November 29, 2021

Via E-Mail to NASAAComments@nasaa.org

Stephen Brey, Patrick Costello and Kristen Standifer
North American Securities Administrators Association, Inc. ("NASAA")
750 First Street, NE, Suite 1140
Washington, DC 20002

RE: Notice of Request for Public Comment Regarding the Proposed Model Rule for Unpaid Arbitration Awards Under the Uniform Securities Acts of 1956 and 2002

Dear Project Group Chairs Brey, Costello and Standifer:

The Financial Industry Regulatory Authority ("FINRA") appreciates the opportunity to comment on NASAA's *Notice of Request for Public Comment Regarding a Proposed Model Rule for Unpaid Arbitration Awards Under the Uniform Securities Acts of 1956 and 2002* ("NASAA's Proposal"). FINRA applauds this effort to address unpaid arbitration awards by providing states with a roadmap to establish clear authority over investment advisers that do not comply with arbitration awards. If adopted in the states, NASAA's Proposal would create a very strong incentive for investment advisers and their representatives to pay arbitration awards entered against them. It would ensure that investment advisers could be held accountable at the state level for their failure to pay arbitration awards from any applicable forum. It would also permit states to consider the failure of a broker-dealer or its registered persons to pay an arbitration award in connection with their investment adviser licensing and remove an incentive for FINRA registered firms or individuals to leave our jurisdiction and continue as an investment adviser because of an unpaid award.

FINRA oversees the broker-dealer industry – approximately 3,400 broker-dealers that conduct business with the investing public in the United States, and the approximately 617,000 registered individuals that they collectively employ. Overseen by the Securities and Exchange Commission ("SEC"), FINRA writes rules, examines for and enforces compliance with FINRA rules and federal securities laws, registers broker-dealer personnel, offers them education and training and informs the investing public.

As part of our mission to protect investors and ensure market integrity, through FINRA Dispute Resolution Services ("DRS"), FINRA administers the largest securities arbitration forum in the United States to assist in the resolution of disputes involving investors, brokerage firms and their registered employees.[1] Consistent

[1] During the past 10 years alone, DRS' arbitration forum has helped resolve over 41,000 intra-industry and customer disputes through arbitration. More information regarding DRS' arbitration forum is available at http://www.finra.org/arbitration-and-mediation.

with our regulatory mission, FINRA has been working to address the important issue of unpaid customer arbitration awards, which are described in more detail below, including publishing a Customer Recovery Paper to encourage a continued dialogue about addressing the challenges of customer recovery across the financial services industry, including recovery in DRS' arbitration forum.[2]

FINRA's Support for the Proposed Model Rule

FINRA commends the NASAA Project Groups for their work on this proposal. As the request for comment recognizes, while FINRA takes action against broker-dealers and their registered individuals who have not paid arbitration awards, FINRA does not have authority over investment advisers or those who leave the broker-dealer industry.

- NASAA's Proposal, if adopted by states, could help encourage investment advisers and their registered persons to pay their arbitration awards, to the benefit of customers, and remove them from the investment advisory business if they fail to do so.
- NASAA's Proposal will also help eliminate regulatory arbitrage. There are several areas where broker-dealers face more scrutiny than investment advisers. Unpaid arbitration awards is one of those areas. As discussed in the Customer Recovery Paper, FINRA's suspension of regulated firms or associated persons for nonpayment of awards applies only to the activities under FINRA's jurisdiction and cannot prevent an individual from continuing to work with retail investors in other parts of the financial services industry, such as by acting as an investment adviser.[3] NASAA's Proposal would take important steps to closing this disparity by permitting states to consider a broker-dealer's failure to pay in connection with their investment adviser licensing, and removing an incentive for FINRA registered individuals to leave a broker-dealer and move to an investment adviser because of an award.
- As highlighted in a recent PIABA report, unpaid awards are also an issue with respect to disputes resolved in federal and state courts, as well as non-FINRA arbitration forums, and may occur in other industries as well.[4] In fact, according

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2 *See* Discussion Paper—FINRA Perspectives on Customer Recovery, http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.

3 *See* FINRA Rule 9554(a). In addition, firms with unpaid awards cannot re-register with FINRA, and individuals cannot register as representatives of any regulated firm, without paying or discharging the outstanding award.

4 Similarly, as is the case with federal and state court systems and other arbitration forums, DRS' arbitration forum does not ensure payment of damages awarded. Arbitration claimants have access to the same collection tools as in a court judgment: if a respondent fails to pay an arbitration award, the claimant may take the award to court and have it converted to a judgment.

to PIABA's report, a significant percentage of investment adviser agreements mandated arbitration be conducted through the American Arbitration Association ("AAA") or the Judicial Arbitration and Mediation Services ("JAMS").[5] Clearly, the NASAA Project Groups also recognize this issue, as the proposed model rule would apply to all unpaid awards, not just those in DRS' arbitration forum. This is an important and critical piece of NASAA's Proposal.

- Conversely, FINRA notes that, while the request for comment references that Exhibit B of NASAA's Proposal would extend the rule to investment advisers, the text in Exhibit B does not appear to include the necessary references to investment advisers. FINRA suggests including the italicized language in the proposed language to amend the investment adviser versions of NASAA's Proposal: "any final judgment or arbitration award resulting from an investment-related, client or customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to between the client or customer and *the investment adviser or investment adviser representative, in writing, and the investment adviser or investment adviser* representative complies with the terms of the alternative payment arrangement(s)," and that corresponding changes be made to the proposed amendments to subparagraphs (x) and (y) of Model Rule USA 2002 502(b) and subparagraphs (x) and (y) of Model Rule 102(a)(4)-1.

FINRA believes a holistic consideration of how customer recovery is (or is not) addressed across related areas of financial services will help inform what steps to better protect customers would be appropriate in the context of each of these areas, and what consequences action in any one area may have for others. For your consideration, the FINRA rules and procedures relating to customer recovery are described below.

Customer Recovery in FINRA Dispute Resolution Services' Arbitration Forum

While broker-dealers and investment advisers often require customers to enter into agreements to arbitrate certain disputes,[6] FINRA rules do not require customers to

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The claimant may then attempt to collect on the judgment using the court's collection procedures. Thus, a customer's recovery depends on factors such as the ability of the respondent to pay, not on whether the customer obtained the award in arbitration or in court.

5 *See* PIABA Report (September 29, 2021).

6 Until the Supreme Court's decision in *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), the courts would not enforce predispute arbitration agreements relating to federal securities law claims. In addition, until its rescission in 1987, SEC Rule 15c2-2(a) provided that: "It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer." As a result of

enter into agreements to arbitrate disputes with regulated firms – nor do FINRA rules preclude customers from pursuing relief in state or federal courts.[7] In DRS' arbitration forum, the majority of customer cases – approximately 69 percent – result in settlements reached by the parties; typically, only about 16 percent of cases proceed to an award, and all awards are made publicly available on FINRA's website.[8] Cases decided by award in DRS' arbitration forum represent a small subset of all cases closed involving customer disputes.

Although a customer claimant can always enforce an arbitration award in court, FINRA will suspend from membership (or association with a regulated firm) any regulated firm or associated person who fails to pay an arbitration award.[9] FINRA also publishes a list of every regulated firm and associated person responsible for unpaid arbitration awards on its website to provide greater transparency regarding those regulated firms and associated persons with unpaid arbitration awards.[10]

McMahon and the rescission of SEC Rule 15c2-2(a), firms can compel arbitration of customer claims through inclusion of predispute arbitration provisions in their customer agreements.

In the Dodd-Frank Act, Congress provided the SEC with explicit authority to prohibit, or impose conditions or limitations on the use of predispute arbitration agreements with customers of any broker, dealer, municipal securities dealer, or investment adviser. *See* Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

7 *See* FINRA Rule 12200.

8 These percentages are based on customer cases closed between 2012-2019. To better inform discussions regarding customer recovery, FINRA also makes available on its website data on unpaid arbitration awards arising in DRS' arbitration forum for the past five years. *See* https://www.finra.org/arbitration-mediation/statistics-unpaid-customer-awards-finra-arbitration. While DRS' arbitration forum is used for both intra-industry and customer disputes, these data are limited to customer disputes.

9 *See* FINRA Rule 9554(a). A firm or associated person or firm has four available defenses to FINRA disciplinary measures for nonpayment in customer cases, including that the firm or individual has filed a petition in bankruptcy and the bankruptcy proceeding is pending or the award payment has been discharged by the bankruptcy court. *See Notice to Members 00-55* (August 2000). In addition, FINRA's Customer Recovery Paper discusses how federal law generally prohibits FINRA from using measures to help enforce collection of the award against a firm or individual that has entered bankruptcy.

In July 2010, FINRA amended its By-Laws to eliminate the "bona fide inability to pay" defense in expedited suspension proceedings when a regulated firm or associated person fails to pay an arbitration award to a customer. *See Regulatory Notice* 10-31 (June 2010).

10 *See* http://www.finra.org/arbitration-and-mediation/member-firms-and-associated-persons-unpaid-customer-arbitration-awards. The list includes the names of firms and individuals whose FINRA registration has been terminated, suspended, canceled or revoked, or who have been expelled from FINRA. These firms and individuals are no longer FINRA regulated firms or associated with a FINRA regulated firm, but they may be operating in another area of the financial services industry where FINRA registration is not required. The list also shows those firms and individuals with unpaid arbitration awards, but where bankruptcy is a defense to non-payment.

This information is also publicly available through the firm's or associated person's BrokerCheck® record. As noted earlier, FINRA's suspension for nonpayment of awards cannot prevent the individual from continuing to work with retail investors in other financial services industries, such as by acting as an investment adviser. FINRA suggests that the states consider providing similar disclosures for investment advisers.

Recently, FINRA developed several rules to help address non-payment of awards:

- Effective July 20, 2020, FINRA amended its rules to prevent a regulated firm that has been terminated, suspended, expelled, or is out of business from enforcing predispute arbitration agreements with customers.[11] FINRA also changed the claim service process to notify claimants systematically if a regulated firm or individual is not registered, and informs the customer that awards against such firms or associated persons have a much higher incidence of non-payment and that FINRA has limited disciplinary authority over inactive firms or associated persons that fail to pay arbitration awards. Upon learning that the firm or associated person is inactive, a customer may determine to amend his or her claim to add others from whom the customer may be able to collect an award.

- Effective September 14, 2020, FINRA amended its membership application program rules to help prevent a regulated firm with substantial arbitration claims from avoiding payment of potential awards or settlements by shifting its assets to another firm and closing down.[12] The amendments also address situations in which regulated firms are considering hiring individuals with pending arbitration claims, where there are concerns about payment of potential awards or settlements, or adequate supervision of those individuals.

- Between April 15 and September 1, 2021, new FINRA rules became effective that: 1) allow a Hearing Officer to impose conditions or restrictions on the activities of a respondent firm or associated person, and require a regulated firm employing such person to adopt heightened supervisory procedures when a disciplinary matter is appealed, or called for review by, to the National Adjudicatory Council; 2) require regulated firms to adopt heightened supervisory procedures for statutorily disqualified associated persons while an application request is under review; 3) require disclosure through BrokerCheck® of the status of a regulated firm as a "taping firm"; and 4) require a regulated firm to submit a written request to FINRA seeking a materiality consultation and approval of a continuing membership application, if

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These firms and individuals may still be active in the broker-dealer industry due to the bankruptcy defense to non-payment.

11 *See Regulatory Notice* 20-11 (June 2020).

12 *See Regulatory Notice* 20-15 (May 2020).

applicable, when a natural person seeking to become an owner, control person, principal, or registered person of the regulated firm has, in the prior five years, at least one "final criminal matter" or at least two "specified risk events."[13]

- The SEC approved new FINRA Rule 4111 on July 30, 2021. Effective January 1, 2022, regulated firms designated as "Restricted Firms" must deposit cash or qualified securities in a segregated, restricted account and adhere to specified conditions or restrictions.[14] One of the many ancillary benefits may be to help address unpaid arbitration awards. For example, Rule 4111 requires consideration of both unpaid arbitration awards and "Covered Pending Arbitration Claims," among other things, in determining a Restricted Firm's "restricted deposit requirement."[15] It also includes presumptions that apply in FINRA's assessment of an application by a previously designated Restricted Firm to withdraw funds from its restricted deposit that would further incentivize the payment of arbitration awards.[16]

The measures described above have helped and will help customers obtain more timely judgments against firms and associated persons, but do not always enable customers to collect awards. Ultimately, it can be difficult for customers to collect from firms or associated persons that are no longer in the broker-dealer industry, whether the customer has an arbitration award or a court judgment. To help further protect customers, FINRA suggests that the states consider future steps with respect to investment advisers that are analogous to the measures described above. FINRA appreciates the opportunity to share our support and comments with the NASAA Project Groups. We look forward to engaging with NASAA in these efforts to address the challenges of customer recovery across the financial services industry. If you have any questions concerning these comments, please contact Kyle Innes of FINRA at kyle.innes@finra.org or 646-315-7367.

Sincerely,

Robert L.D. Colby
Executive Vice President and
Chief Legal Officer
FINRA

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[13] *See Regulatory Notice* 21-09 (March 2021); FINRA Rule 1011(h) (defining "final criminal matter") and (p) (defining "specified risk event").

[14] *See* FINRA Rule 4111(i)(16) (defining "Restricted Firms").

[15] *See* FINRA Rule 4111(i)(2) and (15) (defining "Covered Pending Arbitration Claims" and "Restricted Deposit Requirement").

[16] *See Regulatory Notice* 21-34 (September 2021); FINRA Rule 4111(f)(3).