FINRA ARBITRATION'S PERSISTENT UNPAID AWARD PROBLEM

PIABA'S[1] THIRD REPORT CONCERNING FINRA'S REFUSAL TO TACKLE THE UNPAID ARBITRATION AWARD PROBLEM HEAD-ON

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If the goal is to protect people from suffering devastating injuries, would it be best to install seatbelts before the car accident, or after? Retirement savers and other individual investors today have no meaningful protection against unscrupulous stockbrokers, investment advisors, and firms who handle hundreds of millions of customer dollars but conduct business without sufficient capital reserves or liability insurance. Wall Street and the securities industry as a whole encourages Americans to trust their financial professional with their retirement savings. But few investors understand that the securities industry does not mandate protections to ensure investors can be made whole after successfully proving a claim for recoverable losses against their financial advisor. American investors have enjoyed the benefits of a stock market that has risen to all-time highs without a meaningful correction for the last decade, and a national economy that has flourished under the most adverse of circumstances. Despite these favorable dynamics, unpaid arbitration awards are still hovering at more than 24% of all dollars awarded to investors in arbitration administered through the Financial Industry Regulatory Authority ("FINRA"). Nearly 30% of all FINRA awards in customer claimants' favor in 2020 went unpaid.

Many investors do not discover the misconduct in their investment accounts until there is a market correction. For these investors, most of whom rely on their own savings – often in a retirement plan - rather than a pension to fund their retirements, a meaningful market downturn will likely reveal unprecedented harm to America's retirees and those on the verge of retirement. Since the industry has shown no interest in taking steps to ensure it maintains the same sort of financial responsibility it preaches to its customers, it is time for regulators and legislators to mandate seat belts, in the form of a national investor recovery pool.

The problem of unpaid securities arbitration awards is not a new one. Twenty-one years ago, the U.S. General Accounting Office ("GAO") issued a report on unpaid awards.[3] In its survey of investors who received arbitration awards during 1998, the GAO 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.[4] While FINRA now publishes some recent data on unpaid award statistics, and has implemented or proposed certain rule changes to try to curb abusive industry practices, neither FINRA nor state and federal regulators have directly addressed the fundamental lack of meaningful recovery protection. The problem of unpaid arbitration awards is only growing, thanks in large part to the increasing role of investment advisers, and their common use of commercial and for-profit arbitration forums other than FINRA Dispute Resolution for which there is no public reporting and little regulatory accountability. This report contains PIABA's third analysis of the problem of unpaid arbitration awards, and a renewed call for substantive remedial measures to protect retirement savers and all other individual investors.

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[1] The Public Investors Advocate Bar Association ("PIABA"), is an international, not-for-profit, voluntary bar association of lawyers who represent investors in securities and commodities arbitration and litigation. PIABA's mission is to promote the interests of the public investor in securities and commodities arbitration by seeking to: protect such investors from abuses in the arbitration process; make securities arbitration as just and fair as systematically possible; and, educate investors concerning their rights.

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[3] See United States General Accounting Office, Report to Congressional Requesters, Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards (June 2001), available at https://www.gao.gov/products/gao-01-654r, last accessed July 8, 2021.

[4] Id. at page 33.

BACKGROUND

A. PIABA'S FIRST REPORT

PIABA published its first official position paper on the unpaid award problem on February 26, 2016, titled Unpaid Arbitration Awards – A Problem The Industry Created – A Problem The Industry Must Fix (the "2016 Report"). [5] The 2016 Report presented a comprehensive survey of the problem an¬¬d potential cures. The data available at the time revealed that in one out of three cases in which an investor pursued their claims through an arbitration hearing, successfully proved their claims, and won an award against an industry party, the industry party did not pay. In practical terms – the investor used the dispute resolution process and forum forced upon them by the industry, and won their case, but recovered nothing. The 2016 Report also revealed that nearly one dollar out of every four dollars awarded to investors in arbitration went unpaid.

PIABA presented a detailed analysis of a number of proposed cures for the problem, including: expanding coverage by the Securities Investor Protection Coverage ("SIPC"); requiring increases of net capital; instituting an insurance requirement; and, finally, creating a national investor recovery pool (the "Pool"). PIABA concluded that expanding SIPC was not a viable option since SIPC's authority is limited to ensuring that securities or cash missing from an investor's account are returned (within limits - $500,000 for securities and cash, and $250,000 for cash alone). SIPC does not cover other types of losses, such as those associated with sales practice abuses by an industry professional. Absent legislative amendments, SIPC was not capable of addressing the problem.

PIABA concluded mandating insurance for brokers and investment advisers was appealing, but insurance has practical limitations such as claim exclusions for losses resulting from intentional wrongdoing and policy limits that are exhausted after just one or two claims. While PIABA did not challenge FINRA's argument that insurance would be too expensive, it appears that at least one state that mandated insurance for registered investment advisors ("RIAs") saw no change in the number of RIA firms operating within the state.[6] PIABA concluded that increasing net capital requirements to levels sufficient to address the unpaid award problem was unworkable because net capital requirements are designed simply to ensure that failing firms have sufficient funds to operate as they wind up and transfer customer assets to other, solvent, firms. Furthermore, raising net capital requirements will likely cause industry members to complain that they could not be profitable if they had to set aside sufficient reserves to address their potential/likely liabilities to their customers.

PIABA recommended that a national investor recovery pool be instituted, as it was the best and least expensive option. While certain states had already instituted their own investor recovery pools, those pools were of limited value insofar as maximum payouts were limited, and the pools generally required a finding of a violation of state or federal securities law to enable participation in the pool. Given that arbitrators sit in equity, and rarely issue reasoned awards, unwitting investors lucky enough to be in a state with such a pool could prove their case and get an unpaid award that would be ineligible to draw from the limited state pools. PIABA confirmed that FINRA itself maintained the ability to institute a pool relating to FINRA arbitration awards without a legislative mandate.[7]

PIABA proposed a detailed structure for the proposed Pool, addressing funding (to be potentially sourced from FINRA profits, assessments made upon FINRA members, or assessments made upon individual investors). PIABA also set forth a structure to determine requisite funding for both claims and administrative costs and discussed the types of claims to be paid, the amounts to be paid on those claims, and the timing for claim eligibility.

[5] A copy of the original report is available at: https://piaba.org/system/files/pdfs/Unpaid%20Arbitration%20Awards%20-%20A%20Problem%20The%20Industry%20Created%20-%20A%20Problem%20The%20Industry%20Must%20Fix%20%28February%2025%2C%202016%29.pdf. The authors would like to thank Scot Bernstein, current PIABA member, and former member of its Board of Directors, for his work on the topic in 2004. His work was instrumental in the preparation of the 2016 Report.

[6] Oregon instituted a mandatory insurance requirement for RIAs in January 2018. There were 267 firms registered in Oregon in 2018, 268 in 2019, and 273 in 2020.

[7] The legal basis to promulgate the Pool was addressed in detail in PIABA's 2016 Report at p. 25. In short, FINRA can create the Pool by way of a rule proposal, and the '34 Act allows the SEC to issue a mandate to FINRA and/or impose rules on broker/dealers.

B. FINRA'S RESPONSE

In the days following the publication of PIABA's 2016 Report, Richard Ketchum, then-head of FINRA, was questioned on Capitol Hill concerning a variety of subjects – including the issues surrounding unpaid arbitration awards. He acknowledged that "something should be done about it," and indicated an intent to work with the Securities & Exchange Commission (the "SEC").[8] Mr. Ketchum even went so far as to indicate that FINRA was not writing off the Pool idea, but rather: "We are looking at whether, one way or another, there should be a fund to try to at least address the small investors that are terribly harmed." [9]

FINRA did not institute a Pool, nor were there obvious clues to what, exactly, it was doing to remedy the problem. Rather, two years after PIABA's 2016 Report was published, FINRA responded with what it titled "Discussion Paper – FINRA Perspectives on Customer Recovery." [10] FINRA's positions were disappointing and unsurprising. First, FINRA attempted to minimize the problem, pointing out that only 18% of all customer claims go to hearing, and of those, 7% of all customer awards include some measure of damages, and of those awards, 2% are unpaid. [11] Thus, at surface level, FINRA asserted that the unpaid award problem made up only 2% of awards. However, FINRA's statistics also showed that investors who took their cases to hearing from 2012 through 2016 won only 38.89% of the time. For those fortunate enough to win their cases, the victories were often pyrrhic insofar as the investors' awards went unpaid 28.57% of the time.

FINRA pointed out that it incentivizes award payment by taking steps to revoke the memberships of associated persons and member firms who fail to pay awards. It also pointed out that other dispute resolution forums – such as courts – offer no guarantee of recovery. What FINRA did not address, however, is the importance of holding its members – who preach the need for individuals to maintain financial discipline – to a similar standard when it comes to their own ability to make restitution.

FINRA's discussion paper boasted of its other efforts to curb the problem of unpaid arbitration awards. For example, FINRA pointed out customers' ability to take inactive firms and associated persons to court, rather than proceeding in arbitration. That "solution" does nothing to curb the problem itself insofar as it only shifts the responsibility away from FINRA. The regulator also addressed, in summary terms, other rule proposals it was considering. Those proposals included: allowing investors to go to court when the FINRA respondents were unlikely to be able to pay; providing more information regarding unpaid awards via the Central Registry Directory ("CRD") system; and, potential rule changes to prevent brokers from using the tactic of switching firms or firms from moving assets to a new firm rather than paying an award, leaving a wake of unpaid awards behind.

FINRA also addressed the various suggestions PIABA raised two years previously in its 2016 Report, including: raising net capital requirements; creating a fund for unpaid awards; expanding SIPC's coverage; requiring insurance; greater disclosure requirements; and, bankruptcy code changes. FINRA's discussions of all the options were set forth in a summary fashion across two pages and offered nothing substantial beyond what PIABA had discussed two years previously. Of particular importance, FINRA buried in its discussion the following statement: "FINRA believes that Congress or the SEC should be involved in any decision to create a second brokerage industry fund for unpaid arbitration awards, especially to the extent it would cover claims that Congress has determined should not be covered by SIPC."[12] FINRA, despite acknowledging that it maintained the power to establish the unpaid arbitration award restitution fund without Congress or SEC's involvement, abdicated its responsibility by taking the position that it had no intent to create the fund absent a mandate passed down by the SEC or Congress.

[8] Waddell, Melanie, FINRA Mulls Crackdown on Arb Award Deadbeats, ThinkAdvisor (March 3, 2016), available at: https://www.thinkadvisor.com/2016/03/03/finra-mulls-crackdown-on-arb-award-deadbeats/, last viewed April 11, 2021.
[9] March, Ann, FINRA May Create Fund for Unpaid Arbitration Awards, Financial Planning (March 16, 2016), available at: https://www.financial-planning.com/news/finra-may-create-fund-for-unpaid-arbitration-awards, last viewed April 11, 2021.
[10] See FINRA, Discussion Paper- FINRA Perspectives on Customer Recovery (February 8, 2018), available at: https://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf, last viewed March 31, 2021.
[11] Id. at p. 5.
[12] Id. at 17.

C. PIABA'S SECOND REPORT

PIABA started researching a second report in November 2017 and published the report shortly after FINRA published its Discussion Paper. On March 7, 2018, PIABA released its second report on the issue, titled Unpaid Arbitration Awards – The Case For An Investor Recovery Pool ("Second Report").[13] PIABA's analysis of 2017 data revealed that 36% of investors who won their cases in FINRA arbitration collected nothing, and 28 cents of each dollar awarded went unpaid. Two years following the 2016 Report, and despite FINRA'S efforts to curb the problem, the unpaid arbitration award problem had worsened.

PIABA's Second Report focused on the relationship between the total of unpaid awards and fines assessed against FINRA members as a result of their wrongdoing. For the years 2014 through 2016, FINRA fines against its members exceeded unpaid awards by a margin of no less than 3 to 1. PIABA also viewed FINRA's net income and compared it to the unpaid awards outstanding. Once again, for the years 2014 through 2016, FINRA's profits would have wiped out unpaid awards in two out of three years with minimal impact to FINRA'S bottom line.

PIABA concluded that the problem of unpaid arbitration awards was not getting any better since the GAO had looked at the issue twenty-one years previously. Instead, investors continued to be subjected to an easily prevented harm, and the problem could no longer be ignored. PIABA urged FINRA to institute a Pool.

[13] A copy of the report is available at: https://piaba.org/system/files/2018-03/REPORT%20-%20Unpaid%20Arbitration%20Awards%20%28March%207%2C%20 2018%29.pdf, last viewed April 11, 2021.

D. FINRA'S RESPONSE TO THE SECOND REPORT

Just as two years elapsed between the 2016 Report and FINRA's substantive response, the same pattern occurred following PIABA's Second Report. Rather than address the problem head-on, FINRA instituted a number of measures that painted at the corners of the problem. In September 2020, FINRA put into place amended Membership Application Program ("MAP") rules with the stated intent of incentivizing timely payment awards.[14] FINRA summarized the changes:

The amendments will address situations where: (1) a FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down.[15]

Making it more difficult, if not impossible, for brokers and firms to leave a wake of unpaid awards behind them by moving to another firm addresses what is colloquially called the "cockroaching problem." When the light of investor claims reveals the reprobate (and often destitute) brokers, those same aggrieved investors found the brokers scurrying to new firms to continue the same wrongful conduct that got them in trouble in the first place.[16] Other firms that could not or would not pay awards adopted a tactic whereby they sold whatever assets they had, thereby leaving nothing but an empty shell behind as the firm's principals continued doing business under the shingle of a new firm. While a welcome improvement, FINRA's rule changes do not address the underlying problem of brokers and firms being unable to pay awards and customers being left with nothing.

In November 2020, FINRA sought to adopt Rule 4111, which would identify member firms with risk disclosures significantly higher than their similarly sized peers as "restricted firms," and require those restricted firms to maintain deposit accounts to which they would have limited access without FINRA's explicit approval.[17] The stated purpose of the rule proposal, which was adopted by the SEC on July 30, 2021, was to discourage future misconduct by firms and brokers with a significant history of misconduct.

Most recently, in December 2020, FINRA published a list of associated persons and firms whose membership was revoked as a result of their failure to pay arbitration awards.[18]

While PIABA applauds each step FINRA takes to address abusive industry practices that harm investors, all of FINRA's steps focus on various ways to encourage good behavior and discourage bad behavior without actually addressing the problem. The newly adopted rules do not address the problems that arise when FINRA members violate the rules and are found liable therefor. PIABA continues to insist that a structure be put into place to help those who suffer the effects of unpaid awards.

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[14] See https://www.finra.org/sites/default/files/2020-05/Regulatory-Notice-20-15.pdf, last viewed June 20, 2021.

[15] Id.

[16] McCann, Quin and Yan found that, not only would a bad broker moving to a new firm be likely to continue their ill conduct, but previously problem-free brokers would be significantly more likely to commit misconduct if their co-workers have acted wrongfully. In other words, a bad apple can spoil the bunch. They also found that the bad brokers tended to congregate within a few firms, making it substantially more likely that those firms' customers would be victimized. See McCann, Craig; Quin, Chuan; Yan, Mike, How Widespread and predictable is stock Broker Misconduct (June 2016) available at: https://www.slcg.com/pdf/workingpapers/McCann%20Qin%20and%20Yan%20on%20BrokerCheck%20Final.pdf, last viewed June 12, 2021.

[17] See SEC Release No. 34-90527, available at: https://www.sec.gov/rules/sro/finra/2020/34-90527.pdf, last viewed June 20, 2021.

[18] See https://www.finra.org/arbitration-mediation/member-firms-and-associated-persons-unpaid-customer-arbitration-awards, last viewed June 20, 2021.

THE PROBLEM

A. THE CURRENT PROBLEM

FINRA's latest statistics indicate that 2019 saw 27% of all cases in which investors were awarded money go unpaid, with the amount unpaid equaling 20% of all money awarded to investors that year.[19] FINRA has not yet reported 2020 statistics, so PIABA's staff did what it had previously done in 2016 and 2018: it pulled from the FINRA website all the publicly available customer arbitration awards issued in 2020, reviewed those awards, and determined whether they were paid. [20] Unsurprisingly, 2020 saw far fewer awards issued due to the COVID-related shutdown of in-person hearings. For 2020, FINRA reported 64 awards in customer claimant cases, with total awards of $20,895,826.21. PIABA's analysis showed that, of those totals, 19 customer awards and a total of $5,050,328.98 went unpaid. While the dollar amount of unpaid awards seems modest compared to other years' experience, it reflects 24% of all dollars awarded in 2020 were unpaid.[21] Nearly three out of every ten awards in Claimants' favor went unpaid in 2020.

The 2019 and 2020 figures are consistent with the history of FINRA's reported statistics, which, between 2015 and 2019, have ranged from 12% of dollars unpaid in 2015 to a high of 34% in 2018, and percentage of all awards ranging from 22% in 2015 to a high of 34% in 2017. In short, the problem is not improving since PIABA's initial 2016 Report.

Worse yet is the trend of FINRA-licensed brokers leaving the industry (often in a cloud of scorn following regulatory or customer complaints) and joining the ranks of SEC-registered investment advisors ("IAs").[22] The SEC does not administer a dispute resolution forum for IAs like FINRA does for brokers. PIABA, despite its best efforts, found no centralized database demonstrating the results of claims made against investment advisors. Based a sample of 167 various investment advisory agreements, PIABA members found that nearly 60% of the contracts included a pre-dispute arbitration provision, and 40% of those mandated the arbitration be conducted through the American Arbitration Association ("AAA"): a national private company that does not disclose statistical information regarding claims, award rates, or collection. Even in the absence of publicly available databases showing the results of IA arbitration hearings, be they through AAA or another private company such as JAMS, it is fair to conclude from regulatory actions and discipline that RIAs are misbehaving at the same rate as brokers. The North American Securities Administrators Association ("NASAA") 2020 enforcement report shows that its members named 200 broker-dealer firms in enforcement actions in 2019, and 193 investment advisory firms during the same period. Similarly, 391 individual brokers were named in 2019 enforcement actions while 434 investment advisor representatives were so named.[23] These statistics are not anomalies:

In 2017, 377 enforcement actions were brought against RIA firms and investment advisor representatives combined, NASAA enforcement reports show. In comparison, about 270 were brought against brokers and brokerage firms in the same year. In the previous two years, enforcement actions between advisors and broker-dealers differed by about 40, NASAA figures show.[24]

While NASAA's enforcement actions demonstrate that there as many dishonest investment advisers as there are brokers, there are no statistics showing how many claims are filed by customers against those bad IAs. Accordingly, there are no statistics showing what percentage of arbitration awards brought against IAs in AAA, JAMS, or other private dispute resolution forums go unpaid. As long as regulation of IAs is fragmented, spread across the SEC and various states without centralized oversight or reporting, there is no meaningful chance that the situation will improve.

[19] See https://www.finra.org/arbitration-mediation/statistics-unpaid-customer-awards-finra-arbitration, last viewed April 20, 2021.

[20] The authors extend their deepest and most sincere thanks to Ashley Ringo, Tiffany Zachary, and Robin Ringo for their outstanding efforts to analyze the data necessary to draw conclusions regarding 2020 unpaid awards before FINRA reports those figures at some point in the future.

[21] PIABA's staff pulled every award FINRA reported in both 2019 and 2020 and extracted relevant information from each. The authors, and Mr. Meyer's law clerk, Jared Connors, analyzed the summary reports to make determinations regarding which awards were, or were not, paid. For those cases in which FINRA's Brokercheck reported that the Respondents against whom the awards were issued lost their licenses before the awards were issued, failed to participate in the hearings, lost their licenses after the awards were issued because of a failure to pay awards, or filed for bankruptcy protection after the awards were issued, PIABA assumed the awards were unpaid. Using the same calculus, PIABA estimated that 2019 saw nearly $18 million in unpaid awards (compared to FINRA's reported $19 million), and 18.4% of all dollars awarded were unpaid (compared to FINRA's reported 20%). Thus, PIABA's methodology served to underreport unpaid awards. The authors are therefore confident in stating that their estimate of 24% of all dollars awarded in 2020 going unpaid is a conservative estimate.

[22] Banned brokers often exploit fragmented regulatory structures to establish themselves as investment advisers after losing their FINRA registration. Wusthorn, Michael, The Barred Brokers in Our Midst, The Wall Street Journal (Nov. 3, 2016), available at: https://www.wsj.com/articles/the-barred-brokers-in-our-midst-1478165406, last visited April 22, 2021 (noting the research was made particularly difficult thanks to the lack of a centralized database of brokers and advisers beyond a simple name search).

[23] NASAA 2020 Enforcement Report, available at https://www.nasaa.org/wp-content/uploads/2020/09/2020-Enforcement-Report-Based-on-2019-Data-FINAL.pdf, last viewed April 22, 2021.

[24] Keyes, Garrett, Bad RIAs are Just as Much a Problem as Bad Brokers, Lawyers Claim, Financial Advisor IQ (Aug. 1, 2019), available at: https://financialadvisoriq.com/c/2455443/283193, last viewed April 22, 2021.

B. THE PROBLEM ON THE HORIZON

A future market downturn will disproportionally affect those who have retired or are on the verge of retirement. This can be attributed, in large part, to the general shift by employers away from offering defined benefit retirement plans (pensions) and toward defined contribution plans (401(k)s). The 401(k) plan came into being in 1980, as a quirk of the tax code:

401(k)s are an accident of history. In 1980, a benefit consultant working on revamping a bank's cash bonus plan had the idea of adding an employer matching contribution and taking advantage of an obscure provision in the tax code passed two years earlier clarifying the tax treatment of deferred compensation. Though 401(k)s took off in the early 1980s, Congress did not intend for them to replace traditional pensions as a primary retirement vehicle, and 401(k)s are poorly designed for this role.[25]

The shift into defined contribution plans has accelerated over time. In 1989, assets held in traditional pension plans made up 72% of personal disposable income, while assets held in IRAs and 401(k) plans made up 31% of personal disposable income. In 2016, assets held in pension plans grew to 87% of personal disposable income while assets held in IRAs and 401(k) plans jumped to 102% of personal disposable income.[26] Yet, keep in mind many Americans do not have access to 401(k) plan participation, and most American families have little to no retirement savings. In 2016, those aged 56-61 had a median retirement savings of $21,000.[27] Those same families had median retirement savings of $37,056 in 2007 – right before the 2008 recession.[28] For those with means to participate, their 401(k) savings are subject to the vicissitudes of the markets. While defined benefit (pension) plans are subject to strict regulations designed to ensure that the requisite payouts are made to beneficiaries regardless of market movements, 401(k) plans and IRAs offer no such certainty. [29]

Coupled with the higher percentage of retirement assets in 401(k) plans and/or IRAs, America is on the leading edge of the mass Baby Boomer retirement wave. "The number of Americans aged 65 and older is projected to nearly double from 52 million in 2018 to 95 million by 2060, and the 60-and-older group's share of the total population will rise from 16 percent to 23 percent." [30] Statistics show that the pace of Boomer retirements is accelerating.[31]

In addition to the growth of the 401(k) market, assets in IRAs have boomed as well. At the end of the second quarter 2020, there were $10.83 trillion in IRAs, representing more than one third of the retirement market assets.[32] Based on data from mid-2019, three-quarters of households that owned traditional IRAs held them with investment professionals. [33] Nearly thirty percent were held with full-service brokerage firms. [34]

The stage is therefore set: the markets are trading at all-time highs, more people than ever are retiring (or on the verge of retiring), and their retirement savings are more heavily subject to market movements. When a market correction comes, weaknesses in poor (or fraudulent) investments schemes will be more apparent and likely result in shocking losses. Investors victimized by their financial professional's mismanagement or fraud will roll the dice whether a successful arbitration claim will result in any actual recovery. Retirement-age Americans who do not have the time to rebuild lost savings may ultimately turn to the state and federal welfare systems. In sum, the securities industry shifts the problem of unpaid awards from itself to the American taxpayer. This is an abhorrent dereliction of responsibility by a securities industry that profits massively from of its "trust your advisor" encouragement.

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[25] Morrisey, Monique, Report: The State of American Retirement Savings, at p. 2, Economic Policy Institute (December 10, 2019), available at https://www.epi.org/publication/the-state-of-american-retirement-savings/, last viewed March 31, 2021.

[26] Id. at 4.

[27] Id. at 8.

[28] Id.

[29] Elkins, Kathleen, A brief history of the 401(k), which changed how Americans retire, CNBC (Jan 5, 2017)("'The great lie is that the 401(k) was capable of replacing the old system of pensions,' former American Society of Pension Actuaries head Gerald Facciani tells The Journal. 'It was oversold.'"), available at https://www.cnbc.com/2017/01/04/a-brief-history-of-the-401k-which-changed-how-americans-retire.html, last viewed March 31, 2021. See also Broadbent, John; Palumbo, Michael; and Woodman, Elizabeth The Shift From Defined Benefit to Defined Contribution Plans – Implications for Asset Allocation and Risk Management (December 2006)("The transition from [defined benefit] to [defined contribution] in private sector pensions is shifting investment risk from the corporate sector to households, available at: https://www.bis.org/publ/wgpapers/cgfs27broadbent3.pdf, last viewed March 31, 2021.

[30] Mather, Mark; Scommegna, Paola; Kilduff, Lillian, Fact Sheet: Aging in the United States (July 15, 2019), available at: https://www.prb.org/aging-unitedstates-fact-sheet/, last viewed March 31, 2021.

[31] Fry, Richard, The Pace of Boomer retirements has accelerated in the past year, (November 9, 2020), available at: https://www.pewresearch.org/fact-tank/2020/11/09/the-pace-of-boomer-retirements-has-accelerated-in-the-past-year/, last visited March 31, 2021. (Finding that 3.2 million more Boomers retired in the third quarter of 2020 as compared to the same quarter in 2019.)

[32] Investment Company Institute, The Role of IRAs in US Households' Savings for Retirement, 2020, available at: https://www.ici.org/system/files/attachments/pdf/per27-01.pdf, last viewed August 18, 2021.

[33] Investment Company Institute, The Role of IRAs in US Households' Savings for Retirement, 2019, p. 22, available at: https://www.ici.org/pdf/per25-10.pdf, last viewed August 18, 2021.

[34] Id.

PROPOSED REMEDIES

A. LEGISLATIVE REMEDY

The unpaid award problem is not a new one – having been brought forward more than 20 years ago by the General Accounting Office and having been the focus of PIABA's increasing scrutiny for the last five years. FINRA can solve the problem head-on by instituting a Pool, but it has steadfastly refused to do so and taken the position it will not do so unless ordered by the SEC or Congress. If FINRA remains resolute in its refusal to institute a Pool absent an instruction from Congress or the SEC, then PIABA asks the SEC and Congress to intervene to address the problem and order FINRA to do its job and protect investors.

In contemplating a legislative remedy, it is helpful to review the scenario that led to the passage of the Securities Investors Protection Act (which created SIPC) in 1970. FINRA's Discussion Paper gave SIPC short shrift as a potential cure for the problem. But while PIABA's 2016 Report also identified issues with trying to extend SIPC coverage (such as SIPC's current inability to address recompense for broker fraud and the caps on individual claims payable by SIPC), SIPC as a perennial and well-funded resource pool bears good lessons for how and when a legislative remedy can be crafted.

SIPC was created in what would now be considered an unimaginable time frame. In the late 1960s, the markets were experiencing what was called the "paperwork crunch."[35] What had been a largely retail-based system saw an increasing number of large financial intermediaries and institutional investors participate.[36] The long-serving analog and mechanical back-office systems could handle keeping the majority of shares in firms' street names and delivering the relatively small number of physical share certificates when needed, until trading volumes moved into the tens of millions of shares.[37] Firms could not keep up with the deluge of paper and hundreds of thousands of transactions were left unsettled on a daily basis. Accordingly, dividends were sent to the wrong people since corporate record books were not updated as required. [38] The problem became significant enough the markets were forced to close one weekday each week to allow the firms to catch up.[39]

The problem was summarized:

Widespread failures of broker-dealer firms and concern for the fund so their customers had followed a prolonged period of easy business. Rising brokerage income and rising security prices had produced a general euphoria. In this mood, expansion of sales effort and overhead had not been properly supported by more capital and stronger back office effort. A veritable explosion in trading volume clogged an inadequate machinery for the control and delivery of securities. Failures to deliver securities and to make payment ricocheted though the industry and firms lost control of their records and of the securities in their possession or charged to them. Operational conditions deteriorated so severely that securities markets were required to cease trading one day each week at one point, and later to limit daily trading hours. Those conditions should not be allowed to recur. [40]

[35] See https://www.sipc.org/about-sipc/history, last viewed June 20, 2021.

[36] See https://optimizeronline.com/the-paperwork-crisis/, last viewed June 20, 2021.

[37] Id.; see also Study of Unsafe and Unsound Practices of Brokers and Dealers – Report And Recommendations of the securities and Exchange Commission 92nd Congress, 1st Session, House Document 92-231, P. 13 (December 1971), available at: http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1970/1971_1201_SECUnsafe_01.pdf

[38] Id.

[39] Id.

[40] Id. at p. 1.

A. LEGISLATIVE REMEDY, CONTINUED

The paperwork crunch inevitably led to serious market downturns in 1969. The Dow Jones Index fell 20% through the course of 1969. It continued falling through June 1970.

Entering into 1970, there were two principal institutional protections in place for investors: firms were required to register with the SEC and were further subject to net capital and minimum capital requirements.[41] Those mechanisms were, however, flawed. First, the capital requirements were not applied to all firms equally.[42] Second, it was unclear how, exactly, registration or net capital requirements would help individual investors recover losses from the firms. Net capital figures could be manipulated by a variety of measures and had little correlation to a firm's actual ability to make investors victimized by its ill conduct whole again.[43] The individual exchanges' additional requirements placed upon member firms added little to the already failing federal safeguards. [44] When calls for additional regulation grew louder, the industry resisted:

Quite naturally, leading industry representatives argued for an insurance program by way of self-regulation, that 'such an administrative mechanism would be preferable to creation of another layer of governmental regulation which would be unwieldy as well as unnecessary.' Perhaps. But the industry had been slow to respond to the rapidly emerging need for a new and constructive protection program, and Congress became understandably impatient. The result was the 1970 Act [which created SIPC] which practically spelled an end to self-regulation in this area. [45]

Rather than trust the industry to fix the problem itself, Congress stepped in and enacted the Securities Investor Protection Act and SIPC in December 1970. Investors regained confidence in the markets, which allowed those markets to rebound for a period thereafter. This bears repeating: Congress stepped in when the industry refused, and the capital markets flourished thereafter.

Just as the securities industry resisted the imposition of the Securities Investor Protection Act, it is resisting PIABA's call for the institution of a Pool. FINRA, days after the initial Report was issued, had its CEO, Richard Ketchum testify on Capitol Hill. In response to Senator Warren's question of whether more regulation was needed to ensure investors recovered their losses, Ketchum responded "Something should be done about it; I do believe that we want to work with the [Securities Exchange Commission] on this."[46] Nothing happened for two years, and then Senator Warren introduced legislation that would require FINRA to establish a fund to be used to reimburse aggrieved investors when the firms and brokers were unable to do so . [47] The Securities Industry and Financial Markets Association ("SIFMA") offered its take on Senator Warren's legislation, renouncing the problem and offering no solution. "We strongly support exploring reforms to reduce the number of unpaid arbitration awards . . . An industry-financed pool, however, is unfair to the broker-dealers who honor their arbitration award obligations, is essentially a tax on investors, and introduces numerous moral hazards." [48] As addressed below, SIFMA's excuses are thin; and for now, investors find themselves much as they did in 1970 as calls for passage of the Securities Investors Protection Act were growing louder. It is clear that, left to its own devices, the profit and deregulation-oriented securities and investment advice industry will do nothing to fix the problem. As time and conduct has made abundantly clear, neither will FINRA. Congress must therefore step in and mandate a solution to this long-standing problem.

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[41] Sowards, Hugh L.; Mofsky, James S., "THE SECURITIES INVESTOR PROTECTION ACT OF 1970." The Business Lawyer, vol. 26, no. 4, 1971, pp. 1271–1288, at 1272, available at: www.jstor.org/stable/40684808, last viewed March 28, 2021.

[42] Id. at 1272.

[43] Id. at 1272-1273.

[44] Id. at 1275.

[45] Id. at 1277 (citations omitted).

[46] Waddell, Melanie, Finra Mulls Crackdown on Arb Award Deadbeats, ThinkAdvisor (March 3, 2016), available at: https://www.thinkadvisor.com/2016/03/03/finra-mulls-crackdown-on-arb-award-deadbeats/?t=legal-compliancerefchannel-blogs, last viewed March 28, 2021.

[47] See Compensation for Cheated Investors Act, S. 2499, 115th Congress (2017-2018).

[48] SIFMA Submits Testimony Raising Concerns with Unpaid Arbitration Legislation (S. 2499) (June 28, 2018), available at: https://www.sifma.org/resources/news/sifma-submits-testimony-raising-concerns-with-unpaid-arbitration-legislation-s-2499/, last viewed March 28, 2021.

B. SEC DODD-FRANK REMEDY

If Congress cannot or will not act, and FINRA maintains course and refuses to remedy the problem on its own, the SEC has the authority to step in under Section 921 of the Dodd-Frank Act.[49] The relevant provision authorizes the SEC to:

prohibit, or impose conditions or limitations on the use of agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.

Section 921 also authorizes the SEC to impose the same sort of limitations on IAs. Thus, the SEC could require that, as a condition of including a mandatory arbitration clause in its customer agreements, firms participate in an investor recovery pool. The benefit of having the mandate issued by SEC as opposed to Congress is that the SEC sits closer to its constituents, is better equipped to balance competing interests of the securities industry and its customers, and perhaps most importantly, is not swayed by lobbyists in the same way elected officials can be. Another important benefit to the SEC taking action is that, under the powers authorized by Section 921, this investment pool remedy could be applied to SEC-registered RIAs as well as FINRA-licensed brokers, ensuring that investors are protected across the industry regardless of whether their financial professional is an IA, a broker, or both.

[49] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

C. THE NATIONAL INVESTOR RECOVERY POOL

PIABA's suggestion for the Pool's structure has not changed in a material way since it first suggested the program in 2016. In summary: the Pool would provide a source of recovery for investors who pursue a claim all the way through a final award, and have exhausted reasonable efforts to collect the award from the respondent. The Pool would be designed to be liquidated every year. If investor claims exceed the size of the Pool in any given year, the claims would be paid on a pro-rata basis. Investors who receive recoveries from the Pool would subrogate their claims to the Pool, which would then maintain the right and ability to seek recovery from the firms and brokers who failed to pay.

PIABA's 2016 Report addressed a variety of details concerning how the Pool should be structured, including the definition of "unpaid awards," the manner in which compensatory and punitive damages would be addressed, when pro-rata distributions would be made, claim eligibility timing, an appellate process to resolve disputed claims, and year-to-year funding processes. PIABA's analysis of those issues has not changed since its first Report. Two key elements, however, are worthy of update.

1. SIZE OF THE POOL

PIABA, again, recommends that the previous three years of unpaid award experience be used to establish a funding threshold for the pool for the current year. Using three years of data helps mitigate and smooth unusual highs or lows in unpaid awards. Thus, if one were to rely exclusively on FINRA's published figures, unpaid awards appear as follows:

2017: $22 Million
2018: $31 Million
2019: $19 Million

The average is $24 million, which would be the amount used to fund the 2021 Pool (exclusive of administrative costs, which PIABA contends should be addressed by FINRA).

2. FUNDING UPDATE

The viability of the Pool depends on reliable funding. There are a variety of means to achieve such funding: (1) FINRA fine monies assessed against member firms and associated persons violating FINRA rules; (2) assessments on FINRA members; and, (3) fees levied on the investing public. The pros and cons of each are addressed below.

(i) FINRA FINE MONIES

While using FINRA fine monies collected maintains appeal – since using the monies paid by bad actors to address issues raised by (presumably other) bad actors avoids any sort of moral hazard complaints that firms acting appropriately should not subsidize others who are not – FINRA will surely contend that it simply cannot afford to redirect those funds.

FINRA recently reported its year-end 2020 figures. Last year, FINRA reported that it enjoyed $19.8 million dollars of net income for 2020.[50] FINRA further reported that it had issued $57 million in fines that year.[51] The fine money, which was more than sufficient to address the $5 million of unpaid awards in 2020, was not used to reimburse those investors. Rather, FINRA spent $90.2 million (taking $33.2 million from reserves and adding it to the $57 million in penalties recovered in 2020) and spent it in two broad categories.[52] FINRA spent $73.8 million in the first category, which it describes as: "Capital initiatives or nonrecurring strategic expenditures that promote more effective and efficient regulatory oversight by FINRA (including leveraging technology and data in a secure manner) or that enable improved compliance by member firms, and capital initiatives required by new legal, regulatory or audit requirements." FINRA spent $16.4 million in the second category, which it describes as: "Activities to educate investors, promote compliance by member firms through education, compliance resources or similar projects, or ensure our employees are highly trained in the markets, products and businesses we regulate." While PIABA encourages FINRA's efforts to improve surveillance/compliance infrastructure and investor education, those efforts do not and will not address the issue of unpaid awards.

[50] 2020 FINRA Annual Financial Report, p. 8, available at: https://www.finra.org/sites/default/files/2021-06/2020-annual-financial-report.pdf, last viewed August 17, 2021.
[51] Id. at p. 3.
[52] FINRA, Report On The Use Of 2020 Fine Monies (May 27, 2021), available at: https://www.finra.org/about/annual-reports/report-use-2020-fine-monies, last viewed August 17, 2021.

(ii) ASSESSMENTS ON MEMBER FIRMS AND/OR REGISTERED REPRESENTATIVES

If FINRA were to assess a fee to each firm or registered representative (which would surely be passed along to customers in the way of higher commissions or account maintenance fees), the cost per firm is exceedingly modest. If FINRA were to assess the fee per firm (without regard to each firm's assets under management), the cost in 2019 would have been $6,350.11 per firm.[53] If, instead, FINRA were to assess each registered representative, the 2019 fee would have been $107.26 per representative. [54]

When PIABA last suggested that industry players be required to fund the pool, the entirely expected retort was "Why should firms that follow the rules pay for the bad actors?" There is a myriad of reasons. First, one could simply address it as the cost of doing business. Since neither the SEC nor FINRA have established any sort of insurance requirement, the fees required to fund the pool would be far less than insurance premiums. Consider, for example, the fact that many states mandate automotive insurance for drivers, and malpractice insurance for attorneys and doctors -– regardless of their claim history. While the vast majority of those doctors, attorneys, and drivers will never cause harm to another, as a matter of public policy, it was decided that it would be best to spread the risk of harm across the entire pool of participants. Likewise, the "moral hazard" fearmongering promoted by the industry to suggest that an insurance requirement or investor recovery pool would encourage more violations of securities laws by financial professionals is unconvincing. One cannot argue with a straight face that the presence of insurance encourages reckless driving, or the provision of negligent medical or legal services. Second, the complaint "[i]t's unfair to charge us for that" falls on deaf ears when considering the fact that the industry continues to enjoy record profits year after year. The large wirehouses have reported healthy, if not record, profits through 2020. For example, UBS reported a 137% jump in fourth quarter profits over the 2019 figures; [55] Charles Schwab reported "record operating performance" as "an extraordinary capstone to an extraordinary year"; [56] Edward Jones, the largest firm measured by the number of advisors, said its 2020 revenue grew 7% and profits 18%; and the trend continues for other firms like Morgan Stanley and Raymond James (as examples).[57] Independent firms are no different: the 25 largest independent broker-dealers reported a 4.3% increase in revenue in 2020. [58]

Even if firms were unable to pass the costs along to their customers, the financial burden of $6,350 per firm or $107 per registered representative is exceedingly modest given the industry's health and the Pool's robust benefits.

(iii) CHARGE INVESTORS

While PIABA does not suggest that assessing a direct charge to investors is the best choice, a 2019 Pool would have required less than 14 cents per investor. [59] It simply defies credulity to believe that an investor would not be willing to part with 14 cents in exchange for the benefits the Pool would provide.

[53] The average unpaid awards from 2016 through 2018 was $22.3 Million (see https://www.finra.org/arbitration-mediation/statistics-unpaid-customer-awards-finra-arbitration), and there were 3,517 firms registered with FINRA in 2019 (see https://www.finra.org/rules-guidance/guidance/reports-studies/2020-industry-snapshot).

[54] FINRA reports that there were 624,674 registered representatives in 2019. See https://www.finra.org/rules-guidance/guidance/reports-studies/2020-industry-snapshot, last viewed June 20, 2021.

[55] Amaro, Silvia, UBS Reports 137% Jump in profit, but has concerns over economic recovery, CNBC, Jan 26, 2021, available at: https://www.cnbc.com/2021/01/22/ubs-earnings-q4-2020.html, last viewed June 5, 2021.

[56] Fitzgerald, Maggie, Schwab Earnings top estimates in first reports since TD Ameritrade merger, accounts near 30 million, CNBC (Jan. 19, 2021), available at: https://www.cnbc.com/2021/01/19/charles-schwab-q4-2020-earnings-.html, last viewed June 5, 2021.

[57] UBS: https://www.nasdaq.com/articles/ubs-group-ubs-q1-earnings-rise-y-y-revenues-costs-up-2021-04-28, last viewed June 20, 2021; Morgan Stanley: https://www.morganstanley.com/about-us-ir/shareholder/4q2020.pdf, last viewed June 20, 2021; Raymond James: https://www.raymondjames.com/-/media/rj/dotcom/files/our-company/news-and-media/2020-press-releases/rjf202010284q-earnings.pdf, last viewed June 20, 2021.

[58] Kelly, Bruce, In face of pandemic, IBDs proved resilient in 2020, Investment News, April 26, 2021, available at: https://www.investmentnews.com/in-face-of-pandemic-ibds-proved-resilient-in-2020-205200, last viewed June 5, 2021.

[59] The US Census reports 255,200,373 adult Americans as of July 2019. https://www.census.gov/data/tables/time-series/demo/popest/2010s-national-detail.html, last viewed May 1, 2021. Of those Americans, Gallup found that 55% reported having some investments in the stock markets in 2019 and 2020. https://news.gallup.com/poll/266807/percentage-americans-owns-stock.aspx, last viewed May 1, 2021. Fifty-five percent of the adult population equals 140,360,305 Americans invested in the markets. Dividing the $19 million FINRA reports as being unpaid in 2019 results in a per-person charge of 13.54 cents.

3. THE PROBLEM WITH INVESTMENT ADVISORS

The discussion above is focused largely on FINRA-registered brokers and firms failing to pay awards issued against them. The problem, however, is far broader than that. IAs, while fiduciaries under federal law, are not required to be members of FINRA. Accordingly, where they may maintain arbitration clauses calling for JAMS, AAA, or other private arbitration forums, there is no central repository of arbitration award data and therefore no way to quantify unpaid IA awards in a statistically meaningful manner. While PIABA members are quick to offer anecdotal reports of underfunded IAs and the futility of bringing claims where the expense of a JAMS or AAA arbitration will quickly exceed even the best recovery, it would be best to actually define the problem with objective data first. But the problem lies in obtaining that objective data. While the SEC maintains oversight over IAs registered with the Commission, smaller IAs are instead subject to regulation by the states in which they practice. There are therefore fifty-four differing governing bodies (fifty states, the District of Columbia, Puerto Rico, the US Virgin Islands, and the SEC) overseeing the universe of IAs.

The analysis has to start somewhere and PIABA suggests that, while claims made against IAs and the resolution thereof are "material events" required to be disclosed on Form ADV,[60] the SEC must conduct a sweep of the advisory firms and IAs registered with the Commission and then report statistical summaries concerning where IA arbitrations are being heard, the results of those hearings, and data concerning unpaid awards: much as FINRA started to do after PIABA's first Report. PIABA recognizes that the statistics are of somewhat limited utility, since they will address only those larger firms and IAs registered with the SEC, but the data will offer some initial insight into the nature and scope of the problem.

[60] The SEC reminded registrants that their fiduciary duties required "full disclosure" to clients, and they were not permitted to withhold any material facts. General Instructions for Part 2 of Form ADV, available at: https://www.sec.gov/about/forms/formadv-part2.pdf, last visited June 6, 2021.

CONCLUSION

The SEC and FINRA have demonstrated that they have long recognized the ongoing issue of unpaid arbitration awards but will not address it head-on. In fact, FINRA wants an act of Congress to require it to enact a solution. If, given a market that has consistently grown in value over the course of the last twelve years, nearly one out of four dollars awarded to investors in 2020 went unpaid even as brokerage firm profits held steady or grew to record levels, the next market downturn will likely wreak havoc on the growing population relying on their broker-managed 401(k) plans and IRAs for retirement. Protecting investors, and the taxpayers who will be required to bail them out, is simple: instituting a National Investor Recovery Pool will provide a backstop at a minimal economic cost. Either Congress, the SEC, or both must act now.