



PUBLIC INVESTORS ADVOCATE BAR ASSOCIATION

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November 4, 2021

Via Email [NASAAComments@nasaa.org]

Ms. Kristen Standifer, Project Group Chair
Department of Financial Institutions
Securities Division
PO Box 9033
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Mr. Patrick Costello, Project Group Chair
Massachusetts Securities Division
1 Ashburton Pl #17
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Mr. Stephen Brey, Project Group Chair
Corporations, Securities, & Commercial Licensing Bureau
Securities & Audit Division
PO Box 30018
Lansing, MI 48909

Project Group Chairs
North American Securities Administrators Association, Inc.
750 First Street NE, Suite 1140
Washington, DC 20002

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

Dear Ms. Standifer, Mr. Costello and Mr. Brey:

I write on behalf of the Public Investors Advocate Bar Association (“PIABA”), an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in the North American Securities Administrators Association’s (“NASAA’s”) efforts relating to investor protection.

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PIABA supports the adoption of NASAA's proposed Model Rules as described in its October 5, 2021, proposal. PIABA supports the suspension or expulsion of brokerage firms, advisory firms, broker-dealer representatives, and investment advisory representatives who fail to pay arbitration awards. The proposed rules would allow the state regulators to suspend or expel a financial professional or firm if they fail to pay an arbitration award or otherwise attempt to avoid payment of any client or customer-initiated arbitration.

While the proposed Model Rules are undoubtedly a positive step and important tool for regulators, PIABA repeats its longstanding call to NASAA and the securities industry to institute an Investor Recovery Fund: the most effective solution to address the serious unpaid arbitration issue.

1. Unpaid Arbitration Award Problems Persist Over Decades

The issue of unpaid arbitration awards has long been a concern for both the investing public and PIABA. The U.S. Government Accounting Office ("USGAO") recognized this problem back in June 2000 when it analyzed NASD arbitration awards. The USGAO's conclusion in its 2000 report¹ is worth restating now, some twenty-one years after it was first published:

The securities industry, its regulators, and Congress should be concerned about the extent to which arbitration awards are unpaid. Regardless of how effective and fair the arbitration decision process may be, unpaid awards could negatively affect investors' confidence in arbitration.²

The issue has not gone away. PIABA wrote a report on the issue of unpaid FINRA arbitration awards in 2016, and found that one-third of FINRA arbitration awards (valued at \$62.1 million, equaling 24 cents on the dollar) from 2013 went unpaid. PIABA updated its research twice since its initial 2016 report. In 2018, PIABA reported that 36% of customer awards issued in 2017 went unpaid (equaling 28 cents on the dollar). Then, in 2021, PIABA found that 30% of FINRA arbitration awards in 2020 went unpaid (equaling 24 cents on the dollar).³

This is not an issue limited to the securities brokerage industry. Registered representatives with adverse arbitration awards often leave the brokerage industry to join the investment advisory space regulated by the SEC (instead of FINRA), and thereby continue the same sort of misconduct that got them in trouble in the first place. The proposed Model Rules would close the loophole and allow the state regulators to revoke brokerage *and* advisory licenses of professionals who fail to pay or otherwise attempt to avoid payment of final court judgments, arbitration awards, or regulatory orders and civil penalties.

In order to most effectively enforce the proposed rules, NASAA should consider adding a provision in the Model Rules requiring that brokerage firms, investment advisory firms, and their representatives submit all applicable judgments and arbitration awards to their state regulator for review and publication. Some arbitration forums like AAA and JAMS

¹ In its survey of investors who received arbitration awards during 1998, the USGAO estimated 49% of the awards went unpaid, an additional 12% were only partially paid, and nearly 80% of the total \$161 million awarded to investor claimants that year went unpaid. *See* FN 2.

² United States General Accounting Office, *Securities Arbitration: Actions Needed to Address Problems of Unpaid Awards*, June 2000. <https://www.gao.gov/products/ggd-00-115>.

³ <https://piaba.org/piaba-newsroom/piaba-report-finra-arbitrations-persistent-unpaid-award-problem-september-29-2021>.

have confidentiality clauses that limit or restrict a party from sharing or publicizing an award. These restrictions are typically for the benefit of losing party. If bad actors fail to voluntarily report the awards, state regulators are left blind. As such, NASAA should consider requiring timely disclosure of final judgments and arbitration awards by firms and representatives to close this additional loophole, and strengthen enforcement of the proposed rules.

2. The Proposed Model Rules May Incentivize Insurance Coverage, but an Investor Recovery Fund Remains the Best Solution to Increase Investor Confidence in the Arbitration Process

The proposed Model Rules may create an incentive for brokerage firms, investment advisory firms, and representatives to obtain meaningful levels of insurance to cover themselves in case of potential liability. However, investors will continue to be harmed until the securities industry addresses the unpaid award issue head-on through an Investor Recovery Pool.

Other than Oregon,⁴ states do not require firms and advisers to carry insurance as a prerequisite for serving in the securities brokerage or investment advisory industries. The Model Rules, by allowing states to revoke licenses, create a significant incentive for registered representatives and investment advisory representatives to ensure that they are able to pay awards. Errors and omission insurance is the most obvious, but imperfect, potential source for such payments. While insurance will typically address standard negligence claims, PIABA members have found that policies are rife with exemptions for a variety of things common in securities disputes. For example, particular novel products, options, private placements, insurance products, and fraud claims. Policy design can also be problematic: wasting policies utilize the coverage limit to pay both the cost of defense *and* liability obligations. Defense counsel might be paid first and in full while the investor who wins their claim will not. A repeat bad actor may quickly deplete a million-dollar coverage policy within a coverage period for later-filed claims. Thus, while insurance coverage is desirable, its inherent limitations can lead to an uneven administration of justice and further undermine investors' confidence in dispute resolution and the securities industry at large.

PIABA supports the Model Rules as another important regulatory and enforcement tool, and repeats its call for the institution of an Investor Recovery Pool to most effectively address this decades-long problem. PIABA applauds the proposed Model Rules' intent and prospective investor protections, such as limiting recidivism and incentivizing good behavior. But investor confidence will continue to decline until there is a process, after going through all of the mandated steps to adjudicate claims and win a judgment or arbitration award, to ensure they are made whole for their losses caused by unlawful industry conduct. Despite decades of updated research, ongoing debate, and new regulations, the unpaid arbitration issue still persists. Investors will continue to suffer absent serious change.

3. The Current Text of the Proposed Model Rules in Exhibit B Unintentionally Excludes Awards Issued Against Investment Advisers.

There is a discrepancy in the text of the Model Rules which, as currently written, inadvertently excludes arbitration issued against investment advisers. In Exhibit B of NASAA's Request for Comment, addressing unpaid awards by Investment Advisers, the proposed language in Sections (x) and (y) contain language referencing broker-dealers "...any final judgment or arbitration award resulting from an investment-related, client or customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to between the client or customer *and the broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent...*"

⁴ Oregon instituted a mandatory insurance requirement applicable to certain state investment advisers effective January 1, 2018.

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To have the Model Rules apply to investment advisers, both Sections (x) and (y) need to be revised to read, "...any final judgment or arbitration award resulting from an investment-related, client or customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to between the client or customer *and the investment adviser or investment adviser representative, in writing, and the investment adviser or investment adviser representative...*"

Conclusion

The securities industry has long encouraged investors turn to financial professionals like broker-dealer and investment advisory representatives to help guide their finances. Investors often trust these individuals and firms with their life savings and retirement plans. Many brokers and advisers do help their clients meet their investment objectives. But unlawful conduct will always be present in a multi-trillion-dollar securities industry. Many brokerage and investment advisory firms are so thinly-capitalized that even a \$100,000 adverse judgment or arbitration award would put them out of business let alone enable full payment to the harmed party. Retail investors put their trust and confidence in financial professionals who, due to current loopholes and regulatory gaps, can simply avoid financial obligations. This is not the picture of the financial services industry being marketed to the investing public.

PIABA acknowledges the hard work and considerable thought NASAA put into its proposed Model Rules, and endorses them as an important tool for state regulators to discourage bad behavior and unpaid awards that result therefrom. Accordingly, PIABA supports NASAA's proposed Model Rules to suspend or bar industry professionals who fail to pay or otherwise attempt to avoid payment of final judgments and arbitration awards from client or customer-initiated claims. PIABA encourages NASAA to consider adding additional terms to the Model Rules mandating individuals and firms to timely submit such judgments and awards to state regulators as part of their licensing requirement, with the failure to do so being another express and actionable dishonest or unethical business practice.

Very truly yours,

/s/ Michael Edmiston

Michael Edmiston, President
Public Investors Advocate Bar Association

cc: Kristen Standifer, kstandifer@dfi.wa.gov
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