FIDUCIARY STANDARD, INSIDE JOB, SECRETS OF WIREHOUSE

SECRETS OF THE WIREHOUSE: SELF REGULATORY BODIES FAVOR…THEMSELVES

FEBRUARY 22, 2016

Most consumers don't know that there are two primary regulators for financial advisors. Further, most don't know that one of those bodies is not governmental, but a self-regulatory body.

Advisors who charge fees are generally regulated by the Securities and Exchange Commission, a government regulator, but "Advisors" who earn a living by selling products (receive commissions in exchange for selling mutual funds and variable annuities) are regulated by an entity known as FINRA, the Financial Industry Regulatory Authority, which is a self-regulatory body.

A self-regulatory body has a big hurdle to jump in proving that they are working for the consumer and not their own interests. While I believe FINRA does many things well, there are many conflicts of interests that are simply not addressed and I'm not of the belief that consumers are put first by this organization or its members.

One example of the problem with FINRA is how it discloses problems related to the brokers it claims to regulate. Financial Planning magazine recently ran an expose on the disclosure tool, BrokerCheck and the arbitration (usually mandatory) process.

In "Deleted: FINRA Erases Many Broker Discipline Records", (See article below) Ann Marsh uncovers a practice most consumers would find abhorrent. She writes:

"A Financial Planning *investigation of this regular practice not only raises questions about the value of BrokerCheck, but more crucially about whether the arbitration system used by FINRA's leadership is rigged to hide investor complaints that could have provided a warning to other investors."*

and,

"Absent an overhaul of the process, critics say FINRA will essentially remain a private club sitting in judgment of its own membership. Due to arbitration clauses investors sign when they become clients, investors are forced to seek justice from a group composed of industry players."

It's a complaint that has been made many times in the past. How can an organization that is run by the industry protect consumers? Also, why are there two different (actually three when you factor in the insurance industry regulators) regulatory bodies for the "Advisor" community? Shouldn't all people claiming to be an Advisor be subject to the same rules?

The arbitration and expungement process is essentially a sham according the article, one attorney calling it "a kangaroo court".

There is enough in the article to make you irate…so pour yourself a glass of your favorite wine and take a few sips before digging into this great expose.

Scott Dauenhauer, CFP, MPAS, AIF

Deleted: FINRA Erases Many Broker Disciplinary Records

BY ANN MARSH

DECEMBER 31, 2015

Financial Planning

"I am the daughter and granddaughter of ministers and am known by my integrity in all of the events that I have participated in in my life," ex-Royal Alliance broker Kathleen Tarr told arbitrators. Image: Bloomberg

No client who signs on with a broker expects that doing so will turn her into a regulator.

But every year, more than 100 clients find they've become quasi-regulators – and do very badly at the job – for FINRA, whose mission is to "make sure the securities industry operates fairly and honestly" by acting as the self-regulatory organization for the nation's 640,000 brokers, according to its website.

The problem stems from policies under which FINRA deletes advisors' disciplinary histories from BrokerCheck, its consumer-facing database that allows allow investors to easily search the disciplinary records of advisors and firms registered with the organization. Those policies have permitted many disciplinary records to be expunged unless an aggrieved client fights the process through a separate round of arbitration – placing the responsibility for maintaining the integrity of BrokerCheck on former clients.

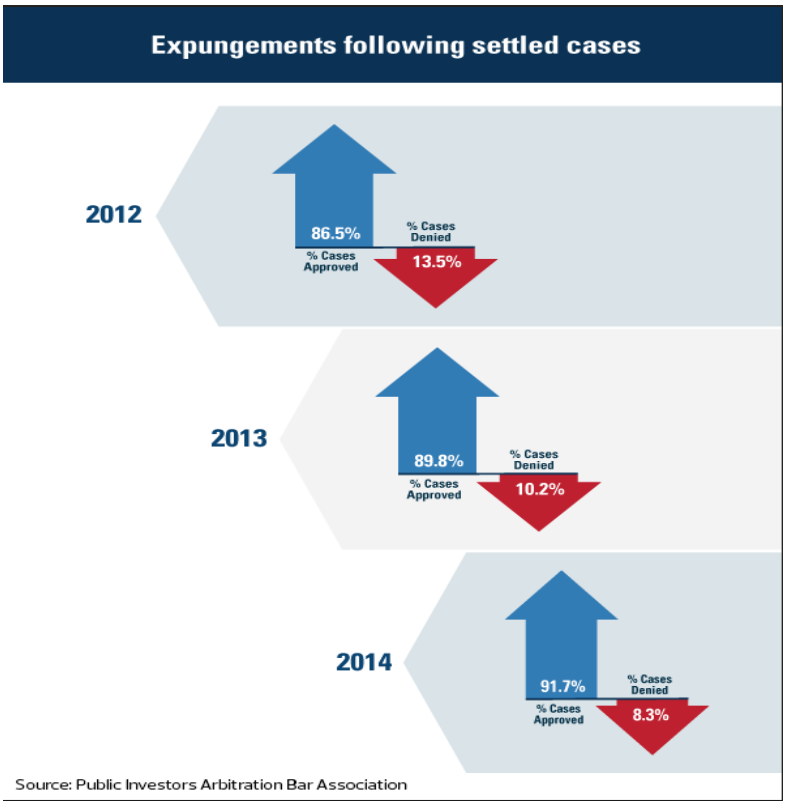
A *Financial Planning* investigation of this regular practice not only raises questions about the value of BrokerCheck, but more crucially about whether the arbitration system used by FINRA's leadership is rigged to hide investor complaints that could have provided a warning to other investors.

"It's not a fair process," a former Royal Alliance client, Sandra Liebhaber, says of her experience in a FINRA hearing, in which arbitrators prevented her from arguing against her former broker's request to erase the public record of Leibhaber's case.

Numerous securities lawyers say FINRA's arbitration system for investor complaints encourages them to take settlements and remain quiet. Those deals also require they not oppose wiping an advisor's BrokerCheck record clean, even though the regulator banned the practice last year. FINRA is considering recommendations to fix this and other issues with the arbitration process.

Absent an overhaul of the process, critics say FINRA will essentially remain a private club sitting in judgment of its own membership. Due to arbitration clauses investors sign when they become clients, investors are forced to seek justice from a group composed of industry players.

At risk are the life savings of Americans who choose to trust advisors who may have already caused other investors financial harm. FINRA is run by many of the same firms whose clients lose between $8 billion to $33 billion in retirement savings annually due to conflicted financial advice, according to the White House Council of Economic Advisers.



'FIRMS WANT IT THIS WAY'

"FINRA set this system up," says securities lawyer Jason Doss of Marietta, Ga. "The firms want it this way. It creates a conflict for FINRA as a regulator."

Those few clients who decide to fight their former advisors' requests to expunge their records end up being the last line of defense of that record remaining in the BrokerCheck database. They must care enough to devote their own time and resources to preserve it since expungement cases are heard after an arbitration ruling. The attorneys who represent them typically do so on a pro bono basis. In essence, the process turns aggrieved clients into regulators by default.

"At the end of the day, this process is a train wreck," says Peter Mougey, a Pensacola, Fla.-based securities lawyer who regularly represents investors in expungement cases. "This is a regulatory function that FINRA has relegated to [clients and their] private counsel."

A FINRA spokeswoman says the regulatory agency has taken numerous steps in recent years to ensure the deletion of complaint records in BrokerCheck is a rare occurrence and has trained arbitrators about how to apply the rules.

An arbitration task force recently made 51 recommendations to improve the process. One calls for FINRA to create a special panel of arbitrators trained to handle expungement requests. Another would publicize arbitration cases to improve transparency. A committee is set to meet in January to review the recommendations.

However, FINRA is also considering relying on FINRA staffers, rather than contracted arbitrators, to handle the expungement process. If that happens, it would render many of the task force recommendations moot, but might also provide a more effective overhaul, advocates say.

88% EXPUNGEMENT RATE

FINRA and the SEC have said repeatedly that expungement should be "an extraordinary remedy." Yet in cases decided on their merits that did not include settlements, expungements were granted in 44% of cases from 2012 to 2014. And over the same period, in cases in which advisors sought to have their records expunged following settlements with aggrieved clients, 404 of 460 brokers succeeded, or a whopping 88%, according to a review by the Public Investors Arbitration Bar Association.

The expungement results of the post-settlement cases are notable because, in those instances, arbitrators generally reviewed little to no evidence about client complaints before deciding to delete the broker's disciplinary record, or keep it intact.

"It defies credulity that the expunged information had no meaningful investor or regulatory value" in such a high percentage of post-settlement cases, says Tampa, Fla., securities lawyer Scott Ilgenfritz.

Under the current process, once a complaint is filed, it frequently leads to settlement negotiations. Securities lawyers say firms are quick to offer money to investors who've filed substantive complaints to contractually buy their silence.

In July 2014, FINRA banned the practice, calling it a pervasive problem. But the hush-money deals persist partly because arbitration proceedings are private, securities lawyers say.

Chicago-based securities lawyer Andrew Stoltmann says he takes the settlement offers regularly.

"It's more Kabuki theater than anything else," Stoltmann says. "It is extraordinarily common for defense lawyers to give a wink and a nudge that expungement is simply expected as a condition on settling the case. … Most claimants' lawyers will agree to expungement as part of a deal to get their client the best settlement."

That's the first duty of a lawyer, he says, not the maintenance of online records for the benefit of the investing public.

FINRA itself acknowledges how vital BrokerCheck can and should be.

The free tool "is part of FINRA's ongoing efforts to help investors make informed choices about brokers and brokerage firms. BrokerCheck also provides information about formerly registered brokers who, although no longer registered in the securities industry, may work in other financial services industries. These individuals could still seek to gain the trust of potential investors, so we feel it's important to include them here."

The disclosure concludes that BrokerCheck "includes current licensing status and history, employment history and, if any, reported regulatory, customer dispute, criminal and other matters."

There is no mention of deleting the records of disciplinary actions or settlements against a broker, although a separate page advises that, "under FINRA's current public disclosure policy, in certain limited circumstances, most often pursuant to a court order, information may be expunged."

The number of expungement requests is small relative to the number of FINRA arbitration cases overall. Of the 7,621 cases from 2012 to 2014, 563 records were expunged, according to the arbitration bar association.

A FINRA spokeswoman calls that analysis flawed because "it reflects no qualitative analysis of the awards recommending expungement, and therefore no assessment of whether the information that was the subject of the recommendation had any investor protection or regulatory value." When asked for FINRA's assessment of that data, the spokeswoman declined to comment.

TESTIMONY BLOCKED

Even when clients or their lawyers try to preserve the record of their FINRA arbitration complaint, the process is cumbersome at best.

Seven weeks ago during an expungement hearing, Mougey, the securities lawyer, says arbitrators tried to prevent him from testifying by phone on behalf of a client who had been charged $50,000 to $60,000 in commissions annually on a $500,000 to $600,000 portfolio.

After he challenged them, he says the arbitrators said they would allow him to testify via a video link. Yet during the hearing, the panel's chairman told Mougey he was only "there to observe," and could not speak to or question the financial advisor. After Mougey challenged them again, the arbitrators went into executive session and decided Mougey could speak, but blocked him from making a closing statement, he says.

Mougey ran into these roadblocks despite recent FINRA guidance telling arbitrators they must allow clients and their counsel to participate in expungement hearings.

"It's a kangaroo court," Mougey says.

Other lawyers offered stories similar to Mougey’s.

"In the past two months," New Orleans attorney Joseph Peiffer says, "I showed up on an expungement hearing and the chairperson cut me off, wouldn't let me give any arguments or introduce any evidence. I got the very distinct impression … that the arbitrators were annoyed that they were going to have to listen to more than 15 minutes of this stuff."

(FINRA's arbitration task force report notes common complaints about the quality of arbitrators and recommends increasing their pay.)

In a separate case, another lawyer dialed in to listen to an expungement hearing his client had agreed not to oppose. The lawyer declined to be identified because the proceedings are conducted in private and are protected by confidentiality agreements.

"The broker said, 'Everything in the statement of claim is false,' " the lawyer recalls. The arbitrators granted an expungement of the broker’s record in this case, in which the client received a six-figure settlement. No one argued against the expungement.

'THEY RAILROADED US'

Sandra Liebhaber, who lives in a small town near Portland, Ore., says she lost more than half of her $325,000 in retirement savings in investments recommended by her former advisor from Royal Alliance, a part of AIG Advisor Group.

Liebhaber pushed back against pressure Royal Alliance applied to get her to not oppose expungement. Instead, she and her lawyer, Robert Banks, tried to prevent her former broker from having the case deleted from BrokerCheck. However, the arbitrators refused to hear any testimony from Liebhaber and cut Banks off short.

"They railroaded us," Liebhaber says. "You work 25 years and for them to take … what you earned for those 25 years, it's a crime."

Since then, FINRA has taken the rare step of supporting her in an action against the regulator's own arbitrators in an ongoing case.

Liebhaber (then Sandra Wanek) met former Royal Alliance broker Kathleen Tarr in 2007 when she was 47 and employed as a customer service representative for AT&T, where she had worked since her 20s.

At the time, Tarr was working out of an office at the AT&T facility. Often during the lunch hour, Banks says, Tarr persuaded dozens of the company's employees to take early retirement and roll their 401(k)s into IRAs that then were invested in high-fee and illiquid variable annuities and often risky nontraded real estate investment trusts. Though nearly two decades shy of the typical retirement age of 65, Leibhaber says she heeded Tarr's advice to roll over her workplace retirement accounts into the new investments.

She was unaware, she says, that the three variable annuities and one nontraded REIT that Tarr recommended paid Tarr and her firm high commissions.

Contacted by phone to discuss the case, Tarr said, "No, thank you," before hanging up. She is no longer registered as a broker and now works as president of a computer systems firm, AeroComputers, of Oxnard, Calif.

Tarr's BrokerCheck record displays details of many separate cases. Although Royal Alliance fired Tarr in 2010, 21 cases against her remained open as of Dec. 31, with most involving the sale of REITs and annuities. Seven other cases, including Liebhaber's, were settled for a monetary award. Another 16 were withdrawn, dismissed or denied. Most involve accusations similar to Liebhaber's, and cumulatively total millions of dollars in alleged losses.

Liebhaber ultimately accepted a settlement of $30,000 from Royal. A year later, Liebhaber learned Tarr wanted the record of the case deleted.

As the expungement hearing approached, "I was trying to put this behind me," Liebhaber says, but opted to participate. On the day of the hearing in August 2014, Liebhaber listened as Tarr spoke to the three FINRA arbitrators.

"I am the daughter and granddaughter of ministers and am known by my integrity in all of the events that I have participated in in my life," Tarr told the arbitrators, according to a transcript of the hearing, as well Banks.

Tarr said she found Liebhaber's allegations "highly offensive and without any basis in fact."

When the two first met, Tarr told the panel that Liebhaber said she needed about $30,000 from her retirement accounts to help fund her transition to working as a flight attendant. Tarr explained that Liebhaber could generate more income by rolling her 401(k) into an IRA, making new investments and taking early withdrawals under Rule 72(t) of the tax code.

"I made her investments according to those considerations at the time," Tarr told the arbitrators. "We left $30,000 in cash. We've had $11,000 in AT&T stock for immediate liquidity, $70,000 was placed in an Inland REIT for both its income and its long-term … potential for growth, and the variable annuities provided over 100 investment choices for specifically allocating her risk in other assets."

NO CROSS EXAMINATION

When Banks asked repeatedly to cross-examine Tarr on this and other points, the arbitrators did not permit him to do so. Nor did they allow Liebhaber to speak.

She didn’t have the opportunity to say that Tarr set regular withdrawals from her IRA at a high rate of about 7%, and that Liebhaber didn't realize they couldn't be stopped. That meant the withdrawals depleted Liebhaber's retirement assets at an especially fast clip during the recession, incurring losses, Banks says. Liebhaber also didn't get a chance to explain that she was unaware of Tarr's conflicts of interests in recommending investments that paid her generous commissions.

The arbitrators' official written decision says Liebhaber gave a "full argument" during the hearing.

"That's an absolute lie," Banks says. "I cannot believe that FINRA would have those people continue as arbitrators after they lied like that. You can read the transcript." A FINRA representative did not respond to that statement but noted that, as a direct result of this case, FINRA sent out guidance to other arbitrators reminding them that they must allow clients and their counsel to speak during hearings.

Immediately after the hearing, Liebhaber says she wasn't worried about the outcome.

"When [the arbitrators] said, 'We don't need to hear anything else,' I thought it was because she wasn't getting [the expungement]."

Instead, the arbitrators found that Liebhaber's "allegation of unsuitability is clearly erroneous." They ordered Tarr's BrokerCheck record deleted.

'A BAD RULING'

Reached by phone in Los Angeles, the chairman of that hearing, arbitrator Richard Stall, declined to discuss the case.

"It's not that I wouldn't want to comment, but I believe that it would not be appropriate," Stall says. Another arbitrator, June McLaughlin, a lawyer in Irvine, Calif., did not respond to multiple emails.

The third arbitrator, Carole Aragon, a former Morgan Stanley advisor and a lawyer in Santa Monica, Calif., says she isn't happy with the way the hearing unfolded.

"I think Richard Stall made a bad ruling," Aragon says.

In a highly unusual turn for an expungement proceeding, a transcript of the hearing entered the public record when it became evidence in a case filed in Los Angeles Superior Court.

During the hearing, Aragon pushed back against Stall, urging the panel to hear more testimony from Liebhaber's side.

"It's a settled case, so we don't have the benefit of knowing everything that's gone on," Aragon told Stall, according to the transcript.

Given that the arbitrators were in possession of documents supporting Liebhaber's side, Stall urged the panel to move on.

"Well, how can we make sure we are not going to be here for another two hours?" Stall asked his fellow arbitrators. "That's the problem."

"He had a luncheon or something," a Superior Court judge remarked later upon reviewing the expungement hearing transcript.

McLaughlin added moments later during the expungement hearing: "I am uncomfortable with claimant's counsel cross-examining [Tarr] in any way."

The judge sounded taken aback that the arbitrators disallowed Banks' questioning. "We don't have hearings in this country where people speak and they don't get to be questioned," she said.

For Aragon, it was only her fourth time serving as an arbitrator, and her second in an expungement hearing, while Stall "has handled millions of them," she says.

Aragon’s acquiescence to Stall seems surprising, however, in light of a recent academic paper she wrote titled, "Expungement: We Can Fix This!" for her graduate coursework at Pepperdine University’s Strauss Center for Dispute Resolution, in Malibu, Calif.

In November, in an online résumé, Aragon referred to her expungement research as her "doctoral thesis." However, the Strauss Center doesn't offer doctoral degrees. Aragon is pursuing a master’s degree, an associate director there says.

Describing the work as part of a doctoral thesis "is not technically accurate," Aragon conceded in an email. She said she had used the term since it is "an acronym uttered by lawyers because it is an advanced-advanced degree." She later removed the reference to the doctoral thesis.

For years, FINRA has been dogged by criticism about the quality of its arbitrators and for failures in vetting their credentials. Last year, FINRA removed an arbitrator who served on 38 cases over 15 years before it was discovered that he wasn't a lawyer as he had claimed, Reuters reported.

FINRA says it has since improved its system to prevent this kind of misrepresentation.

FINRA spokeswoman Nancy Condon declined to say whether the regulator will take any action regarding Aragon's academic misrepresentation. "We have certified that she has disclosed that she is enrolled in a master of laws degree curriculum," Condon says. "Everything she has certified and disclosed to us has been accurate."

'WHAT RIGHTS DOES SHE HAVE?'

Months after the arbitration panel's decision to expunge Tarr's BrokerCheck record, a Los Angeles Superior Court judge threw out the arbitrators' decision, concluding that Liebhaber's rights were "substantially prejudiced." Royal Alliance appealed; the case is pending.

During a hearing in May, a Royal Alliance lawyer argued in favor of upholding the arbitrators' decision to allow the deletion of the record of the case from BrokerCheck.

"What rights does she have?" Royal Alliance attorney G. Thomas Fleming asked Judge Susan Bryant-Deason of Liebhaber. "I would suggest really none that could be prejudiced because her

claims already had been resolved." Later, he added, "It was Kathleen Tarr's request to restore her representation that was at issue. Ms. Liebhaber had no interest in it."

To the contrary, Liebhaber's interest in the case is "absolute," argued attorney Leonard Steiner who, like Banks, represented Liebhaber pro bono.

She has a right both to contest the charge that she was "a liar" in filing her original complaint and to play her part in upholding the integrity of the publicly available record, Steiner maintained.

A FINRA lawyer weighed in against Royal Alliance.

"FINRA does have an interest and really a duty here," attorney Betty Brooks told the judge, "in protecting the integrity of the [BrokerCheck record] and the information contained in it. That information is used by the public, by future employers, by registered representatives and also by regulators such as the State of California." The arbitrators broke FINRA's rules in denying Leibhaber and Banks the chance to testify, Brooks argued.

Bryant-Deason agreed.

"It appears to the court that FINRA's concern is certainly a righteous concern," the judge said. The organization manages “the forum for the public to assure itself that the incredibly huge financial structure where people invest their money every day with people they don't know is secure and has a level of integrity."

Royal Alliance, through AIG Advisor Group, declined to discuss the case.

The broker-dealer wants as many violations expunged from Tarr's record as possible to help it win the 21 arbitration cases still pending against her, Steiner says.

In those cases, "They can say, 'Hey, the arbitrators granted expungment. We have it on appeal. We think we will be successful,' " Steiner says. But lost in the broker-dealer's legal quest, he argues, is the broader issue of whether the BrokerCheck record will be maintained or deleted.

WHO SHOULD DECIDE?

In issuing recommendations for an overhaul of FINRA’s expungement process, a report by the Public Investors Arbitration Bar Association suggests that arbitrators should presume aggrieved clients' claims are true and require brokers to prove, at a high standard of evidence, that they are not. Instead, FINRA grants brokers the presumption of innocence in arbitration and expungement hearings, although BrokerCheck does list all client complaints associated with a broker and allows

them to re-but clients' claims if they wish. The complaints remain on the site unless a broker requests expungement and it's granted.

While the bar association proposal that would seem to bolster client allegations runs directly counter to the presumption of innocence that underlies the American legal system, FINRA's critics note that the self-regulatory body judges its own people in a system rife with favoritism – brokers, for example, sometimes proceed through arbitration hearings on a first-name basis with arbitrators, while their former clients typically do not. The implication seems to be that brokers are the insiders and investors are the outsiders.

Throughout her expungement hearing, Tarr was referred to as "Kathy," while her former client was called "Ms. Liebhaber."

"I'm not sure what that means," the judge remarked in the Superior Court case in Los Angeles, after reading the expungement hearing transcript. "It certainly indicates something."

In another sign of its insularity, the FINRA case involving Liebhaber and Tarr was labeled: "Customer vs. Member."

"The arbitrators are used to only one-sided cases," Joseph Peiffer, the securities attorney, says.

This continues despite the fact that FINRA pledges to investors that its regulatory process is "independent" and ensures the fairness of the U.S. securities markets: "Our independent regulation plays a critical role in America's financial system – by enforcing high ethical standards, bringing the necessary resources and expertise to regulation and enhancing investor safeguards and market integrity – all at no cost to taxpayers," it says.

However, absent an overhaul of the expungement process, the high level of approval of requests to delete BrokerCheck records throws "the credibility of the system as a whole into question," says Christine Lazaro, director of the Securities Arbitration Clinic at St. John's University law school in New York City.

"You aren't going to know if you are doing business with the broker who has the legitimately clean record or who has the expunged clean record," Lazaro adds.