate, monitor, or supervise the investment advisor's actions or any of the trading activity in the accounts."*
- *"[BD's] duties were to "merely carry out transactions as directed"*
- *"[BD] had only limited duties with respect to Claimants' custodial accounts, mainly the execution of trades and delivery of trade confirmations and monthly statements."*
- *"...scope of any duties owed by broker will generally be confined to executing investor's orders."*
- *"[BD] had only limited duties with respect to Claimant's custodial accounts."*

From that same case, the BD's prehearing brief was peppered with the "no duty" mantra:

- *"Although the SEC supervises the activities of SEC-registered investment advisors like [broker], the law is clear that, as an execution-only broker holding Claimants' nondiscretionary accounts, [the BD] had no contractual obligation or extra-contractual legal duty to do so."*
- *"Instead, the execution-only broker's only limited duty— to use ordinary care in executing the trades it is directed to execute by the customer—…"*
- *"a broker's duty in a non-discretionary account is simply to execute the transactions requested."*

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broker-dealers, are non-discretionary accounts (a discretionary account is where one of the brokers at the broker-dealer has discretionary trading authority over the account). That's because by and large, online broker-dealers don't accept discretionary accounts. Yet that doesn't keep the crafty lawyers from introducing case law language that is totally irrelevant.

- *"A broker or dealer that lacks discretionary control over investment decisions usually has no duty of care that extends beyond the execution of transactions*."

In a 2019 and earlier FINRA arbitration claims against another online broker-deal, in an account that was being managed by a third-party investment advisor, the firm stated in its Answer:

- "*…[BD] was authorized to act in reliance on the instructions of Claimant's agent without any duty of inquiry."*
- *"Here, the rights and duties of [BD] and Claimants are set forth in the Customer Agreement. Claimants fail to establish or even allege any additional duty owed by [BD] independent from the Customer Agreement."*
- *"Claimants' relationship with [BD] was contractual; all duties owed arose out of the contract between the parties."*

I have seen almost identical language in many other answers and briefs by online broker-dealers. Ignoring for a moment that FINRA strictly prohibits broker-dealers from putting any language in their customer agreements that restrict clients' rights, the above statements/defenses border on something between ridiculous and comedic. As you see in this article, the plethora of securities regulations that establish a laundry list of duties, obligations, and requirements hark back to the above defenses of the online firms. These are defenses that would have investors, claimants, and arbitration panels believe that the security regulations are written for someone else and that the online BDs can ignore those regulations and only keep their eyes on the customer agreement.

From the get-go, online broker-dealers have been banging the "no duty" drum, though not always with success. The following is what I wrote 23 years ago about E*TRADE's defense:

*I am still in shock about information I recently learned regarding E*Trade. In two recent arbitrations in which I was the expert witness, a number of E*Trade's high-ranking officials provided testimony, testimony that was echoed in the opening and closings of E*Trade's counsel. E*Trade's position is that two of the most sacrosanct guidelines of the industry do not apply to E*Trade – the NASD "suitability" rule and the NYSE "know your customer" rule. E*Trade's attorney stated, and I quote:*

> *...that is why E*Trade assumes no duty with regard to protecting the customer - who knows if we are protecting the customer or hurting the customer. Mr. xxx [a licensed trading manager at E*Trade] is there to protect the firm, and E*Trade has made this very clear to its customers.* [29]

It is most telling that for all this language of no duties in the broker-dealers' answers and prehearing briefs, **<u>none of it is supported by the securities regulations</u>**. It's either

[29] "No Duty – Does Suitability Apply to Internet Brokerage Firms?" Published and presented at Public Investor's Arbitration Bar Association Meeting, PIABA October 2000.

unsupportable claims by the BD and its lawyers or case law from long ago in other jurisdictions. Remember, case law cannot and does not trump securities regulations.

No Duty - But We Do It Anyway (or The Cake and Eat It, Too Defense)

This is a practice by broker-dealers that I've been witnessing for 34 years. I attribute it to the fact that so much of FINRA arbitration is behind closed doors, where no one is privy to what the BDs and their lawyers are arguing and presenting to arbitration panels. On the heels of the online BDs' defense to suitability claims that since the trade was unsolicited, they had no duties to determine if the trade was suitable, they often launch into the defense of "But the trades were suitable, nonetheless". This is the "cake and eat it, too" defense.

But the BDs have taken this art of arguing both sides of the same argument/defense to a new level in online trading cases. In addition to the claim of no suitability duties, they further claim they have absolutely no duties whatsoever to supervise or monitor the trading in online accounts. Lo and behold, through discovery we see all kinds of internal monitoring software systems and reports, evidencing that some of the largest online broker-dealers do monitor self-directed accounts, even when their brokers are making no recommendations. The reports additionally evidence that these internal monitoring systems are even applied to accounts that are being managed by separate third-party investment advisors, who have power of attorney to trade the accounts for their clients. A major online BD admitted in its prehearing brief in one recent FINRA arbitration "…[The BD] conducted due diligence on the third-party investment advisor, in accordance with its Know-Your-Customer obligations under FINRA Rule 2090."

Total Hypocrisy or Much Worse?

In a 2021 FINRA arbitration case that I was involved in, not surprisingly, the online broker-dealer respondent argued repeatedly in its Answer and even more vehemently in its prehearing brief that it had no duty whatsoever to monitor the trading activity in its clients' accounts being managed by a third-party investment advisor who had power of attorney to trade the accounts.[30] Here is just some of the language:

More importantly, it was understood and agreed to by [Claimant] that [BD's] role as a custodian of Claimant's accounts would not include the duty to investigate, monitor, or supervise [the advisor] or any of the trading activity in the subject accounts. More importantly, it was understood and agreed to by [Claimant] that [BD's] role as a custodian of Claimant's accounts would not include the duty to investigate, monitor, or supervise [the advisor] or any of the trading activity in the subject accounts.

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[30] Remember the clients, under the regulations, are clients of the broker-dealer; the firms don't dare argue otherwise.

Now here comes the hypocrisy, or the "cake and eat it, too" defense from the BD's prehearing brief:

Although [BD] was never able to conclusively determine whether any preferential trading or otherwise inappropriate trading had taken place, it decided to end the relationship with [the advisor] because there were three factors that—taken together—weighed in favor of termination: (1) the block trade allocation alert; (2) [the advisor's] failure to adequately explain the activity that was observed in the alert; and (3) [the advisor's] practice of allocating block trades the next business day. Once [BD] made its decision to stop working with [the advisor], it sent a letter to [Claimant]in August 2018, announcing the decision by using the words "terminated," "termination" or "terminating" repeatedly to inform him that the termination was the result of [BD's] unilateral decision to end the relationship. … In providing the notice, [BD] fulfilled all of its obligations to [Claimant]. Notably, contrary to Claimant's position in this arbitration, there is nothing in the agreements that Claimant executed that would have required [BD] to provide some explanation for its decision to terminate the [advisor] relationship.

To put in proper context both the language and the questionable activity of the BD that I just quoted, compare it to what the SEC said about such a situation:

The "continued execution of [an] adviser's orders where a **broker-dealer has knowledge of improprieties in an investment adviser's handling of accounts may subject the broker-dealer to liability for aiding and abetting a violation of the federal securities laws if the adviser is in fact a primary violator of some provision of those laws"[31]**
[emphasis added].

To summarize, though the above broker-dealer disclaimed any duty to review the trading in the third-party accounts, the evidence revealed that it clearly was reviewing, supervising, and monitoring the trading in the Claimant's accounts. As a result of such a review, the firm terminated its relationship with this investment advisor, who had hundreds of accounts and had been generating millions of dollars in commissions for the firm. Worse yet, though the firm was mum with investors on why the advisor was terminated, the Claimant through discovery had obtained other termination letters that described the wrongdoing that resulted in the termination!

We Don't Make Recommendations…. We Merely Educate

The constant broker-dealer boilerplate defense/refrain you see here from online broker-dealers when a wronged investor files a claim in arbitration is, "We make no recommendations, so we have no duties." In one arbitration, when a slew of evidence was presented to the arbitration panel of recommendations, the response of the broker-dealer was, "We merely educate; we don't recommend." This reminds me of the defense of the BDs who fleeced the American public

[31] In re Merrill Lynch, Pierce, Fenner & Smith, Inc., Securities Exchange Act Release No. 19070 (Sept. 21, 1982)

by selling over $1 billion of conflict-ridden, illiquid limited partnerships in the early 90s: "I didn't recommend those partnerships. I just showed the investor a number of them and let him make his own choice." That defense did not fly, landing Prudential Securities, one of the worst perpetrators, with one of the SEC's largest fines at the time.[32]

In another one of my cases, my jaw dropped when I heard a stockbroker on a taped phone call with the client state, "I am not allowed to make recommendations, but here is what I would do." His advice related to the client entering trades to get out of a complicated options strategy. Even a layperson, much less somebody with a securities background and training, would have to conclude that was a recommendation.

Online broker-dealers will not be protected from claims of recommendations the more that their "education" of investors crosses the line into investment recommendations. Generally, the more tailored the communication is to the client, the closer to a recommendation it becomes. In their zeal to "educate", many online firms go so far as to offer investment advice. Schwab has a learning center offering clients "real-time trade analysis and decision support from investing professionals.[33] When does that "decision support" turn into a recommendation? Schwab's "Options Idea Hub" provides clients "with specific options trade ideas based on whether you're bullish, bearish, or neutral."[34] Schwab even has an "options specialist team [that] is dedicated to using its decades of trading experience to help you evaluate and implement your options strategies."[35] How can "specific option trade ideas" not be a recommendation? TD Ameritrade offers an immersive education curriculum "that's built around you".[36] And Ameritrade also offers "24/7 support to help answer your option trading questions."[37] And if the option trading question is "Should I purchase option A or B?" and the broker replies, "I would go with option B," is there any doubt that is a recommendation?[38]

Remember that when a recommendation is made, the FINRA Suitability Rule 2111 applies to online firms every bit as much as full-service broker-dealers. As FINRA has stated, "In all cases, the suitability rule applies to recommendations..."[39] Also, when "education" morphs into investment **strategy** advice, as opposed to specific investment advice, that too could subject an online broker-dealer to a suitability claim. FINRA has clarified that:

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[32] See the Massachusetts Complaint against Robinhood on this point, described later in this article.
[33] https://www.schwab.com/trading/education
[34] https://www.schwab.com/options/how-to-trade-options
[35] https://www.schwab.com/trading/education
[36] https://www.tdameritrade.com/education/education-offering/investment-classes.html
[37] https://www.tdameritrade.com/investment-products/options-trading.html
[38] For additional understanding on what is a recommendation or a solicited or unsolicited trade, see these three prior articles of mine: "Unauthorized Discretionary Trading 2020", PIABA Bar Journal, Vol 27, No 1 (2020); "Unauthorized Trading, Time and Price Discretion & the Mismarking of Order Tickets" Practicing Law Institute (PLI) Securities Arbitration 2001, August, 2001; "When Is An Order An Order? Unauthorized Trading by Securities Brokers" Published in Securities Arbitration 1994, Practicing Law Institute, July 1994
[39] https://www.finra.org/rules-guidance/key-topics/suitability/faq

The "investment strategy" language would apply to recommendations to customers to invest in more specific types of securities, such as high dividend companies or the "Dogs of the Dow," or in a market sector, regardless of whether the recommendations identify particular securities. It also would apply to recommendations to customers generally to use a bond ladder, day trading, "liquefied home equity," or margin strategy involving securities, irrespective of whether the recommendations mention particular securities.[40]

Online broker-dealers' communications with clients, though cloaked in an "education" aura, may well be crossing the line into making recommendations.

No Duties, so Long as We Ignore All the Other Securities Regulations

You might wonder how the Internet broker-dealers get away with their constant refrain and mantra of, "no duty", "no obligations", and "no monitoring". Since FINRA arbitrations occur behind closed doors, there is no media, no press, and no observers to witness such defenses. And everything but the award itself is kept nicely hidden and secret due to draconian confidentiality agreements. In other words, no one is watching. But wait, you might ask, isn't FINRA or the SEC watching? The short answer is, no.[41]

If the broker-dealers are correct that they have no duties to the clients with online self-directed accounts and if it were so black and white, then why aren't motions to dismiss and summary judgments granted more often? And why do FINRA arbitration panels, often rule for the claimants in these kinds of cases?

The reason is that the broker-dealers are wrong. As my earlier articles make clear, under the securities regulations, BDs have numerous duties and obligations to clients in their self-directed accounts. What follows are some of those duties and obligations.

Online Option Accounts

Because of my extensive option trading experience as a stockbroker and then as a commodities broker, over the decades I've attracted a lot of option cases. Along with my experience and expertise with online broker-dealers, likewise, I've attracted a large number of online broker-dealer cases so, I have acquired quite a library of securities regulations relating to options and online option cases. Here is an example of a specific securities regulation that pierces the defense by the broker-dealers that they don't have any duties with self-directed or third-party power of attorney accounts where they make no recommendations. The following is a quote

[40] FINRA Rule 2111 (Suitability) FAQ; https://www.finra.org/rules-guidance/key-topics/suitability/faq

[41] Read the chapter entitled titled, "The Fox Guarding the Hen House" in my book Brokerage Fraud – What Wall Street Doesn't Want You to Know, co-author, Dearborn Publishing, 2002. The book addresses the rules and regulations of the securities industry and puts them in layman's terms for the investing public. The book covers such subjects as the top abuses in the industry, the regulators, how to choose a stockbroker and how investors can navigate the investment markets.[42] "Supervision of Third-Party/Power of Attorney Accounts" 2016 PIABA Bar Journal, Vol. 23. No.2

from the options section of my article titled, Supervision of Third-Party/Power of Attorney Accounts.[42]

Options –
When it comes to options, the online brokerage firms' defenses fail even more so than with margin. FINRA's Option Rule 2360 states:

"In approving a customer's account for options trading, a member or any person associated with a member shall exercise due diligence to ascertain the essential facts relative to the customer, his financial situation and investment objectives." Another reason FINRA should revert to "due diligence" instead of the watered-down "reasonable diligence" in the current suitability rule is so that it will be consistent with the options rule. ***<u>The option rule makes no distinction for unsolicited trades and no distinction for online/internet broker-dealers.</u>*** *Additionally, the Chicago Board of Options Exchange (CBOE) has its own detailed set of regulations that apply to each and every BD (a point that internet/online broker-dealers love to ignore) dealing with options. It includes strict requirements as to knowing the customer, including detailed documentation of option experience and knowledge, as well as compliance and supervision which specifically includes monitoring the accounts. And again, these regulations are not watered-down if the account is going to be managed by a POA.* [citations omitted] [emphasis added]

In November 2022, FINRA released a notice addressing option account opening and supervision - **FINRA Provides Update on Sweep: Option Account Opening, Supervision and Related Areas**.[43] Here is some key language from FINRA, as it relates to the BD defenses of no duties and no obligations, especially when the claimant's/investors' accounts are option accounts. I have only pasted a few sections of this FINRA release. But it is quite apparent that the defenses of the BDs when it comes to Know Your Customer and option accounts are just flatly false.

Below FINRA poses several questions for firms to consider as they evaluate whether their supervisory systems are reasonably designed to address risks related to supervising the approval of options accounts ***<u>– both self-directed and full-service brokerage accounts</u>*** *– and monitoring the trading activity in options accounts. The questions for consideration in this update are based on FINRA's observations to this point in our review. The questions focus on firms': (1) processes for collecting and reviewing facts about their customers in connection with approving customers to trade options; (2) disclosures about options trading; and (3) supervision of approved options accounts. In addition, the Appendix notes additional guidance FINRA has provided regarding member firms' obligations related to options.* [emphasis added] *Member firms that offer options trading should be aware of their regulatory obligations pursuant to FINRA Rule 2360 (Options), as well as other relevant obligations, including but not limited to FINRA Rules 2090 (Know Your Customer), 2210 (Communications with the Public), 2220 (Options Communications), 2260 (Disclosures), 2264 (Margin Disclosure Statement),*

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[42] "Supervision of Third-Party/Power of Attorney Accounts" 2016 PIABA Bar Journal, Vol. 23. No.2
[43] https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/sweep-update

3110 (Supervision), 4210 (Margin Requirements) and 4512 (Customer Account Information). In addition, members that recommend an options account or an options transaction to a retail customer must comply with the SEC's Regulation Best Interest (Reg BI). [emphasis added]

To comply with this obligation, firms may establish processes to, among other things, review options account applications for completeness and accuracy, compare information contained in options applications with other information available to the firm (including information contained in other options applications submitted by the same customer), and verify that customers who change their account profile information continue to be eligible to trade options.

- ***Consider whether customers' investment objectives align with their desired options-trading levels (e.g., growth or speculation for higher levels)?***
- *Impose enhanced requirements for complex options trading (e.g., options spreads, uncovered options writing), such as requiring that customers:*
    - *Attest to having extensive product knowledge?*
    - *Have a specified amount of options-trading experience?*
    - *Meet your firm's requirements for the risk level of the selected option level?*

- *Comparing the information on the account application with other customer information already held at your firm;*
- ***Identifying potential logical inconsistencies in the application*** *(e.g., a 21-year-old applicant who claims to have ten years of option trading experience or an applicant who selects all of the listed investment objectives; a customer who has provided the firm with conflicting information about his investment experience or objectives); or*
- *Identifying customers whose claimed investment experience, options-trading experience, annual income or liquid net worth, warrants further scrutiny, in light of the customers' age or employment (e.g., a 20-year-old student who claims to have an annual income of $300,000)?* [emphasis added]

On April 9, 2021, FINRA issued **FINRA Regulatory Notice 21-15 Options Account Approval, Supervision and Margin**. This is just one more regulatory example of the fallacy of the broker-dealers' claims they have no duties, especially relating to Know Your Customer, suitability and supervision. Here are some excerpts:

Regardless of whether the account is self-directed or options are being recommended, members must perform due diligence on the customer and collect information about the customer to support a determination that options trading is appropriate for the customer. *In addition, FINRA reminds members that options accounts are subject to specific supervisory reviews, including, among others, reviewing the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved, and are subject to other FINRA rules that apply when opening customer accounts, including* *among others, customer identification requirements under anti-money laundering rules. FINRA also reminds members of the margin requirements for options transactions.* [emphasis added]

FINRA Rule 2090 requires that a member use "reasonable diligence" in regard to the opening and maintenance of each account to know the "essential facts"…

FINRA rules require that each customer must be specifically approved (or disapproved) for options trading prior to the time the member accepts an options order from the customer, ***regardless of whether the brokerage account is self-directed*** *or options are being recommended.5 The rule sets forth the steps that must be taken as part of that approval. FINRA Rule 2360(b)(16) requires a member to exercise due diligence to ascertain the essential facts relative to the customer. Specifically, the member must seek to obtain and consider detailed customer information, including, among others, the customer's knowledge, investment experience, age, financial situation and investment objectives.*[44]

In addition, members must retain options accounts records to permit timely and periodic supervisory reviews, including, among others, reviewing the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved. Members also must retain records to permit the review of the size and frequency of options transactions, profit or loss in the account and any undue concentration in the account.[45]

FINRA refers to CBOE Rule 9.1 (Opening of Accounts) and 9.2(j) (Supervision of Accounts) in footnote #2 of the Release[46]. In my 33 years of testifying in option cases, I don't believe I have ever seen broker-dealers refer to the Chicago Board of Options Exchange (CBOE)22-08 option rules. As discussed in the section The Broker-Dealer Defense of 2111, 2111, 2111, the standard practice of the BDs is to only quote FINRA Rule 2111, the Suitability Rule. The BDs really want to ignore the CBOE rules, because the CBOE rules don't limit the requirements for option accounts to only apply if there is a recommendation. And yes, that includes all option accounts; there are no special provisions or exceptions for online brokerage accounts.

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[44] The rule lists the minimum information that members should gather from customers who are natural persons. See FINRA Rule 2360(b)(16) (B)(i). The rule also lists specified information that members must be retain in a customer's account records, including sources of background information and financial information concerning the customer. See FINRA Rule 2360(b)(16)(B)(ii). Information considered in approving an account for options must be reflected in the records of the account. See FINRA Rule 2360(b)(16)(B)(v). FINRA encourages members to use a standard account agreement to facilitate obtaining all required information. FINRA also reminds members of the recordkeeping requirements of SEA Rule 17a-3.

[45] https://www.finra.org/rules-guidance/notices/21-15

[46] CBOE Rule 9.1. Opening of Accounts

(a) Approval Required. No TPH organization shall accept an order from a customer to purchase or write an option contract unless the customer's account has been approved for options transactions in accordance with the provisions of this rule.

(b) Diligence in Opening Account. In approving a customer's account for options transactions, a TPH organization shall exercise due diligence to learn the essential facts as to the customer and his investment objectives and financial situation, and shall make a record of such information which shall be retained in accordance with Rule 9.2. Based upon such information, the branch office manager or other Registered Options Principal shall approve in writing the customer's account for options transactions; provided, that if the branch office manager is not a Registered Options Principal, his approval shall within a reasonable time be confirmed by a Registered Options Principal.

FINRA Regulatory Notice 22-08 Complex Products and Options - This is a recent notice from FINRA, which is most illustrative because it repeatedly discusses the regulatory requirements for "Self-Directed Platforms" a.k.a. online accounts.

Although complex products do not always translate into more investment risk, their complexity may confuse investors who may not adequately understand their features. These concerns may be heightened when a retail customer is accessing these products through a self-directed platform and without the assistance of a financial professional, who may be in a position to explain the key features and risks of the product to the retail investor.

Similar to transactions in complex products, buying or selling options can be risky for retail investors who trade options without understanding their vocabulary, strategies and risks. Like the concerns associated with complex products, these concerns may be heightened when retail investors make self-directed decisions through online platforms without the assistance of a financial professional.

The rules governing options, security futures and warrants impose, among others, account opening requirements ***irrespective of whether a recommendation has been made****; specific suitability requirements when recommending these products, including a reasonable belief that the customer has the knowledge and experience to evaluate the risks involved and the financial ability to bear these risks.* [47]

Anti-Money Laundering – AML

The Anti-Money Laundering regulations are another set of regulations that upend this refrain of broker-dealers that they have no duties to online brokerage accounts as it relates to opening the accounts, monitoring and supervising those accounts. Once again, this mantra is undermined by the multitude of serious regulations required to be followed by all broker-dealers, and there are no limitations on those regulations just because the accounts are online, self-directed, or third-party power of attorney accounts. FINRA's Anti-Money Laundering Compliance Program, Rule 3310, has strict protocols for identifying customers and ongoing review. All firms must:

Include appropriate risk-based procedures for conducting ongoing customer due diligence, to include, but not be limited to:
(i) Understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and

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[47] FINRA Regulatory Notice 22-08, Complex Products and Options, FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements, March 8,2022

(ii) Conducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information. [48]

But even with these anti-money laundering rules in place broker-dealers, behind the closed doors of arbitration, dare to state in their answers, briefs, and opening statements that even as it relates to the AML rules, they claim they have no duties at all except for proper execution of trades. That argument is unsupportable given FINRA's notice relating to the Anti-Money Laundering (AML) Program.[49]

Money Laundering Red Flags

FINRA published a list of "money laundering red flags" in Notice to Members 02-21 (NTM 02-21). Since NTM 02-21 was published, guidance detailing additional red flags that may be applicable to the securities industry have been published by a number of U.S. government agencies and international organizations. FINRA is issuing this Notice to provide examples of these additional money laundering red flags for firms to consider incorporating into their AML programs, as may be appropriate in implementing a risk-based approach to BSA/AML compliance.[50]

- *The customer is reluctant or refuses to provide the firm with complete customer due diligence information as required by the firm's procedures, which may include information regarding the nature and purpose of the customer's business, prior financial relationships, anticipated account activity, business location and, if applicable, the entity's officers and directors.*
- *The customer refuses to identify a legitimate source of funds or information is false, misleading or substantially incorrect.*
- *Wire transfers or payments are made to or from unrelated third parties (foreign*
- *or domestic), or where the name or account number of the beneficiary or remitter has not been supplied.*
- *There is wire transfer activity that is unexplained, repetitive, unusually large, shows unusual patterns or has no apparent business purpose.*

[48] See 31 CFR 1023.220; FINRA Rule 3310(b). For further information on Anti-Money Laundering requirements, please visit the FINRA Anti-Money Laundering (AML) page. FINRA also reminds members of the recordkeeping requirements of SEA Rule 17a-3 with respect to accounts.

[49] See FINRA Regulatory Notice 19-18 Anti-money Laundering (AML) Program, May 6, 2019:
Money Laundering Red Flags. NASD (now FINRA) issued a very similar notice back in 2002: Special NASD Notice to Members 02-21, Anti-Money Laundering.

[50] "Bank Secrecy Act", The Currency and Foreign Transactions Reporting Act of 1970 (which legislative framework is commonly referred to as the "Bank Secrecy Act" or "BSA") requires U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering. Specifically, the act requires financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding $10,000 (daily aggregate amount), and to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities. It was passed by the Congress of the United States in 1970. The BSA is sometimes referred to as an "anti-money laundering" law ("AML") or jointly as "BSA/AML." Several AML acts, including provisions in Title III of the USA PATRIOT Act of 2001, have been enacted up to the present to amend the BSA. (See 31 USC 5311-5330 and 31 CFR Chapter X [formerly 31 CFR Part 103]).

III. Potential Red Flags in Securities Trading

- *The customer, for no apparent reason or in conjunction with other "red flags," engages in transactions involving certain types of securities, such as penny stocks, Regulation "S" stocks and bearer bonds, which although legitimate, have been used in connection with fraudulent schemes and money laundering activity. (Such transactions may warrant further due diligence to ensure the legitimacy of the customer's activity.*
- *There is a sudden spike in investor demand for, coupled with a rising price in, a thinly traded or low-priced security.*
- *The customer's activity represents a significant proportion of the daily trading volume in a thinly traded or low-priced security.*
- ***A customer buys and sells securities with no discernable purpose or circumstances that appear unusual.***
- *A customer accumulates stock in small increments throughout the trading day to increase the price.*
- *A customer attempts to influence the closing price of a stock by executing purchase or sale orders at or near the close of the market.*
- *A customer engages in a frequent pattern of placing multiple limit orders on one side of the market at various price levels, followed by the customer entering orders on the opposite side of the market that are executed and the customer canceling the original limit orders (activity indicative of "layering").*
- *Two or more unrelated customer accounts at the firm trade an illiquid or low-priced security suddenly and simultaneously.*
- *The customer makes a large purchase or sale of a security, or option on a security, shortly before news or a significant announcement is issued that affects the price*
- *of the security.*

[emphasis added]

As additional proof that the regulators consider AML violations by online broker-dealers as serious as regular broker-dealers, see the language **from FINRA AWC Case NO. 2015047770302, Department and Enforcement re: Arnold Feist**:

"Feist was interactive brokers' AMLCO…. And required him to review one of each of the firm's surveillance reports every month to ensure that analysts "handled [them] in accordance with [the firm's] procedures." "Additionally, while he was AMLCO, Feist learned about, but failed to recognize the import of, facts that should have alerted him that Interactive Brokers' AML program was not reasonably designed to detect and cause the reporting of suspicious activity or to comply with Bank Secrecy Act Regulations."

Again, the AML rules apply to broker-dealers regardless of whether the account is online, self-directed, or handled by a third-party advisor.

FINRA Rule 2130 - Approval Procedures for Day Trading

Once again, the refrain of the online BDs of "no duty to monitor" fails when we look at the FINRA regulations on the issue of day trading. FINRA defines day trading as: "*In general, day traders seek to profit from very small movements in the price of a security. Such a strategy often requires aggressive trading of a brokerage account. As a result, day trading generally requires a significant amount of capital, a sophisticated understanding of securities markets and trading techniques, and high-risk tolerance.*"[51]

Day trading is one of those investment-related activities like margin, options, private placements, and leveraged ETFs in that FINRA recognizes that these items contain significant risks that investors don't always appreciate, much less fully understand. It is a well-accepted, long-established axiom that short-term trading, scalping, or day trading is a much riskier investment strategy than long-term investing. As a result, FINRA has issued special regulations and regulatory notices to their member BDs, requiring them to have written policies and procedures to protect investors.

FINRA Rule 2130 - Approval Procedures for Day-Trading Accounts and FINRA Rule 2270 - Day-Trading Risk Disclosure Statement discuss the requirements of FINRA on day trading. But the more informative is **FINRA Notice to Members 00-62 - SEC Approves Day-Trading Rules**[52], which states:

Account Approval Requirement
As part of the account approval process, the firm will be required to make a threshold determination that day trading is appropriate for the customer. ***In making this determination, the firm will be required to exercise reasonable diligence to ascertain the essential facts relative to the customer, including his or her: investment objectives; investment and trading experience and knowledge; financial situation; tax status; employment status; marital status and number of dependents; and age. The firm also will be required to prepare a record setting forth the basis on which the firm has approved the customer's account.*** *Any record or written statement prepared or obtained by the firm pursuant to the rule change will have to be preserved in accordance with NASD Rule 3110(a).* [emphasis added]

Take note of this key language by FINRA: "…..the firm will be required to make a threshold determination that day trading is **appropriate** for the customer." The thesaurus' first synonym for "appropriate" is "suitable". And note that nowhere in the rule itself, or in this FINRA NTM, does the requirement of a "recommendation" appear. This is one more example that the "no duty" claim by broker-dealers should fail.

[51] FINRA Notice to Members 00-62, SEC approves day–trading rules, effective date: October 16, 2000
[52] Id.

Lastly, broker-dealers often argue, behind the closed doors of arbitration, that the day trading rules don't apply to them, because they did not promote day trading, they were merely "introducing" and "educating".[53] FINRA addresses that issue in FINRA NTM 00-62:

Members That Promote Day Trading
A member will be subject to the day-trading rules if it affirmatively promotes ***day-trading activities or strategies through advertising, training seminars, or direct outreach programs****.* *For instance, a firm generally will be subject to the new rules if its advertisements address the benefits of day trading, rapid-fire trading, or momentum trading, or encourages persons to trade or profit like a professional trader. A firm also will be subject to the new rules if it promotes its day trading services through a third party. Moreover, the fact that many of a firm's customers are engaging in a day-trading strategy*[54] *will be relevant in determining whether a firm has promoted itself in this way.*

Margin and Margin Liquidations

Margin and margin liquidations are along the same lines of "no duties" but with a different twist. Many lawyers and experts won't take margin liquidation cases because they know that the margin regulations and the BD policies are stacked woefully in favor of the brokerage firms. My first case as a securities expert started with the margin liquidation cases that came from the famous 1987 stock market crash, and thus over the decades I've had more than my share of margin liquidation cases. Yes, the securities regulations and the internal policies of the broker-dealers are stacked against the investor when it comes to margin and margin call liquidations. And, yes, when an investor/claimant files an arbitration complaint against the BD for inappropriate margin call liquidations, the answer of the BDs is replete with A) the margin regulations, B) the margin handbook, and C) the signed customer agreement and margin agreement. It's no wonder that an investor ever opens a margin account because the margin clauses read more like a contract of adhesion, they are so one-sided:

- The BD can change the margin requirements at any time without notice.
- The BD can liquidate all or a portion of an account to meet an initial or maintenance margin call.
- The BD can liquidate whichever securities it wishes, without any input from the client.
- The BD can make margin call liquidations without any prior notice to the client.

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[53] See in this article the section We Don't Make Recommendations…We Merely Educate

[54] FINRA NTM 11-02 Know Your Customer and Suitability, - Strategies -The new rule explicitly applies to recommended investment strategies involving a security or securities.12 The rule emphasizes that the term "strategy" should be interpreted broadly.13 The rule is triggered when a firm or associated person recommends a security or strategy regardless of whether the recommendation results in a transaction. Among other things, the term "strategy" would capture a broker's explicit recommendation to hold a security or securities.14 The rule recognizes that customers may rely on firms' and associated persons' investment expertise and knowledge, and it is thus appropriate to hold firms and associated persons responsible for the recommendations that they make to customers, regardless of whether those recommendations result in transactions or generate transaction-based compensation.

The contractual language that may discourage lawyers and experts from taking margin liquidation cases. But the securities industry is one of the most highly regulated industries in the country and there have been many instances where arbitration panels have found that, despite the contract language, the BD didn't treat the customer fairly, and has awarded damages.

When presenting testimony to an arbitration panel in a margin liquidation case, it is best to admit that the broker-dealer did have a right to sell out the client if you only look at the margin regulations. But when you consider all of the other duties and obligations the broker-dealer has as it relates to the use of margin and margin liquidation, the broker-dealer can't rely solely on the contract language. Broker-dealers' claims of immunity in margin and margin liquidation cases are identical to their claims of no duties relating to suitability and third-party power of attorney claims. But those defenses fail because the securities regulations don't allow for broker-dealers to be "partially responsible". All the rules apply all the time. It is for that reason, clients can be successful in margin liquidation cases.

In a FINRA arbitration where I was the securities expert for the claimant, the claim was that Ameritrade made improper margin liquidations, many of which involved options. An additional claim was that TD Ameritrade illegally restricted or canceled some of the claimant's option trades. The Panel awarded $2,082,148. September 22, 2021.[55]

In another FINRA arbitration where I was the securities expert for the claimant, the claimant was a professional option trader, who had traded complex option strategies (Iron Condors, etc.) for years at TD Ameritrade. The arbitration claim was that TD Ameritrade wrongly restricted the claimant's options trading and made improper and unfair margin liquidations. The panel awarded $6,924,538.[56]

Senior and Elderly Investors

Further evidence of how hollow and false the broker-dealers' claims are that they have no duties is when the customer is over the age of 65 or has mental or physical impairments. FINRA recently stated, "Older Americans are one of the fastest-growing demographics in the country, with an average of 10,000 Americans turning 65 every day. Con artists tend to target older people, in part because they are more likely to have built up nest eggs...[57] FINRA has continually addressed the needs of seniors through its Regulatory Notices over the years."[58]

[55] Elliott vs. T.D Ameritrade FINRA Case No. 20-00400
[56] Daydream vs. T.D. Ameritrade FINRA Case No. 09-02054, July 8, 2010
[57] https://www.finra.org/investors/insights/senior-financial-exploitation
[58] Regulatory Notice 07-43 (FINRA Reminds Firms of Their Obligations Relating to Senior Investors and Highlights Industry Practices to Serve these Customers); Regulatory Notice 17-11 (SEC Approves Rules Relating to Financial Exploitation of Seniors); Regulatory Notice 20-38 (FINRA Adopts Rule to Limit a Registered Person From Being Named a Customer's Beneficiary or Holding a Position of Trust for or on Behalf of a Customer)

In 2021, FINRA released a report titled, **Protecting Senior Investors 2015 – 2020**. The following are some of the comments by FINRA:

Seniors make up an increasingly large share of the American population1 and hold higher levels of wealth than other generations. These factors, among others, make seniors an attractive target for financial exploitation, with evidence suggesting that such exploitation has been increasing in terms of both scope and magnitude.

Most recently, in November 2019, FINRA held a Senior Investor Protection Conference to address issues relating to financial exploitation, diminished capacity, suitability, sales practices, scams, legal requirements and regulatory developments…[59]

FINRA has a rule addressing the handling of senior accounts which again, does not exclude or exempt the online firms from complying. Nor are the requirements of this rule adjusted if the trading was solicited or unsolicited. Additionally, the rule is just as applicable to accounts that are being managed by a third party or an individual with power of attorney. The rule provides, in pertinent part:

FINRA Rule 2165 Senior Investors

(a) Definitions
(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.
(2) For purposes of this Rule, the term "Account" shall mean any account of a member for which a Specified Adult has the authority to transact business.
…
(B) any act or omission by a person, including through the use of a power of attorney, guardianship, or any other authority regarding a Specified Adult, to:
(i) obtain control, through deception, intimidation or undue influence, over the Specified Adult's money, assets or property…
(c) Supervision
(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.

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[59] https://www.finra.org/rules-guidance/key-topics/senior-investors/protecting-senior-investors-2015-2020

Broker-dealers in arbitration like to interpret FINRA Rule 2165 as saying that it is only to protect these senior investors from non-broker-related individuals. That is not true. And here's just one example of why FINRA doesn't think so:

Helpline Helps Enforcement Stop Registered Representative who Stole Approximately $200,000 to Purchase Two New York Apartments in His Name Helpline staff assisted FINRA Enforcement, which found that the registered representative converted approximately $200,000 from an elderly and legally blind senior investor, coerced him to open a joint account at a non-affiliated bank and used those funds to purchase two apartments in the registered representative's name by taking advantage of the investor's poor eyesight and inability to read documents. The <u>registered representative</u> maintained sole ownership of both apartments, including the investor's primary residence, and even rented the second apartment to tenants and collected and retained the rent. ***FINRA found that the registered representative violated FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) and barred him from the industry****.*[60] [emphasis added]

FINRA Rule 3110 Supervision

One of the longest and most encompassing of the FINRA securities regulations is FINRA Rule 3110 on Supervision. Once again, we have the broker-dealers' lawyers and defense experts trying to mislead the arbitration panel into believing Rule 3110 doesn't apply to online broker-dealers because they don't have brokers making recommended trades. Au contraire! This 14-page regulation requires all broker-dealers (again no carveout for online broker-dealers or firms that don't make recommendations) to supervise and monitor all their activities, all of their employees, the opening of all their customer accounts, and all the trading activity in those accounts. Supervision and monitoring are key aspects of this regulation.

(1) Each member shall include in its supervisory procedures a process for the review of securities transactions that are reasonably designed to identify trades that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive device that are effected for the:
(A) accounts of the member;

(b) Written Procedures
(1) General Requirements
Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages *and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.*

[60] https://www.finra.org/rules-guidance/key-topics/senior-investors/protecting-senior-investors-2015-2020

(7) Maintenance of Written Supervisory Procedures
A copy of a member's written supervisory procedures, or the relevant portions thereof, shall be kept and maintained in each OSJ and at each location where supervisory activities are conducted on behalf of the member. Each member shall promptly amend its written supervisory procedures to reflect changes in applicable securities laws or regulations, including FINRA rules, and as changes occur in its supervisory system. Each member is responsible for promptly communicating its written supervisory procedures and amendments to all associated persons to whom such written supervisory procedures and amendments are relevant based on their activities and responsibilities.
(c) Internal Inspections
(1) Each member shall conduct a review, at least annually (on a calendar-year basis), of the businesses in which it engages. The review shall be reasonably designed to assist the member in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable FINRA rules. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses. Each member shall also retain a written record of the date upon which each review and inspection is conducted.[61]

Arguably, if the online broker-dealers such as TD Ameritrade, Charles Schwab, E*Trade, Interactive Brokers, and Robinhood comply with the "type of business" primarily offered by these firms - providing online trading services and trading platforms to investors and advisors on a non-solicitation basis, then their supervision of that business should be just as rigorous as traditional firms' supervision of accounts.

Red Flags in Monitoring and Supervision

NASD Notice to Members 98-38, **SUBJECT: NASD Reminds Members of Supervisory And Inspection Obligations**[62]

*"Many failure-to-supervise cases involve indicators of misconduct, or "**red flags,"** that should immediately alert management to potential wrongdoing. In circumstances where a firm's compliance and supervision system is inadequate to discover the indications of problematic conduct, the personal responsibility for supervision cannot be fulfilled by a supervisor who is simply unaware of the indicators."*[63]

If a broker-dealer is not supervising and monitoring all the activity related to its clients' accounts, how can it catch red flags or potential abuses? It can't - that's why the securities regulations require all firms to monitor and supervise all accounts, all activity, and all trading.

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[61] https://www.finra.org/rules-guidance/rulebooks/finra-rules/3110
[62] NASD Notice to Members 98-38, SUBJECT: NASD Reminds Members Of Supervisory And Inspection Obligations, May 1998, Pages 274-275
[63] https://www.finra.org/rules-guidance/notices/98-38

NASD Notice to Member 99-45, NASD Provides Guidance on Supervisory Responsibilities

Internal Inspections - Rule 3010(c)

It is important that members not only review their supervisory systems and procedures to ensure that they are current and adequate, but also conduct inspections to determine whether the systems and procedures are being followed. Paragraph (c) of the Rule, therefore, requires members to annually review the businesses they conduct, and sets forth the standard for this review.

The mandatory annual review must be reasonably designed to assist members in detecting and preventing violations of the securities laws. The "reasonably" designed standard means, for example, that indications of problems, or "red flags," must be investigated. ***When a member receives an indication of irregularities in a customer's account (e.g., a compliance program indicates or a supervisor discovers a frequency of trading in a customer's account that exceeds the customer's normal level of trading****), it must require that the account be examined to determine whether churning or some other violative conduct has occurred. If it does not, then that member's examination procedures would not be reasonably designed to detect or prevent irregularities or abuses.* [64]

In an SEC enforcement case, the SEC wrote: "Supervisors must also respond vigorously to indications of possible wrongdoing. Supervisors must inquire into red flags and indications of irregularities and conduct adequate follow-up and review to detect and prevent future violations of the federal securities laws."[65]

In another SEC enforcement case, the SEC wrote:

Red Flags' and suggestions of irregularities demand inquiry as well as adequate follow-up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of the federal securities laws.[66]

FINRA Rule 2090 Know Your Customer – KYC

FINRA Rule 2090 Know Your Customer

1. (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.*

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[64] NASD Notice to Member 99-45, NASD Provides Guidance on Supervisory Responsibilities (June 1999). Page 299

[65] In the Matter of Western Asset Management Co., And Legg Mason Fund Adviser, Inc., Securities Exchange Act Release No. 1980 (September 28, 2001), Page 5.

[66] In re. George J. Kolar, SEC Initial Decision Release No. 152 (Oct. 28, 1999).

.01 Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.
[emphasis added]

FINRA NTM 11-02 Know Your Customer and Suitability

Know Your Customer
In general, new FINRA Rule 2090 (Know Your Customer) is modeled after former NYSE Rule 405(1) and requires firms to use "reasonable diligence,"4 in regard to the opening and maintenance5 of every account, to know the "essential facts" concerning every customer.6 The rule explains that "essential facts" are "those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."7 ***The know-your-customer obligation arises at the beginning of the customer-broker relationship and does not depend on whether the broker has made a recommendation.*** *Unlike former NYSE Rule 405, the new rule does not specifically address orders, supervision or account opening—areas that are explicitly covered by other rules.*

In my earlier article on third-party accounts[67] I quote another section of NTM 11-02:

A broker-dealer must know its customers not only at account opening but also throughout the life of its relationship with customers in order to, among other things, effectively service and supervise the customers' accounts. Since a broker-dealer's relationship with its customers is dynamic, FINRA does not believe that it can prescribe a period within which broker-dealers must attempt to update this information. As with a customer's investment profile under the suitability rule, a firm should verify the "essential facts" about a customer under the know-your-customer rule at intervals reasonably calculated to prevent and detect any mishandling of a customer's account…[68]

Despite the clear mandate that all broker-dealers must know their customers, I have sat in many a FINRA arbitration and heard from FINRA license broker-dealers, stockbrokers, their attorneys and defense experts that:

- The Know Your Customer rule doesn't apply to us because we do not make any recommendations (the no duty refrain)
- The customer's new account forms are filled out merely as a formality or as a convenience. Or it's extraneous information.

[67] "Supervision of Third-Party/Power of Attorney Accounts" 2016 PIABA Bar Journal, Vol. 23. No.2.
[68] https://www.finra.org/rules-guidance/notices/11-02

Nothing could be better evidence of this violative attitude toward the Know Your Customer rule and the regulatory requirements relating to new account forms than the sworn testimony in the recent FINRA arbitration by one of the major online firm's witnesses. What makes this sworn testimony that much more disturbing is that the person giving that sworn testimony was previously Managing Director and Chief Compliance Officer at the respondent firm for 5 years. This defense witness gave the following astonishing testimony when questioned about new account form information gathering:

A…So I view that, the collection of that information **<u>they're not using information that they're collecting.</u>**
Q. So I want to be really clear on your position. They have to collect investment information or they do not?
A. They choose to **<u>as matter of convenience</u>** collect it.
Q. Okay. Which parts are not required under the securities regulation?
A. Okay. So when you're since they have no suitability obligation to Mr. xxx, you know, **<u>the idea that they need to know what his investment objective and risk tolerance are extraneous</u>**.

Again, I think it's very important for the reader to think back on all the regulations and notices I've listed and quoted in this article, detailing a laundry list of duties, obligations, and requirements on broker-dealers. And then think to yourself, "How can a broker-dealer fulfill their regulatory obligations when they open a client's account and don't even perform even a cursory review of the information to make sure it is complete, accurate, and non-conflicting?" And then consider that after obtaining this information, the broker-dealers, in many of the cases I've been involved in, ignore the information as if it doesn't even exist. Not only are the BDs required under FINRA Rule 2090 to know their customers at account opening, but they are required to continually update information as required in the SEC Books and Records regulation 17 CFR § 240.17a-3. These broker-dealers are making a mockery of FINRA Rule 2090 and the Books and Records regulation.

<u>Additional Regulations That Always Apply</u>

Regulators and arbitrators need a reminder when confronted with the "no duty" claim, that numerous regulations apply. Here are just a few more regulations that always apply.

One of those additional regulations is FINRA Rule 2020.
FINRA Rule 2020 Use of Manipulative, Deceptive or Other Fraudulent Devices *- No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.*

This is often referred to as the FINRA version of the SEC 10B-5, antifraud regulation. The Rule states, no one can make a false statement, a misleading statement, or an omission of a material fact.

One of the most cited rules in FINRA's disciplinary hearings when fining, censuring, and suspending brokers and broker-dealers is FINRA Rule 2010:

FINRA Rule 2010 STANDARDS OF COMMERCIAL HONOR AND PRINCIPLES OF TRADE
A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.[69]

This rule, which applies to all broker-dealers without exception, requires firms to treat their customers and accounts in a professional, consistent, fair manner in every aspect of their business.

In addition, FINRA regulations prohibit any broker-dealer from putting language in a customer agreement that limits or restricts a person's rights:

FINRA Regulatory Notice 21-16 - Predispute Arbitration Agreements in Customer Agreements - FINRA Reminds Members About Requirements When Using Predispute Arbitration Agreements for Customer Accounts.[70]

Indemnity and Hold Harmless Provisions
Some customer agreements contain indemnification or hold harmless provisions, such as broad provisions that require that the customer indemnify and hold harmless the member firm from all claims and losses arising out of the agreement. Indemnification and hold harmless provisions do not comply with FINRA Rule 2268 where the provisions, if given effect, would limit the customer from bringing a claim or receiving an award from the member firm or associated person that they would otherwise be entitled to receive. For example, an indemnification and hold harmless provision that could be invoked to assert that a customer could not bring a claim alleging a failure to supervise against a member firm that the customer would otherwise be entitled to bring under applicable law would not comply with FINRA Rule 2268.

In addition, a well-developed line of case law has held that it is contrary to public policy for a person to seek indemnity from a third party for that person's own violation of the federal securities laws. Accordingly, FINRA believes that it would be unethical and not in compliance with FINRA Rule 2010 for a member firm or associated person to attempt to seek indemnity from customers of costs or penalties resulting from the firm's or associated person's own violation of the securities laws or FINRA rules. For example, FINRA believes that

[69] https://www.finra.org/rules-guidance/rulebooks/finra-rules/2020
[70] FINRA Regulatory Notice 21-16, Predispute Arbitration Agreements in Customer Agreements, April 21, 2012

a member firm would violate FINRA Rule 2010, and be subject to disciplinary action, if it sought to recover from a customer the attorney's fees that it incurred as a result of a regulatory investigation into the member firm's own misconduct.[citations omitted].

Yet FINRA Rules 2268 & 2010 did not keep one broker-dealer from putting in a recent arbitration Answer:

"[Claimant] has ratified all of [broker's] transactions and is obligated to indemnify and hold harmless TD Ameritrade from losses arising from [broker's] transactions in the [Claimant's Trust.] The indemnification and hold harmless agreement states:…"

In this Answer, the broker-dealer uses the "hold harmless" language several times, in addition to highlighting the "hold harmless" language in the customer agreement. In other cases, two of the largest online broker-dealers utilize "hold harmless" language in the customer agreements in an attempt to limit a customer's rights.

In a 2021 FINRA arbitration where a major online BD was ordered to pay Claimant millions in damages, the firm's prehearing brief contained the following defense:

CLAIMANT'S INDEMNIFICATION DUTY EXTENDS TO THIS PROCEEDING.
Section 14(h) of the Client Agreement contains a broad indemnification provision under which Claimant agreed to "indemnify and hold harmless" [the broker-dealer] from any and all liabilities, costs, judgments, penalties, claims, actions, damages, expenses, or attorneys' fees resulting or arising directly or indirectly from" his use of [the broker-dealer] services.

It would certainly appear that such a defense is violative of the NASD/FINRA's long-standing prohibition from putting anything in customer agreements that limit the rights of investors and claimants.

NASD NTM 05-09 Predispute Arbitration Agreements[71] - *Restrictions on Provisions That Limit Rights and Remedies*
Rule 3110(f)(4)(A) currently prohibits the use of provisions in predispute arbitration agreements that limit a customer's rights or remedies, or limit the ability of an arbitrator to make an award. To amplify on this provision, the amendments provide that predispute arbitration agreements may not include any condition that would: (i) limit or contradict the rules of any SRO; (ii) limit the ability of a party to file any claim in arbitration; (iii) limit the ability of a party to file any claim in court that could otherwise be filed in court under the rules of the forum(s) in which a claim may be filed under the agreement; or (iv) limit the ability of arbitrators to make any award. These amendments are intended to, among other things, address provisions that attempt to circumvent NASD Rule 10304, governing the eligibility of claims in arbitration.[72]

[71] NASD NTM 05-09 Predispute Arbitration Agreements, NASD Amends Rule Governing Predispute Arbitration Agreements with Customers; Effective Date: May 1, 2005
[72] https://www.finra.org/rules-guidance/notices/05-09

Too Busy, Too Swamped, Too Many Accounts

It's 1999, markets are booming, and the tech/telecom market bust is about to happen. Americans are opening these newfangled online/internet brokerage accounts by the tens of thousands. And because I had experience as a broker, advisor, and trader trading online starting as early as with Charles Schwab back in the 1970s, I attracted a lot of online securities cases as an expert witness. But there was a problem. These upstart online broker-dealers could not keep up with the demand, not only opening all the new accounts but more importantly handling all the trading and regulatory requirements. Once in arbitration behind closed doors, these firms would often seek sympathy from the arbitration panels that it was almost impossible for them to do everything required due to the onslaught of new accounts and volume of trading. I bring this up because now - 24 years later - because this is still a defense/excuse I hear from online broker-dealers.[73]

I wrote one of my first online/internet trading articles in July 1999 called "Internet Trading – Take A Walk On The Wild Side"[74], wherein I addressed a similar problem in a section I titled, "Inadequate Systems And System Failure". FINRA caught wind of these defenses and excuses by the broker-dealers and issued the following regulatory notice:

FINRA Notice to Members 99-11 - NASD Regulation Issues Guidance Regarding Stock Volatility

Footnote #3 This Notice addresses possible responses to recent stock price volatility, particularly in stocks traded through online brokerage firms. While it does not address firms' suitability obligations in connection with recommended transactions or their know-your-customer obligations, firms are reminded that the existence of these obligations does not depend upon whether a trade is executed on-line or otherwise.

Recently, there has been a marked increase in the price volatility of many stocks, particularly those of Internet issuers. This volatility has been coupled with record trading volume in many of these stocks. Customers eager to trade Internet stocks have flooded their brokers with large numbers of orders, leading to large order imbalances, systems queues, and backlogs…
.
First and foremost, NASD Regulation reminds member firms of their obligations under Securities and Exchange Commission (SEC) Staff Legal Bulletin No. 8 to ensure that they have adequate systems capacity to handle high volume or high volatility trading days.1 In this connection, we note that the SEC staff's position relates to all firms handling orders and is premised on a legal obligation to treat customers fairly.

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[73] See section in this Article entitled Online Broker Dealer's Growth Numbers

[74] "Internet Trading - Take a Walk on the Wild Side" Published in Securities Arbitration 1999, Practicing Law Institute, July 1999. This article addresses the booming market in Internet trading, the pitfalls, and conflicts in trading through Internet brokerage firms, as well as the liability.

• Member firms must have adequate systems capacity to handle high volume or high volatility trading days. Firms should provide adequate, clear disclosure to customers about the risks arising out of evolving volatility and volume concerns and any related constraints on firms' ability to process orders in a timely and orderly manner.

• Firms' procedures for handling customer orders must be fair, consistent and reasonable during volatile market conditions and otherwise.

• Firms may use advertisements or sales literature to make claims about the speed and reliability of their trading services. These communications must not exaggerate the members' capabilities or omit material information about the risks of trading and the possibilities of delayed executions. Members should have the system capacity to support any claims they make about their trading services.[75]

And more recently FINRA issued:

FINRA Regulatory Notice 21-12 Customer Order Handling, Margin and Liquidity

The foundation of the securities industry is fair dealing with customers. Fair dealing is a core principle that underlies many FINRA rules, and FINRA guidance repeatedly has emphasized the importance of preserving fair customer treatment, even during times of market stress. In light of recent market events, including the extreme volatility of certain stocks' trading prices, FINRA is reminding member firms that the duty of best execution requires the fair, consistent and reasonable treatment of customer orders at all times. Further, it is important that customers are informed about member firms' order handling.[76]

The Regulators Chime in

You would expect that the regulators, though renowned for acting slowly, would step in to address some of the issues raised in this article. After all, FINRA currently proclaims on its website:

FINRA is dedicated to protecting investors... Every investor in America relies on one thing: fair financial markets; every investor receives the basic protections they deserve; any securities product sold to an investor is suitable for that investor's needs, and investors receive complete disclosure about the investment product before purchase. FINRA is authorized by Congress to

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[75] chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.finra.org/sites/default/files/NoticeDocument/p004569.pdf
[76] https://www.finra.org/rules-guidance/notices/21-12

protect America's investors by making sure the broker-dealer industry operates fairly and honestly. [77]

An individual not familiar with securities regulations or securities arbitrations, might wonder; "How can these BDs make such blatant statements of no duties, when the regulations state exactly the opposite?" Now you know why Wall Street lobbied so hard to get litigation out of the courts, and into the secret, closed-doors, confidential NASD/now FINRA arbitrations. Where there are rarely court reporters. No press. No media. And there aren't even any regulators. It is sadly ironic that the agency tasked with writing and enforcing rules for broker-dealers – FINRA – is funded primarily by its broker-dealer members.

Though the regulators are not privy to the made-up, lawyer-contrived defenses, there is still further evidence that these defenses are baseless by virtue of the following regulatory actions, as well as the numerous regulations outlined in this article. We can look at what the regulators themselves have put in writing as to what the duties and obligations are on the issues raised in this article. The following are just a few examples:

In June 2021, FINRA announced the following in a News Release:

FINRA announced today that it has fined Robinhood Financial LLC $57 million and ordered the firm to pay approximately $12.6 million in restitution, plus interest, to thousands of harmed customers. The sanctions represent the largest financial penalty ever ordered by FINRA and reflect the scope and seriousness of the violations[78].

In the settlement of FINRA's Enforcement Action against Robinhood, FINRA found the following:

"Robinhood is a FinTech1 firm that offers commission free, <u>self-directed</u> trading for retail investors.." Thus it is established, that the firm only offers trading on an unsolicited bases, and that the firm does not make any recommendations. [79]

Failure to exercise due diligence before approving options accounts *– Since Robinhood began offering options trading to customers in December 2017, the firm has failed to exercise due diligence before approving customers to trade options. Although the firm's written supervisory procedures assign registered options principals the responsibility of approving accounts for options trading, the firm, in practice, has relied on computer algorithms—known at Robinhood as "option account approval bots"—with only limited oversight by firm principals. This system suffers from a number of flaws, including the following:*

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[77] https://www.finra.org/about, December 17, 2022
[78] https://www.finra.org/media-center/newsreleases/2021/finra-orders-record-financial-penalties-against-robinhood-financial
[79] Financial Industry Regulatory Authority, Letter of Acceptance, Waiver and Consent, No. 2020066971201, accepted by FINRA: June 30, 2021

• The bots were programmed to approve options trading based on inconsistent or illogical information, including for customers who were younger than 21 years old but who claimed to have had more than three years' experience trading options.
• The bots approved certain customers with low risk tolerance for options trading, even though the firm's written procedures prohibited the firm from approving those customers from trading options.
• The bots were programmed only to take into account the most recent information provided by customers, meaning that the firm approved for options trading customers whom it had previously rejected for options trading—often only minutes earlier.

<u>As a result of these flaws and Robinhood's overall failure to exercise due diligence before approving customers for options trading, the firm has approved thousands of customers who did not satisfy the firm's eligibility criteria or whose accounts contained red flags that options trading may not be appropriate for them, in violation of FINRA Rules 3110, 2360, and 2010.</u> **[emphasis added]**

Robinhood communicated false and misleading information to customers.
FINRA Rule 2010 requires firms to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business. Making a negligent misrepresentation or an omission of a material fact to customers violates FINRA Rule 2010, as it is inconsistent with just and equitable principles of trade. ***FINRA Rules 2210 and 2220 set forth content standards for firms' communications with customers. FINRA Rule 2210 requires, among other things, that communications be "fair and balanced"; not contain any "false, exaggerated, unwarranted, promissory or misleading statement or claim"; and not omit "any material fact . . . if the omission, in light of the context of the material presented, would cause the communications to be misleading." And FINRA Rule 2220, which addresses member firms' communications about options trading, requires firms to "avoid[]" making "broad generalities" about the risks of options trading, and prohibits, among other things, making "any untrue statement or omission of a material fact" or any statement that "is otherwise false or misleading," or that "fails to reflect the risks attendant to options transactions and the complexities of certain options investment strategies." A violation of FINRA Rules 2210 and 2220 also constitutes a violation of FINRA Rule 2010.*** [emphasis added]

FINRA Rule 3110 requires that firms establish and maintain a supervisory system, and establish, maintain, and enforce written supervisory procedures, that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. A violation of FINRA Rule 3110 also constitutes a violation of FINRA Rule 2010.

Customer 3 deposited more than $14 million into his interactive brokers account - a figure that should have triggered red flags since it was well beyond his stated income or resources.

Additionally, customer 3 regularly incurred trading losses of more than $100,000 each month and seemingly replenish this account with fresh deposits that exceeded his stated annual income. ***The firm consequently did not investigate customer 3 or speak with him to understand the source of his deposits or to ask him about his apparent lack of concern regarding his significant monthly trading losses.*** [emphasis added]

The SEC during the same timeframe issued an Order Instituting Administrative and Cease and Desist Proceedings against Interactive Brokers, stating:

[D]uring the relevant period, IB ignored or failed to recognize numerous red flags, failed to properly investigate certain conduct as required by its written supervisory procedures, and ultimately failed to file SARs on suspicious activity. [80]

As further, recent proof that the regulators do not accept these contrived defenses of the broker-dealers as it relates to duties and obligations on option accounts, there is a **March 8, 2023, FINRA AWC NO. 0201070581401 against Webull Financial**. The following is some of the language from the AWC:

Flaws in that system—and the firm's supervision of the system—resulted in customers being approved for options trading authority who did not satisfy the firm's eligibility criteria or whose accounts contained red flags that options trading was potentially inappropriate for them. As a result, the firm violated FINRA Rules 3110, 2360, and 2010.

FINRA Rule 3110(b) requires a member firm to "establish, maintain, and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA Rules." A violation of FINRA Rule 3110 or Rule 2360 also constitutes a violation of FINRA Rule 2010, which requires firms to observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business.

The firm's automated system also did not review customers' previous applications to search for and incorporate into its analysis any materially different information, or applications that had previously been denied by the firm. As a result, the firm's automated system approved customers for options trading authority even when those approval decisions were based on information that was inconsistent with information that customers had previously submitted.

In June 2014, FINRA issued an AWC No. 2011030752701 against TD Ameritrade, stating as follows:

TDAC's Failure To Maintain Updated Account Records

[80] SEC Administrative Proceeding file No. 3-19907, Release No. 89510, August 10, 2020

SEC rule 17a-3(a))17) requires that a firm create and maintain an account record including, among other things, the accounts investment objective. The rule further requires that, in the event of a change in the customer's investment objective, a firm create and maintain a record that it sent to the customer a copy of the updated account record reflecting the change in the investment objective within 30 days of the change.

Specifically, the data files containing new or updated customer suitability information failed to route to TDAC's printing vendor such that changes in customers' investment objectives were not sent to approximately 300,000 customers, during the period from approximately August 2010 through November 2011. [81]

FINRA also fined E*Trade $350,000 for its rule violations, as follows:

As set forth below, however, this supervisory system was not reasonably designed with respect to detecting potential manipulative trading involving wash sales, prearranged trading, and marking-the-close. [82]

State of Massachusetts filed a complaint against Robinhood, **Amended Administrative Complaint, Docket No. E-2020-004 7 Filed October 21, 2021** alleging that:

Robinhood used advertising and marketing techniques that targeted younger individuals, including Massachusetts residents, with little, if any, investment experience. The median age of a Robinhood customer has been reported as 31 years old and approximately 68% of Massachusetts customers approved for options trading on the Robinhood platform identified as having no or limited investment experience. [83]

The Complaint further alleges that Robinhood rapidly increased its customer base in 2020 and then encouraged them to trade constantly:

Once individuals become customers, Robinhood relentlessly bombards them with a number of strategies designed to encourage and incentivize continuous and repeated engagement with its application. The use of these strategies is often referred to as gamification: the application of typical elements of game playing to other activities, typically as a marketing technique to boost engagement with a product or service. Robinhood rewards customers with colorful confetti raining down their screens after executing trades on its application. In 2019, Robinhood rolled out a new cash management feature with an early access waitlist and utilized gamification to reward customers who interacted daily with the application by improving their positions on the

[81] Financial Industry Regulatory Authority, Letter of Acceptance, Waiver and Consent, No. 2011030752701, accepted by FINRA July 2, 2014.
[82] Financial Industry Regulatory Authority, Letter of Acceptance, Waiver and Consent, No. 2014039952901, accepted by FINRA January 10, 2022.
[83] Commonwealth Of Massachusetts, Office of The Secretary of The Commonwealth Securities Division, In the Matter of: Robinhood Financial, LLC, Respondent, Amended Administrative Complaint, Docket No. E-2020-004 7 Filed October 21, 2021. The case is still pending.

waitlist. Customers who did not interact daily with the application watched their position on the waitlist precipitously decline, while those who succumbed to the psychological effects of Robinhood's gamification soared up and up the waitlist.

The Complaint also makes clear that the Massachusetts Securities Division considers providing a list of investments to customers to be a recommendation:

Robinhood gives customers the platform and tools to make potentially an unlimited number of trades. In an effort to encourage trading, Robinhood provides lists of securities on its application, including lists of the most-traded securities on Robinhood's platform and the most popular securities traded by Robinhood customers. ***This is no different from a broker-dealer agent handing a list of securities to a customer, pretending to be surprised when the customer purchases securities from that list, and then proclaiming that he made no recommendations to the customer****. [emphasis added]*

The Complaint reveals that in Robinhood's zeal to increase its customer base and encourage trading, it completely violated the option rules.

Robinhood gave hundreds of customers with limited or no investment experience the ability to make thousands of trades in a matter of months. At least 670 Robinhood customers with limited or no investment experience averaged at least five trades per day, with two customers averaging close to 100 trades per day. As one example, Robinhood allowed a customer with no investment experience to make more than 12,700 trades in just over six months.

While encouraging constant engagement with its platform, Robinhood failed to properly screen customer profiles and allowed thousands of inexperienced investors to engage in very risky trading activity. Robinhood failed to follow its own policies and procedures in place regarding the approval of options trading in customer accounts.

Compliance, Supervisory and Policies & Procedures Manuals

As further evidence that this "no duty" defense is nothing more than made-up, hypocritical, legal mumbo-jumbo, all one needs to do is to read the compliance manuals of the online broker-dealers. Since as a securities expert I do so many online cases, I have performed an extensive review of these internal manuals of many of the major online broker-dealers.[84] I cannot paste specific text from those manuals because of confidentiality agreements in those cases, but I can assure you that these compliance, supervisor, and policies and procedures manuals are filled with specific language that requires the broker-dealers to:

[84] These requirements are not just for self-directed accounts or unsolicited trades; many of these policies address third-party accounts by money managers who were using the online broker-dealers as custodians for clearing services.

- Monitor the new account opening forms to make sure they are current, accurate, complete
- Monitor the trading activity in the accounts to make sure it matches the investment objectives, risk tolerance, and the KYC information for each account
- Scrutinize deposits, withdrawals, and transfers for any potential violations or account abuses
- Create and monitor computerized screens that keep track of such things as, monthly losses, year-to-date losses, fees and commissions, number of trades, concentration levels, potential margin problems, strange or out-of-the-ordinary trading activity, trading in low-priced or penny stocks, day trading, and excessive trading.
- Due diligence requirements for all individuals holding a power of attorney over the accounts, including third-party investment advisors
- Monitoring the accounts of separate, independent investment advisors to catch inappropriate or illegal trading activities (such as front running, illegal bunching, favorable and illegal allocation of bunch trades) and other potential account abuses
- Due diligence and exhaustive background checks on all investment advisors applying to use the BD's trading platform
- Quarterly and annual due diligence reviews to ascertain if there are any changes relating to the third-party investment advisor, including broad internet searches, FINRA's broker check, the SEC's website, NFA, Basic systems, governmental and state records, and more
- All due diligence and background checks on investment advisors must be thoroughly documented and updated
- They are required to issue quarterly reports on the investment advisors' accounts at the online BD that evidence:
    - accounts with the top losses
    - accounts generating the most commissions
    - losses compared to equity
    - amount of losses and losses concentrated in one client's account
    - profitability year to date
    - fees being paid to advisor and the percentage of equity
    - potential senior fraud, churning, penny stocks, market manipulation, know your customer obligations

So much for the convoluted defense of "no duty" to monitor and supervise the activities of self-directed and independently managed third-party power of attorney accounts! The reality is that broker-dealers' mantra of "no duty" is belied by not only the securities regulations but the firm's own policies and procedures. This reinforces the need to obtain all such policies and procedures manuals from the firms.

Third-Party & Power of Attorney Accounts at Online Clearing BDs

An additional key point is that the argument made by the BDs that they have no duty to monitor the trading activities of third-party accounts is the same argument they make about having no duty to monitor the trading activities of self-directed accounts. This is what prompted me to write a PIABA Bar Journal article on that subject back in 2016.[85] My registered investment advisory firm managed clients' accounts through the platform offered by Charles Schwab, and I was shocked to years later learn of the problems and violations related to third-party money managers who likewise domicile and clear their trades at accounts at online broker-dealers.

The broker-dealers' argument and defense are one and the same: "We are not recommending trades in either one of these types of accounts, thus FINRA's Suitability Rule 2111 does not apply and there is no duty to monitor either of these types of accounts." I have established throughout this article that the duty to monitor trading activity in both of these types of accounts is by no means globally limited merely based on FINRA Rule 2111.

I have provided evidence from my own cases that the online broker-dealers' "no duty" defense extends to power of attorney and third-party accounts.[86]

FINRA has a bevy of other rules and guidance that apply to clearing firms and online broker-dealers with self-directed accounts:

FINRA Rule 4311 is a regulation that addresses the relationship between investment adviser firms (often called introducing firms) and the clearing firm broker-dealer (often referred to as respondent/carrying firm.)

FINRA Rule 4311 Carrying Agreements
(4) Each carrying firm shall ***conduct appropriate due diligence*** *with respect to any new introducing firm relationship to assess the financial, operational, credit and reputational risk that such arrangement will have upon the carrying firm. FINRA, in its review of any arrangement, may in its discretion require specific items to be addressed by the carrying firm as part of such firm's due diligence requirement under this Rule. The carrying firm shall maintain a record, in accordance with the timeframes prescribed by SEA Rule 17a-4(b), of the due diligence conducted for each new introducing firm.*[emphasis added]

.03 Due Diligence. *For purposes of paragraph (b)(4) of this Rule, the carrying firm's due diligence may include, without limitation, inquiry by the carrying firm into the introducing firm's business model and product mix, proprietary and customer positions, FOCUS and similar reports, audited financial statements and complaint and disciplinary history.*

FINRA NTM 11-26 Financial Responsibility[87]
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*

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[85] Supervision of Third-Party/Power of Attorney Accounts" 2016 PIABA Bar Journal, Vol. 23. No.2e
[86] Refer in this article to the "We Don't Make Recommendations, So We Have No Duties" section.
[87] FINRA NTM 11-26 Financial Responsibility, SEC Approves Consolidated Financial Responsibility and Related Operational Rules, Effective Date: August 1, 2011

to be conducted prior to the commencement of the relationship. ***The rule provides that such due diligence must assess the financial, operational, credit and reputational risk that such arrangement will have upon the carrying firm.*** *15 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 SEA Rule 17a-4(b), of the due diligence conducted for each new introducing firm***. [emphasis added]

NASD Notice to Members 99-57 SEC Approves Rule Amendments Governing Clearing Firms and Their Introducing Firm Clients' Relationship.[88] This notice has very key language from the regulators as to the **required duties of clearing firms relating to their supervisory obligations, to the introducing firms, and the introducing firm's clients** (which are also the clients of the clearing firm). The following is some key language from the notice:

The NASD's and NYSE's amendments address the content and approval of clearing agreements to specify requirements for handling customer complaints; providing, requesting, and retaining exception reports; and issuing checks.
Exception Reports. ***All NASD member firms are required under NASD and federal regulations to establish, maintain, and enforce supervisory systems and procedures that are designed to address all areas of a member's business. A key aspect of these supervisory procedures is exception and other compliance reports that a member creates to help meet these supervisory responsibilities****. In a fully disclosed clearing arrangement, the clearing member generally provides exception reports that are available to assist the introducing member in carrying out its supervisory obligations. In addition, officers and managers of introducing members should be on notice of the reports and information that were available to them in meeting their supervisory and monitoring obligations. [emphasis added]*

FINRA Notice to Members 92-32 -Request for Comments on Proposed Amendment to the Rules of Fair Practice Relating to the Respective Obligations and Supervisory Responsibilities of Introducing and Clearing Firms

At the time the Securities and Exchange Commission (SEC) considered the NYSE's proposed rule, the NASD commented to the SEC that permitting certain functions to be allocated to the introducing member may result in compliance failures and violations resulting from the inability of the introducing member to adequately perform those functions. The NASD urged that ***members should not be permitted to avoid obligations or responsibilities which would otherwise be theirs under the securities laws***. [emphasis added]

In its order approving the NYSE Rule 382, the SEC recognized the NASD's concerns and stated, "... ***no*** *contractual* ***arrangement for the allocation of functions between an introducing and***

[88] NASD Notice to Members 99-57, Effective Date: July 19, 1999

***carrying organization can operate to relieve either organization from their respective responsibilities under federal securities laws and applicable SRO* rules**." [emphasis added and citations omitted]

Regulatory Findings

The following are regulatory case sites that are additional proof (in addition to the regulations themselves) that broker-dealers have extensive regulatory requirements when it comes to third-party and investment advisor power of attorney accounts.

In December 2019, FINRA sanctioned 5 brokerage firms $1.4 million for failing to supervise custodial accounts. The news release stated:

FINRA Rule 2090 requires member firms and their associated persons to use reasonable diligence to determine the "essential facts" about every customer and "the authority of each person acting on behalf of such customer." FINRA Regulatory Notice 11-02 stated that a firm must "know its customers not only at account opening but also throughout the life of its relationship with customers in order to, among other things, effectively service and supervise the customers' accounts," and that a firm should "verify the 'essential facts' about a customer … ***at intervals reasonably calculated to prevent and detect any mishandling of a customer's account*** *that might result from the customer's change in circumstances."[emphasis added]*

UTMA and UGMA accounts are custodial accounts that provide a way to transfer property to a minor beneficiary without the need for a formal trust. The custodian makes all investment decisions on the beneficiary's behalf until the beneficiary reaches the age of majority, at which point the custodian is required by state law to transfer control over the custodial property to the beneficiary.

The five firms that FINRA has sanctioned permitted customers to open UTMA and UGMA accounts, yet failed to establish, maintain, and enforce reasonable supervisory systems and procedures to track or monitor whether custodians timely transferred control over custodial property to UTMA and UGMA account beneficiaries. As a result, UTMA Account custodians authorized transactions in UTMA Accounts months, or even years, after the beneficiaries reached the age of majority and after the custodians had become obligated to transfer the custodial property.

"FINRA Rule 2090 requires firms to verify the authority of any person purporting to act on behalf of a customer," said Jessica Hopper, Senior Vice President and Acting Head of FINRA's Department of Enforcement. "This is essential to safeguarding customer assets—particularly in the case of UTMA and UGMA accounts, where it is essential for firms to implement supervisory systems reasonably designed to verify custodians' authority to make investment decisions after the account beneficiaries reach the age of majority."

All broker-dealers, not just online ones, have a duty to react to red flags of third-party advisors. See *In re Pryor, McClendon, Counts & Co., Inc.*, Securities Exchange Act Release No. 45402 (February 6, 2002) (a broker-dealer has a duty to disclose to its customer information indicating that the customer's **agent** is engaged in fraud with respect to the customer's investments); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Securities Exchange Act Release No. 19070 (Sept. 21, 1982) ("continued execution of [an] adviser's orders where a **broker-dealer has knowledge of improprieties in an investment adviser's handling of accounts may subject the broker-dealer to liability for aiding and abetting a violation of the federal securities laws if the adviser is in fact a primary violator of some provision of those laws");** *Ruiz v. Charles Schwab & Co.*, 736 F. Supp. 461, 462-63 (S.D.N.Y. 1990) (While churning typically involves a violation by a broker-dealer or its associated persons, when an investor has an agent making its investment decisions, the agent is a "potential churner."); *In the Matter of Moore and Co.*, 32 S.E.C. 191 (1951) (broker effecting transactions directed by customer's agent without disclosing to customer facts known to broker about agent's self-dealing "**was guilty along with [agent] of violations of the antifraud provisions)**; *In the Matter of William I. Hay, et al.*, 19 S.E.C. 397 (1945) (broker effecting transactions directed by customer's agent without disclosing to customer facts known to broker about agent's self-dealing violated antifraud provisions; noting that customers were victimized by "two agents, one with discretionary power over their accounts acting faithlessly and the other, a broker, knowing of the faithlessness yet claiming to be free of any duties"), *In the Matter of Richard Decastro*, 1998 WL 295513 (AMEX Disciplinary Panel Decision 97-D01**), ("The Panel believes that the existence of a third party power of attorney does not relieve a member organization or its supervisory personnel of their obligations under the Exchange' s rules to supervise the accounts of their customers."** The Panel specifically rejected the broker's argument that the branch office manager had **no duty** to supervise an advised account.); *In The Matter Of Herbert L. Wittow doing business as Wittow & Company John F. Coughenour*, S.E.C. File No. 3-2182 (1971)(Even though agent told broker-dealer that his customer was aware of the arrangement, broker-dealer **"was under an obligation, in light of the highly abnormal nature of the transactions, to ascertain whether full disclosure was being made to the customer concerning all aspects of the transactions. In view of his failure to do so, [broker-dealer] must be deemed a participant in a fraudulent scheme".).**

Aiding and abettor liability under Rule 10b is a very strong claim that can be made against broker-dealers with third-party accounts or clearing firms. In *Faturik v. Woodmere Securities*, Inc.,431 F. Supp. 894 (S.D.N.Y. 1977), the New York court addressed for the first time clearing firm liability in deciding a Motion to Dismiss brought by the clearing firm Bear Stearns. The broker worked at Woodmere Securities and cleared his trades through Bear Stearns. The Plaintiff provided the broker with a power of attorney who proceeded to churn the Plaintiff's account. Plaintiff sued Woodmere, the broker and Bear Stearns for damages. The Court first reasoned that Bear Stearns could not be found liable for churning, because it had no control over the trades or even an ability to make trades in the Plaintiff's account, as all trading decisions were made by the broker. The Court then reasoned that two of the claims could survive – aiding and abetting liability and know your customer liability - as follows:

Aider-Abettor Liability under § 10(b).
As our Court of Appeals recently recognized, "the knowing assistance of or participation in a fraudulent scheme gives rise to liability under § 10(b) as an aider or abettor." Hirsch v.duPont, 553 F.2d 750, at 759 (2d Cir. 1977), citing Kerbs v. Fall River Indus., Inc., 502 F.2d731 (10th Cir. 1974); see also Hochfelder v. Midwest Stock Exchange, 503 F.2d 364 (7thCir.), cert. denied, 419 U.S. 875, 95 S. Ct. 137, 42 L. Ed. 2d 114 (1974); Brennan v.Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 989,90 S. Ct. 1122, 25 L. Ed. 2d 397 (1970). Whether the assistance to a fraudulent scheme is in the form of active participation or mere inaction from an "improper motive," the one clear requirement for establishing aider-abettor liability under § 10(b) is actual knowledge of the fraud. F.2d at 759. Hochfelder, 503 F.2d at 374.

Plaintiff does allege some facts indicating that Bear Stearns may have had knowledge; for instance, its offices are in the same building and on the same floor as Woodmere's offices, and the two firms apparently enjoy a continuing close working relationship. Plaintiff also alleges that Bear Stearns' knowledge of vigorous activity in plaintiff's account (by virtue of its executive and record-keeping function) put Bear Stearns on notice of possible churning, and that Bear Stearns' fiduciary responsibility to plaintiff required it to inquire further into the circumstances surrounding the trades. While we voice no opinion as to the ultimate sufficiency of these alleged facts, we simply cannot say at this juncture that plaintiff "can prove no set of facts in support of his claim which would entitle him to relief." Conley v.Gibson, 355 U.S. 41, 45-46, 78 S. Ct. 99, 102, 2 L. Ed. 2d 80 (1957).

The Court also approved of liability being shown by way of the violation of the Know Your Customer rule which at the time was NYSE Rule 405, rejecting the defense that Woodmere, rather than the Plaintiff, was Bear Stearns' customer. The Court allowed the Plaintiff's claim to proceed because the complaint alleged: "there were irregularities or suspicious circumstances putting Bear Stearns on notice and indicating a possible violation of Rule 405." *Faturik* at p.5.

The Court concluded with something it would be wise to ensure that arbitration panels understand when dealing with these types of cases:

We do not say here, of course, that clearing brokers are per se liable for fraudulent or manipulative schemes by trading brokers; nor do we say, however, that clearing brokers ***are per se insulated*** *from liability simply because they execute and/or clear orders from another broker and not from the customer himself. [emphasis added]*

Woodmere was not the only broker-dealer that Bear Stearns cleared for and was a custodian for the brokerage accounts. One of the other firms was A.R. Baron, a boiler room operation. The SEC found that A.R. Baron engaged in widespread sales practice and related securities violations which defrauded customers of millions of dollars. In SEC administrative proceeding, in August 1999[89], the SEC found that Bear Stearns violated securities regulations as part of their clearing operation for Baron. Both the Woodmere and the A.R. Baron cases do not deal with third-party money managers, but instead with broker-dealers clearing through Bear Stearns. But the cases are illustrative because they show that the securities regulators hold clearing firm broker-dealers responsible for proper monitoring and supervision of accounts that they are clearing for.

The SEC found Bear Stearns (BSSC) was reckless in not recognizing that some of the trading in one of the A.R. Baron customer accounts was unauthorized. Additionally, "**BSSC knew or should have known** that many of its requests to the NYSE for extensions on behalf of Baron were not in good faith, and thus violated Regulation T….In addition, BSSC failed to maintain various books and records documenting the problems at Baron…As demonstrated by the facts discussed above, BSSC's actions were a cause of Baron's fraud, as defined in section 21C of the exchange act, and enabled Baron to defraud customers during its clearing relationship with BSSC."

Bernie Madoff – Third Party

I had the pleasure of working as a securities expert on a couple of the Bernie Madoff cases. The Bernie Madoff scandal is another prime example of how firms cannot simply close their eyes to red flags by investment advisers doing business with them. Madoff, as a third-party adviser, used J.P. Morgan as both a bank and as a securities broker-dealer to orchestrate a Ponzi scheme that robbed investors of more than $65 billion. A Forbes article entitled, "A Look At JPMorgan Chase's 20 Years of Watching Madoff Commit Crimes" encapsulates the many glaring red flags J.P. Morgan continually ignored.[90] J.P. Morgan not only faced several class actions against it for its wrongdoing (with settlements totaling more than $2.2 billion)[91] but was the first financial institution to be criminally charged for two violations of the Bank Secrecy Act, with the U.S. Attorney stating:

> *Today, the largest financial institution in the country stands charged with two criminal offenses. Institutions, not just individuals, have an obligation to follow the law and to police themselves. They must exercise due care not only with their own money but with other people's money also. In this case, J.P. Morgan connected the dots when it mattered to its own profit, but was not so diligent otherwise.*[92]

In a related Dow Jones Wall Street Journal article entitled, J.P. Morgan Settles It's Madoff Tab, the following comments were made:

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[89] SEC Release No. 7718, August 5, 1999 and Release No. 41707. Administrative proceeding File No. Three – 9962
[90] https://www.forbes.com/sites/kotlikoff/2014/09/26/jpmorgan-chases-20-years-of-watching-madoff-commit-crimes-read-chapter-2-at-jpmadoff-com/?sh=660ab44a3b89
[91] https://www.hbsslaw.com/cases/jp-morgan-madoff-lawsuit
[92] https://www.justice.gov/usao-sdny/pr/manhattan-us-attorney-and-fbi-assistant-director-charge-announce-filing-criminal

"After years of denying culpability in the Ponzi scheme, the bank agreed to 2.6 billion in payments to resolve charges it failed to police Mr. made us activities…US attorney Preet Bharara, who conducted his investigation with the Federal Bureau of Investigation said at a news conference that ***J.P. Morgan "failed miserably" as an institution and repeatedly ignored warnings about Mr. Madoff despite "plenty of reasons to be uniquely suspicious."***[93] *[emphasis added]*

In *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F.Supp. 528 (1978), investors alleged various securities law violations, as well as common law claims, against their investment adviser and Merrill Lynch. Merrill Lynch argued that the investment adviser had complete control over the investment decisions and that Merrill Lynch therefore owed no duty beyond simply executing unsolicited orders. The court denied Merrill Lynch's motion for summary judgment, holding that factual issues existed with respect to the "degree of sophistication of the plaintiffs, the extent of the reliance of the plaintiffs on Merrill Lynch and [the broker], and the degree of involvement of Merrill Lynch and [the broker] with [the investment adviser] and the plaintiffs." The court noted that the investors were unsophisticated, that Merrill Lynch placed the investment adviser on its list of approved investment advisers, that the broker-dealer advised the investment adviser almost daily on trades, that Merrill Lynch derived substantial commissions from its frequent transactions in the accounts, that the investors relied on Merrill Lynch's reputation, and that the investors believed that the investment adviser worked closely with Merrill Lynch. The court concluded that Merrill Lynch and its broker may have been "significantly involved in these transactions beyond mere execution of orders."

Arbitration Awards & Claims

Arbitration awards and claims have also found that broker-dealers are not insulated from third-party wrongdoing claims.

On July 7, 2021, a Dallas FINRA arbitration panel awarded roughly $648,000 to a multiparty claimant where the respondent was Pershing, LLC. Case number: 20-03862. One of the claims was that the clearing firm, Pershing, aided and abetted, and gave material assistance to a Ponzi scheme, which was perpetrated by a third-party investment advisor, Stanford Group Company, SGC. There was an explained decision:

The Panel finds that, based on all of the evidence and testimony presented, by the beginning of 2008, Respondent had the requisite level of knowledge, as to SGC's wrongful conduct in connection with the CD scheme, that it knew or should have known that it was providing meaningful/substantial assistance to that wrongful scheme by remaining the clearing firm for SGC in the United States and, more particularly, by facilitating wire transfers for the purchase of CDs issued by SIBL on behalf of Charles A. Pope, Dudley Devore IRA, and Joyce E. Cagle during 2008.

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[93] https://www.wsj.com/articles/SB10001424052702304887104579306323011059460

On March 26, 2021, a FINRA arbitration panel in Seattle gave an award of $2,727,000 against Interactive Brokers and an award of $606,087 against Charles Schwab. And, to boot, an additional award of $1,590,000 against both respondents which included about $1 million in attorneys' fees. There were multiparty claimants. The basis of the claim was that both respondent online broker-dealers did not properly monitor and supervise the activities of the third-party registered investment advisor who was managing his accounts at both firms. FINRA Arbitration Case No. 19-03250

A 2015 Houston arbitration panel awarded over $1 million against Interactive Brokers for allowing a trustee to decimate a trust through reckless trading. FINRA Arbitration Case No. 13-01876.

In William J. Pickert v. McLaughlin, Piven, Vogel Securities. Inc. and Steven D. Ircha, Respondents, and TD Ameritrade, Inc., Third-Party Respondent, FINRA Arbitration Case No. 06-04088, decided February 2008, the claimant sued his broker and brokerage firm (MPV) for stealing $400,000 from him. MPV named TD Ameritrade as a third-party respondent liable to them for 50% contribution as a joint and several defendant. TD Ameritrade made a motion to dismiss the arbitration against it, arguing that it had no legal duty to the claimant and that the actions complained of involved solely the broker and MPV and not TD Ameritrade. The Panel denied the motion and evidently bought the arguments of MVP that TD Ameritrade's negligent policies and procedures and their failure to comply with applicable securities laws, rules and regulations made the unauthorized transfers from Claimant's account possible; Ameritrade owed a duty to Claimant to abide by the rules and regulations of SEC and FINRA and failed to do so, and Ameritrade breached its duty with respect to the opening and handling of Claimant's account. The Panel awarded the claimant damages against MPV and TD Ameritrade, jointly and severally - compensatory damages of $400,000.00, interest o93,000.00, attorney's fees of ~$55,000.00, costs of ~$11,000.00, and $1.2 million in punitive damages. TD Ameritrade tried to appeal arguing it owed no duties to the claimant, who wasn't even a customer. The Court rejected this argument and upheld the award.[94]

Reinen v. Interactive Brokers LLC, FINRA No. 2-02028 filed January 6, 2021. Case summary: 40 claimants mainly from Arkansas claimed Keuttel Capital, an RIA, opened over 200 client accounts utilizing IB's trading platform and that Keuttel engaged in a "highly irrational trading strategy… overconcentrating his clients in ultra speculative nontraditional triple leveraged investments…and caused in excess of $25 million in investor losses overall." The claim further alleged that "Had IB taken simple investigatory steps, such as conducting a routine CRD broker search and background check, IB would have discovered that Mr. Kuettel was subject to a FINRA investigation for selling away, a serious securities law violation involving dishonesty, right at the time of termination with his most recent broker-dealer. In addition, Mr. Kuettel had already been terminated by one firm for cause because he hid a

[94] TD Ameritrade, Inc. v. McLaughlin, Piven, Vogel Sec., Inc., 953 A.2d 726, 738 (Del. Ch. 2008)

criminal violation that was never reported on his BrokerCheck. Mr. Kuettel was a high-risk advisor that appears to have never been able to keep a job longer than a couple of years." It appears the case settled.

Cucinelli v. TD Ameritrade filed April 19, 2022, **FINRA NO. 22-00887** Case Summary: The Cucinellis are each 75 years old. Their accounts were managed by a Third Party investment advisor, Mr. Boselli. "Had TDA disclosed to them that the trading by Mr. Boselli was in fact highly speculative and that they could lose their entire initial investment … the Claimants would not have allowed Mr. Boselli to manage at TDA." Though Boselli's ADV speaks of "…pursuit of performance is preservation of capital…" "TDA was in the best possible position to detect the fact that the trading strategy employed by Mr. Boselli materially deviated from these representations, thereby making them false or misleading." Case is pending.

Alanes v. Interactive Brokers, FINRA No. 22-02402 filed October 18, 2022. Case summary: again, roughly 40 claimants based in Southern California alleged losses of approximately $38.5 million in their IB brokerage accounts. The claim states that Hercules Investments LLC, an RIA, and CEO McDonald mismanaged and abused the claimants' accounts in his trading the accounts on IB's trading platform which included options. The SOC states: "Importantly, McDonald was recently charged civilly by the Securities and Exchange Commission ("SEC") and criminally by the Department of Justice in connection with his fraudulent and criminal actions involving both Hercules and an earlier fund, ISA, which also maintained accounts at IB…As alleged herein, the Claimants were customers of IB and sought to preserve their portfolios for retirement. Most Claimants had a low to moderate tolerance for risk and principal losses. Despite these investment objectives, IB relied on McDonald and Hercules to truthfully state Claimants' risk tolerance. IB should have consulted Claimants about the aggressive investing strategy in their portfolios, especially considering many of the Claimants' advanced ages. The risk tolerance sections of many Claimants' accounts show an increased threshold for risk, not in line with Claimants' actual risk tolerance." FINRA arbitration is pending.

Credon v. Vora Wealth PLLC, & Fidelity Brokerage Services LLC, FINRA No. 22-02010 filed October 20, 2022. Case summary: Mr. Vora and Vora Wealth, an SEC RIA, manage claimant's money by opening a discretionary account at Fidelity brokerage. The claim alleges that "Mr. Vora placed all of Mr. Creedon's principal in horribly unsuitable investments known as Structured Notes. Fidelity's failure to flag Mr. Vora's suspicious activities rises to the level of gross negligence and thus cannot be waived by contract. Fidelity easily would know from its own statements of the portfolio how recklessly the portfolio was being managed. Fidelity was grossly negligent in, at a minimum, failing to ascertain whether Mr. Creedon understood the risks he was taking in his investments held by Fidelity." The arbitration is pending.

Costa v. Interactive Brokers LLC, FINRA No. 21-03054 filed August 2, 2021. The claim alleges that Melikova of Melikova Advisory Services, an RIA, was not licensed in California where the claimant resided and that he opened discretionary accounts at Interactive Brokers utilizing IB's trading platform and traded the claimant's accounts in a speculative manner without any proper monitoring, supervision or oversight by Interactive Brokers. The claimant lost $432,671 and the FINRA arbitration is pending.

Cagle, Babin, et al. v. Pershing, FINRA No. 20-00922 & 20-03862. On July 7, 2021 a Dallas FINRA arbitration panel awarded roughly $648,000 to multiparty claimants. One of the claims was that the clearing firm Pershing aided and abetted and gave material assistance to a Ponzi scheme, which was perpetrated by a third-party investment advisor Stanford Group Company. The panel wrote in an explained decision:

The Panel finds that, based on all of the evidence and testimony presented, by the beginning of 2008, Respondent had the requisite level of knowledge, as to SGC's wrongful conduct in connection with the CD scheme, that it knew or should have known that it was providing meaningful/substantial assistance to that wrongful scheme by remaining the clearing firm for SGC in the United States and, more particularly, by facilitating wire transfers for the purchase of CDs issued by SIBL on behalf of Charles A. Pope, Dudley Devore IRA, and Joyce E. Cagle during 2008.

Guerrero v. Charles Schwab & Co. and Interactive Brokers, FINRA No. 19-03250. On March 26, 2021, a FINRA arbitration panel in Seattle awarded $2,727,000 against Interactive Brokers and $606,087 against Charles Schwab. And, to boot, an additional award of $1,590,000 against both respondents which included about $1 million in attorneys' fees. There were multiparty claimants. The basis of the claim was that both respondent online broker-dealers did not properly monitor and supervise the activities of the third-party registered investment advisor who was managing the accounts at both firms.

Tubbesing v. Interactive Brokers, Finra No. 21-02271 filed September 7, 2021. I was the expert in this case that involved the same questionable RIA that managed the accounts at IB in the **Guerrero** arbitration award mentioned above. This claim alleged that the SEC licensed RIA, Vita Intellectus, opened a discretionary account for the claimants on IB's trading platform. The claim alleges Vita engaged in high-frequency trading, day trading, and excessive trading that was speculative in nature. (the claimant withdrew the case) The claim states: (the claim was withdrawn)

There is no indication that Interactive Brokers ever collected or documented the Tubbesings' risk tolerance in their internal documentation before opening their accounts or at any time before the Tubbesings' closed their accounts…Because Interactive Brokers controlled the manner of trading in the Tubbesings' accounts with proprietary algorithms, Interactive Brokers voluntarily accepted a heightened duty to not only monitor the trading in the Tubbesings' accounts for suitability but a duty to warn Claimants because the volume of trading, and the accompanying risk, was exceptionally high.

One of my FINRA arbitration cases involved a registered investment advisor (where in federal court he was convicted of 21 counts of fraud and is still serving time in federal prison) who worked in a tight-knit Pennsylvania community where he garnered the trust of hundreds of hard-working individuals who attended a church where the broker's father was the pastor. This advisor had serious customer complaints when he was a FINRA-registered stockbroker and had received a lifetime bar from FINRA. He subsequently opened hundreds of accounts at Ameritrade where he proceeded to defraud his clients out of millions of dollars. The claimants in this multi-party arbitration claimed that if Ameritrade had done just a modicum of investigation to fulfill its obligation to know the Investment Adviser with power of authority, it would have discovered the fraud. Instead, Ameritrade was blinded by the fees and commissions it was earning and failed to detect not one of the multiple red flags. The case was settled for a substantial amount, despite Ameritrade's claims that it had no duties.

I was hired as a securities expert in another similar FINRA arbitration where, once again, a crooked, unlicensed individual opened numerous third-party accounts at Scottrade. The following is from the Statement of Claim:

FINRA Arbitration XXX v. Scottrade

Scottrade's failures (a) permitted the improper opening of the claimant's accounts, (b) allowed two unlicensed individuals to trade multiple options accounts maintained at Scottrade, including claimants' accounts, (c) permitted unauthorized access to plaintiffs' accounts, as well as (d) wrongfully allowing a wildly speculative and reckless options trading strategy in claimants accounts. All these failures led to claimants' massive losses. ($8.7 million) Unbeknownst to claimants, JYL had previously been ordered to cease-and-desist by the securities exchange commission, and had been convicted and served prison time for a mortgage and bank fraud scheme. None of the claimants knew that, despite being required to be registered as an investment advisor and/or broker-dealer, JYL had no state or federal licenses…. As such, fraudster JYL persuaded third parties Ronald Huxtable and David Calvo and others, to serve as a front for his illegal options investment and trading scheme. Huxtable and Calvo were to execute options trades in claimants' accounts… Huxtable was not licensed as an investment advisor or broker-dealer. Likewise, Calvo was not licensed as an investment advisor or broker-dealer. Scottrade allowed these fraudsters to set up the claimant's accounts in such a way that the claimant did not even have a manner or opportunity to discover the fraud. As described, Scottrade provided no copies of the completed applications to claimants and conducted no follow-up, and emails about margin calls or other account issues went to the unlicensed third parties, not to claimants…

Additional claims:

- Scottrade did no due diligence or investigation on the third-party power of attorney individuals
- Scottrade failed to take notice of faults and inconsistent information on the new account forms
- Scottrade failed to follow the option regulations as to opening option accounts

- Scottrade neither monitored nor informed their clients of the huge volume in speculative option trading
- Scottrade failed to take notice of the numerous red flags, much less take any action resulting from them
- Scottrade allowed unauthorized trading in claimants' accounts
- Scottrade failed to notice strange wire transfers and check request
- Scottrade failed to note the massive losses, in claimants and other third-party accounts

Scottrade's answer can be summed up, not surprisingly, as no duties. There are so many shocking revelations about the facts of the case and Scottrade's defenses. It is not unlawful for a broker-dealer to allow an unlicensed individual to gain power of attorney and trading authority over an account. But almost all reputable broker-dealers will only permit it when that individual is a family member. Additionally, most reputable broker-dealers won't allow an unlicensed individual to have power of attorney over more than one or two accounts that are related. In this case, Scottrade gave the unlicensed individuals power of attorney over numerous unrelated individuals' accounts.

Another online broker-dealer case involving a third-party money manager where I was the securities expert was the case of Althaus vs. TD Ameritrade, FINRA Case No. 18-00253. A claim relating to the improper listing of values of private placements by a third-party money manager that Ameritrade then reflected on its account statements. The panel awarded $720,816 including interest and expert witness fees on August 28, 2019.

In the introduction to my article on third-party accounts,[95] I pointed out that there was a serious and dangerous situation with these crooked, third-party money managers fleecing investors by dodging scrutiny by opening their customer's accounts at online broker-dealers. I accused the regulators of being asleep and stated I hoped that the article would wake them up. Seven years later, the regulators are still asleep on this issue but improving.

One of my FINRA arbitration cases against Schwab and Interactive Brokers involved a third-party advisor who defrauded hundreds of clients first at Schwab and then continued the same wrongdoing at Interactive Brokers. The wrongdoing was so egregious and obvious (favorably allocating trades, allocating trades the next day, etc.) that Schwab fired the investment advisor but failed to disclose to the customers the results of its internal investigation that led to the firing (or the investigation at all). As a result, many clients followed the investment advisor to Interactive Brokers where he caused even more financial damage to these customers.

Instructive is the lengths to which brokerage firms will go to defend cases such as these. A pleading filed by Interactive Brokers stated, "As Interactive will demonstrate at the final hearing, the U.S. Securities and Exchange Commission (the "SEC")—<u>and not a clearing broker-dealer, like IB</u>—is charged with registering, supervising, reviewing, inspecting, monitoring and,

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[95] "Supervision of Third-Party/Power of Attorney Accounts" 2016 PIABA Bar Journal, Vol. 23. No.2.

if necessary, enforcing the federal securities laws and regulations against RIAs." At the hearing, a defense expert testified that as to the firm's supervision, including even duties related to the AML rules, the broker-dealers had "reduced due diligence" and "relaxed requirements" because they claim since the SEC watches investment advisers like a hawk, we don't have to.

That testimony is patently false. First, there is no support for any such proposition; FINRA rules do not refer to "reduced" or "relaxed" supervision and frankly, it would be shocked to hear those words. Second, most RIAs in the country have assets under management under $100 million and thus, their primary regulator is the state, not the SEC. Finally, even for those RIAs who are registered with the SEC, it's not as if the SEC is some omnipotent entity. All of the major brokerage and investment scams that have happened over the last few decades took place right under the nose of this supposed "hawklike" government agency: Bernie Madoff, Stanford Financial, Bear Stearns[96], subprime debt, microcap debacle, Stratton Oakmont a.k.a. Jordan Belfort, Ivan Boesky, Michael Milken, Stablecoin (not so stable), and the MEME collapse – the list goes on and on. And more recently, the cryptocurrency bloodbath.[97] Not to mention the thousands of investor complaints that are filed yearly with the SEC and FINRA.

Let's just look at one example that illustrates that the SEC is anything but omnipotent or has this "hawklike" ability to catch all wrongdoing. In the case mentioned just prior, an SEC document was introduced where they admitted that the SEC did not have the staff to adequately supervise the roughly 15,000 registered investment advisors in the United States.

The Bernie Madoff scandal – It is well known that the SEC botched its reactions to multiple red flags about Madoff dating back a decade since his arrest in December 2008, that even the Wikipedia page on the Madoff Investment Scandal states, "The U.S. Securities and Exchange Commission (SEC) was criticized for not investigating Madoff more thoroughly; questions about his firm had been raised as early as 1999" (a decade earlier).[98]

The New York Post was more on the mark with its February 5, 2009 article entitled, "How SEC Bozos Blew It" wherein it wrote:

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[96] Bear Stearns – a September 2008 article at the WSJ entitled, "SEC Faulted for Missing Red Flags at Bear Stearns" states: The Securities and Exchange Commission missed "numerous potential red flags" leading up to the shotgun sale of Bear Stearns Cos., and failed to require the investment bank to rein in its risk taking, according to a scathing report from the agency's inspector general.
Inspector General David Kotz said it is "undisputable" that the SEC "failed to carry out its mission in its oversight of Bear Stearns."
https://www.wsj.com/articles/SB122247236868380919
[97] Gary Gensler (SEC Chairman) has been the 'cop on the beat'—but he took little interest in FTX as the scandal developed. Regulators "can't actually distinguish between good and bad," Mr. Bankman-Fried told a Vox reporter last month. At least it doesn't seem as if Mr. Gensler can.
"Where Was Biden's SEC Sheriff on Sam Bankman-Fried?" By Allysia Finley, Wall Street Journal, December 18, 2022
[98] https://en.wikipedia.org/wiki/Madoff_investment_scandal

"*The man who tried to warn federal regulators about Bernard Madoff's $50 billion Ponzi scheme told Congress yesterday that the Securities and Exchange Commission is a totally incompetent agency that "roars like a lion and bites like a flea."*

"I'm saying that if you flew the entire SEC staff to Boston, sat them in Fenway Park for an afternoon, they could not find first base," Harry Markopolos said at a hearing of a House Financial Services subcommittee."[99]
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There was also the bombshell news that came out in 2013 that SEC lawyers were instructed to NOT bring cases against investment advisors like Bernie Madoff. A May 31, 2013, article in Rolling Stone Magazine entitled, "Why Didn't the SEC Catch Madoff? It Might Have Been Policy Not To; Whistleblower complaint alleges a pattern of negligence at the regulatory agency" stated:

The most recent contribution to the broadening canvas of dysfunction and incompetence surrounding the SEC is a whistleblower complaint filed by 56-year-old Kathleen Furey, a senior lawyer who worked in the New York Regional Office (NYRO), the agency outpost with direct jurisdiction over Wall Street.

Furey's complaint is full of startling revelations about the SEC, but the most amazing of them is that Furey and the other 20-odd lawyers who worked in her unit at the NYRO were actually barred by a superior from bringing cases under two of the four main securities laws governing Wall Street, the Investment Advisors Act of 1940 and the Investment Company Act of 1940.

According to Furey, her group at the SEC's New York office, from a period stretching for over half a decade through December, 2008, did not as a matter of policy pursue cases against investment managers like Bernie Madoff. Furey says ***she was told flatly by her boss, Assistant Regional Director George Stepaniuk, that "We do not do IA cases."*** *[emphasis added]*[100]

In addition, the SEC was criticized for its handling of Bear Stearns. In a September 2008 article at the WSJ entitled, "SEC Faulted for Missing Red Flags at Bear Stearns" states:

The Securities and Exchange Commission missed "numerous potential red flags" leading up to the shotgun sale of Bear Stearns Cos. and failed to require the investment bank to rein in its risk taking, according to a scathing report from the agency's inspector general. Inspector General David Kotz said it is "undisputable" that the SEC "failed to carry out its mission in its oversight of Bear Stearns."[101]

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[99] HOW SEC BOZOS BLEW IT, By Daphne Retter, New York Post, February 5, 2009, https://nypost.com/2009/02/05/how-sec-bozos-blew-it
[100] Why Didn't the SEC Catch Madoff? It Might Have Been Policy Not To, Whistleblower complaint alleges a pattern of negligence at the regulatory agency, Rolling Stone, By Matt Taibbi, MAY 31, 2013
[101] SEC Faulted for Missing Red Flags at Bear Stearns, by Kara Scannell, Wall Street Journal, September 17, 2008, https://www.wsj.com/articles/SB122247236868380919

Conclusion

In Las Vegas casinos and used car parking lots, it is a “Buyer Beware” market. If you listen to our legislators, read the securities regulations of the feds, the states, and FINRA and if you visit the websites of those regulatory agencies, they broadcast loud and clear that the securities markets in the United States are not and should not be a “Buyer Beware” market. Yet, the major online broker-dealers through their mantra, “We Have No Duties” have created just such a casino-gambling environment, where millions of investors are losing millions of dollars, and sadly far too often, their life savings.