PIABA
PUBLIC INVESTORS ADVOCATE BAR ASSOCIATION

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June 11, 2025

Via Email Only @ pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1700 K Street, NW
Washington, DC 20006

RE: Comment Letter Regarding FINRA Regulatory Notice 25-04 / FINRA Launches Broad Review to Modernize Rules Regarding Member Firms and Associated Persons

Dear Ms. Mitchell:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA”), an international bar association comprised of attorneys who represent investors in in securities arbitration and litigation. Since its formation in 1990, PIABA has promoted the interests of public investors in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members represent and advocate for investors harmed by fraud, misconduct, and the damage caused by members of the securities industry who put their interests ahead of their clients. As a result of representing the public investors, PIABA is in the unique position to uncover patterns of conduct and regulatory inefficiencies that lead to customers being misled, misinformed, or mistreated.

Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority (“FINRA”) particularly relating to investor protection issues. As such, PIABA frequently comments upon proposed rule changes and retrospective rule reviews to protect the rights and fair treatment of the investing public.

Background

PIABA agrees substantial improvements can be made to modernize the FINRA Rules and regulatory landscape to better address the risks to investors and the markets. However, PIABA believes that any efforts to modernize FINRA Rules and standards must *prioritize* and *strengthen* investor protection. FINRA’s notice is admittedly rather broad, but PIABA suggests several areas that FINRA should focus on in modernization efforts to balance the interests of protecting the investing public and integrity of the capital markets.

In short, PIABA supports a variety of common-sense amendments and improvements that will enhance investor protection, but PIABA encourages FINRA to ensure that any considered changes would prioritize the strengthening of investor protection and integrity of the markets. PIABA looks forward to the opportunity to comment on any future proposals.

I. Remote Inspections

In 2024, FINRA launched its voluntary, three-year Remote Inspections Pilot Program (the "Pilot Program"), allowing eligible member firms to meet their inspection obligations under FINRA Rule 3110 without conducting on-site visits. While we understand the intent to modernize regulatory oversight in a remote work environment, PIABA submits this comment to express strong concerns that movements towards entirely remote and disconnected supervision and inspections undermine FINRA's foundational mission of investor protection.

The flexibility granted by the Pilot Program creates a significant gap in supervision, particularly for representatives operating out of residential or remote offices. This structure increases the risk of misconduct, including sales abuses and regulatory evasion, especially in cases where representatives work in isolation without direct, in-person oversight.

In prior comments, PIABA highlighted numerous regulatory actions involving brokers who engaged in misconduct—such as "selling away" or orchestrating Ponzi schemes—from remote, often one-person offices. These cases, cited by both FINRA and the SEC, underscore the heightened supervisory challenges such environments pose. *See* PIABA Comment Letter to Vanessa Countryman, File No. SR-FINRA-2022-019 (November 22, 2022), pp. 3-4. Given this reality, reducing or eliminating on-site inspections for such locations amplifies fraud probabilities and weakens investor safeguards.

FINRA's position, that firms can rely on remote surveillance and technological tools to supervise representatives, fails to fully address the limitations of such methods. As PIABA has previously noted, observing certain red flags requires physical presence. For example, in-person audits allow compliance personnel to observe indicators of potential misconduct—such as signs of financial excess, physical marketing materials for unauthorized investments, or other evidence of off-the-books activity. These types of risks are difficult, if not impossible, to detect remotely.

We acknowledge that remote supervision tools can complement a firm's oversight framework. However, they should not replace in-person inspections—particularly for residential supervisory locations. At a minimum, these locations should be subject to annual, unannounced, in-person audits. Even inspections every three years would be preferable to eliminating them entirely. To suggest otherwise is to accept a diminished standard of oversight and, by extension, diminished investor protection.

We urge FINRA to reconsider the Pilot Program's structure and adopt more robust safeguards to ensure that all investor-facing offices, regardless of location, remain subject to effective and meaningful supervision.

II. Account Statement Modernization

PIABA has noticed concerning trends of investors being unable to track their investments recommended to them by members and their associated persons. PIABA believes member firms ought to be required to modernize the brokerage account statements they provide their customers to include insurance products and non-conventional investments ("NCIs"), among other things, that their registered representatives sell to their brokerage customers, especially when the member or associated person receive compensation for the sale of those investments or they are sold or held through the same brokerage or affiliated entities.

As the financial services landscape continues to evolve, so too must the tools and disclosures investors rely upon to make informed decisions. Today's investors are often sold a variety of products ranging from diverse portfolios that span traditional securities such as stocks, bonds, ETFs, and mutual funds, as well as complex investment products. These more complex investments include products such as insurance-based products (e.g., variable annuities and indexed universal life policies), and NCIs such as private placements, real estate investment trusts (REITs), or alternative funds. These products are frequently sold by the same registered representatives under the umbrella of a single broker-dealer or affiliated entities. Yet, these products are often excluded from the investor's regular brokerage statements, creating fragmented and potentially misleading representations of their financial position.

From a compliance and supervisory perspective, integrated reporting allows firms and regulators to better monitor for sales practice abuses, overconcentration, best-interest or suitability type concerns, and improper switching between product types. When products are omitted from account statements, it becomes more difficult to identify red flags or patterns of misconduct. Likewise, from an investor perspective, it creates a confusing, fragmented view of their investments, especially seniors and other vulnerable investors. In PIABA's experience, retail investors face confusion and harm due to their inability to follow their investments status, performance, and a variety of complex name changes and corporate actions.

The financial industry today possesses the technological capabilities to incorporate these products into comprehensive, unified statements. Many broker-dealers already maintain back-end data systems that track these holdings for internal use or compensation purposes. Extending this data to investor-facing statements is a logical and achievable next step. Moreover, doing so would promote consistency across firms and reduce investor confusion when comparing offerings. In addition, investors should be provided an opportunity for efficient electronic access to account statements and tools to fully track their investments.

Should FINRA consider enhancements to Rule 2231 and related guidance, I respectfully recommend that it explicitly require the inclusion of insurance products, non-conventional investments, and other products sold or held through affiliated entities in customer account statements. Doing so would modernize account disclosures, strengthen investor protection, and align reporting practices with the realities of today's financial markets.

III. Issues Regarding Collection and Storage of Electronic Communications

Associated persons of member firms now have access to a nearly endless number of options to communicate with customers—including text messaging, WhatsApp, and other internet-based services. These "alternative" and often unapproved and unsupervised messaging platforms are increasingly being used to engage with customers. PIABA members have observed a troubling rise in misconduct, including "selling away" and material misrepresentations, that occur via these unofficial and unmonitored communication platforms. These methods enable associated persons to communicate with customers in ways that circumvent regulatory oversight and firm compliance functions.

A. Communication Platform Disclosure

To address this risk, associated persons should be required to disclose all communication platforms they use to engage with clients, in the same manner they are currently obligated to disclose outside business activities. Member firms and regulators must strictly prohibit the use of any non-disclosed or unmonitored communication methods. Moreover, there should be a presumption of impropriety associated with the use of any undisclosed communication platform—creating a liability framework that shifts the burden to the associated person and firm. This deterrent would reduce misconduct and protect investors from individuals attempting to evade supervision.

B. Record Retention on Separation

In addition to proactive monitoring, member firms should be required to obtain a forensic copy of all electronic communications between associated persons and customers on an annual basis, or at a minimum upon the termination of an associated person's employment. These records often play a critical role in FINRA arbitration proceedings. Unfortunately, firms frequently claim that relevant communications are unavailable because they are stored on an associated person's personal device, allegedly beyond the firm's control. Courts, however, have repeatedly held that employers can and must produce such records where relevant. *See, e.g.*, *In re Gonzalez*, 2022 WL 17583628, at *8 (S.D. Fla. Aug. 8, 2022) (citing *Matter of Skanska USA Civ. SE Inc.*, 2021 WL 4953239 (N.D. Fla. Aug. 5, 2021) and *State Farm Mut. Auto. Ins. Co. v. Precious Physical Therapy*, 2020 WL 7056039 (E.D. Mich. Dec. 2, 2020)).

C. Reasonably Accessible Record Storage Standards

Member firms should not be permitted to ignore their supervisory obligations while benefiting from the very misconduct they fail to prevent. Member firms often resist producing documents that are presumptively discoverable under the FINRA Discovery Guide, citing undue burden based on their own poor recordkeeping practices. Specifically, firms claim that searching for responsive documents is difficult because records are not stored in a searchable electronic format. This problem is entirely self-created. In the modern era, virtually all documents originate in digital form and can easily be made searchable. Firms that convert documents to paper and then re-scan them without using OCR software embrace inefficiency to deliberately obstruct the discoverability and usability of their records. This conduct frustrates both regulatory oversight and the fair administration of arbitration. It is inconsistent with the "high standards of commercial honor and just and equitable principles of trade" that FINRA demands from its Members. FINRA Rule 2010.

FINRA should modernize its expectations and require member firms to store all documents in standardized, searchable formats—such as PDF/A—which many courts now require. Doing so would reduce regulatory burden, enhance document accessibility for customers and regulators, and ensure that firms cannot manipulate record formats to avoid producing usable documents.

IV. Issues Regarding Commissions/Fees and Trade Cost Disclosures

FINRA Members now fail to provide transparency surrounding the costs associated with individual transactions. These costs include commissions, mark-ups and mark-downs, and execution prices assigned to trades as compared to the open market bid and ask values. While public investors often understand that commissions may be incurred on a specific trade, they often lack a clear understanding of the form of commission, or how it affects the profitability of a trade. In the case of mark-ups and mark-downs, public investors are often unaware that their firm might be charging them more, or providing less, than the firm received in a corresponding and underlying transaction. The aggregate costs of any commission or fees are often difficult for investors to track and understand, and Members should provide investors with information and data regarding the aggregate trading costs on a periodic basis through account statements or confirmations. Members already maintain this type of data and information electronically, and there would be minimal burden in providing such important data to customers.

As with many aspects of the relationship between customer and member firm, full and fair disclosure should be the guiding principle. Member firms should be required to disclose, in a clear and conspicuous manner, the precise commission paid on all trade confirmation slips. Member firms are already required to maintain this information, so including the data on a confirmation slip would not present any additional burden on firms or regulators. By contrast, providing this disclosure would enhance customers' understanding of the true costs of trading and would enable them to make more informed decisions. Moreover, firms could offer lower transaction costs as a competitive advantage to benefit themselves in the marketplace. Increased competition, and lower consumer costs, are both benefits that support requiring disclosure.

The same information should be included for any mark-ups or mark-downs applied to any trade. Investors deserve to know how a firm's internal trading processes affect their personal trading costs, and when and how a firm is charging them an amount different than what was available on the open market, and the percentage the customer is being charged.

Finally, member firms should be required to provide the intraday high and low trading prices for any relevant security on a confirmation slips. While firms are not currently obligated to provide "best execution," many trades for retail investors are executed at prices that fall at or beyond the high or low of the trading day. This practice significantly benefits the firm while disadvantaging the customer. Requiring firms to disclose the day's trading range would give investors valuable insight into the quality of the execution received. While such data is readily available from public electronic sources, firms will not voluntarily provide it, as doing so would underscore the profitability of their trade execution practices. However, if such disclosure were required industry-wide, firms could virtuously compete by delivering superior execution quality.

In summary, FINRA member firms should be required to provide the highest level of transparency in their dealings with retail customers. Transparency promotes investor protection and fosters informed decision-making. Given the minimal burden on firms and the substantial benefit to the investing public, these suggestions deserve urgent and favorable consideration.

V. Modernizing "Recommendations" Across Various Communication and Social Media Platforms.

As registered representatives increasingly rely on digital communication platforms, including social media and messaging apps, to engage with customers, it is critical that FINRA's Rules and regulatory guidance reflect the realities of today's communication landscape. Advisors may use tools like LinkedIn, WhatsApp, iMessage, and Instagram not only for general branding but also for sharing market updates and personalized commentary or recommendations. FINRA's current regulatory framework, which largely centers on traditional and firm-controlled communications, presents challenges in monitoring, supervision, and compliant recordkeeping in this evolving environment.

FINRA's regulatory guidance as to what constitutes a "recommendation" under Rule 2111 or Regulation Best Interest is necessarily broad to encompass the many ways that firms and their representatives can solicit transactions and investment strategies with their customers. While PIABA agrees with this broad-based approach, FINRA's Rules and guidance should continue to clarify that recommendations do not only occur through traditional communication channels.

NASD Notice to Members 01-23 (released 24 years ago) discussed and confirmed that recommendations made through electronic communications constituted recommendations under NASD (now FINRA) Rules, and it gave examples of types of electronic conduct that would be considered a recommendation. FINRA then issued Regulatory Notice 17-18 which discussed social media in a compliance and regulatory context. These types of clarifications should continue and should be updated to encompass current communication activities.

To effectively modernize its rules, FINRA should consider continuing to establish clear, platform-agnostic guidance that confirms that "recommendations" can occur across various digital formats and communication methods. Additionally, FINRA could encourage or endorse the use of third-party compliance technology solutions that enable real-time monitoring and archiving of all digital communications with customers or potential customers. By doing so, FINRA can help ensure that investor protections remain intact in this age of modern communication.

VI. Electronic Delivery of Offering Materials and Disclosures

As brokerage firms become more reliant on digital tools in client interactions it is essential that FINRA remind its member firms that the use of these technologies does not relieve them of their core regulatory obligations. Specifically, we urge FINRA to issue clear and updated guidance emphasizing that electronic delivery of a prospectus or disclosures does not replace full fair and balanced disclosure obligations, and electronic signatures or "clickwrap" acknowledgements do not substitute informed consent or understanding. These digital processes and their myriad disclosures and disclaimers cannot immunize firms against verbal misrepresentations or misconduct, and firms still have supervisory responsibilities to ensure their employees are complying with FINRA rules.

The convenience of delivering disclosure documents electronically does not in any way diminish the obligation of brokers and brokerage firms to provide full and fair disclosure, including meaningful explanations of product features, costs, risks, and conflicts of interest. Simply sending a prospectus via email or secure link does not fulfill the requirement to ensure that customers understand the nature and implications of the products being offered. Electronic signatures are a functional equivalent of handwritten signatures, but they do not establish that a customer fully understood the investment or transaction.

Member firms must continue to take steps to ensure that customers are truly informed, and that consent is meaningful, regardless of whether the process is conducted electronically or in person. The delivery of these electronic prospectuses creates new challenges and hurdles for firms that were not present in an in-person meeting. The electronic process does not allow the same type of opportunity for customers to ask questions or about the investment itself or anything they may read on the prospectus. This hands-off process will require broker-dealer firms to take extra steps to ensure the firm has made full and fair disclosures, and also to ensure that there is informed consent on the part of the customer. We urge FINRA to remind broker-dealer firms that this more convenient electronic delivery method brings with it more challenges and the need to update their procedures to ensure full and fair disclosure.

Simply sending clients a prospectus with risk disclosures and disclaimers that contradict oral representations made by a registered representative of the firm cannot insulate the firm from liability for those oral representations. The integrity of verbal representations must match the content of written materials, whether delivered electronically or otherwise. Investors should not be left with no recourse simply because a misleading investment pitch was followed by a stack of fine print delivered via email. Supervisory systems must be adapted to address risks inherent in electronic interactions, including the need to monitor and document oral communications, track electronic disclosures, and ensure consistency across verbal and written representations. FINRA should make clear that firms are expected to supervise digital engagement with the same rigor as traditional channels.

VII. Common Sense Insurance

PIABA strongly urges FINRA to require all member firms to maintain appropriate liability insurance. Our proposal addresses a long-standing and well-documented source of investor harm: the epidemic of unpaid FINRA arbitration awards. We also recommend that respondents in customer arbitration matters be required to disclose, in confidence during discovery, the existence and extent of any insurance coverage. Such information should remain inadmissible at the hearing.

The rationale for insurance is simple: financial professionals and firms that harm investors should not be able to walk away from responsibility simply because they lack the means to pay an award. The current system permits firms and FINRA members to skirt responsibility. Many firms operate without any liability insurance, and some even structure themselves with no intention of satisfying adverse arbitration awards. In these cases, aggrieved investors—often retirees with little recourse—are left empty-handed.

This is not a new problem. The Government Accountability Office has reported that a significant number of arbitration awards go unpaid. FINRA has the authority to suspend brokers and firms for non-payment, but that sanction provides little help to investors once their money is gone. Enforcement remedies only go so far if there are no assets or insurance proceeds to satisfy awards.

PIABA has written extensively on this issue. Attached please find our recent discussion on insurance.

Requiring insurance solves several problems simultaneously:

1. **Insurance ensures recoverability**. It dramatically reduces the number of unpaid awards by providing an external funding source when a firm fails or disappears.

2. **Insurance enforces discipline**. Insurers price risk. They require firms to implement compliance programs, reject known bad actors, and avoid risky behaviors that lead to claims. In effect, insurers act as a private market discipline mechanism.

3. **Insurance is commonplace and feasible**. States like Oregon and Oklahoma already require investment advisers to carry insurance. Major custodians like Schwab and Fidelity have also implemented insurance mandates for firms on their platforms. These requirements have *not* reduced access to financial advice, and the number of advisers in those jurisdictions increased post-implementation.

4. **Disclosure aligns FINRA with the broader legal system**. In federal court and nearly every state, parties must disclose the existence of insurance coverage. FINRA is an outlier in not requiring this. Allowing for confidential, non-evidentiary insurance disclosure in arbitration would promote fairness and efficiency.

5. **The market supports implementation**. Empirical data show that requiring even modest insurance coverage (e.g., $1 million per firm) does not drive professionals from the industry. If anything, mandatory insurance can enhance investor trust and attract more business to reputable, well-insured firms.

Congress, North American Securities Administrators Association (NASAA), and the SEC have called on FINRA to address unpaid awards. Insurance as a solution. The tools exist and the path for implementation is clear.

PIABA urges FINRA to act decisively: require all member firms to carry meaningful insurance and mandate disclosure of insurance coverage in FINRA arbitrations. Investors deserve a system that not only adjudicates claims but ensures justice is served.

VIII. FINRA Members Using Holding Companies to Escape Liability

FINRA currently permits non-member holding companies and non-associated persons ("Holding Companies") to own FINRA member firms. However, because these Holding Companies are not themselves FINRA members, FINRA states that it lacks authority to directly regulate their conduct or to require them to participate in FINRA arbitration proceedings. This remains true even where the Holding Company owns 100% of the FINRA member, is listed as a "Control Person" on the member firm's Form BD and exercises full operational control over the member's activities.

This situation presents a serious inconsistency. Under FINRA Rule 1011(b)(3), a Holding Company that controls a member firm meets the definition of an "associated person of a member." Despite this definition, FINRA does not consistently assert jurisdiction over Holding Companies, and when it does, arbitration panels often decline to enforce that jurisdiction. In other cases, Holding Companies that are compelled to participate in FINRA arbitration may seek relief in court, including temporary restraining orders, to avoid arbitration entirely. These tactics disrupt the FINRA arbitration process and undermine investor protection.

This is a pressing problem with real-world consequences. In January and February 2025 alone, millions of dollars in arbitration awards went unpaid due to the use of Holding Companies that controlled FINRA members but were not themselves subject to FINRA oversight or arbitration. In these instances, individuals and entities that own and control FINRA members continue to operate in the industry and benefit from their associations—while injured investors, including elderly and vulnerable individuals, are left without any meaningful opportunity for recovery, even after spending years pursuing claims through FINRA arbitration.

This gap in FINRA's jurisdiction causes substantial harm:

1. **Lack of Arbitrability** – Investors are unable to bring claims against Holding Companies, even when those companies are responsible for the conduct or solvency of the FINRA member.

2. **Lack of Regulatory Oversight** – FINRA has no effective authority to supervise or sanction misconduct by Holding Companies, despite their control over regulated member firms.

3. **Avoidance of Liability** – Holding Companies can avoid paying arbitration awards by closing broker-dealer subsidiaries with large liabilities and shifting operations to affiliated entities.

This problem arises from deliberate corporate structuring designed to avoid accountability, and FINRA's current rules do not adequately address it. The result is a regulatory framework that allows responsible parties to benefit from FINRA membership while avoiding the obligations that should accompany that status.

PIABA urges FINRA to revise its rules to close this gap. Specifically, FINRA should:

1. Require any individual or entity that owns or controls a FINRA member firm to submit to FINRA jurisdiction;

2. Mandate that Holding Companies and control persons participate in FINRA arbitration under Rule 12200, where they are alleged to have responsibility for investor harm;

3. Prohibit associated persons, owners, and control entities from remaining in the industry if they are affiliated with firms that fail to pay arbitration awards.

These reforms are necessary to protect investors and to ensure that FINRA arbitration remains a fair, effective, and enforceable dispute resolution process.

IX. **PIABA's Concerns Regarding FINRA's Unilateral Changes to Arbitrator Qualifications**

PIABA is deeply concerned by FINRA's recent, sweeping changes to arbitrator qualification standards — changes that were implemented without public notice, meaningful consultation, or adherence to FINRA's historically transparent and consensus-driven rulemaking process through the National Arbitration and Mediation Committee (NAMC). These abrupt departures from long-standing practice will likely shrink the arbitrator pool, introduce procedural inefficiencies, and ultimately harm investors seeking redress through the arbitration forum.

Historically, FINRA (and previously NASD) maintained arbitrator qualification standards that balanced educational achievement with real-world experience. For example, the **NASD Arbitrator Application Booklet (March 2003)**permitted candidates with two years of college-level coursework and five years of business or professional experience, including an exception for those without college credits, but with substantial relevant experience. FINRA's new standard now mandates a four-year college degree and restricts eligibility to individuals with "professional" work experience — narrowing the pipeline of qualified applicants and excluding many capable candidates, including small business owners and others with decades of meaningful practical experience.

This change risks severely limiting the availability of arbitrators, particularly in small and mid-size cities where the pool is already thin. As a result, FINRA is likely to rely even more heavily on "traveling" arbitrators — those assigned to cases far from their home jurisdictions — which increases scheduling conflicts and delays. PIABA has long expressed concerns that such arbitrators, especially repeat participants, may be more prone to industry bias and less reflective of the diverse perspectives necessary for a truly fair forum.

PIABA supports efforts to diversify and improve the quality of the arbitrator pool. However, raising educational and professional barriers in this way is counterproductive. Unlike juries in state or federal courts, FINRA arbitrators are now subject to stricter qualifications than jurors or even licensed financial professionals. For example, no college degree is required to sit for the Series 7 exam or become a financial advisor. It is unreasonable to assume that individuals without a college degree cannot effectively grasp or adjudicate the types of issues that arise in securities arbitration. Arbitrators with significant life, business, and community experience — yet who may not hold a degree — can offer invaluable insights and fairness to the process.

The fairness of FINRA arbitration is already a topic of concern, particularly given that the industry prevails in roughly 70% of customer cases, and nearly one-third of awards go unpaid. Instead of addressing these systemic imbalances, FINRA's changes appear to further tilt the process in favor of the industry — without input from the investing public or the broader arbitration community.

For these reasons, PIABA urges FINRA to: immediately halt implementation of the new qualification standards; open a public comment period to gather feedback from stakeholders; reassess the changes through the transparent NAMC process; and focus on reforms that broaden, rather than narrow, access to a diverse and capable arbitrator pool.

Investors deserve a fair forum. Procedural shortcuts and exclusionary policies undermine that goal. FINRA must do better.

CONCLUSION

In sum, PIABA supports a variety of common-sense amendments and improvements that will enhance investor protection, but PIABA encourages FINRA to ensure that any considered changes would prioritize the strengthening of investor protection and integrity of the markets. We urge FINRA to issue specific, enforceable guidance affirming that technological convenience must not come at the expense of investor protection. The core principles of fairness, transparency, and acting in the customer's best interest must remain intact and be upheld regardless of changes in technological advancements. PIABA looks forward to the opportunity to comment on any future proposals.

Sincerely,

Adam J. Gana
Public Investors Advocate Bar Association
President

Attachment

THE INSURANCE SOLUTION FOR FINANCIAL ADVICE FAILURES

ADAM J. GANA AND BENJAMIN P. EDWARDS[1]

ABSTRACT

Solving the retirement savings crisis requires widespread access to reliable financial advice. Yet financial advisers now often operate without insurance, collecting fees and commissions from customers and leaving them penniless when substandard advice causes harm. Instituting insurance coverage requirements would provide protection for investors and allow market forces to discipline misconduct. For decades, advocates and regulators have raised awareness about the millions of unpaid arbitration awards each year; an insurance solution would greatly reduce the harm suffered.

This essay aims to create a roadmap to solve the problem. It identifies the problem and maps out the different levers available to policymakers to increase overall insurance coverage across a fragmented regulatory landscape.

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[1] Adam J. Gana is the managing partner of Gana Weinstein LLP and the president of the Public Investor Advocate Bar Association. Benjamin P. Edwards is a Professor of Law at the William S. Boyd School of Law at the University of Nevada, Las Vegas. Thanks to Adam Marchant for research assistance and Jennifer Shaw for thoughtful comments on the draft.

Comments welcomed at benjamin.edwards@unlv.edu.

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Comments welcomed at benjamin.edwards@unlv.edu.

I. INTRODUCTION AND BACKGROUND

Investors wronged by wealth management firms often find themselves unable to recover. For example, Bruce Wilkerson reached the Super Bowl as an offensive tackle for the Green Bay Packers in 1996.[2] After he left the National Football League, having played for the Packers, Jaguars, and Raiders, he worked as a machinist and trusted Resource Horizons Group, a brokerage firm, to manage the wealth he earned by putting his body on the line.[3] After one of the brokerage's registered representatives ran a Ponzi scheme, an arbitration within the Financial Industry Regulatory Authority's ("FINRA") Dispute Resolution Forum found Resource Horizons Group liable for over $600,000 in compensatory damages and another $1.4 million in damages under the Tennessee Consumer Protection Act.[4] Yet Wilkerson would never see any recovery because Resource Horizons Group closed its doors without insurance to cover Wilkerson's claim.[5]

For decades, bottom-tier financial services firms have profited by selling high-commission products only to fold once claims for abusive sales practices arrive.[6] In 2000, the Government Accountability Office found that nearly two-thirds of arbitration awards against stockbrokers and brokerage firms went unpaid.[7] Often, the brokers involved scurry from one brokerage to another, continuing to exploit investors. This occurs so often that some use the term "cockroaching" to describe "brokers moving from one problem firm to

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[2] Mason Braswell, *Ex-NFL player left out in the cold after $2 million award*, INVESTMENT NEWS (Jun. 22, 2015), https://www.investmentnews.com/industry-news/features/ex-nfl-player-left-out-in-the-cold-after-2-million-award-61449.

[3] Benjamin Edwards & Hugh Berkson, *Fix the flaw in financial self-regulation*, THE HILL (Mar. 19, 2018), https://thehill.com/opinion/finance/379134-fix-the-flaw-in-financial-self-regulation/.

[4] *Wilkerson v. Resource Horizons Group, LLC, FINRA Case Number 14-00904, (available at* https://www.finra.org/sites/default/files/aao_documents/14-00904-Award-All%20Public%20Panel-20150311.pdf).

[5] Melanie Waddel, *Savings of Ex-NFL Player Left Gutted by Unpaid FINRA Arb Award*, THINKADVISOR (Mar. 7, 2018), https://www.thinkadvisor.com/2018/03/07/ex-nfl-player-wilkerson-deeply-affected-by-unpaid-finra-arb-award/.

[6] United States General Accounting Office, SECURITIES ARBITRATION: ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS, U.S. GOV'T ACCOUNTABILITY OFFICE 33 (2000), https://www.gao.gov/assets/ggd-00-115.pdf.

[7] *Id.* (finding that "an estimated 61 percent . . . of investors who won arbitration awards in 1998 either were not paid or received only partial payment.").

another."[8] Financial advisers will sometimes even shift from selling securities to other financial products simply to evade federal oversight.[9]

Wall Street's deadbeat firms come in different varieties. Some operate as FINRA-supervised brokerage firms,[10] generally selling securities in exchange for transaction-based compensation.[11] Others operate as registered investment advisory firms, generally receiving compensation directly for investment advice about securities.[12] Often, firms and individuals will operate under both regimes simultaneously, with their duties and obligations shifting depending on the hat worn at the time.[13] Adding to the complexity, many financial advisers also sell insurance products under lax state regulation and supervision.[14]

In recent years, business models have shifted, with more brokers and brokerage firms shifting to operate as investment advisers.[15] Private equity firms have accelerated this move by acquiring investment advisory firms for their predictable cash flows and growth.[16]

Both brokerage and advisory firms often operate without any insurance and leave investors unable to recover if problems arise.[17] Although the unpaid award problem has been extensively studied and documented in the brokerage

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[8] Jean Eaglesham & Rob Barry, *More Than 5,000 Stockbrokers From Expelled Firms Still Selling Securities*, WALL ST. J. (Oct. 4, 2013), https://www.wsj.com/articles/more-than-5000-stockbrokers-from-expelled-firms-still-selling-securities-1380843149.

[9] Colleen Honigsberg, Edwin Hu & Robert J. Jackson, Jr., *Regulatory Arbitrage and the Persistence of Financial Misconduct*, 74 STAN. L. REV. 737, 742 (2022) (studying "financial advisors who exit federal oversight after committing serious misconduct yet continue to advise investors" in insurance transactions).

[10] FINRA is a trade association of brokerage firms charged with serving as the front-line regulator for brokerage firms. The Securities and Exchange Commission supervises FINRA and a number of other self-regulatory organizations.

[11] *See* SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS iii (Jan. 2011) (describing broker-dealers and investment advisory firms) *(available at* https://www.sec.gov/files/913studyfinal.pdf).

[12] *Id.*

[13] *Id.* at 12-13.

[14] Honigsberg, Hu & Jackson, *supra* note 9, at 740-42.

[15] Justin Mack, *Independent and hybrid RIA channels are adding advisors the fastest, Cerulli report says*, FINANCIAL PLANNING (Nov. 1, 2023), https://www.financial-planning.com/list/independent-and-hybrid-ria-channels-are-adding-advisors-the-fastest-cerulli-report-says.

[16] Ian Salisbury, *Your 'Independent' Advisor Now Works for Private Equity. What It Could Mean for Your Portfolio.*, BARRON'S (Jun. 14, 2024), https://www.barrons.com/articles/financial-advisors-private-equity-clients-portfolio-de076c68.

[17] North American Securities Administrators Association (NASAA), E&O INSURANCE SURVEY REPORT, NASAA 2 (Dec. 2019), https://www.nasaa.org/wp-content/uploads/2019/12/2019-BD-EO-Survey-Report-Formatted-FINAL.pdf.

context,[18] the problem extends beyond brokerages. NASAA enforcement reports show that both investment advisors and brokers regularly misbehave.[19]

After decades of harm, federal policymakers have taken notice and demanded action. The U.S. Securities and Exchange Commission (SEC or the "Commission") Investor Advocate recently called for investment advisers to disclose more information to better understand the scope of the problem in the advisory context.[20] Congress has also begun applying pressure for FINRA to take action to address the problem in the broker-dealer space. The Senate Committee on Appropriations recently found that "FINRA has failed to undertake steps to address unpaid arbitration awards by its members."[21] It directed that the "SEC shall continue to engage with FINRA to identify ways to reduce and eliminate the occurrence of unpaid awards."[22]

Despite this problem persisting for decades and leaving investors with enormous losses, a solution to dramatically mitigate the problem exists—insurance. In this context, insurance requirements offer two major benefits. First, insurance companies may force brokerages and advisory firms to adopt better practices to maintain coverage at favorable rates. Second, a reasonable degree of insurance will allow more investors to recover in instances when and if harm arrives. Notably, this insurance solution does not guarantee that all investors will recover every dime in every instance of misconduct. Yet, an industry carrying insurance offers investors substantially better protection than an industry without it.

The states have taken some action to improve insurance coverage. Notably, two states—Oregon and Oklahoma—have already moved to require some wealth management firms to carry insurance.[23] Their requirements offer some lessons for a broader insurance mandate. At a minimum, the existing numbers in the aftermath of this natural experiment indicate that creating modest insurance requirements does not lead to any material reduction in the

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[18] *See* Hugh Berkson & David P. Meyer, *Finra Arbitration's Persistent Unpaid Award Problem*, PUBLIC INVESTOR ADVOCATE BAR ASSOCIATION (Sept. 2021), https://piaba.org/piaba-newsroom/piaba-report-finra-arbitrations-persistent-unpaid-award-problem-september-29-2021 (documenting the unpaid arbitration award problem in the brokerage context).

[19] NASAA, 2020 ENFORCEMENT REPORT 13 (2020), https://www.nasaa.org/wp-content/uploads/2020/09/2020-Enforcement-Report-Based-on-2019-Data-FINAL.pdf.

[20] SEC OFFICE OF THE INVESTOR ADVOCATE, FISCAL YEAR 2023: REPORT ON ACTIVITIES 43 (Dec. 5, 2023), https://www.sec.gov/files/2023-oiad-annual-report.pdf (explaining that "[a]n absence of information prevented Staff from generating reliable statistics about the frequency of SEC-registered adviser arbitration or the number of unpaid arbitration awards").

[21] S. REP. NO. 118-206, at 103 (2024).

[22] *Id.*

[23] Or. Rev. Stat. Ann. § 59.175; Okla. Admin. Code 660:11-7-11.

availability of financial advice for main street investors.[24] However, the existing insurance requirements only reach a portion of the wealth management firms operating within those jurisdictions.[25]

This essay aims to explore the critical need for insurance and provide guidance for how to require insurance across a fragmented financial advice industry.[26] Part II discusses the imperfect existing insurance requirements and errors and omissions insurance marketplace available today. Part III frames the elements of a successful insurance program and overviews the regulatory mechanisms for instituting insurance requirements.

II. EXISTING INSURANCE REQUIREMENTS ARE IMPERFECT

At present, state and federal law says little about insurance requirements for wealth management firms.[27] As financial advisers may be supervised by FINRA, state securities regulators, state insurance regulators, the SEC, or some combination of the foregoing, requiring coverage across the industry will require coordinated action from an array of regulators.

Fragmented and overlapping regulation may partially explain the inaction when it comes to mandatory insurance. For example, if FINRA moved first and mandated that brokerage firms carry insurance, it might place brokerage firms at a competitive disadvantage to state and SEC-registered investment advisory firms. The same may be true if the states or SEC acted first.

Despite the pressure toward inaction, some insurance requirements have emerged and merit consideration at the state level and from clearing firms.[28] Critically, current evidence indicates that insurance requirements, as currently implemented, do not appear to meaningfully alter the public's ability to access investment advice.[29]

A. Limited Existing State Insurance Mandates Have Not Reduced Access to Investment Advice

Many financial advisers now practice without insurance or enough insurance to cover liability.[30] Currently, only two states—Oregon and

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24 *See* Qin & McCann, *infra* note 65.
25 OR. REV. STAT. § 59.175 (2018); OKLA. ADMIN. CODE § 660:11-7-11 (2024).
26 *See* Christine Lazaro & Benjamin P. Edwards, *The Fragmented Regulation of Investment Advice: A Call for Harmonization*, 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 47 (2014) (explaining how fragmented regulatory structures complicate overseeing financial advice).
27 § 59.175; 660:11-7-11.
28 *Id.*
29 *See* Qin & McCann, *infra* note 64.
30 *See* NASAA, *supra* note 17.

Oklahoma—require some financial advisers to carry some professional liability insurance for errors and omissions. Yet both have exemptions for broker-dealers, relying on FINRA to fill the regulatory gap—an invitation FINRA has yet to accept.[31]

In 2018, Oregon began requiring all state-registered investment advisers to carry at least $1 million in errors and omissions insurance.[32] The $1 million requirement applies to all firms regardless of size, capturing intra-state brokerage operations and state-registered investment advisers.[33]

Oregon's requirement does not capture all investment advisers operating in the state because Oregon only oversees a portion of the market. Investment advisers may register with the SEC when their regulatory assets under management reach $100 million or more.[34] At that point, the SEC oversees their operations instead of the state.[35]

Oregon's flat $1 million coverage requirement may generate a degree of inequity among financial firms. For example, under Oregon's statute, a firm with $6 million in assets under management has the same insurance requirements as a firm with $96 million in assets under management.[36] To the extent that policies cost approximately the same, firms with smaller assets under management will pay a higher relative cost than firms with more assets. The requirement may also create an incentive for smaller advisory firms to merge with larger firms to reduce costs or entirely avoid Oregon's insurance requirement by transitioning to SEC oversight.

When Oklahoma followed Oregon's lead in 2020 with an administrative rule requiring state investment advisers to carry $1 million in errors and omissions insurance, it too missed the opportunity to provide a tailored coverage requirement.[37] Notwithstanding the gaps in coverage, the laws increase investor protection in both states to this day.[38]

Although the insurance mandate itself is simple, both states worked to facilitate compliance. To make sure that all licensees can access the coverage they need, Oregon and Oklahoma both admitted surplus line insurers and risk

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[31] § 59.175; § 660:11-7-11.
[32] § 59.175.
[33] *Id.*
[34] 17 C.F.R. § 275.203A-1(a)(1) (2011) ("You may, but are not required to register with the Commission if you have assets under management of at least $100,000,000 but less than $110,000,000, and you need not withdraw your registration unless you have less than $90,000,000 of assets under management").
[35] *Id.*
[36] § 59.175.
[37] § 660:11-7-11.
[38] § 59.175; § 660:11-7-11.

retention and purchasing groups into the state.[39] In Oregon, licensees simply submit annual proof of insurance.[40] Firms that fail to submit proof of insurance risk having their licenses canceled.[41]

B. Industry Insurance Requirements

Some financial advisers carry insurance because some custodial platforms insist on insurance for advisers using their platforms.[42] For example, in 2021, Charles Schwab & Co. ("Schwab") launched a program to eventually require all Registered Investment Advisers ("RIA") using its custodial services to carry at least $1 million in insurance, including errors and omissions coverage.[43] Like Oregon and Oklahoma, Schwab undertook measures to ensure that the insurance market could accommodate the new rule, which included working with insurance companies to obtain preferred pricing for Schwab's clients.[44]

RIA firms voluntarily elected to comply with Schwab's insurance requirement instead of seeking a different custodial platform. Unlike the states, where in-state advisers had to comply or lose their licenses, Schwab's users could have readily chosen to shift to a different custodial platform because none of Schwab's competitors imposed similar requirements.[45]

Instituting the insurance requirement did not reduce Schwab's market share. Despite 2022 being one of the worst-performing years for stocks and bonds in history, Schwab's net income still increased after mandating insurance, and Schwab saw rapid RIA growth in 2023.[46]

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[39] OR. ADMIN. R. 441-175-0185(3) (2018); OKLA. ADMIN. CODE § 660:11-7-21 (2024).
[40] OR. REV. STAT. § 59.225 (2018).
[41] § 59.225.
[42] When a person buys securities, a brokerage firm ordinarily keeps custody of the securities for the benefit of the individual. Investment advisers managing client portfolios generally use select brokerage platforms to custody and transact business.
[43] *What Insurance Is Required for RIA Firms?*, SCHWAB, https://advisorservices.schwab.com/navigating-risk-regulation/advisor-insurance (last visited July 27, 2024).
[44] *See* Sam Del Rowe, *Schwab Requiring RIA Firm Clients to Purchase Errors and Omissions, Other Insurance*, FINANCIAL ADVISOR IQ (Dec. 20, 2021), https://www.financialadvisoriq.com/c/3441634/437184/schwab_requiring_firm_clients_purchase_errors_omissions_other_insurance.
[45] *Id.*
[46] *2022 Annual Report*, SCHWAB 6 (2022), https://content.schwab.com/web/retail/public/about-schwab/schwab_annual_report_2022.pdf; Diana Britton, *Schwab Benchmarking: RIA Growth Rebounds in 2023*, WEALTH MANAGEMENT (July 18, 2024), https://www.wealthmanagement.com/ria-news/schwab-benchmarking-ria-growth-rebounds-2023.

Schwab's insurance requirement may provide it with a range of benefits. In instances where a claimant names Schwab as a defendant alongside an advisor using its platform, Schwab may now be readily assured that the RIA firm will have coverage and counsel—potentially mitigating Schwab's costs.

Schwab's insurance requirement may also provide a filtering mechanism for uninsurable firms. To the extent that any RIA firm cannot obtain insurance because of risks unique to that RIA firm, Schwab likely benefits by excluding the firm from its platform. Thus, the insurance requirement may allow Schwab to use insurance companies to exclude firms that would draw the most litigation and attendant problems for Schwab from its platform.

Despite Schwab's influence in the marketplace, private insurance requirements have not yet proliferated and changed broader industry practice.[47] Financial advisers often operate without insurance, and other custodial platforms do not require firms to maintain insurance.

C. Existing Insurance Disclosure Requirements

Insurance disclosure requirements might also play a role in investor protection. Knowledge of insurance coverage can influence an investor's behavior, such as whether to work with an adviser and whether and how to pursue a claim if the adviser causes harm. Yet, as it stands, investors are generally poorly situated to evaluate insurance information and often lack access to basic information about a financial adviser's insurance.[48]

1. Kansas Insurance Disclosure Requirement

In 2012, Kansas began requiring investment advisers to disclose their professional liability insurance status to all current and prospective clients.[49] In theory, requiring investment advisers to disclose their professional liability insurance information allows clients to take this information into account when deciding between firms.[50] A disclosure requirement may even drive some financial advisers to obtain insurance to avoid disclosing that they operate without insurance.

Securities law often defaults to a disclosure-oriented model because disclosure plays such a critical role in both the market and the SEC's regulation

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[47] *See* Sam Del Rowe, *supra* note 43.

[48] *Does My Investment Advisor Have Insurance?*, SAMUELS YOELIN KANTOR LLP (Oct. 30, 2018), https://www.investordefenders.com/blog/does-my-investment-advisor-have-insurance/.

[49] In Re: Waiver of Certain Requirements Under K.A.R. 81-14-9 and New Requirement Authorized By KA.R. 81-14-10 For Disclosure Regarding Insurance Coverage, 2012 WL 5473856 at *2 (Nov. 7, 2012).

[50] An Oregon legislator recently proposed a bill that would similarly allow the state to require investment advisors to disclose their policy and coverage information. H.B. 2274, 82nd Or. Leg. Assemb., Reg. Sess. (Or. 2023).

of public company disclosures.[51] Yet disclosure-oriented rules may not achieve investor protection goals in this context because many people work with financial advisers because they desire informed guidance. Unlike public company disclosures, no market price transmits information about a financial adviser in real-time to other persons seeking information about the financial adviser.[52] No market mechanism makes uninformed investors aware that sophisticated investors have shunned advisers without insurance.[53]

In this context, disclosure requirements may even expose the least sophisticated investors to greater risks. If some relatively sophisticated clients alert to risks and leave the adviser, the remaining clients likely face greater peril because the advisor still needs to pay bills and must now generate the same income from a shrinking client base. Unscrupulous advisers may opt to make up the difference by exploiting investors.

Kansas's disclosure requirements may be most useful for investors after harm occurs. Because Kansas firms must disclose their insurance status, investors who have suffered harm can take insurance information into account when deciding whether to pursue relief.[54]

2. Limited Access to Insurance Coverage Information

Despite Kansas's requirement, insurance coverage information often remains a closely guarded secret. In contrast to ordinary litigation, FINRA arbitration does not require its members to produce information about insurance coverage in arbitration.[55] FINRA's current discovery guide does not require brokers to provide information about any insurance coverage they may have.[56] As a result, investors may pursue actions against uninsured brokers who cannot afford to pay claims.[57] In contrast, the Federal Rules of Civil Procedure mandate parties to disclose insurance coverage.[58]

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[51] See Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. L.Q. 417, 418 (2003) ("Securities regulation is motivated, in large part, by the assumption that more information is better than less. Perhaps this is no surprise since the SEC's chief regulatory tool is to require companies to disclose more.").

[52] *See* David Harper, *Forces That Move Stock Prices*, INVESTOPEDIA (May 20, 2024), https://www.investopedia.com/articles/basics/04/100804.asp.

[53] *Id.*

[54] In Re: Waiver of Certain Requirements Under K.A.R. 81-14-9 and New Requirement Authorized By K.A.R. 81-14-10 For Disclosure Regarding Insurance Coverage, 2012 WL 5473856 at 2 (Nov. 7, 2012).

[55] *See Discovery Guide*, FINRA (2013), https://www.finra.org/sites/default/files/ArbMed/p394527.pdf.

[56] *Id.*

[57] *See* NASAA, *supra* note 17, at 2.

[58] *See* FED. R. CIV. P. 26(a)(1)(A)(iv) (requiring disclosure of "any insurance agreement under which an insurance business may be liable to satisfy all or part of a possible judgment in the action").

Realizing the inequity in its process, in 2018, FINRA requested comments about a potential rule that would require brokers to disclose their insurance information in arbitration proceedings.[59] Making insurance information presumptively discoverable could prevent wronged investors from digging a hole for themselves by pursuing claims against uninsured brokers that might never be able to satisfy an award.[60]

Requiring parties to exchange information about insurance coverage does not come without risks. The contemplated rule aimed to ensure that insurance coverage information would not overly shift outcomes in arbitrations.[61] FINRA aimed to address concerns that knowledge about insurance coverage might prejudice arbitration panels by designating insurance information as inadmissible absent extraordinary circumstances.[62]

For reasons that remain unclear, FINRA chose not to move forward with the rule.[63] As a result, many investors now proceed with claims against uninsured brokerages incapable of paying damages.[64]

D. Marketplace Impacts from Insurance Requirements

To forestall any regulation, the financial advice industry will sometimes argue that raising standards would hurt the public because it would reduce their access to financial advice. Opponents of mandatory insurance contend that insurance requirements would do more harm than good by reducing the public's ability to find financial advice. Yet the best available evidence indicates that this simply is not true.

Consider how advice markets reacted to the introduction of existing insurance requirements. After implementing errors & omissions insurance mandates, Oregon and Oklahoma did not experience a reduction in financial advisory services.[65] In fact, after the mandates became effective in each state, the number of investment advisers increased and did not fall relative to other states without a mandate.[66] An in-depth study of the number of investment advisers in Oregon and Oklahoma before and after the mandates introduction shows

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[59] FINRA, REGULATORY NOTICE 18-22 (2018), https://www.finra.org/rules-guidance/notices/18-22.
[60] *See* NASAA, *supra* note 17, at 2.
[61] *See* FINRA, *Discovery Guide*, *supra* note 54.
[62] *Id.*
[63] *See* FINRA, REGULATORY NOTICE 18-22, *supra* note 58.
[64] *See* NASAA, *supra* note 17, at 2.
[65] Chuan Qin & Craig McCann, *RIA Insurance Mandates Didn't Reduce Access to Advisory Services*, SLCG ECONOMIC CONSULTING (Aug. 2024), https://www.slcg.com/resources/blog/713 (last visited Aug. 28, 2024).
[66] *Id.*

that the insurance requirements had no material effect on the number of financial advisers in either state.[67]

Although the benefit to the public will be significant, industry insurance costs appear low relative to the profitability of financial advice firms. After Schwab's insurance requirement for investment advisors, the number of advisors using Schwab's custodial services also increased despite a severe economic downturn.[68]

Despite the marginal cost, insurance requirements may increase the volume of financial advice business. More widespread insurance requirements could drive demand by making the industry easier to trust. With insurance behind the industry, more members of the public may work with advisers.

III. A FRAMEWORK TO IMPROVE INSURANCE COVERAGE

Widespread insurance coverage would likely benefit both investors and financial professionals. Investors would more often recover damages in instances of misconduct and benefit from any risk reductions generated by insurance company requirements. Responsible financial firms already carrying insurance would no longer operate against competitors without insurance.

A. Elements of A Successful Insurance Program

Successful insurance reforms should aim to achieve some core objectives. We propose three here: (1) ensuring appropriate coverage amounts and terms for firm size; (2) generating functioning markets that price risk and reduce misconduct; and (3) providing information about coverage.

1. Appropriate Coverage Amounts and Terms for Firm Size and Characteristics

Although one-size-fits-all insurance coverage requirements do some good by mandating coverage, they also generate problems. A per claim two-million-dollar coverage requirement will be too small for some firms and too large and expensive for others. Rather, insurance requirements must consider the size of the firm and provide coverage requirements proportional to the amount of risk that a firm imposes on the public. Appropriately tailored insurance requirements would ensure adequate coverage without imposing undue costs on financial services firms.

Insurance coverage requirements should increase with a firm's assets under management. Tying a firm's insurance level to its asset level ensures that it will be able to afford appropriate coverage. One simple solution would be to

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[67] *Id.*

[68] SCHWAB, *supra* note 46, at 6.

require firms to maintain the greater of either (1) a million dollars in coverage or (2) insurance coverage equivalent to 2% of assets under management. This would mean that a firm with $99 million in client assets would need just under $2 million in coverage. In contrast, a firm with only $15 million in assets would only need to carry a million in coverage.[69]

Regulators crafting insurance requirements should also ensure that policy terms do not render protective benefits illusory. For example, a firm might acquire coverage with a high per-incident deductible. Functionally, these policies mean that insurance funds will only become available for a claim after the deductible has been met and each claim must meet its own deductible before tapping into coverage. If the insurance policy only applied after the firm spent more than $250,000 in costs for defense, a firm facing five or six claims arising out of selling a toxic financial product to investors might face up-front costs greater than the insurance policy's coverage amount and simply opt to go out of business.

This does not mean that no firms should be able to use higher-deductible coverage. A regulatory response here should aim to preserve flexibility while ensuring that insurance coverage improves outcomes. One solution to this problem would be to require firms using high-deductible policies to hold cash or other high-quality assets equivalent to their insurance deductibles.

Here, risk does not always scale uniformly between firms. Some firms pose heightened risks to the public and might benefit from additional coverage. For example, FINRA internally designates certain firms as "restricted" and selects them for a higher degree of oversight because of the risks their operations pose to the public.[70] Although FINRA does not currently require these firms to carry *any* insurance, a uniform insurance requirement would do enormous good simply by ensuring that these toxic firms carried insurance as well.

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[69] Tying the insurance requirement to a firm's asset level avoids the need to index for inflation or make other changes. As the firms grow, their insurance should grow with them.

[70] *See Rule 4111 Frequently Asked Questions*, FINRA, https://www.finra.org/rules-guidance/key-topics/protecting-investors-from-misconduct#:~:text=Firms%20with%20a%20Significant%20History%20of%20Misconduct,-FINRA%20Rule%204111&text=Rule%204111%20allows%20FINRA%20to,numeric%2C%20threshold%2Dbased%20criteria (last visited Aug. 29, 2024) (explaining that the "rule allows FINRA to impose new obligations on broker-dealers with significantly higher levels of risk-related disclosures than other similarly sized peers, based on numeric, threshold-based criteria").

2. Functioning Insurance Markets Price Risk And Reduce Misconduct

Insurance coverage requirements may generate a range of benefits. At the outset, coverage requirements may reduce prices for insured firms by mandating participation. By requiring all firms to procure insurance, risk pools expand—allowing insurance companies to offer coverage at lower prices through economies of scale.

Well-functioning insurance markets also spread risk across firms. Firms hiring financial advisers may not always be able to determine which advisers will generate liability and which ones will not.[71] By requiring the entire industry to maintain insurance, the cost of financial adviser misconduct gets spread across many different firms.

Yet insurance requirements offer another benefit—the ability to price and limit known risks. To the extent that certain firms or individuals pose greater risks to the public—insurance companies now use that information to price their coverage.[72] Since insurance companies charge more for hiring these high-risk individuals, an insurance requirement may disincentivize firms from hiring them or, at minimum, spread the risk of their bad behavior. These coverage requirements also force riskier firms to internalize the risk their operations create.

For insurance to provide the most benefit, it must cover every financial adviser working with the public. At present, some insurance companies write policies for financial services firms that exclude specific financial advisers from coverage because of identified risks associated with the individual.[73] This creates a gap in coverage for those most likely to create harm.[74]

Requiring firms to procure coverage for these higher-risk advisers would generate real benefits. To the extent that a particular financial adviser is too costly to insure, the insurance market may protect the public more swiftly than a regulatory bar by excluding the individual from the industry.

3. Insurance Disclosure

Insurance disclosure requirements may also ensure that investors benefit from coverage. A good disclosure rule would require all investment advisors and

[71] Pricing financial adviser risk may be challenging because of how much complaint data has been expunged from public records. *See* Benjamin P. Edwards, *Adversarial Failure*, 77 WASH. & LEE L. REV. 1053 (2020) (detailing how a flawed expungement process led to the deletion of public records about complaints against financial advisers).

[72] *See* NASAA, *supra* note 17, at 6 ("[I]n general, a firm may reduce the cost of its policy by excluding a high risk representative from coverage").

[73] *Id.*

[74] *Id.*

broker-dealers to disclose to current and prospective clients information about insurance coverage and provide their current and prospective clients with a copy of their policy upon request.[75] Although this will not ensure that every meritorious claim will be paid, it could keep many harmed investors from going deeper into the hole by pursuing claims against firms unable to pay an award.[76]

Disclosure requirements would also allow more sophisticated investors to select financial advisers with greater coverage. This would allow the market to reward financial advisers for carrying additional insurance. Although this solution would not do much to help unsophisticated clients *ex-ante*, they would be better able to assess their options *ex-post* should a claim arise.

B. Possible Implementation Sources

Although the need for widespread insurance for financial services firms appears clear, no single regulator now possesses the power to mandate insurance across the market. Rather, a range of different overlapping state, federal, and self-regulatory organizations must take steps to introduce insurance requirements.

1. Uniform State Legislation or Regulation

At the outset, states retain substantial influence over financial regulation and directly regulate a subset of investment advisers and brokerage firms.[77] Although states sometimes chart their own course on securities law issues, they often adopt model legislation and regulations promulgated by the North American Securities Administrator's Association. ("NASAA").[78] Nevada, for example, even explicitly statutorily directs its state securities regulator to consult NASAA's model regulations when crafting rules.[79]

By acting through NASAA and generating uniform insurance legislation and regulations, state securities regulators can increase the odds states will enact

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[75] In Re: Waiver of Certain Requirements Under K.A.R. 81-14-9 and New Requirement Authorized By K.A.R. 81-14-10 For Disclosure Regarding Insurance Coverage, 2012 WL 5473856, at 2 (Nov. 7, 2012).

[76] *See* SAMUELS YOELIN KANTOR LLP, *supra* note 48.

[77] *Guide to Broker-Dealer Registration*, SEC (Apr. 2008), https://www.sec.gov/about/reports-publications/divisionsmarketregbdguidehtm#III (Broker-dealers must "apply for broker-dealer registration with each state [they conduct] business"); Advisers Act Rule, 17 C.F.R. § 275.203A-1(a)(1) (providing that advisers with less than $90 million in AUM must withdraw their SEC registration and switch to state registration, advisors with between $100 million and $110 million in AUM may elect to register with the SEC, and advisers with over $110 million in AUM must register with the SEC).

[78] *NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation*, NASAA, https://www.nasaa.org/industry-resources/senior-issues/model-act-to-protect-vulnerable-adults-from-financial-exploitation/ (last visited Aug. 23, 2024).

[79] *See* NEV. REV. STAT. § 90.785(2)(a) (2023).

insurance requirements covering a significant portion of the industry. Uniform regulation also offers an additional benefit—when states take the same approach, it minimizes the burden for firms operating across multiple state jurisdictions.

NASAA has succeeded in generating widespread investor protection reforms in the past. For example, its model legislation to protect vulnerable adults from exploitation has been adopted in most states.[80] NASAA adopted the model legislation in 2016, and most states have enacted it in one form or another, providing substantially greater protection to vulnerable adults in adopting states.

2. Securities and Exchange Commission Action

The SEC may act to impose insurance requirements directly on registered investment advisers and indirectly for brokerage firms.[81] The Commission has direct regulatory authority over registered investment advisers with over $100 million in assets under management.[82] It also enjoys a degree of direct authority over brokerage firms and substantial flexibility through its oversight of the Financial Industry Regulatory Authority.[83]

In an ideal world, all investment advisers and broker-dealers should be required to maintain an errors and omissions insurance policy or policies in the aggregate amount of at least two percent of assets under management as a condition of SEC registration. Yet the road to this goal may be complicated because the Supreme Court recently weakened administrative agencies power to regulate.[84] Under new precedent, courts no longer defer as much to administrative agencies interpreting and applying somewhat ambiguous statutes.[85] This does not mean that the SEC should stand idle for fear of some possible challenge.

a. Investment Advisers

The SEC enjoys substantial authority to increase insurance coverage and might opt to do so in different ways. To simply impose an insurance requirement, the Commission could make insurance a condition of

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[80] *See* NASAA, *supra* note 78.
[81] *See* 15 U.S.C. § 78s(c) (stating that the SEC may by rule "add to, and delete from ... the rules of a self-regulatory organization ... to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this chapter ... or otherwise in furtherance of the purposes of this chapter").
[82] Advisers Act Rule, 17 C.F.R. § 275.203A-1(a)(1).
[83] *See* Benjamin P. Edwards, *Supreme Risk*, 74 FLA. L. REV. 543, 556-60 (2022) (describing the SEC's power to oversee SRO regulation).
[84] *See* Loper Bright Enters. v. Raimondo, 144 S. Ct. 2244, 2265 (2024) (eliminating *Chevron* deference).
[85] *Id*.

registration.[86] Although the law does not explicitly grant the Commission the power to impose an insurance requirement, the Commission would be within its authority to deem carrying insurance "necessary or appropriate in the public interest or for the protection of investors."[87]

In the alternative, the Commission might use its power to regulate arbitration agreements to impose a coverage requirement. Dodd-Frank gave the SEC the power to impose conditions on arbitration agreements.[88] Congress explicitly authorized it to "impose conditions or limitations" on arbitration agreements "if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."[89] As these arbitration agreements often impose significant costs on investors, the SEC may require firms to maintain an insurance backstop ensuring some ability to pay before forcing investors into a costly dispute resolution forum.

At the same time, the Commission might also require investment advisers to make disclosures about their insurance coverage.[90] Although this power would not allow it to impose a mandate to purchase insurance, it would force firms to notify their clients about their insurance coverage.

The Commission might simultaneously adopt a severable coverage and disclosure requirement to address the risk that a federal court would deem the insurance requirement beyond the scope of the Commission's authority.

b. Brokerage Oversight

Brokerage regulation may be more flexible because FINRA, an ostensibly private entity, serves as the primary regulator for brokerages under SEC supervision.[91] At present, FINRA does not need congressional authorization to make investor protection rules.[92] Rather, the self-regulatory

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[86] *See* § 15 U.S.C.A. 80b-3(c)(1) (West) ("An investment adviser. . . may be registered by filing with the Commission an application . . . containing such of the following information and documents as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors").
[87] *Id.*
[88] 15 U.S.C.A. § 78o (West). The Act also grants the SEC authority to impose requirements through self-regulatory organizations, such as FINRA. *Id.*
[89] 15 U.S.C.A. § 80b-5(f) (West).
[90] *Id.*
[91] *See* Edwards, *supra* note 83 at 556-60 (2022) (describing SRO model).
[92] *See FINRA Rulemaking Process*, FINRA, https://www.finra.org/rules-guidance/rulemaking-process#:~:text=Following%20SEC%20approval%2C%20FINRA%20issues,and%20announces%20the%20effective%20date. (last visited Aug. 23, 2024).

organization could simply impose an insurance requirement as a condition of membership.[93]

FINRA also enjoys the power to solve disclosure problems. It maintains a "discovery guide" to facilitate disclosures in securities arbitration.[94] FINRA could ensure insurance disclosure as well by simply finalizing the disclosure rule it considered in 2018.[95]

As the federal regulator overseeing FINRA, the SEC enjoys power to cause FINRA to amend its rules. It could do so informally through moral suasion or explicitly though its power to amend FINRA's rules.[96]

Although the primary regulator for brokerage firms, FINRA could also use its authority to improve investment adviser conduct. Investment advisers generally custody assets through FINRA brokerage firms. FINRA could require that brokerage firms only allow third parties such as investment advisers to manage securities accounts for others if they maintain appropriate insurance. Indeed, as explained above, Schwab has already taken this approach on its own initiative.

IV. CONCLUSION

Ultimately, the need for widespread insurance remains clear. Until now, financial services firms have largely succeeded at externalizing the cost of bad financial advice while keeping the profits for themselves. Insurance solves for some of this problem by causing the industry to internalize some of the costs created by misconduct.

This essay charts a path for improving insurance coverage across a financial advice market governed by a broad coalition of regulators. Although the available tools to impose insurance requirements will differ depending on the regulatory actor, the need remains urgent across the market.

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93 To its credit, FINRA has taken some measures to cause brokerage firms known to pose heightened risks to keep more cash on hand to protect future creditors. *See* FINRA Rule 4111, Restricted Firm Obligations. These requirements would be more effective alongside insurance.

94 *See* FINRA, *supra* note55.

95 *Id.*

96 *See* 15 U.S.C.A. § 78s(c) (West).