REQUEST FOR PUBLIC COMMENT REGARDING A PROPOSED MODEL RULE FOR UNPAID ARBITRATION AWARDS UNDER THE UNIFORM SECURITIES ACTS OF 1956 AND 2002

October 5, 2021

Deadline for Public Comment: November 4, 2021

The Broker-Dealer Market and Regulatory Policy and Review Project Group, the Broker-Dealer Arbitration Project Group, and the Investment Adviser Regulatory Policy and Review Project Group (the "Project Groups") of the North American Securities Administrators Association, Inc. ("NASAA") are seeking public comment on proposed model rules (the "Model Rules") to provide member jurisdictions with an additional tool to address unpaid Financial Industry Regulatory Authority ("FINRA") arbitration awards by broker-dealers, agents, investment advisers, and investment adviser representatives. Ultimately, the Model Rules will serve as bases for enforcement actions related to unpaid awards and allow member jurisdictions to prevent the registration of firms and individuals, whether as broker-dealers, agents, investment advisers, or investment adviser representatives, if the firm or individual has outstanding FINRA arbitration awards or other regulatory obligations.

The Model Rules, attached hereto as Exhibits A and B, will add the following provisions to the dishonest or unethical business practices of broker-dealers, agents, investment advisers, and investment adviser representatives:

- Failing to satisfy an arbitration award resulting from a client or customer-initiated arbitration;
- Attempting to avoid payment of any client or customer-initiated arbitration; and
- Failing to satisfy the terms of any order resulting from a regulatory action taken against the registrant.

Please send any comments on the proposed Model Rules by November 4, 2021. At this time, we are only able to accept electronic submissions. Please email your comments to NASAA at NASAAComments@nasaa.org with a cc: to the Project Group Chairs, Kristen Standifer (kstandifer@dfi.wa.gov), Patrick Costello (patrick.costello@sec.state.ma.us), and Stephen Brey (breys@michigan.gov).

Thank you.

I. Background

FINRA arbitration is often the only viable option for customers seeking recourse for the misconduct of their broker-dealers or agents. Broker-dealers often require customers opening accounts to agree in writing to arbitrate disputes. Investment advisers may also use the FINRA forum to settle client disputes. However, investors who pursue FINRA arbitration claims cannot always recover on their awards. In these situations, investors are left both defrauded and without restitution while the firms and/or individuals may continue to operate within the financial services industry.

A. Scope of Unpaid Awards[1]

Year Award Issued	Total Amount Awarded	Total Unpaid Award Amount
2015	$203M	$24M
2016	$119M	$14M
2017	$84M	$22M
2018	$92M	$31M
2019	$96M	$19M

B. Need for Additional Measures

Under FINRA rules, a respondent must pay a monetary award within 30 days of receipt, unless the respondent has a defense to non-payment.[2] If a FINRA member firm or associated person fails to comply with an arbitration award or a settlement agreement related to an arbitration, FINRA may suspend the membership of the firm or the associated person.[3] Although FINRA prevents the suspended firm or associated person from being an active FINRA member or associating with a FINRA member until the award has been satisfied, suspended firms and individuals may still register with NASAA member jurisdictions in other capacities, such as an investment adviser or investment adviser representative.

The Model Rules would form the basis for enforcement actions related to unpaid awards and allow NASAA member jurisdictions to prevent the registration of firms and individuals in any capacity if the firm or individual has an outstanding arbitration award.

[1] https://www.finra.org/arbitration-mediation/statistics-unpaid-customer-awards-finra-arbitration.
[2] *See* FINRA Rule 12904(j).
[3] *See* FINRA Rule 1014.

II. Drafting Considerations and Additional Solutions

The Broker-Dealer Project Groups met during the 2019 NASAA Broker-Dealer Training to address the issue of unpaid arbitration awards. The Broker-Dealer Project Groups drafted the provisions of the Model Rule addressing the failure to satisfy an arbitration award resulting from a customer-initiated arbitration, and the attempt to avoid payment of any customer-initiated arbitration.

After the in-person meeting, the Broker Dealer Project Groups coordinated with the Investment Adviser Section Regulatory Policy and Review Project Group to discuss jointly issuing a rule. Together the Project Groups refined the rule language and added a third section, addressing failure to satisfy the requirements of an order issued in a regulatory action. The complete model rule proposes to include three additional provisions to the enumerated practices classified as dishonest or unethical business practices for broker-dealers, agents, investment advisers, and investment adviser representatives.

Although states currently lack specific authority to take direct action against a firm or individual with an unpaid arbitration award except in circumstances where the unpaid award results in the firm or individual being insolvent, other tools attempt to address the problem. The Project Groups continue to track the efficacy of other solutions and the progress of certain proposals, including:

- The proposed creation of a recovery fund to cover the cost of unpaid arbitration awards. Limitations of this proposal include:
    - Recovery funds must be set up by each state or federally and even though the insurance industry has an industry-wide recovery fund and at least one state created a fund, there is not yet widespread political support for a recovery fund to address the issue of unpaid arbitration awards.
    - The amount of the recovery fund would be finite and may not entitle investors to complete recovery of the unpaid award.
    - Payouts would be delayed to allow all impacted investors to file a claim.
    - Does not address the conduct of the individual or firm.

- The requirement that firms and individuals maintain errors and omissions (E&O) insurance.
    - NASAA members do not have the authority under NSMIA to require broker-dealers to obtain E&O coverage.
    - However, on the investment adviser side, at least one state mandates that its state registered investment advisers obtain E&O insurance.
    - Suggestions of E&O coverage as a potential solution have met with industry resistance on the grounds that it is too expensive and too difficult for smaller

firms to obtain. However, the 2019 survey by the Broker-Dealer Section Market and Regulatory Policy and Procedure Project Group demonstrated that 77% of the broker-dealer firms surveyed had E&O insurance and the policies paid claims.

- Similar to the recovery fund, there is not yet widespread support for an insurance mandate.
- Coverage is provided for arbitration awards; however high risk alternative products and fraud, two areas ripe for arbitration awards, are typically excluded from coverage.

- Applicable FINRA Rules include:
  - FINRA Rule 1013 requires an applicant for FINRA membership to notify FINRA of any arbitration claim against the applicant or associated persons that is filed, awarded, or becomes unpaid during the application process.
  - FINRA Rule 1014 provides the criteria used by FINRA in reviewing new and continuing membership applications. FINRA Rule 1014 allows FINRA to deny and suspend membership of firms or individuals with unpaid arbitration awards. However, firms or individuals may continue to operate elsewhere in the financial services industry where FINRA registration is not required, including acting as an investment adviser.
  - FINRA Rule 1017 addresses a member's application for approval of change in ownership, control or business operations and prevents executive officers of a broker-dealer with an unpaid arbitration award from being an executive officer of another broker-dealer. Like Rule 1014 above, this Rule does not prevent individuals from registering in other sectors of the financial services industry.
  - FINRA Rule 4111 requires restricted firms to set aside funds that cannot be withdrawn without permission from FINRA (one permissible use: pay unpaid arbitration awards). This rule only applies to a narrowly defined class of "restricted firms". A firm would not be considered restricted until it has extraordinary disclosure events based on a formula FINRA has not made public. The amount of restricted funds required to be set aside may not be enough to cover an unpaid arbitration award.

III. Overview of the Model Rules

The broker-dealer version of the Model Rule is comprised of three provisions, each of which addresses a subset of the unpaid award problem or a slightly different version of the problem of unpaid awards. Below is a section-by-section overview of the proposed Model Rule, with accompanying explanations of each provision.

1. Failing to pay and fully satisfy any final judgment or arbitration award resulting from an investment-related, customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to between the customer and the broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangement.

   This provision addresses primarily situations in which a firm or individual fails to satisfy an arbitration award resulting from a customer-initiated arbitration.

2. Attempting to avoid payment of any final judgment or arbitration award resulting from an investment-related, customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to between the customer and the broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangements.

   This provision addresses any measures or steps a firm or individual takes in order to avoid payment of any client or customer-initiated arbitration award such as asset transfers that leave behind no financial resources for payment of judgments or arbitration awards. It would also address situations where an individual acted as a manager, partner, executive officer, etc. for a series of firms that failed to pay customer-initiated arbitration awards and the individual moved to a new firm.

3. Failing to pay and fully satisfy any fine, civil penalty, order of restitution, order of disgorgement, or similar monetary payment obligation imposed upon the broker-dealer or agent by the Securities and Exchange Commission, the securities or other financial services regulator of any state or province, or any self-regulatory organization.

   This catchall provision addresses failures by a firm or individual to satisfy the terms of any order resulting from a regulatory action taken against the registrant.

The investment adviser versions of the Model Rule amendments come in two forms and are included as Exhibit B. One version amends NASAA Model Rule USA 2002 502(b) Prohibited Conduct in Providing Investment Advice ("2002 IA Rule), while the other amends NASAA Model Rule 102(a)(4)-1 Unethical Practices of Investment Advisers, Investment Adviser Representatives, and Federal Covered Advisers ("1956 IA Rule"). The language of the 2002 IA Rule and 1956 IA Rule proposed amendments are identical to each other, and deviate only slightly from the broker-dealer version of the proposed Model Rule:

(x) Failing to pay and fully satisfy 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 broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangement.

(y) Attempting to avoid payment of 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 broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangements.

(z) Failing to pay and fully satisfy any fine, civil penalty, order of restitution, order of disgorgement, or similar monetary payment obligation imposed upon the investment adviser or investment adviser representative by the Securities and Exchange Commission, the securities or other financial services regulator of any state or province, or any self-regulatory organization.

The proposed amendments to the 2002 IA Rule and the 1956 IA Rule differ from the broker-dealer version of the Model Rule only in that they include the phrase "client" in addition to customer-initiated arbitration proceedings. This reflects the industry verbiage on the advisory side as well as the broker-dealer side. These provisions are primarily directed at conduct that occurs on the broker-dealer side of the industry, and is intended to prevent bad actors from exiting the broker-dealer regulatory regime, and becoming investment advisers and investment adviser representatives.

IV. Requests for Comment

The Project Groups request public comment on all aspects of the proposed Model Rules. In particular, the Project Groups submit the following questions for public consideration:

1. Are there issues related to unpaid customer-initiated arbitration awards that the proposed rules would not address?

2. The "automatic stay" under the Bankruptcy Code generally stays any action to collect a debt owed by a person that has filed a bankruptcy petition. In light of this, is additional language necessary in the second provision to clarify that proposed rules do not interpret a bankruptcy filing as an attempt to avoid payment of any final judgment or arbitration award?

3. Does the broad reach of paragraph three undermine the focus on unpaid customer-initiated arbitration awards?

4. Are there other ways to address unpaid customer-initiated arbitration awards?

5. What concerns do you have about the proposed rules?

EXHIBIT A

Rule ___. [ ]

Add a new provision to the Dishonest or Unethical Business Practices of Broker-Dealers and Agents section 1:

u. Failing to pay and fully satisfy any final judgment or arbitration award resulting from an investment-related, customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to between the customer and the broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangement.

Add a new provision to the Dishonest or Unethical Business Practices of Broker-Dealers and Agents section 1:

v. Attempting to avoid payment of any final judgment or arbitration award resulting from an investment-related, customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to between the customer and the broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangements.

Add a new provision to the Dishonest or Unethical Business Practices of Broker-Dealers and Agents section 1:

w. Failing to pay and fully satisfy any fine, civil penalty, order of restitution, order of disgorgement, or similar monetary payment obligation imposed upon the broker-dealer or agent by the Securities and Exchange Commission, the securities or other financial services regulator of any state or province, or any self-regulatory organization.

Amend section 2f:

Engaging in conduct specified in Subsection 1.b,c,d,e,f,I,j,n,o,p,q, [u, v, or w].

EXHIBIT B

Rule USA 2002 502(b) Prohibited Conduct in Providing Investment Advice

A person who is an investment adviser, an investment adviser representative or a federal covered investment adviser is a fiduciary and has a duty to act primarily for the benefit of its clients. The provisions of this subsection apply to federal covered investment advisers to the extent that the conduct alleged is fraudulent, deceptive, or as otherwise permitted by the National Securities Markets Improvement Act of 1996. While the extent and nature of this duty varies according to the nature of the relationship between an investment adviser, an investment adviser representative or a federal covered investment adviser and its clients and the circumstances of each case, an investment adviser, an investment adviser representative or a federal covered investment adviser shall not engage in prohibited fraudulent, deceptive, or manipulative conduct, including but not limited to the following:

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(x) Failing to pay and fully satisfy 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 broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangement.

(y) Attempting to avoid payment of 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 broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangements.

(z) Failing to pay and fully satisfy any fine, civil penalty, order of restitution, order of disgorgement, or similar monetary payment obligation imposed upon the investment adviser or investment adviser representative by the Securities and Exchange Commission, the securities or other financial services regulator of any state or province, or any self-regulatory organization.

Rule 102(a)(4)-1 Unethical Business Practices Of Investment Advisers, Investment Adviser Representatives, And Federal Covered Advisers

A person who is an investment adviser, an investment adviser representative or a federal covered adviser is a fiduciary and has a duty to act primarily for the benefit of its clients. The provisions of this subsection apply to federal covered advisers to the extent that the conduct alleged is fraudulent, deceptive, or as otherwise permitted by the National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290). While the extent and nature of this duty varies according to

the nature of the relationship between an investment adviser or an investment adviser representative and its clients and the circumstances of each case, an investment adviser, an investment adviser representative or a federal covered adviser shall not engage in unethical business practices, including the following:

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> (x) Failing to pay and fully satisfy 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 broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangement.
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> (y) Attempting to avoid payment of 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 broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangements.
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> (z) Failing to pay and fully satisfy any fine, civil penalty, order of restitution, order of disgorgement, or similar monetary payment obligation imposed upon the investment adviser or investment adviser representative by the Securities and Exchange Commission, the securities or other financial services regulator of any state or province, or any self-regulatory organization.

The conduct set forth above is not inclusive. Engaging in other conduct such as non-disclosure, incomplete disclosure, or deceptive practices shall be deemed an unethical business practice. The federal statutory and regulatory provisions referenced herein shall apply to investment advisers, investment adviser representatives and federal covered advisers to the extent permitted by the National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290).