



PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

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April 9, 2018

Via email to pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: **FINRA Regulatory Notice 18-06**
Program to Incentivize Payment of Arbitration Awards

Dear Ms. Mitchell:

I write on behalf of the Public Investors Arbitration Bar Association (“PIABA”), an international, not-for-profit, voluntary bar association that consists of attorneys who represent investors in securities and commodities arbitration proceedings. Since its formation in 1990, PIABA’s mission has been to promote the interests of the public investor in arbitration proceedings by, amongst other things, seeking to protect such investors from abuses in the arbitration process, seeking to make the arbitration process as just and fair as possible, and advocating for public education related to investment fraud and industry misconduct. Our members and their clients have a fundamental interest in the rules promulgated by the Financial Industry Regulatory Authority (“FINRA”) that relate to investor protection.

We are writing in response to Regulatory Notice 18-06 and welcome the opportunity to comment on the FINRA’s proposals to incentivize payment of arbitration awards. To characterize unpaid arbitration awards as a *problem* would be a massive understatement. As discussed in more detail herein, at this time, nearly one in three arbitration awards are never paid in full. These numbers are staggering and are demonstrative of the fact that unpaid awards are not just a *problem*, they are an epidemic wreaking havoc on investors, while eroding public confidence in FINRA, its members, and the dispute resolution system, at the same time. PIABA continues to support FINRA’s efforts to incentivize the payment of arbitration awards; however, we continue to maintain that more can be done to assure that all awards are paid.

The unpaid award problem is very real and continues to grow worse. Two years ago, PIABA determined that the then-most recent data demonstrated that 33.3% of all awards in favor of investors went unpaid, and more than 24% of the dollars awarded to investors went unpaid. PIABA updated its analysis two months ago and found the most recent data, for 2017, showed that 36% of all awards in favor of investors went unpaid, with 28.18% of the dollars awarded to investors went unpaid. Clearly, the crisis is not resolving itself and something must be done to stop it.

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Unpaid awards often follow a troubled firm closing its doors, at a time when it is without assets or insurance to satisfy the award(s). This practice is permitted under the FINRA Rules and can result in firm leadership either starting a new firm, or moving on to another firm, with impunity and without ever making any contribution to the corresponding award. Further, unpaid awards frequently arise in situations where an award is entered against an individual, such as a registered representative, an officer, or a control person. However, under the current system, troubled brokers are free to jump from one troubled firm to another, prior to the resolution of their claim and prior to satisfaction of the award. These practices need to be stopped; FINRA needs to institute stronger policies to ensure that the awards entered in its dispute resolution system have strong ramifications.

Regulatory Notice 18-06 requests comments on a series of specific topics, each of which is addressed in detail below.

1. Should FINRA consider proposing to apply a presumption of denial in connection with pending arbitration claims and CMAs? If so, under what circumstances?

PIABA supports a presumptive denial of continuing member applications (CMAs) when associated persons or members are subject to numerous pending arbitrations claims. PIABA understands that not all arbitration claims jeopardize the financial stability of a member firm or a registered representative of that firm, and further, that not all arbitration claims are in fact meritorious. However, PIABA members frequently encounter situations where the conduct of control persons, principals, registered representatives, and firms affects a large class of investors. In these situations, investor claims often involve similar products, individuals, and types of misconduct, which often arise during similar periods of time. These are the situations when the presumptive denial should come into play.

PIABA believes that the presumptive denial should be triggered when more than five claims are pending against any control person, principal, registered representative, or other associated person of the firm. If any of these parties are subject to five or more claims, it is clearly indicative of a problem within the firm, or with the corresponding individual, that warrants additional scrutiny by FINRA. After all, only .0055% of all registered representatives have 5 to 9 disclosable events on the CRD report.¹ Further, unresolved arbitration claims are strong indicators of the potential for future investor harm.²

Given these statistics, it is highly unlikely that an individual with five or more claims could argue that the claims pending against them are isolated or non-meritorious claims. When any control person, principal, registered representative, other associated person is subject to five or more claims, the presumptive denial of the CMA should apply, requiring the applicant to rebut presumption with evidence of their ability to satisfy the claims, if the claims were in fact successful.

With respect to member firms, a presumptive denial based upon a fixed number of pending arbitration claims is likely not the answer. The presumptive denial needs to apply when the pending claims are posing a realistic threat to the continuing viability of the member firm. Accordingly, PIABA feels that the presumptive denial, as it relates to

¹ See Wall Street Journal, *FINRA is Cracking Down on 'High Risk Brokers'*, November 21, 2013.

² "The improved performance of the model with all customer disputes suggests that not only the brokers disputes leading to award or settlement above a threshold amount, but also those pending, denied, or closed without action are useful in determining the likelihood of future investor harm." See *How Widespread and Predictable is Stock Broker Misconduct*, Securities Litigation and Consulting Group, April 21, 2016, Page 18.

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pending arbitration claims against a member firm, should be applied based upon the aggregate amount of damages pleaded in all pending arbitration claims, taking the nature and quality of those claim into account, compared to the value of cash assets and insurance held by the member. If this ratio tends to suggest a substantial risk of insolvency or simply a present inability to pay all pending legitimate claims in full, then the presumption should apply.

PIABA is mindful of the fact that damages are not always easy to ascertain and *pro se* parties often lack the sophistication necessary to properly compute their potential losses. To this end, FINRA should be permitted to look beyond damages stated in a statement of claim, and discuss the issues related to damages directly with investors, their representatives, and the FINRA members and their counsel, in confidential sessions, prior to applying a presumptive CMA denial. PIABA feels that FINRA should weight the claimant's information more heavily than the member's, but FINRA should be free to develop its opinion based on all available information. Obviously, FINRA should keep in mind that the investor will present one biased view and the member, cognizant of its fight against both the claim and the possible loss of its membership status, will present a different and likely more vigorous biased view.

If a firm can overcome the presumptive denial of a CMA, and it still desires to onboard or continue the employment of individuals with five or more pending arbitration claims, those individuals with such claims pending against them should be subject to heightened supervision immediately and not be permitted to serve in a supervisory capacity until all pending arbitration claims against them have in fact been resolved, and the corresponding awards or settlements, if any, have been paid in full. Following the conclusion of such proceedings, the decisions related to an individual's supervision or supervisory capacity, should rest with the firm. Again, as statistics show, individuals with five or more pending arbitration claims represent some of the most problematic brokers in the country and pose a significant threat to the public investor. FINRA's Rules should be modified to ensure that these individuals are not permitted to move from one firm to another without regard to problems that occurred at their former firms.

2. *If an applicant designates a clearing deposit or the proceeds from an asset transfer for purposes of demonstrating its ability to satisfy a pending arbitration claim, unpaid award or unpaid arbitration settlement, should FINRA require the applicant to provide some form of guarantee that the funds would be used for that purpose?*

PIABA believes that it is of the utmost importance to assure that assets used to demonstrate a firm's ability to satisfy pending arbitration claims should be earmarked for payment of the corresponding claims. To this end, PIABA feels that a written guarantee that the funds would be for that purpose is important, but it might not be enough to truly protect the arbitration claimants in question. If a guarantee is put into place to use the funds for a particular purpose, there needs to be strict penalties in the event of a breach of that guarantee. An appropriate penalty would likely be the immediate suspension of a member's broker-dealer license.

Special care must be taken when the member firm in the process of closing and winding up its affairs. A firm knowing its membership is already ending must still be incentivized to ensure the funds supposedly earmarked to satisfy awards are not directed elsewhere. The guarantee under those circumstances must be secured by a lien in favor of FINRA or the investor and be enforceable against other FINRA members. For example, if a clearing deposit was being used to demonstrate ability to pay, that deposit could be secured by statutory lien and notice could be provided to the clearing firm. If the clearing firm knew that it could be liable to FINRA or an investor for disbursing the funds to a member firm, it is highly unlikely that the funds would ever be used for any purpose other than satisfying the corresponding claim. And, if the funds were diverted elsewhere, the investor and/or FINRA would then have a right of recovery against the clearing firm. The same logic would work in the event of an asset sale: if

the purchaser knew of the lien, they would likely hold the funds pending resolution of the lien, to avoid further liability. While a guarantee that funds would be used to pay pending claims is important, there needs to be a way to secure the funds, to prevent them from being depleted for other purposes.

A better solution would be to hold funds in an escrow account, with clear instructions to the third-party escrow agent (who would be unaffiliated with the closing member firm) to disburse the funds only under very particular circumstances.

3. *The proposed amendments would not permit any direct or indirect acquisitions or transfers of a member's assets or any asset, business or line of operation where one or more of the transferring member's associated persons has a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, unless the member first seeks a materiality consultation for the contemplated acquisition or transfer and the Department has determined that the member is not required to file a CMA for approval of the acquisition or transfer. Should the proposed amendment be limited to principals, control persons or officers? Please explain.*

PIABA believes that limitations on transfers of member's assets, business assets or lines of operation should not be limited to instances where principals, control persons or officers have a covered pending arbitration claim, but rather, the restriction should include scenarios where an associated person also has a covered pending arbitration claim. PIABA's members often experience situations where a firm's solvency can be jeopardized by one broker, who is not necessarily a control person, a principal, or an officer. This is particularly common in cases involving a broker who is selling away from his or her firm. In these cases, a particular broker could be running a large scheme, without the knowledge of the control persons, principals, or officers.

In cases of smaller or mid-size broker-dealers, a scheme run by a representative could be large enough to threaten the viability of the firm and its ability pay the corresponding awards. Control persons, principals, or officers are often not added to proceedings like this, particularly at the onset of the arbitration case. To permit an asset transfer under circumstances like these, simply because the control persons, principals, or officers were not named in the proceeding, would result in a manifest injustice to investors and potentially foreclose on their right to a meaningful recovery.

4. *Are there any material economic impacts associated with the proposed definition of a "covered pending arbitration claim"? Should FINRA include in the definition only those pending arbitration claims filed prior to a specified time period or event? For example, should FINRA limit the definition of a covered pending arbitration claim to those claims filed prior to public announcement of the contemplated transaction? Please explain.*

PIABA feels that the definition of "covered pending arbitration claims" should be drafted in a broad manner, and should not include a limitation related to claims filed prior to a specific date. If the limitation is added, related to claims filed prior to a specific date, it would again, unjustly enrich a firm who was in the process of shifting assets prior to a claim being filed. Firms would therefore be incentivized to announce a transaction upon the learning of bad conduct by a broker that could lead to potential arbitration hearings. In adopting such an amendment, FINRA would be, possibly inadvertently, establishing a troubling policy that promotes its members' firms' depletion of their assets rather than preserving them to pay investors who have fallen victim to the firm's and its associated persons' wrongdoing.

If FINRA does choose to include a limitation related to claims filed prior to a specific date, FINRA should also require that any funds received in consideration for the transaction assets be frozen or subject to a lien in favor of the investor, pending the resolution of all pending arbitration claims filed within a certain period following the transaction closing. This way, the hasty transaction can close, but assets would still be available to satisfy claims of aggrieved investors. While the assets should not be held indefinitely, a set time should be established to bring a claim against the firm – perhaps a year after the transaction closes.

5. *Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposed amendments? If so: a) What are these economic impacts and what are their primary sources? b) To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models? c) What would be the magnitude of these impacts, including costs and benefits?*

Paragraphs 5 and 6 will be addressed together below.

6. *Are there any expected economic impacts associated with the proposed amendments not discussed in this Notice? What are they and what are the estimates of those impacts?*

PIABA feels that the greatest economic impact associated with not adopting the above rules or other policies to ensure payment of arbitration awards will be borne by aggrieved investors. Unpaid arbitration awards leave investors penniless every day, and as written, the FINRA rules enable firms to onboard troubled brokers and shift assets when it is clear that pending claims may be larger than what the firm can afford to bear. Adding the above said restrictions to onboarding and asset transfers is a step in the right direction to protecting investors, and will likely help address the pervasive cockroaching problem, but FINRA needs to do more.

The time has come for FINRA to create an unpaid arbitration award pool, paid for by the financial industry. The unpaid awards pool is the only way to ensure that aggrieved investors are compensated for losses when a firm or registered representative fails to pay an award entered in favor of an investor.

Respectfully submitted,



Andrew Stoltmann
PIABA President