Public Investors Arbitration Bar Association Report

UNPAID ARBITRATION AWARDS

A PROBLEM THE INDUSTRY CREATED – A PROBLEM THE INDUSTRY MUST FIX

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Acknowledgements[2]

There is a debate raging right now over what duty a broker should have towards an investor. Should a broker be held to a fiduciary standard, and act in the best interests of his or her clients, avoiding all conflicts of interest; or, should a broker be held to the suitability standard? However, there is a second, equally important and arguably more fundamental, issue to be considered.

In the event an investor can establish that a broker has violated whatever standard is applicable, and overcome the hurdles inherent in the dispute resolution process,[3] there is still one more hurdle for the investor to overcome. The arbitration award is meaningless if the broker or brokerage firm does not have the resources to pay the award. Unfortunately, this is an all too common problem, and has been for quite some time.

Approximately fifteen years ago, the U.S. Government Accounting Office issued a report addressing a previously unquantified issue: unpaid securities arbitration awards. Not only did the GAO quantify the issue, but it set forth a number of suggested cures. Unfortunately, as the years have passed, few of the suggested cures have actually been implemented and the problem appears to be on the rise again – a surprising turn given the fact that the markets have (until very recently) been on an upward trending glide path.

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[2] It is impossible to overstate the value of Robin Ringo, PIABA's executive director, and the entire PIABA staff, without whom I could not have gathered and analyzed the award data discussed in this report. I would also like to thank Marnie Lambert, PIABA's Executive Vice President, as well as David Neuman and Christine Lazaro, two PIABA board members, for their help in editing this Report. Finally, the author would like to thank fellow PIABA member Scot Bernstein, who addressed the topic in 2004.

[3] See Jason Doss, on behalf of PIABA, The Importance of Arbitrator Disclosure, available at: https://piaba.org/system/files/pdfs/The%20Importance%20of%20Arbitrator%20Disclosure%20(October%207,%202014).pdf.

FINRA has been reticent to publish information regarding unpaid awards, with good reason. The latest information, and the first since a news article published in 2013, indicates that $62.1 million of customer awards issued in 2013 were unpaid. The Public Investors Arbitration Bar Association's ("PIABA's") analysis of the 2013 awards reveals that more than 1 out of 3 cases investors take through to an arbitration hearing and win an award assessing liability and damages goes unpaid. Viewed differently, nearly $1 of every $4 awarded to investors in arbitration hearings goes unpaid.

The industry promotes itself as offering the advice necessary for investors to meet their financial goals, plan for their retirement, and maintain their wealth. However, there is a fundamental disconnect between the industry's efforts to promote investors' financial health (using the industry's services, of course) while at the same time not ensuring that the firms maintain their own financial health. Firms are entrusted with investors' life savings and retirement funds, and when an arbitration award is issued granting investors damages as a result of sales practice abuses (or other wrongdoing on the firm's behalf), too many firms lack sufficient funds to meet that obligation. And investors are left with no recourse.

Members of PIABA and their clients face the problem of underfunded, if not outright insolvent, brokerage firms and individual brokers on an all-too-frequent basis. Investors are invariably stunned to learn that their trusted financial advisors are not required to maintain insurance, that their firms are thinly capitalized at best, and that the likelihood of collecting a significant award is therefore compromised. This serious problem requires immediate attention.

The Nature of the Problem

The industry actively promotes financial health for investors – and in the abstract, that is a good thing. Take, for example, the mission statement of the Center for Financial Services Innovation:

> Our mission is to improve the financial health of Americans, especially the underserved, by shaping a robust and innovative financial services marketplace with increased access to higher quality products and practices.[4]

The Center for Financial Services Innovation is supported by a number of industry members, such as American Express, Bank of America, Charles Schwab Bank, Capital One, Citi, Morgan Stanley, U.S. Bank, and the New York Stock Exchange Euronext Foundation. The CFSI's motivation is also included in its mission statement:

[4] *See* http://www.cfsinnovation.com/About-Us/Mission-and-Vision.

> We believe finance can be a force for good in people's lives, and that serving the needs of consumers responsibly is ultimately more profitable for the financial services industry.[5]

Brokerage firms make direct pleas for investors to maintain financial health. A good example can be found in the Merrill Lynch Advisor Special Health Issue: "Your Health Your Money."[6] Merrill's publication discusses in detail the tie between physical and financial health. Morgan Stanley has done the same in its piece: "Integrated Wealth Planning: A Healthy Approach to Address Concerns About the Changing Medical Care Landscape."[7] Morgan Stanley urges investors to "navigate changes in U.S. health care and learn how new dynamics may affect their wealth management strategy."[8] Brokerage firms preach the importance of investors maintaining healthy finances in order to weather unpredictable maladies.

There is more than a small amount of irony in the fact that so many brokerage firms do not follow their own advice and fail to ensure that they can withstand customer claims arising from sales practice violations. Take, for example, the plight of Securities America. In 2010, it was found to be the fifth largest independent brokerage firm in the country.[9] The firm boasted that it had more than 1,900 "financial professionals worldwide" with more than $53 billion in client assets under those "professionals'" supervision.[10] On March 1, 2011, Securities America reported that its 2010 year end net capital was $1,991,058 – which was above its required $250,000.[11] As of June 2011, the firm advertised itself as the seventh largest independent brokerage firm in the nation.[12] Yet, a mere three months earlier, in March 2011, three weeks after reporting it had nearly 8 times the required net capital, Securities America's CFO testified in open court that if a limited fund class action settlement was not approved, the firm "might have to close."[13] More specifically, the CFO testified that "if a settlement was not approved, the firm would go out of business soon, due to defense costs

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5 Id.

6 A copy of the publication is available at https://www.ml.com/publish/pdf/ml-advisor-health-issue-2015.pdf.

7 https://www.morganstanley.com/public/04092014.html.

8 Id.

9 "The Biggest, Fastest Growing Independent Broker-Dealers," Financial Planning (June 2010), available at: http://daweswealthmanagement.com/pdf/financialplan.pdf.

10 Securities America press release (May 18, 2010), available at: http://www.securitiesamerica.com/downloads/SAI_NatlConference_Pre_4-28%2010_v3.pdf.

11 Form X17A05, SEC File No. 8-26602 (Mar 1, 2011), available at http://www.sec.gov/Archives/edgar/vprr/1101/11016481.pdf. See p. 12. The calculation of net cap requirements is complicated, but is addressed in summary fashion beginning at pp. 14-18, *infra*.

12 http://www.saionline.com.

13 Bruce Kelly, "Securities America on brink without legal settlement, CFO says arbitration awards would cripple firm," Investment News (Mar. 20 2011), available at http://www.investmentnews.com/article/20110320/reg/303209979/securities-america-on-brink-without-legal-settlement.

and arbitration awards."[14] Securities America sold $400 million of private placements that were in default (thanks to the fact that the investments were, in fact, Ponzi schemes), and therefore faced actions brought by various state regulators and individual investors. Obviously, the firm did not carry insurance sufficient to allow it to withstand the onslaught of claims, or it would not have threatened to shutter if the proposed settlement was declined.

Facing hundreds of millions of dollars of liability to investors, Securities America bargained from a position of weakness: take $X or we'll file for bankruptcy. Those negotiating on behalf of investors had to gamble on whether Securities America's parent company would save the struggling brokerage firm. "Securities America says it does not have enough money to pay all the potential damages, but plaintiffs' lawyers are betting deep-pocketed Ameriprise will ultimately make its unit's customers whole and keep a firm with 1,800 independent brokers afloat."[15] While there are conflicting reports regarding the actual extent of Ameriprise's participation in the settlement of the claims against Securities America, there is no doubt that Ameriprise did provide some financial means for the settlement and thereafter Ameriprise ended up selling Securities America in the wake of the debacle.[16] Once again – this entire debacle happened to the seventh-largest independent brokerage firm in the nation. The problem, of course, is not limited to independent brokerage firms. The financial meltdown of 2008 saw established and well-respected firms Bear Stearns and Lehman Brothers collapse. When a brokerage firm shuts down, for whatever reason, the likelihood that any arbitration awards against the firm will be paid is slim if not entirely non-existent.

The Size of the Problem

FINRA, like the NASD before it, does not publish a summary figure of any particular year's unpaid awards. The first data is seemingly found in the June 2000 GAO report. Curiously, the GAO did not rely on NASD for the data. The GAO found that "NASD did not have procedures to monitor whether awards were paid, but it did follow up when investors complained. These complaints were the only source of information NASD had on unpaid or partially paid awards."[17]

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[14] Bruce Kelly, "CFO: Securities America on the brink without legal settlement," Investment News (Mar 18, 2011), available at http://www.investmentnews.com/article/20110318/FREE/110319929/cfo-securities-america-on-the-brink-without-legal-settlement.

[15] Joseph Giannone, "Exclusive: Ameriprise may let brokerage go under," Reuters (Mar 24, 2011), available at http://www.reuters.com/article/us-ameriprise-securitiesamerica-idUSTRE72N4K320110324.

[16] Suzanne Craig, "Ameriprise to Sell Securities America," Dealbook (Apr 25, 2011), article available at http://dealbook.nytimes.com/2011/04/25/ameriprise-to-sell-securities-america/?_r=0.

[17] GAO, "Securities Arbitration, Actions Needed to Address Problems of Unpaid Awards," at 7 (June 2000), available at http://www.gao.gov/products/GGD-00-115. It should be noted that the focus naturally fell upon arbitration awards since the vast majority of customer disputes are resolved in arbitration, rather than court. In 1987, the U.S. Supreme Court held that pre-dispute arbitration clauses were enforceable in the *Shearson/American Express v. McMahon* case, 482

Since NASD, the entity tasked with administering the securities arbitration process, had no data, the GAO conducted its own study. "GAO developed its estimates by surveying a random probability sample of 247 of the 845 investors who received monetary awards in cases decided in 1998. Nearly all of the nonpayments involved NASD-decided cases."[18]

The results of the initial GAO survey were surprising. "GAO estimated that about 500 NASD awards to investors in 1998 either were unpaid or were partially paid."[19] The GAO estimated that 64% of NASD awards were unpaid in 1998.[20] While that percentage is shockingly high, the dollar figures were staggering. GAO estimated that unpaid awards totaled $129 Million, or 80% of the $161 Million awarded in 1998.[21] The larger awards were the ones that were far less likely to be paid: 44% of the awards under $100,000 were paid in full while 5% of the awards in excess of $1.15 Million were paid in full.[22]

The GAO reported the most frequent reasons for the unpaid awards: (1) the broker/dealer was out of business; (2) the broker/dealer claimed to be financially unable to pay the award; (3) the individual broker owing all or part of the award could not be found; and, (4) the broker/dealer filed for bankruptcy.[23] Reasons one, two and four are substantially similar: the broker/dealer simply did not have the financial resources to pay the award. Obviously, those firms failed to maintain the sort of financial health the industry recommends that individual investors maintain.

Over the next decade, NASD and then FINRA continued to fail to report or publicize the extent of unpaid awards. The next data was instead publicized by Wall Street Journal reporters, Jean Eaglesham and Rob Barry, in 2013. They reported:

> Finra said $51 million of arbitration awards granted in 2011 remain unpaid. That is 11% of the total awards that year, compared with the unpaid levels of 4% for 2010 and 2009. Finra declined to provide more-recent data.[24]

The statistic was notable for a variety of reasons. First, the data was reported by the media, not FINRA. FINRA provided the information to a reporter upon her request, but failed to make the data readily available to investors. Second, while

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U.S. 220 (1987). Since then, virtually every brokerage firm has included arbitration clauses in their customer agreements, and virtually every customer dispute has therefore been heard in arbitration, not court.

[18] Id.

[19] Id.

[20] Id. at 33.

[21] Id. at 34.

[22] Id.

[23] Id. at 35.

[24] Jean Eaglesham and Rob Barry, "More Than 5,000 Stockbrokers from Expelled Firms Still Selling Securities," Wall Street Journal (October 4, 2013).

the article was published in late 2013, it referenced data for 2011. No comment was made regarding why information for 2012 was not readily available.

By this point, it should be no surprise that detailed information regarding the extent of unpaid awards continued to be unavailable on FINRA's website or other publications. The next and most recent figure reported was in late 2015, via the FINRA Arbitration Task Force Report, issued December 16, 2015. FINRA drafted the 13-member task force in July 2014, and asked the group to suggest strategies to enhance the transparency, impartiality, and efficiency of FINRA's arbitration forum. Page 50 of the report addresses the unpaid award issue.[25] The report notes that FINRA issued arbitration awards in 539 customer cases in 2013, with 75 of those awards going unpaid, for a total of $62.1 million.[26] The majority of the unpaid awards were against brokerage firms or associated persons no longer registered in the industry.[27]

Unfortunately, the Task Force Report does not contain information sufficient to put the unpaid award problem into context. For example, while $62.1 million seems to be a high number for unpaid awards, especially since the market has improved since 2011 when the unpaid awards were reported at $51 million, FINRA does not report the *total* dollar amount awarded in investors' favor in 2013. Taken on its face, we are left to guess whether the unpaid awards comprise 75% of the total awards issued, or 5%. Neither does FINRA provide any information regarding the size of the unpaid awards. We do not know whether there is one $60 million unpaid award and then 74 additional unpaid awards that total $2 million. FINRA also does not indicate how many brokerage firms and/or associated persons failed to pay the requisite awards.

Knowing that a context for the problem was important, if not critical, to framing the issue, the author contacted FINRA to ask for information, including: how many firms/persons were found liable in the 75 unpaid awards; of the 51 awards taken against person or firms no longer in the industry, how many different firms and persons were involved in those awards; the size of the individual unpaid awards; and the total amount of damages issued to customers in 2013. FINRA responded, indicating: it did not have the requested data available; compiling the data would require a great deal of staff resources and time; and, FINRA will not make a determination of whether the requested data would be made available for several months. FINRA's refusal to provide the data, either to the Task Force or the author, is puzzling given its professed interest in promoting transparency in the arbitration process. The Task Force Report starts with an explanation of the purpose of the Task Force: "FINRA formed a task force in June 2014, to consider possible enhancements to its arbitration and mediation forum . . .. FINRA charged this group to work together to suggest

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[25] FINRA Dispute Resolution Task Force, Final Report and Recommendations of the FINRA Dispute Resolution Task Force, available at https://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf, hereinafter the "Task Force Report."

[26] Id. at 50.

[27] Id.

strategies to enhance the transparency . . . of FINRA's securities dispute resolution forum . . .."[28] And, while the word "transparency" appears time and time again through the task force report, there is an entire section of the report titled "Transparency." The Task Force recommended, among other things, "FINRA should adopt a policy of promoting, to the maximum extent possible, transparency about its dispute resolution forum."[29] And yet FINRA chose to provide the Task Force with limited information regarding the unpaid award issue and refused to provide anything further to put the data it did provide into context.

While PIABA would prefer to use data provided by FINRA to put the issue into context, FINRA has declined to promote transparency and declined to provide the requested information. Accordingly, PIABA staff delved into its database of awards. PIABA receives from FINRA every reported award and catalogs those awards in a database. Staff pulled every award issued in 2013. Awards issued in industry disputes were removed, leaving 836 awards issued in customer cases. Narrowing the results to awards issued in Claimants' favor, PIABA found 225 awards in which some amount of damages was awarded to Claimants.[30]

The FINRA task force report stated that there were 75 awards issued in 2013 that went unpaid. Put into context, 33.3% of awards in Claimants' favor went unpaid in the context of the number of awards issued.[31]

How, then, does the \$62.1 million of unpaid awards relate to the total damages issued to investors? The awards to Claimants totaled \$256,749,289.[32] The unpaid awards comprise 24.2% of the total.[33]

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[28] Task Force Report at p. 1.

[29] Task Force Report at p. 44.

[30] PIABA is at a loss to determine why it found 225 awards granting Claimants some amount of damages in 2013 where FINRA's official statistics page states that there were 212 such awards during that time period. *See* http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics. It should be noted that PIABA's figure does *not* include arbitration awards in investors' favor which were later overturned by a court of competent jurisdiction.

[31] If we use FINRA's statistic of 212 awards issuing damages to Claimants, unpaid awards comprise more than 35% of the awards.

[32] The dollar figure is drawn from the awards themselves. Curiously, FINRA's BrokerCheck system occasionally identified a different sum awarded to a particular investor. For example, three Claimants in case 11-04766 were granted an award totaling \$111,000. BrokerCheck indicated an award of \$37,000. PIABA relied on the awards themselves, not the BrokerCheck figures since PIABA was unable to understand why BrokerCheck's figures were occasionally different than the awards.

[33] FINRA, by failing to identify *which* awards were unpaid, made it impossible for PIABA to confirm FINRA's reported \$62.1 million of unpaid awards. PIABA analyzed the 225 Claimant awards it found and identified 76 such awards in which one or more of the Respondents were no longer licensed by FINRA, which is different than the 51 such awards FINRA reported to the Task Force. PIABA found that some of the Respondents' licenses were pulled before the awards were issued, and others were pulled later. If one were to presume the awards against unlicensed Respondents are the unpaid awards (presuming further that a majority of the license revocations

This bears repeating: 1 in 3 cases where an investor pursues the case through to hearing and is awarded some damages is actually meaningless because the investor does not recover anything. Viewed differently, almost 1 dollar of every 4 dollars awarded to Claimants goes unpaid. It must be noted that the statistics FINRA reported almost certainly underreport the magnitude of the problem. Many arbitrations are never filed since counsel know the brokerage firms involved will never be able to pay an award and, accordingly, the investor would not be well served to prosecute a claim and thereby throw good money after bad.

Previous Attempts To Address The Problem

The GAO report released in June 2000 included a discussion regarding a number of potential solutions offered by investors' attorneys. Those solutions to the unpaid award problem included: (1) providing SIPC coverage of unpaid awards; (2) establishing a separate SRO-sponsored fund for unpaid awards; and, (3) raising net capital requirements or requiring additional bonding or insurance to cover malpractice claims. The GAO reviewed these proposals with the SEC, NASD, and affected organization officials including SIPC officials, and unsurprisingly, the industry representatives criticized each in turn as increasing costs to brokerage firms and investors, incentivizing frivolous arbitration claims, and creating "moral hazards," or the increased tendency to engage in loss-prone activities when there are safeguards such as insurance to cover the losses. The GAO ultimately recommended that NASD monitor unpaid awards, increase investor education, and periodically assess the feasibility of alternative approaches such as those suggested by the attorneys.[34]

Approximately six months after the GAO report was issued, Congress entered the fray. In January 2001, then - U.S. Representative Edward J. Markey (D-MA) requested that the GAO review the status of issues identified in its June 2000 report. Representative Markey also asked the GAO to comment on additional proposed solutions made by PIABA member William S. Shepherd to make clearing firms liable for acts of introducing brokers and to require introducing brokers to carry insurance. In its April 27, 2001, response to Rep. Markey, the GAO punted by referring back to the SEC, SIPC and industry officials' comments in the June 2000 report, and essentially said the alternative proposals needed further review.[35] The GAO did note, however, that some steps had been taken to try to reduce the extent of the problem. First, it noted that NASD adopted procedures for monitoring award payment. Next, NASD adopted

related to FINRA Rule 9554 actions to pull licenses as a result of unpaid awards), the total for the awards is $73,742,861. That figure is obviously much greater than the one reported by FINRA through the Task Force. But, given FINRA's near total lack of transparency on the issue, PIABA is unable to confirm or analyze FINRA's claim of $62.1 million of unpaid awards.

34 Id. at 45.

35 GAO-01-654R, "Evaluation of Steps Taken to Address the Problem of Unpaid Arbitration Awards" (April 27, 2001), at p. 8, available at http://www.gao.gov/assets/100/90697.pdf.

program changes designed to make it easier for investors to establish claims and judgments against defunct brokers. Finally, both the SEC and NASD took actions to better educate investors about the possibility of non-payment. These steps, while commendable, did nothing to actually promote payment of awards. Rather, to the extent that these steps worked to reduce the extent of unpaid awards, it would have been the result of investors knowing they were unlikely to recover and therefore not filing the arbitrations in the first place.

To Rep. Markey's great credit he persisted and made additional requests in May 2001, April 2002, and May 2002 for status updates. The GAO's April 11, 2003, response noted that the rate of unpaid awards had fallen for 2001, with 55% of NASD awards remaining unpaid, totaling $55 Million.[36] The GAO also reported on NASD's efforts to cure the problem. Notably, the GAO indicated that NASD started requesting that investors notify them if awards went unpaid for 30 days following the issuance of the awards. NASD would then begin the process of suspending the license of the brokerage firm or the associated person. At the time, then-current NASD Rule 9510 series allowed non-summary proceedings to suspend or cancel a firm or associated person's membership upon their failure to pay an arbitration award or settlement agreement.[37] Rather than suggest new measures to further combat the problem, the GAO noted that SEC staff had assessed various approaches, discussed those approaches with the industry, and concluded that expanding insurance and bonding would not be appropriate. In short, the GAO noted that time must be allowed to see how the relatively new initiatives would work. It also expressed some hope that the SEC's continued analysis of the feasibility of alternative approaches could result in further reducing unpaid awards. Interestingly, while the GAO recommended to the SEC that it work with SROs to develop and publicize information to focus investor attention on the possibility of unpaid awards, neither the NASD nor the SEC provided data to investors regarding the scope of the problem or the frequency of unpaid awards.[38]

In 2004, the SEC approved amendments to NASD by-laws that strengthened the NASD's ability to prevent former brokers from re-entering the industry if they still had outstanding arbitration awards or settlements due.[39] NASD Rule 9554, effective in June 2004, allowed NASD to institute summary suspension or cancellation proceedings against any member or associated member who failed to pay an arbitration award or settlement agreement, with the suspension being effective 20 days after NASD's service of the notice of suspension.[40] The rule was then amended in 2010 to remove a broker's claim of a

[36] GAO-03-162R, "Follow-up Report on Matters Relating to Securities Arbitration" (April 11, 2003), pages 4-5, 8, available at http://www.gao.gov/products/GAO-03-162R.
[37] NASD Rule 9511(a)(2), available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3321.
[38] GAO-03-162R, at pp. 11 – 12.
[39] NASD NTM 04-57, available at http://www.finra.org/sites/default/files/NoticeDocument/p009798.pdf.
[40] NASD Rule 9554, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7845.

bona fide inability to pay as a defense to removal from the industry upon a failure to pay an award.[41]

However, the problem did not improve. Jean Eaglesham and Rob Barry's 2013 WSJ article highlighted the problem – all too familiar to PIABA's members and their clients – of fly-by-night brokerage firms that simply shut down after losing in a FINRA arbitration hearing rather than pay the award to the harmed investor.[42] FINRA responded to the newspaper's investigation and told the WSJ that it would "consider" requiring brokerage firms to carry insurance for the purpose of unpaid awards. Susan Axelrod, FINRA's executive vice president of regulatory operations, went so far as to say that "We're going to evaluate the whole area and see if there are additional steps we can take."[43]

Now a U.S. Senator, the Honorable Mr. Markey responded to the October 2013 WSJ article. In a letter to FINRA's Chair and CEO Richard Ketchum, Senator Markey strongly criticized the SRO's ability to protect investors from "rogue brokers," as exposed in the WSJ articles, stating that he was "appalled" that so many arbitration awards went unpaid, and warned that "If an investor successfully proves their claim but is never paid, the integrity of the entire system is threatened."[44] To PIABA, this is no surprise. Unpaid awards plague our clients. PIABA's members must consider the likelihood of an unpaid award as they counsel their clients regarding the cost/benefit of pursuing a matter to an arbitration award.

It seems it took FINRA nearly a year to contemplate and assess the viability of an insurance requirement. Eleven months after the WSJ article was published, it was reported that FINRA would not impose an insurance requirement on brokers and brokerage firms. The explanation was simple: insurance would be too expensive.

> "We researched various types [of] coverage in this area and found that insurance underwriters didn't necessarily want to cover 'higher' risk firms, precisely the ones about which we are most concerned," said Nancy Condon, a spokeswoman for FINRA.
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> "We found that if an underwriter has to cover those firms, and would spread the risk across all firms, the cost became prohibitively high."[45]

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[41] http://finra.complinet.com/net_file_store/new_rulebooks/f/i/finra_10-31.pdf.
[42] Jean Eaglesham and Rob Barry, "More Than 5,000 Stockbrokers from Expelled Firms Still Selling Securities," Wall Street Journal (October 4, 2013).
[43] Jean Eaglesham and Rob Barry, "FINRA to Consider Requiring Brokerages to Carry Arbitration Insurance," Wall Street Journal (October 4, 2013).
[44] http://www.markey.senate.gov/documents/2013-10-25_FINRA.pdf.
[45] Emily Flitter, "Watchdog won't fore brokers to insure against U.S. legal action," Reuters (Sep 29 2014), available at http://www.reuters.com/article/us-usa-brokers-insurance-idUSKCN0HO22B20140929.

FINRA did not comment on whether it considered any other solutions to the problem.

The FINRA arbitration Task Force echoed Senator Markey's concerns: "unpaid awards diminish investor confidence and reflect poorly on the securities industry and FINRA."[46] The report described FINRA's efforts to curb the problem: which is essentially limited to revoking or suspending a member's or associated person's license upon their failure to pay an arbitration award within thirty days of the receipt of the award. FINRA will not pursue cancellation or suspension if there is a valid legal basis for nonpayment, including the filing of a motion to vacate or modify (until such time as the motion is ruled upon in favor of the investor), or a bankruptcy filing (unless the award is ruled nondischargeable). The report indicates that FINRA boasted that threats of suspension or cancelation "often" prompt payment.[47] FINRA also told the Task Force that it has taken steps to streamline an investor's pursuit of claims against firms or individuals no longer in business. Obtaining a prompt judgment does not, however, always (or perhaps ever) result in a collection from the defunct member or firm. After being advised that FINRA had considered an insurance requirement, but declined to adopt it since the cost would be "prohibitively high," the Task Force declined to reconsider the issue as no consensus could be obtained. In short, the Task Force offered no suggestions whatsoever, and only reported what it had learned from FINRA.

Perhaps unsurprisingly, the industry is very interested in securing FINRA's help in ensuring that brokers pay back amounts due the firms under promissory notes (typically associated with retention bonuses). The securities industry trade group, the Securities Industry & Financial Markets Association (SIFMA) wanted FINRA to change its rules to prohibit brokers from pleading poverty to avoid an arbitration repayment order.[48] Under the existing rules, brokers were able to seek leniency for their non-payment of industry arbitration awards. Upon demonstration of his inability to pay back a note, a broker was able to avoid suspension and seek employment with a different firm. It should come as no surprise that SIFMA members were "aggravated" by a system by which a broker could "stiff" them and yet continue to work elsewhere.[49] SIFMA's argument was summarized:

> SIFMA made its case to Finra in November in a six-page letter and in subsequent meetings. It argued that allowing deadbeat brokers to work in the industry, especially without disclosure of their financial predicament, puts customers at risk.[50]

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[46] Task Force Report at p. 50.
[47] Id.
[48] Dan Jamieson, "SIFMA, Finra clash over deadbeat brokers," Investment News (Jan 15, 2012) available at http://www.investmentnews.com/article/20120115/REG/301159976/sifma-finra-clash-over-deadbeat-brokers.
[49] Id.
[50] Id.

SIFMA's general counsel was quoted: "This is money firms gave in good faith to these brokers, so I'm not sure why regulators wouldn't facilitate payment of awards."[51] Naturally, SIFMA offers no comment on the money investors give in good faith to firms to manage.

Potential Remedies

There are a number of ways to address the problem. The potential solutions include: expanding SIPC coverage, increasing net capital requirements, imposing insurance requirements, and/or creating an investor recovery pool. Each is analyzed below and has its own challenges, as will be discussed in further detail. Of each option, creating an investor recovery pool presents the most viable option because it can be created within the existing regulatory structure and will present both the lowest financial impact to the brokerage industry and the best financial impact for aggrieved investors.

Expanding SIPC – Beyond the Scope of SIPC's Prime Mission

One potential option would be to expand the coverage of the Securities Investor Protection Corporation (SIPC). The SIPC fund, which constitutes an insurance program, is designed to protect the customers of brokers or dealers subject to the Securities Investor Protection Act of 1970 ("SIPA") from loss in case of financial failure of the member. SIPC sets forth its mission:

> SIPC oversees the liquidation of member broker-dealers that close when the broker-dealer is bankrupt or in financial trouble, and customer assets are missing. In a liquidation under the Securities Investor Protection Act, SIPC and the Trustee work to return customers' securities and cash as quickly as possible.[52]

Of particular concern is the limitation on the nature of SIPC's work. As it succinctly stated: "SIPC was not chartered by Congress to combat fraud."[53] Accordingly SIPC can not investigate or regulate its member brokerage firms.

All too often, investors wonder why SIPC denies their claims when they hear about FDIC ensuring that depositors receive their monies from failed banks. The difference in perception, which is largely based in reality, is derived from the similarities and differences between the FDIC and SIPC. The FDIC explains its mission:

> Congress created the FDIC in the Banking Act of 1933 to maintain stability and public confidence in the nation's banking system. The statute provided a federal government guarantee of deposits in U.S. depository institutions so that depositors' funds, within certain

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[51] Id.
[52] http://www.sipc.org/about-sipc/sipc-mission.
[53] Id.

> limits, would be safe and available to them in the event of a financial institution failure. In addition to its role as insurer, the FDIC is the primary federal regulator of federally insured state-chartered banks that are not members of the Federal Reserve System. The FDIC also acts as receiver for insured depository institutions (IDIs) that fail and has resolution planning responsibilities (jointly with the Federal Reserve Board) for large and complex financial companies under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act).[54]

The FDIC, like SIPC, guarantees a portion of a depositor's funds. Both the FDIC and SIPC ensure that depositors and investors have access to their funds if their bank or brokerage firm fails. However, the FDIC is the primary federal regulator of certain banks, where SIPC does not serve as a regulator with oversight over any brokerage firm.

Losses suffered by investors are often fundamentally different than those suffered by bank depositors. Investors' losses are often the product of sales practice abuses, which can stem from negligence or fraud. Losses may be out of pocket (i.e., the investor lost money on poor investments) or well-managed (i.e., the investor would have done better had the broker done his job in an appropriate fashion). SIPC insurance is limited to ensuring that securities or cash that may be missing from an investor's account are returned; it does not cover investment losses even when the result of misconduct. In sum, SIPC steps in and provides for the orderly liquidation of failed firms. If securities have gone missing, investors are covered to a limit ($500,000 for securities and cash, and $250,000 for cash alone). SIPC does not and cannot cover other types of losses under its current mission. SIPC reform would need to come from Congress.

Another consideration is the concern that the SIPC fund is in constant jeopardy of depletion. Adding another stresser of covering unpaid arbitration awards would serve to deplete the fund more quickly, requiring additional and unplanned costs being passed on to firms and their customers. While that argument is specious (since any remedy will cost someone something), SIPC's institutional reticence to pay money needs to be taken into account. The goal is not to make an investor's pursuit of an unpaid award more difficult than it already has to be. It must also be noted that SIPC appears to be more willing to spend money guarding its assets than paying investor victims. For example, SIPC came under heavy fire as it stepped in to wind up the infamous Stratton Oakmont firm (recently the focus of the film "The Wolf of Wall Street.") SIPC was criticized for its refusal to address investor losses resulting from Stratton Oakmont's regular practice of refusing to fulfill customer sell orders.[55] In an article published in 2000, SIPC was revealed to have paid $233 million in investors' claims between 1971 and 1999, while it had paid $320 million to the trustees

[54] https://www.fdic.gov/about/strategic/strategic/bankingindustry.html.
[55] "Many Unhappy Returns," Newsday (Dec. 20, 1998).

administering the firm liquidations during the same time period.[56] In fairness, it should be noted that SIPC also distributed $3.4 billion in cash and securities to investors from investors' accounts at failed firms during the same time period.[57]

Accordingly, given the need to expand SIPC's statutory charge, change its institutional mindset, and lower the cost of distributions, moving SIPC into the unpaid award space would take a herculean effort.

Net Capital Increase – Difficult and of Limited Value

Another potential way to limit unpaid awards is to increase net capital requirements for FINRA members. SEC Rule 15c3-1 (the "Net Capital Rule") requires all brokerage firms to keep net capital in specified amounts that are determined by the types of business the brokerage firm conducts. The goal is to ensure that firms have adequate liquid assets to meet their obligations to investors and creditors.[58]

That said, the investor protection promoted by the net capital rule is not related to sales practices claims, but rather, in the event of the failure of the firm. "Securities broker-dealers and futures commission merchants continue to operate under what are called net capital rules that SEC and CTFC use in order to protect customers and other market participants in the financial markets from losses due to firm failures, not from bad investments."[59]

> The primary purpose of the Net Capital Rule is to protect the customers and creditors of registered broker-dealers from monetary losses and delays that can occur when a registered broker-dealer fails. The Rule generally requires the registered broker-dealer maintain sufficient liquid assets to enable it to liquidate without the need for a formal proceeding if it falls below the minimum net capital requirements. By setting the liquidation threshold at a level at which a broker-dealer will have adequate liquid assets to satisfy customer claims, the Net Capital Rule, together with the other financial responsibility rules, promotes orderly self-liquidation of financially distressed broker-dealers and reduces the likelihood that the failed broker-dealer will have to be

[56] Gretchen Morganstern, "INVESTOR BEWARE: Many Holes Weaken Safety Net For Victims of Failed Brokerages," New York times (Sep. 25, 2000), available at http://www.nytimes.com/2000/09/25/business/investor-beware-many-holes-weaken-safety-net-for-victims-of-failed-brokerages.html?pagewanted=all.
[57] Id.
[58] Michael P. Jamroz, "The Net Capital Rule," The Business Lawyer, Vol. 47, No. 3, at 863 (May 1992).
[59] GAO/GGF 98-153, "Risk Based Capital," at p. 6 (July 1998). It should be noted that the GAO's reference to customer claims presumably relates solely to customer efforts to access their investments held through the failed broker-dealer – not customer claims related to sales practice abuses.

> liquidated pursuant to the Securities Investor Protection Act (SIPA).[60]

The investor claims referenced in the GAO quote above seem to be those related to the return of securities or cash in the failed brokerage firm's custody. The SEC explained how it sees the net cap rule protecting investors:

> Above the beyond accounting for costs [such as the costs of employees needed to wind up the firm and the costs associated with the space occupied by the failing firm], the Commission notes that customers of a firm undergoing a SIPC liquidation are usually unable to access their accounts during the liquidation. Aside from possible financial harm to customers, the delay in a liquidation causes considerable customer anxiety. Although every attempt is made to transfer the accounts of the insolvent broker-dealer to a healthy firm as quickly as possible, or to disburse the assets of the accounts directly to customers, delays can occur for many different reasons. A supervised self-liquidation can avoid the delays that might arise in the context of a court-imposed liquidation.[61]

As viewed by the SEC, the purpose of the net capital rule is to ensure there are funds sufficient to operate the firm while it, among other things, distributes customer account holdings to other, solvent, firms. The SEC believes that a court-imposed liquidation delays investors' access to their investments and thereby exposes them to additional risks. An orderly self-liquidation, as the SEC sees things, promotes investor protection in the simple fact that they'll be able to access their investments more quickly and can avoid market risks suffered if they can't buy or sell securities when they want/need to do so.

The SEC specifically notes that an increase in the net cap rule will not reduce the number of firms that fail:

> While requiring additional amounts of capital will not prevent firms from failing, the additional capital serves as a fund from which the expenses associated with a liquidation can be paid. Moreover, the greater sum will act as a more reliable cushion against the use of SIPC money to liquidate a failed broker-dealer. . . . The self-regulatory organizations will be less hesitant to intervene and supervise a self-liquidation if there are thereby fewer questions concerning the liquidity of the firm's assets or if there is less of a thread by outside creditors to move against the broker-dealer. This is the most desirable situation for the customers of a firm that is no longer viable.[62]

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[60] Id. at 863 – 864.
[61] SEC Release No. 34-31511, 57 FR 56973-01, at 56975 (Dec. 2, 1992).
[62] Id.

In short, knowing that the firm will be able to finance its own liquidation and not drain SIPC's resources will encourage FINRA or other regulators to step in, supervise the liquidation, and avoid serious difficulties sorting out and prioritizing claims against the firm.

The calculation of net capital requirements does not take into consideration the possibility of arbitration claims by investors stemming from sales practice violations. For example, if a firm offers for sale promissory notes in what turns out to be a Ponzi scheme (like Securities America did with Medical Capital), the net cap calculation does not take into consideration the need to maintain - at the time of sale - adequate capital to cover the (inevitable) investor claims for wrongdoing. Securities America, which met the net cap requirements even as the MedCap and Provident frauds came to light,[63] was quickly found to be wildly undercapitalized, as evidenced by its CFO's testimony in open court that the Judge's refusal to approve the proposed settlement would result in the firm's prompt closure. The timeline is important. On December 31, 2010, the firm was facing hundreds of millions of dollars of claims brought by aggrieved investors, yet the firm reported on March 1, 2011, it had roughly $1.75 million in excess of its required minimum net capitalization as of the end of 2010.[64] On March 20, 2011, the firm's CEO testified that the firm would go bust in the absence of a limited fund class action settlement. The firm was then sold and reported for the end of 2011 that it maintained net capital of $8,261,264, which was $8,011,264 in excess of its required net capital of $250,000.[65] Securities America provides a clear example of how a net capital requirement of $250,000 has no relation whatsoever with ensuring the firm is able to pay its aggrieved customers. Should the regulators agree that the net cap rules *should* have some relation to the firm's exposure to aggrieved investor claims, they are free to improve the net cap rule.

FINRA Rule 4110, which governs capital compliance of member firms, explicitly provides FINRA with the authority, when necessary for the protection of investors or in the public interest, to increase the net capital or net worth requirements of any carrying or clearing member or all carrying or clearing members, including more stringent treatment of items in computing net capital or net worth. Accordingly, FINRA has the authority to increase net capital requirements, as long as the newly revised requirements comply with SEC rules.

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[63] On March 1, 2011, three weeks before the company's CFO testified that the firm would seek immediate bankruptcy protection should the judge not approve a class action limited fund settlement, Securities America filed its year end 2010 Focus report. Securities America stated therein that, as of December 31, 2010, it had net capital of $1,991,058, which was $1,741,058 in excess of its required net capital of $250,000. Securities America Annual Audited Report Form X-17A-5, SEC File No. 8-26602 (3/1/2011), available at http://www.sec.gov/Archives/edgar/vprr/1101/11016481.pdf.

[64] We are not suggesting that Securities America was not in compliance with the net cap regulatory requirement. Rather, it was obvious to the scores of investors and their legal counsel that $1.75 million was woefully insufficient to cover the firm's exposure on the Medical Capital and Provident claims.

[65] Securities America Annual Audited Report Form X-17A-5, SEC File No. 8-26602 (Jul. 9, 2012), available at http://www.sec.gov/Archives/edgar/vprr/1206/12061828.pdf.

It is not necessary to amend the SEC Net Capital Rule for FINRA to increase the net capital requirements for its members.

When considering raising net capital requirements, one must first consider the current requirements. Most brokerage firms maintain a surprisingly small amount of net capital. Summary figures of how many firms maintain certain amounts of net capital are not easily found. Short of pulling the Focus Reports for the more than 4,000 brokerage firms registered with FINRA, the only other source of the information is its mention in SEC releases.[66] The most recent such release is dated January 2014, and it addressed the removal of certain references to credit ratings under the Securities Exchange Act of 1934.[67] Seventy-two pages into the release, the SEC sets forth a table identifying the capital tiers, the number of firms in each tier, and the sum of total capital maintained at each firm as of the end of 2012. The table is re-created here:[68]

Capital	**Number of Firms**	**Sum of Total Capital (In Millions)**
Less than $500,000	2,347	$345
Greater than or equal to $500,000 and less than $5 million	1,273	$2,207
Greater than or equal to $5 million and less than $100 million	569	$9,712
Greater than or equal to $100 million and less than $500 million	83	$5,632
Greater than or equal to $500 million and less than $1 billion	27	$19,688
Greater than or equal to $1 billion and less than $5 billion	26	$56,034
Greater than or equal to $5 billion and less than $10 billion	7	$47,922
Greater than or equal to $10 billion	9	$185,028
Total	**4,462**	**$352,028**

Net capital requirements are as little as $5,000 for certain types of firms.[69] There are also minimum requirements of $10,000, $25,000, $50,000, $100,000, and $250,000,[70] but the delineation of how many firms fall into each of these tiers is not articulated in the table. The table is remarkable as it shows that more than half of the broker-dealers maintain less than $500,000 in net capital. There is no indication how much each firm maintains in required net capital.

[66] FINRA reports that more than 4,000 brokerage firm are registered with it. https://www.finra.org/newsroom/statistics.
[67] SEC Release 34-71194 (Jan 8, 2014), available at https://www.gpo.gov/fdsys/pkg/FR-2014-01-08/pdf/2013-31426.pdf.
[68] Id. at p. 72.
[69] SEA Rule 15c3-1.
[70] Id.

On one hand, net capital requirements could be raised across the board. That sort of increase would undoubtedly raise arguments from a number of smaller firms, claiming they simply cannot afford to set aside hundreds of thousands, if not millions of dollars, simply for the privilege of doing business. On the other hand, net capital requirements could be set based upon a risk-based model. For example, sales of Reg D private placements would require that x% of the gross sales be reserved as capital to satisfy potential claims by investors, sales of the equity tranche of collateralized debt instruments would require that y% of the gross sales be reserved as capital to satisfy potential claims by investors, and so on. A difficulty associated with a risk-based model would be the fact that the complexity of the calculation would quickly become overwhelming. Moreover, the net capital requirements would have to be raised by a massive amount (potentially to hundreds of millions of dollars) to make this a meaningful solution.

Unfortunately, any increase to the net capital requirement will likely be seen as an unfeasible solution. It seems the SEC itself is reluctant to address the issue. The last time the net cap requirement was increased was in late 1992, with the changes going into effect on January 1, 1993.[71] Any significant increase in net capital requirements would allegedly put many firms out of business, or it would allegedly cut profit margins to the point that it would be unattractive for firms to stay in business. Those were exactly the complaints raised when the last increase was put into place in 1993. The SEC received 275 letters in response to its last proposed net cap increase. The SEC summarized the comments:

> The Commission received almost 275 letters in response to the proposed rule changes [increasing the minimum net capitalization requirements]. Approximately 200 of the commenters objected generally to the proposed increases in minimum net capital requirements. Most of the commentators writing in protest against the increases objected to the proposed increases to the net capital requirements for introducing and mutual fund broker-dealers. Primarily, these firms feared that an increase in net capital requirements would restrict entry into the securities business and force exiting entities to close. A frequently voiced complaint was that the proposal discriminated against smaller firms in favor of larger enterprises without justification.[72]

Given the statutory need to avoid an undue burden on competition, the SEC should be expected to be hesitant to raise net capital requirements again.

Raising the net capital requirement turns each and every firm into a self-insurer. To be meaningful, those firms would have to have enough capital to cover any exposure not otherwise covered by their own errors and omissions coverage. Given that the problematic cases (like Medical Capital) expose firms to

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[71] SEC Release No. 34-31511, 57 FR 56973-01 (Dec 2, 1999).
[72] Id. at 56974.

hundreds of millions of dollars of exposure, it is unreasonable to think that the firms will be willing or able to maintain a capital balance sufficient to pay those claims in full.

Insurance – Emotionally Attractive and Practically Difficult

The vast majority of investors who learn that their broker and his or her firm have no liability insurance coverage are stunned. Consumers may not understand the intricacies of insurance, but understand the core principle that it protects them in the event they suffer (or cause) some sort of accidental loss. Most states tell them that they <u>must</u> maintain at least a minimum automobile liability coverage, their banks require homeowners insurance, the U.S. Government now requires health insurance, and the list goes on. Professionals are often required to maintain liability insurance. Doctors and lawyers are frequently required to carry some degree of malpractice insurance. The question of why stockbrokers, who may decimate a family's life saving and destroy a hard-earned retirement, are allowed to conduct business without any liability insurance coverage whatsoever remains unanswered.

The issue has been addressed a number of times – most recently in 2015 when FINRA reiterated its position to its arbitration Task Force that insurance would be "too expensive" to require. The contention that insurance would be too expensive weighs both in favor and against requiring it. The insurance industry is highly skilled in valuing risk. By saying that insurance would be too expensive, what FINRA is actually saying is that the firms' conduct is exceptionally risky and therefore it would be exceptionally expensive to cover it. This, of course, raises the question of whether the firms should be engaged in the risky business in the first place.

A mandate by FINRA for firms to provide insurance coverage may be a tacit way to regulate which products a brokerage firm might sell. Firms that sell alternative investments like hedge funds or private placements may face higher premiums or higher deductibles as a result of selling these products.[73] This could potentially make it difficult for firms who are selling these products to obtain adequate coverage. However, a mandatory insurance regulation may force the firms to limit the alternative products they sell in order to get lower premiums or deductibles. In essence, a regulation like this could incentivize a firm to limit the risky products it sells. Limiting the sales of risky products would be great for the investing public, especially at a time when FINRA is concerned about fraud and sales abuses emanating from the sale of these products.[74]

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[73] *See* "E&O Insurance: Cost and Deductibles Skyrocket" ThinkAdvisor (Aug. 30, 2013), available at http://www.thinkadvisor.com/2013/08/30/eo-insurance-cost-and-deductibles-skyrocket (hereinafter "E&O Insurance").

[74] *See* FINRA's article, "Private Placements—Evaluate the Risks Before Placing Them in Your Portfolio" available at http://www.finra.org/investors/alerts/private-placements-risks.

Firms may also face higher premiums for troubled brokers, or an inability to get any coverage at all. Not so surprisingly, much like a driver with a history of accidents and traffic violations would expect their auto insurance premiums to rise, a broker with a poor credit history, tax liens, a recent bankruptcy, or being placed under heightened supervision would likely face higher premiums.[75] Indeed, insurance policies commonly exclude coverage for brokers with three or more complaints within the preceding three years.[76] If firms are unable to afford coverage for brokers with troubled histories, perhaps it is for the best that those brokers be removed from the industry altogether. In sum, a mandatory insurance regulation could help the firms police themselves. Firms may think twice about hiring a broker with a suspect history. More careful hiring practices could well serve to weed out problem brokers and clean up the industry in the long run. Firms may also become more careful about the products they sell and ensure they are not exposing customers to undue risk.

An insurance solution is an imperfect one. First, there is the issue of exclusions or limits of coverage. One problem associated with brokers or firms that now purchase errors and omissions insurance is that there are a number of exclusions on these policies. Insurers often exclude or have reduced coverage for risky, "alternative" products like direct private placements, non-listed REITs, and hedge funds. This became a particular problem in 2009, 2010, and 2011, when a number of brokerage firms sold risky private placements like Medical Capital, Provident Royalties, and DBSI that turned out to be large Ponzi schemes. A long list of brokerage firms like Gunn Allen, QA3 Financial, Pacific West Securities, Workman Securities Corp., DeWaay Financial Network, CapWest Securities, and many others succumbed to the slew of lawsuits that arose from the sales of these products, because these firms had little or no insurance coverage available to them.

Consider the example of QA3 Financial, which folded after it sold a large number of risky private placements. It was involved in a lawsuit against its insurer, Catlin Specialty Insurance Co. (*Catlin Specialty Ins. Co. v. QA3 Financial Corp*., Case No. 2010cv08844 (S.D.N.Y)), over a coverage dispute regarding whether the full $7.5 million insurance policy covered the private placements, or whether a rider for private placements would apply that only provided $1 million in coverage. After submitting the coverage issue to a jury, the jury found that only the $1 million rider applied. Considering that most of that $1 million policy was already depleted by defense costs by the time that investors' attorneys were aware of the coverage dispute, very little money was left for investors who were sold the risky private placements.

Any requirement by FINRA to mandate insurance coverage must be accompanied by regulations specifying that the coverage must be meaningful and must not include large exclusions.

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[75] See E&O Insurance, *supra* at n. 73.
[76] See E&O Insurance, *supra* at n. 73.

A significant limitation of insurance is that damages caused by egregious conduct, such as fraud, selling away, and Ponzi schemes, are nearly impossible to cover under insurance. As a matter of law and public policy, insurance cannot cover intentional wrongdoing like fraud or criminal conduct. Further, if the amount of coverage is based upon a broker's or firm's book of business, insurance would not cover damages in Ponzi schemes and selling away cases, as such conduct would obviously not be reported as a part of their book of business. This could be a huge problem because even though a firm has insurance, there likely would not be enough coverage to cover the substantial losses if a broker steals his customers' money through fraudulent investments.

The single largest problem of insurance as a solution to the unpaid award issue is the oft-repeated argument that the expense of insurance will place an undue burden on smaller firms, in violation of the 34 Act's Section 15A(B)(9).[77] Stated differently, the argument contends that smaller firms (presumably engaging in riskier conduct) simply cannot afford the insurance required to protect against their negligent conduct. FINRA, like the NASD before it, has considered imposing an insurance requirement and refused to do so upon the explicit finding that the coverage would be too expensive. However, FINRA dismissed the idea without giving adequate consideration to the potential benefits, weighing industry concerns more heavily that investor protection.

Curiously, FINRA has not imposed any requirement upon its members to disclose the nature and extent of whatever insurance coverage they do or do not maintain. Investors should know whether their trusted brokers and brokerage firms maintain minimal, or no, coverage. Once again, just as the insurance itself may steer brokerage firms from risky products and brokers, the extent of coverage may steer investors toward firms that avoid those risks.

While a requirement to carry insurance could be helpful in limiting unpaid arbitration awards, there are so many limitations and loopholes inherent in the concept that it is not the ideal solution. A principal benefit of insurance may be its effect in steering firms away from the conduct that leads to arbitration awards in the first place. With that in mind, using an insurance requirement in conjunction with something like an unpaid award pool could work in tandem to help solve the pressing problem of unpaid arbitration awards.

Investor Recovery Pool – The Best, Least Expensive Option

A. <u>National Recovery Pool – The Short Version</u>

A national recovery pool would provide a source of recovery for those investors who carry a claim all the way through award and have exhausted reasonable efforts to collect the award from the brokerage firm and/or broker. The pool would be designed to be liquidated each and every year. If investor

[77] Section 15A(b)(9) states that "the rules of the association [should not] impose any burden on competition not necessary or appropriate in furtherance of the purpose of this chapter."

claims exceed the size of the pool in any given year, investors would receive a pro-rated recovery. The pool structure would have to discourage poor behavior on both investors' and brokers' behalf. Investors bringing claims against <u>any</u> Respondent would have to be held to their burden of proof. The Pool would maintain a subrogated interest and be able to pursue on its own behalf those Respondents it believed to be collectable.

B. <u>The Pool Must Be National in Scope</u>

Even though a number of states have put some form of investor recovery pools into place, those pools are limited in their ability to produce a meaningful recovery for investors, and there are states that are incapable of enacting their own pools absent fundamental legislative and regulatory changes.

Three states have enacted legislation establishing investor recovery pools. Montana, North Dakota, and Indiana all passed investor recovery fund legislation.[78] Indiana was first to the table, passing its version of a pool in 2010. Montana modeled its program on Indiana's. And, as discussed below, North Dakota appears to have gone its own way.

Indiana and Montana's recovery pools share many common elements. Recoveries are minimal. Indiana limits the recovery to the lesser of $15,000 or 25% of the out of pocket loss.[79] Montana is more generous, limiting the recovery to the lesser of $25,000 or 25% of the out of pocket loss.[80] As discussed below, however, these payouts may be even lower depending on how flush the pools are with available funds. Another common theme between the Montana and Indiana pools is that the pools are not funded with taxpayer monies, but instead with penalties and fines assessed against those who have violated the requisite state statutes. There are other commonalities: one payment per victim; the claimant cannot have contributed to, or been a participant in, the fraud; and, penalties are levied against those who make false claims against the funds. Generally speaking, however, each of these two states' pools appear to be generally available to state residents victimized by unscrupulous brokers or investment advisors.

There are three fundamental problems with the approach Montana and Indiana have taken. First, the maximum payout is woefully low in relation to the size of losses most investors suffer. The payout is low both in absolute dollars ($15,000 to $25,000) and as a percentage of the actual loss. Given that the maximum recovery is 25% of the loss, most investors would never come close to being made whole – even if the pool had more than sufficient funds to pay the entire award.

Second, these pools require a violation of state or federal securities law. Indiana requires that a state or federal securities statute be violated. Montana

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[78] 30-10-1003, et seq., MCA; Burns Ind. Code Ann. § 23-20; N.D. Cent. Code § 10-04-03.
[79] Burns Ind. Code Ann. § 23-20-1-23.
[80] 30-10-1006, MCA.

requires that the commissioner prosecute a claim to a final award of restitution that remains unpaid. Unfortunately, the vast majority of unpaid arbitration awards will not articulate a specific finding of a state or federal securities violation. The reason no such clear findings are common is simple: the majority of awards are issued by FINRA arbitration panels, FINRA arbitration panels sit in equity, and FINRA panels rarely issue reasoned awards. While the lack of reasoned awards is a topic better addressed on its own, the basis in equity is important in this context. "Generally, arbitrators are not obliged to follow strict rules of law in the matter at hand and they are privileged to apply broad principles of justice."[81] Arbitrators' equitable powers are perhaps the principal benefit for investors in the arbitration system. Aggrieved investors need not plead formal legal claims like negligence, breach of fiduciary duty, or violations of applicable state or federal law. Burdens of proof for statutory claims are invariably more onerous than claims sounding in negligence or breach of fiduciary duty, and they are *always* more onerous than claims sounding in equity. Forcing a change in the pleading and arbitration award requirements simply to ensure an arbitration award is eligible for participation in an unpaid award pool would not work for investors' benefit.

Third, the pools are designed to preserve their own well-being before they preserve the well-being of the investors they're supposed to protect. Note that, once the pools run low on funds (as each statute defines the term), they start paying out even less. Indiana, for example, suspends payments for two months once the fund drops below $250,000. Following the two-month suspension, payments are then made on a pro-rata basis.[82] Montana's administrative rules limit victim payments when the fund "approaches zero," which is defined as dropping below $1 million.[83] When the fund drops below that threshold, payments are limited based upon the ratio of the loss to the victim's net worth. If the loss makes up 10% or less of the victim's net worth, the recovery is limited to

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[81] 6 C.J.S. *Arbitration* §104. *See also National Iranian Oil Co. v. Ashland Oil, Inc.* (en banc) 817 F.2d 326 (5th Cir 1987)("[A]rbitration proceedings are by nature equitable."); *Application of Columbia Broadcasting System, Inc.*, 26 Misc.2d 972, 205 N.Y.S. 2d 85 (1960)("It is the settled policy of our courts to encourage arbitration and to enforce arbitration agreements with complete relief from legal technicality . . . [and] proper relief is ordinarily granted when the facts warrant, regardless of what may have been asked for."); *In the Matter of Arbitration Between Stanley J. Stalinski and Pyramid Electric Co.*, 6 A.D.2d 565, 180 N.Y.S.2d 20 (1958)("As already pointed out, as embodied in the arbitration statute and as recognized in our highest court, arbitration may provide relief in circumstances and on conditions which even a court has no power to grant."); *Harold Rosa v. Transport Operators Co.*, 45 N.J. Super. 438, 133 A.2d 24 (1957)("We recognize that an arbitrator does not always decide a case according to strict legal principles, but sometimes according to his own concept of what is just and right, and in such cases the courts will not disturb his decision except for very cogent reasons."); *California State Council of Carpenters v. The Superior Court of Orange County*, 11 Cal.App.3d 144, 89 Cal. Rptr. 625 (1970)("Arbitrators may base their decisions on broad principles of justice and equity and every intendment of validity must be given the award.").

[82] Burns Ind. Code Ann. § 23-20-1-28.

[83] Section 30-10-1008 of the Montana Code authorizes the commissioner to adjust payments if the fund "approaches zero." The rules defining what "approaches zero" means and how payments will be adjusted are set forth in Mont. Admin. R. 6.10.702 and 6.10.703.

$2,500. There is then a sliding scale, whereby as the loss percentage of net worth increases, the payout does as well, topping out at a loss of 75% or more of the victim's net worth in which the recovery could be as much as $25,000. While the administrative rules claim that the loss ratio ensures that the payments are "fair," one's wealth should have nothing whatsoever to do with whether one is entitled to make a full claim against the pool.

North Dakota's system is fundamentally different than those articulated in the Montana and Indiana state statutes. North Dakota's fund does not appear to be one available to the community at large. The details of the fund are not provided in the State's statute, as they are in other states. Rather, embedded in the State's blue sky statute is what amounts to a passing reference to the fund:

> All fees, civil penalties, or other moneys collected under this chapter must be deposited in the general fund of the state treasury, except funds permitted to be deposited into the investor education and technology fund under subsection 4 or civil penalties collected from enforcement actions for the purpose of distribution to aggrieved investors, which may be deposited in the **investor restitution fund**. Funds in the **investor restitution fund** are appropriated to the securities commissioner on a continuing basis for distribution to aggrieved investors.[84]

No details are provided regarding the manner in which the funds are to be distributed, nor are there particular funding level requirements. Details regarding the manner in which the fund is administered can be found via anecdotal evidence, specifically the State's Securities Department orders for civil penalties. A common thread among those orders is a requirement that a sum "shall be deposited into the North Dakota Investor Restitution Fund (Fund # 262), for the purpose of reimbursing the complainant for losses incurred as a result of the investment with the Respondents."[85] The language in all of the awards is identical, and each order requires that any money *not* paid to "the complainant" within one year be repaid to the State's General Fund. It is therefore clear that the North Dakota Investor Restitution Fund is funded by penalties assessed in particular cases, to be paid to the complainant in each such case. It is not, as the other States have instituted, a fund created for the benefit of the state's investors at large.

While the investor recovery pools in Montana, North Dakota, and Indiana leave something to be desired, those states are to be commended for making the

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[84] N.D. Cent. Code, § 10-04-03 (emphasis added).
[85] *See*, for example, *In The Matter of True Investments Inc. and Ty Olstad*, Order for Civil Penalty and Notice of Right to Request a Hearing, http://www.nd.gov/securities/sites/default/files/enforcement/true-investments-and-ty-olstad-order-for-civil-penalty.pdf, *In The Matter of David W. Torson*, Cease and Desist Order, Order For and Notice of Civil Penalty, and Notice of Right to Request a Hearing, http://www.nd.gov/securities/sites/default/files/enforcement/torson-d-ceaseanddesist-09142010.pdf.

effort. Other states have refused to so much as try a pool. Ohio, for example, has given its securities regulators no ability to assess penalties or fines. Ohio's Division of Securities tells investors:

> Q: Can the Division recover money lost on an investment?
>
> A: No. The Ohio Securities Act, which the Division administers and enforces, does not grant the Division direct authority to recover money on behalf of investors. The Division has no authority to fine or impose monetary penalties. The Act does provide investors with a private cause of action. R.C. 1707.43 provides that every sale or contract for sale made in violation of the Act is voidable at the election of the purchaser. An action for rescission under this section must be brought within two years of when the purchaser knew of the violation or within four years of when the purchase was made, whichever is shorter. A purchaser should consult legal counsel to pursue this remedy.[86]

Ohio's legislature has, in essence, let Ohio citizens know that they're utterly on their own if they want to seek a recovery based upon securities sales practice wrongdoing.

Obviously, having a state investor recovery pool is better than nothing. Unfortunately, however, the low payouts, strict requirements for eligibility, and design to limit payments as the pools' resources dwindle leave much to be desired.

C. <u>Legal Authority to Promulgate the Pool</u>

A national investor recovery pool need not be created via legislation - as SIPC had been via the enactment of the Securities Investor Protection Act of 1970. Rather, either the SEC or FINRA is capable of creating the Pool via the rule-making process. The SEC maintains oversight of FINRA per section 19 of the '34 Act, "Registration, Responsibilities, and Oversight of Self-Regulatory Organizations." The SEC's powers in this regard are thorough and broad. Applications for SRO registration are approved or denied by the SEC pursuant to Section 19(a) of the Act. All SRO rule proposals must be filed with the SEC pursuant to Section 19(b) of the Act. The key, however, is section 19(c), which permits the SEC to "abrogate, add to, and delete from" the rules of an SRO as the SEC deems necessary or appropriate to ensure the fair administration of the SRO, to conform its rules to the requirements of the '34 Act, or otherwise in furtherance of the '34 Act. It is also important to note that Section 15 of the Act grants the SEC direct oversight of brokerage firms. Section 15(c)(3)(A) requires the SEC to prescribe rules and regulations:

[86] *See* http://www.com.ohio.gov/secu/faq.aspx.

> as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers, including but not limited to, the acceptance and custody and use of customers' securities and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall (A) require the maintenance of reserves with respect to customers' deposits or credit balances, and (B) no later than September 1, 1975, establish minimum financial responsibility requirements for all brokers and dealers.

Note that the SEC is charged with ensuring firms maintain "financial responsibility," and must further ensure that there are "minimum financial responsibility requirements for all brokers and dealers." Accordingly, the SEC is capable of itself instituting rules to create and govern a national recovery pool, and is able to direct that pool to be maintained and managed by FINRA.

If the SEC is to engage in rule-making on the issue, it must conform to the requirements of the '34 Act. One cannot assess whether a national investor recovery pool would be deemed in furtherance of the '34 Act without first understanding the purpose of the '34 Act itself. The SEC describes the Act's purpose as follows:

> With this Act, Congress created the Securities and Exchange Commission. The Act empowers the SEC with broad authority over all aspects of the securities industry. This includes the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self regulatory organizations (SROs). The various securities exchanges, such as the New York Stock Exchange, the NASDAQ Stock Market, and the Chicago Board of Options are SROs. The Financial Industry Regulatory Authority (FINRA) is also an SRO.
>
> The Act also identifies and prohibits certain types of conduct in the markets and provides the Commission with disciplinary powers over regulated entities and persons associated with them.
>
> The Act also empowers the SEC to require periodic reporting of information by companies with publicly traded securities.[87]

Accordingly, the '34 Act focuses upon ensuring that the markets and those involved trading securities protect investors by playing on a level field. Just as the SEC has promoted investor protection through the net capital rules, it maintains the authority to take investor protection to the next level – ensuring that those who fall victim to sales abuses in violations of law and FINRA rules are able to recover monies lost to such wrongful conduct.

[87] *See* https://www.sec.gov/about/laws.shtml.

D. A Proposed Structure For The Pool

Saying that there should be a Pool is easy. Defining how it should be structured and how it should operate is, to put it mildly, more difficult. It is impossible to address in great detail all of the arguments in favor of and against each element of the Pool. The author has therefore attempted to provide the basic outline for the Pool and highlight issues for discussion. There are two fundamental issues to be addressed as one considers a Pool: (1) how should the Pool be funded; and, (2) how should claims be defined and paid?

1. Funding

a) *The Pool would be funded by contributions by FINRA, member firms or associated persons.*

There are three potential sources for the Pool's funding: FINRA, FINRA members (including their associated persons), and individual investors. For a variety of reasons discussed below, PIABA suggests that the majority, if not the entirety, of the Pool be funded by FINRA and/or its members.

The logical underpinning for charging FINRA and/or its members to fund the Pool is simple: the wrongdoing giving rise to the unpaid awards was the result of wrongful conduct of FINRA members. It is illogical to ask investors to bear the burden of ensuring that victims of sales practice abuses are compensated.

FINRA itself is more than capable of funding the Pool. Keeping in mind that FINRA is a non-profit regulator, it has been so flush with net income that it has issued refunds to its members every year since 2010. In 2014, FINRA reported net income of $129 million and refunded $20 million to its members.[88] In 2013, FINRA reported net income of $1.7 million and refunded $20 million.[89] There were also rebates in each of the years 2010, 2011, and 2012.[90] The refunds were justified by FINRA:

> Financially, 2014 was a strong year for FINRA due primarily to an increase in revenue and our continued efforts to control costs. In light of FINRA's strong operating revenue for 2014, FINRA distributed a $20 million discretionary rebate to firms, and for the second consecutive year, all active firms in good standing received a $1,200 rebate to offset their minimum Gross Income Assessment fee. Firms also received a rebate based on their prorated share of regulatory fees paid into FINRA, including the Gross Income

[88] FINRA 2014 Year in Review and Annual Financial Report, available at: https://www.finra.org/about/annual-reports-financials.
[89] FINRA 2013 Year in Review and Annual Financial Report, available at: https://www.finra.org/about/annual-reports-financials.
[90] FINRA 2012 Year in Review and Annual Financial Report, available at: https://www.finra.org/about/annual-reports-financials.

Assessment, Branch Office Assessment, Trading Activity Fee and Personnel Assessment.[91]

Putting this into context, FINRA's arbitration Task Force reported that $62.1 million of the awards issued in 2013 went unpaid, while the regulator tasked with promoting investor protection refunded $20 million to its members - nearly a third of the unpaid awards. FINRA could have made a substantial dent in the amount due on outstanding unpaid awards, but instead, returned the funds to its members.

Not only could a substantial portion of the Pool be funded by FINRA's annual net income (profit), but it should be noted that FINRA's net worth is staggering. FINRA's 2014 Annual Financial Report revealed that the regulator maintains a net worth of $1.474 billion. While PIABA recognizes that a portion of FINRA's operating expenses are defrayed thanks to the earnings on that portfolio, it bears repeating that a non-profit regulator bears a net worth of nearly $1.5 billion, yet dedicates none of the principal or interest to ensuring that aggrieved investors collect the awards due them as a result of the wrongful conduct of its members.[92]

FINRA could well decide that it won't fund any portion of the Pool and instead require its members to do so. FINRA reports that it oversees more than 643,322 registered reps.[93] If the Pool required $62.1 million, a fee of $96.53 per broker would fund the Pool (without regard to administrative expenses). While any increase in an individual broker's fees invariably results in cries that the fee will drive brokers out of the business in droves, it is difficult to believe that a fee of less than $100 per broker would have such a catastrophic effect.

Ignoring the logic of asking investors to pay for FINRA members' wrongdoing, funding the Pool from investors directly would create an insignificant cost for each investor. Based upon an estimated 134,750,000 individual investors in the markets (without regard to how many accounts are maintained by each of those investors) a fee of 46 cents per investor would fund the Pool sufficiently to pay the 2013 unpaid awards (without regard to the Pool's administrative expenses).[94] So, while it is not intellectually appealing to have

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[91] FINRA 2014 Year in Review and Annual Financial Report.

[92] To put this figure into context, FINRA's net worth would put it in the top 54 of the 849 universities ranked by endowment in the National Association of College and University Business Officers and Commonfund Institute 2014 report, based on 2013 data. *See* http://www.nacubo.org/Documents/EndowmentFiles/2013NCSEEndowmentMarket%20ValuesRevisedFeb142014.pdf. While FINRA is behind Harvard University (ranked No. 1 with an endowment of $32.3 Billion), it is ahead of Boston University (ranked No. 57 with an endowment of $1.37 Billion).

[93] *See* http://www.finra.org/newsroom/statistics.

[94] The number of estimated investors is calculated as follows: there are in excess of 240 million adults in the United States. *See* http://quickfacts.census.gov/qfd/states/00000.html, http://datacenter.kidscount.org/data/tables/99-total-population-by-child-and-adult#detailed/1/any/false/869,36,868,867,133/39,40,41/416,417. Gallup has estimated that 55% of Americans are invested in the stock market. http://www.gallup.com/poll/182816/little-

investors pay for firms and their brokers' wrongdoing, it is exceptionally unlikely that any investor would refuse to pay between fifty cents to one dollar per year for the right to ensure that an arbitration award will be paid.

b) *Funding would be based on the amount needed to cover deficient awards based on a running five-year average of deficiencies.*

Contributions made to fund the pool should be based on the amount needed to cover deficient awards, based on a running five-year average of deficiencies. Thus, the contributions will change depending on the actual loss experience. By using a running average, outlying years with unduly large or small loss experiences will not serve to skew the calculations in an undue fashion. Of course, an actuarial approach could also be used to estimate predicted unpaid awards. However, using that approach would undoubtedly add meaningful expense to the administration of the Plan.

c) *A reserve would be kept to pay the Pool's administrative costs.*

A reserve will be required to pay the Pool's administrative costs. The funds raised for the Pool will need to pay not only claims, but the administration of the Pool for the current and following year. While the goal is that the Pool exhaust its funds on an annual basis, continued cash flow is obviously required. Accordingly, an appropriate reserve must be established to ensure ongoing operations.

2. Eligibility and Payment

a) *"Unpaid awards" eligible for payment from the Pool must be clearly and unambiguously defined.*

"Unpaid Awards" would be eligible for payment from the Pool. Accordingly, the term must be defined. We suggest that an "Unpaid Award" would be defined as a settlement or final and non-appealable arbitration award that has: (1) been confirmed by a court of competent jurisdiction; and, (2) remained unpaid by the Respondent(s) who were ordered to pay the award for a period of thirty day after the award was confirmed. To qualify as an "Unpaid Award," the Claimant must also have made a request to FINRA that the Respondent (presuming the Respondent is a member or affiliated with a member of FINRA) be suspended pursuant to FINRA Rule 9554.

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change-percentage-americans-invested-market.aspx. Presuming that Gallup's figure applies to American adults and not the entirety of the American population, 55% of $244,000,000 is 134,750,000. If, instead, Gallup's figure applies to the entirety of the American population, there would be far more investors and a lower per-investor burden needed to fund the Pool.

As discussed in detail below, a bankruptcy (prior to or following an award) complicates matters. In the event of a bankruptcy, the investor would not necessarily be required to establish an allowed bankruptcy claim, but would have to: (1) provide evidence that a proof of claim was filed (or could not have been filed thanks to the Bankruptcy Court's order); and, (2) provide sufficient evidence that they would have been successful had the claim gone to a FINRA hearing. As discussed below, there will have to be a mechanism in place to judge the quality of the unadjudicated claims against bankrupt brokers or firms.

b) Both compensatory and punitive damage awards would be eligible for payment from the Pool.

"Unpaid Awards" include both compensatory and punitive damage claims, although payment of punitive damages would be allowed only if the Pool was able pay all unpaid compensatory damage awards in full. An argument could be made that punitive damages should not be eligible for payment by the Pool since the purpose of a punitive damage award is to punish and/or deter similar conduct and, with the Respondent out of business, that goal had already been achieved. However, it is often the case that the underlying compensatory award is minimal and the punitive damage award is required to cover the expenses of prosecuting the action. Accordingly, refusing to pay *any* punitive damage award presented to the Pool would serve to subject investors to undue harm. In an effort to balance the equities involved, the Pool should give priority to the compensatory damage claims and then pay punitive damage awards as best it can.

c) Eligible claims would be paid on a pro-rata basis, with compensatory awards being prioritized.

Ideally, the Pool should be able to pay all Unpaid Award claims ("Claims"), be they compensatory or punitive, in full. However, if the Pool's resources that year are insufficient, priority should be given to compensatory awards Claims. If there are insufficient funds to pay compensatory awards Claims in full, they should be paid on a pro-rata basis, based upon the size of the Claims. If there are funds sufficient to pay compensatory awards Claims in full, but not punitive awards Claims, then the unpaid punitive award Claims should be paid on a pro-rata basis with the funds remaining after the compensatory award Claims have been paid in full.

d) Claims must be made within 120 days of their eligibility, with the Pool re-setting itself every year.

Claimants must make Claims upon the Pool within 120 days of the claims' eligibility as an "Unpaid Award." While the short time frame will require diligence of those who would make Claims upon the Pool, it also ensures that trying to match the Pool's collections for anticipated unpaid awards is in line with the actual loss experiences.

The Pool will re-set every January 1. Claims received during the calendar year shall be validated as quickly as possible. However, all Claims must be validated by July 1 of the year following the year in which a Claim is made. If a Claim is made in January (Year 2) for an unpaid award issued the previous December (Year 1), the Claim shall be considered a Year 2 Claim subject to validation no later than July 1 of Year 3. Payments on Claims will be made as close as possible to July 1 of the year following the one in which the Claim is submitted.

e) The Pool would maintain an appellate process to resolve any disputed claims.

There will have to be an appeal process to resolve the eligibility of any Claim. It is conceivable, if not outright probable, that there will be instances in which a Claimant submits a claim and the Pool denies its eligibility. Say, for example, that the investor obtained an arbitration award, but failed to satisfy any of the prerequisites to qualify as an "Unpaid Award," like failing to ask FINRA to suspend the member per FINRA Rule 9554. A process must exist to resolve such disputes. However, the process cannot serve to interfere with the payment of that year's undisputed eligible Claims. We suggest that the Pool itself maintain an appellate review process. A dissatisfied Claimant could then appeal the Pool's final decision to a District Court. Should the appellate process result in the Claim being deemed eligible for payment, it would be considered a Claim made in the year in which the appellate process is finalized.

f) Any funds not distributed would be used to offset the funding obligation for a subsequent year.

If the Pool has funds that were available for distribution, but were not distributed thanks to a lack of eligible Claims, those funds will roll over into the next year and thereby reduce the sums due to fund the Pool for that year. To illustrate: assume the funds available for distribution to eligible claims in Year One are $35 million. As of July 1 of Year Two, when the Claim verification process is complete, it is determined that the Year One eligible Claims total $30 million. If the Pool required $40 million total for Year Three (thanks to the five-year average), it would only need to collect $35 million thanks to the $5 million overage from Year Two.

g) Investors would subrogate their interests to the extent they are paid by the Pool.

Any Claimant who submits a Claim to the Pool must subrogate their interest in the Claim to the extent they receive a payment from the Pool. The Pool can then, in its discretion, pursue the subrogated Claims against the non-paying Respondents. If such a Claim is filed, any Claimant who received less than 100% reimbursement would be an additional named party to the subrogation action and would be entitled to participate in the proceeding.

Similarly, if a Claimant pursues a Respondent to recover those sums not paid by the Pool, the Claimant would be required to name the Pool as an additional party, with the Pool being entitled to participate in any recovery.

E. Arguments In Favor Of The Pool

Of all of the potential cures to the plague of unpaid awards, the Pool would provide the most equitable solution. Modeling itself somewhat in the SIPC mold, the platform is one well understood and respected by the general population. Fear that establishing a pool will lead to additional taxpayer costs and more government bureaucracy can be easily alleviated through two simple concepts embedded in the plan: (1) the Pool is funded by the industry, not taxpayers;[95] and, (2) the Pool would be managed by FINRA, which already has experience managing its members and interfacing with the Claimants in the arbitration process. The Pool therefore differs from SIPC in two fundamental ways. First, where SIPC has gained a (well-deserved) reputation of jealously hoarding its stores and claiming that forcing it to pay large sums will leave it destitute, the Pool is designed to be rendered destitute each and every year. Second, where SIPC has no interaction with the investors making claims upon it, FINRA has already worked with the Pool Claimants – since those Claimants started with a FINRA-sponsored arbitration.

There will be those who claim that providing a safety net such as the Pool encourages bad behavior. The argument is much like that used against insurance: an insured broker feels free to do whatever he wants since the client can always recover from the insurance company. The Pool, however, is fundamentally different from an insurer. An insurer is *not* free to attempt to recover from its insured upon the insured's negligence or other wrongdoing. Thus, a misguided insured can feel a sense of freedom, knowing that he can operate with impunity. The Pool, however, would maintain a subrogated interest and would be able to pursue the bad actors to recover the sums paid out to aggrieved investors. The broker therefore knows that, upon his wrongdoing, *someone* is going to pursue him for a recovery.

F. Potential Issues With The Pool

While the concept of the Pool is relatively simple, the details provide fertile ground for debate and compromise. Some of these issues are addressed below.

1) How will the premiums required to fund the pool be collected?

We have suggested that FINRA participate in funding the Pool, to be supplemented by a per-broker premium. However, it could well be argued that

[95] At worst, the Pool would be funded by investors, who stand to gain by having the security of knowing that their investments are protected. The Pool would not be funded by taxpayers who choose not to participate in the securities markets.

the cost should be allocated by the size of the account, or by the size of a broker's assets under management, or the size of a broker's production. We contend, however, that varying the cost based upon account size, performance or other variable metrics adds a huge level of complexity that principally serves to add to the overall expense of the program. To the extent firms and their associated persons fund the Pool in whole or in part, something as simple as a pro-rata assessment based upon the number of firms and/or associated members is fundamentally fair and no different than other standardized fees FINRA charges its members, which fees are not determined by the size of the broker's production. For example, a broker with a $2 billion book doesn't pay a larger registration fee than does a broker with a $150,000 book. Furthermore, were it to be decided that investors should fund the Pool in whole or in part, applying a charge per account would likely result in some customers being charged far more for the Pool than would others with identical total account balances.

2) How will member firms recoup the expenses?

The industry will argue that funding a pool will create additional expenses that would limit their ability to serve a broad base of investors. The argument is specious. Any time a regulatory "burden" is placed upon the industry, its members play "Chicken Little" and claim the sky is falling – but the fact remains that the industry continues to post record profits year after year.[96] Which raises the question of whether the industry's profits should trump investor protection.

Furthermore, if the Pool is designed so that a portion of the Pool premiums would be sourced from investors, the average client would pay pennies in order to gain the protection of knowing that they're insulated against the firm's inability to make them whole upon its wrongdoing.

Member firms will also argue that the operation costs will be too high and will eat into the funds available for distribution. The same can be said for any organization: its overhead is too high. The mere fact that there will be

[96] It is interesting that, as technology has increased efficiency and lowered costs throughout the economy, the financial sector's charges have only increased over time. While the charges have increased, no benefits to the investing public have manifested themselves. Thomas Philippon, an economist at New York University, poses the question:

> Historically, the unit cost of intermediation has been somewhere between 1.3% and 2.3% of assets. However, this unit cost has been trending upward since 1970 and is now significantly higher than in the past. In other words, the finance industry of 1900 was just as able as the finance industry of 2010 to produce loans, bonds and stocks, and it was certainly doing it more cheaply. This is counter-intuitive, to say the least. How is it possible for today's finance industry not to be significantly more efficient than the finance industry of John Pierpont Morgan?

Thomas Philippon, *Finance vs. Walmart: Why are Financial Services So Expensive?*,, Russell Sage Foundation (2011), available at http://www.russellsage.org/sites/all/files/Rethinking-Finance/Philippon_v3.pdf. Mr. Philippon concludes that the industry has facilitated more trading, which puts more money in the firms' pockets without providing any value to investors. Accordingly, he states that the finance industry's share of GDP is about 2 percentage points higher than it needs to be.

administration costs does not outweigh the fundamental good the Pool will provide to aggrieved investors.

3) Defining "Unpaid Awards" can be difficult.

While the concept itself is very simple: an "unpaid award" is simply an award that goes unpaid; the issue becomes much more complex upon further study. For example, many Claimants choose not to pursue claims because they know that the firm or broker is uncollectible and they're not inclined to waste additional resources on a fruitless effort. Under this proposal, those Claimants would be required to seek arbitration when they know that the *only* likely source of recovery is the Pool. They won't know how likely the Pool will be able to pay 100% of all eligible claims, and the investor would therefore be required to proceed to arbitration without any understanding of what he might actually collect upon a final award. Moreover, the investor will still have to prove their claims to arbitrators, and obtain an award finding liability.

Another issue is defining *when* an award is considered "unpaid." Is it unpaid after 30 days? How about 60? We have proposed that the award would have to be confirmed, and then an additional 30 day period would elapse. This will surpass the 30 days FINRA permits for payment to elapse. It also allows FINRA to respond to the Claimants' request that a suspension be issued per Rule 9554. The confirmation of the award will ensure that any challenge a Respondent may have had to the award was considered. Finally, the additional 30 days following confirmation gives the Respondent a final opportunity to pay the award before it is submitted to the Pool. We believe this is the best compromise and protects all parties.

4) A bankruptcy complicates matters.

A bankruptcy filing adds a tremendous amount of complexity to the issue. On one hand, in the absence of fraud, a bankruptcy completely voids the bankrupt's obligation to the aggrieved investors. If the bankrupt has no legal obligation to the investor, how can the investor still argue they have a claim? Obviously, the argument relies on legal sophistry and ignores the fundamental idea that the bankrupt's wrongdoing caused the investor's damages. If the goal is to ensure that valid awards are paid, a Respondent's bankruptcy should not serve to prohibit the investor from making a Claim against the Pool.

In crafting a solution to structure the process in the appropriate manner, we must be cognizant that a bankrupt Respondent will not have resources available to fight a claim. We also need to be cognizant that the failure to exhaust remedies in the Bankruptcy Court would invalidate the Pool's efforts to make a subrogated claim in that forum.

We therefore suggest that the Claimant facing a bankrupt Respondent: (1) file a proof of claim in the bankruptcy if possible; (2) prosecute an adversarial action if possible; and, (3) if the proof of claim is allowed, or the adversarial action won, the Claim would be deemed an "Unpaid Award" eligible for payment from the pool. If the bankruptcy court does not allow the claim (because it does not fall within one of the allowed categories of claims eligible to survive the bankruptcy), then the Claimant must: (1) submit to the Pool a written statement of claim, a narrative expert report, and all supporting material; with the Pool then: (2) assigning the matter to a single specially trained arbitrator (selected by the Claimant through the normal rank/strike methodology); (3) requiring the arbitrator to hold a factual hearing to allow the Claimant to present whatever evidence they see fit and be subject to cross examination by the arbitrator; and, (4) requiring the arbitrator to issue a final award. That final finding shall be immediately deemed an "Unpaid Award," and the Claimant shall not be required ask that the Respondent be suspended pursuant to Rule 9554.

In the event an investor's claim is allowed by the bankruptcy court, but not paid in full because of the limit of the bankruptcy estate size, the unpaid balance should be eligible for payment by the Pool.

5) Should compensatory and punitive awards be treated identically?

An argument could be made that an award is an award, and should be treated equally by the Pool. A more compelling argument, however, is that the goal of the Pool is to help make Claimants whole. Punitive damages are not designed to make Claimants whole, and therefore should not be placed on equal footing with compensatory award Claims by the Pool. That said, if the Pool has sufficient resources to pay the punitive award Claims after paying all compensatory award Claims in full, it should do so.

6) How should shortfalls in the Pool's available funds be treated?

There are two fundamental ways shortfalls can be addressed. First, the fund could pay on a first-in, first-out methodology whereby the first verified Claims are paid in full, with subsequent Claims being paid as funds allowed. The downsides with such a strategy are obvious. First, there is the fundamental inequity of paying the first in line but not the later Claimants because of the simple fact that their awards were issued later in the year. Second, the methodology promotes waiting until the first of the year to file a Claim – which may not be possible depending on how "Unpaid Awards" are defined. Thus, a second approach is much more palatable: making distributions on a pro-rata basis based upon the size of the individual Claims. Compensatory award Claims should be paid in full first and, if funds allow, punitive award Claims should be paid next.

7) What process should be used to validate claims made against the Pool?

Most claims can likely be validated easily. A copy of the award, proof of the court's confirmation of the award, an attestation that the Respondent has failed to pay the entirety of the award, and a copy of the request made to FINRA to suspend the member will serve to validate the majority of the Claims. Claims made against bankrupt firms or associated persons should be handled as described above, which process will test the validity of investors' claims.

8) What process should be used to resolve disputes concerning the eligibility of claims against the Pool?

There will almost invariably be some instances in which Claimants contend that the Pool's refusal to allow their Claims were in error. Say, for example, the investor made the requisite request for suspension pursuant to Rule 9554, but forgets to submit to the Pool a copy of the request letter, and the Pool denies the Claim as the investor seemingly failed to satisfy the prerequisites. There must be some sort of review or appellate process available. That process cannot, however, serve to delay the Pool's payment of other, eligible, Claims. We suggest that the Pool have an appeal department in place to review contests in a prompt manner. And, if the Pool's review is again subject to challenge, aggrieved Claimants would then have the right to seek review by a District Court. There then becomes an issue of whether a reserve should be set aside to pay the Claim should the contest be successful. It is possible that the Claim is of a sufficient magnitude that its approval would result in all Claims being paid on a pro-rata basis. It is also possible that the Pool has the funds available to pay the award in full. We therefore suggest that, if the Pool has funds sufficient to pay the Claim in full in the year in which it is originally made, then the funds should be set aside in a reserve to be paid if and when the contest is successful. If the contest is unsuccessful, the funds will be deposited in the Pool and made available for distribution again. If, however, the Pool does not have funds sufficient to pay the Claim in full in the year in which it is made, then the Claim should be considered made in the year in which the contest is finally resolved. It will then be treated as any other Claim and will be paid as the Pool allows that year.

9) Issues with subrogation?

The Pool should be encouraged to pursue subrogation Claims, but should maintain discretion to assess the likelihood of a successful and cost-effective outcome. How will the subrogation issues work? Will it mirror how insurance claims are subrogated? There are two fundamental options available. First, a Claimant could be required to assign their entire Claim (not just the amount paid by the Pool), and would be entitled to participate in any recovery had by the Pool in its efforts to pursue the subrogated Claims, presuming the Pool failed to pay the investor's Claim in full. The principal issue with that course of action would be that Claimants would assign 100% of their Claims without knowing how much they'll recover from the Pool. They would therefore be surrendering something of value in exchange for an uncertain payment. Requiring Claimants to assign 100% of their Claims would simplify the subrogation process and would encourage the Pool to seek recovery (since it would be going after a larger number).

The other option would be to require Claimants to assign only as much of their Claim as is paid by the Pool. The Claimant would then be free to pursue the non-paying Respondent to collect the balance. However any such effort would require the Pool be allowed to participate in the Claimant's action should it choose to do so.

Conclusion

FINRA, like the NASD before it, has remained quiet regarding the issue of unpaid awards. Because the NASD kept no records of unpaid awards, the GAO was forced to craft its own calculation in 2000. Neither NASD nor FINRA reported unpaid awards over the years – the first updated figure following the GAO report of 2000 was set forth in 2013, by reporters for the Wall Street Journal. The next update came just this past December, in the form of FINRA's Task Force Report. Why would FINRA not publish this information as it publishes other arbitration statistics?

The answer is simple: the unpaid award statistics do not paint a favorable picture of the industry. One out of three investors who pursue their dispute with the industry all of the way through to a hearing and is awarded some damages receives no meaningful recovery because the award is not paid. Viewed differently, almost one out of every four dollars awarded to investors in arbitration does not get paid.

There are a number of potential solutions to the very real and very large problem. The most logical solution is a national investor recovery pool to be maintained and administered by FINRA. The problem is purely of the industry's making: FINRA does not have sufficiently stringent financial responsibility requirements in place for its members; and the unpaid awards arise from FINRA members' wrongdoing. Accordingly, it is only appropriate for FINRA and its members to fund the Pool. Unpaid Awards must be verified, with measures in place to ensure fraudulent claims against firms are not eligible for payment by the Pool. The Pool must be designed to avoid the hoarding problem SIPC suffers, and must therefore be designed to exhaust its resources on an annual basis (save the funds needed for ongoing operations).

Allowing one in three awards to go unpaid is unconscionable. FINRA's cures: barring from the industry those who fail to pay awards, and notifying Claimants that they can pursue actions in court against former FINRA members, have failed to cure, or put a meaningful dent in, the problem. Steps must therefore be taken to put forth a new division of FINRA to craft and administer a national recovery Pool.