



**Written Testimony before the
House Financial Services Committee
Capital Markets Subcommittee**

Regarding

**The Role of Self-Regulatory Organization in
U.S. Markets: Examining FINRA and the MSRB**

March 5, 2026

Submitted by

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PIABA

Organized in 1990, the Public Investors Advocate Bar Association (“PIABA”) is an international bar association comprised of attorneys who represent investors in securities arbitration and litigation. PIABA promotes the interests of the public investors in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. PIABA is a voluntary association whose members represent and advocate for investors harmed by fraud, misconduct, and the damage caused by members of the securities industry who put their interests ahead of their clients. As a result of representing public investors, PIABA is in the unique position to uncover patterns of conduct and regulatory inefficiencies that lead to customers being misled, misinformed, or mistreated. For more information visit:

www.piaba.org

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I. Professional Background

I am here today on behalf of the Public Investors Advocate Bar Association (“PIABA”) where I have served as Executive Director since 2022. PIABA's mission is to advocate for the interests of investors in matters of securities fraud and other issues related to securities laws and regulations. PIABA is an active participant in the development of new legislation, rules, and/or regulations to advocate for and protect the rights and interests of public investors across all investor platforms.

In my role as Executive Director, I work closely with the Board of PIABA, and its current President Michael Bixby, to advocate for these principles through the development of position papers, press releases, and legislative and regulatory comments, as well as planning and moderating conferences, seminars, and CLE sessions on matters of securities regulation and securities fraud. Prior to working with PIABA, I served as an enforcement attorney for the Oklahoma Department of Securities for over fifteen years. While at the Department I was primarily responsible for overseeing investor education outreach for the state of Oklahoma as well as investigating and prosecuting individual cases of securities fraud. I have participated as a member of the North American Securities Administrators Association (“NASAA”) Senior Outreach Project Group (where I was awarded the Outstanding Team Service Award). I am pleased and honored to have the opportunity to speak here today on behalf of PIABA and appreciate the time and attention of the members of this Committee on these matters of critical importance to PIABA members and the investing public as a whole.

II. Role of the PIABA

PIABA is an international bar association comprised of attorneys who represent investors in securities arbitration and litigation. PIABA promotes the interests of the public investors in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and securities industry misconduct. PIABA is a voluntary association whose members represent and advocate for investors harmed by fraud, misconduct, and the damage caused by members of the securities industry who put their interests ahead of their clients. As a result of representing public investors, PIABA is in the unique position to uncover patterns of misconduct and regulatory inefficiencies that lead to customers being misled, misinformed, or mistreated.

PIABA also meets regularly with the Securities and Exchange Commission (“SEC”), NASAA, and securities regulatory groups to discuss and address investor protection issues. Further, our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority (“FINRA”) particularly relating to investor protection issues. As such, PIABA frequently comments upon proposed rule changes and retrospective rule reviews to protect the rights and fair treatment of the investing public.

III. Summary of PIABA’s Written Testimony

The purpose of this hearing is to examine the role of self-regulatory organizations (SROs) in the U.S. markets including FINRA and MSRB. PIABA supports the concept of SROs as generally having a positive impact on the capital markets but remains increasingly concerned about

whether today’s SROs have a positive impact on investor protection. Because of our concerns, we believe there is a need for change and the adoption of additional safeguards. However, when SROs like FINRA and MSRB actually operate as intended and fulfill their investor protection and market integrity purpose, SROs have the potential to be a powerful force for good for investors and the market.

The Financial Industry Regulatory Authority (FINRA) is a non-profit SRO registered and supervised by the SEC but not part of the government. It serves as primary regulator for broker-dealers and its rules and regulations contour much of the investor protection landscape, and “FINRA’s mission is to protect investors and safeguard the integrity of our vibrant capital markets to ensure that everyone can invest with confidence.”¹

PIABA believes that improvements need to be made to the SRO structure that increase investor protections and the integrity of the markets. PIABA has consistently worked to highlight investor concerns with regulatory inefficiencies and outline ways for improvement. PIABA regularly meets with FINRA executives and officers and makes its positions known through comments and letter writing. FINRA has oftentimes been responsive in the past to our concerns. However, more recently, FINRA’s actions have contradicted its stated purpose – Investor Protection – and PIABA has become increasingly concerned with recent actions by FINRA that will result in serious harm to investors. PIABA is concerned that FINRA is increasingly beholden to the interests of the industry (particularly the powerful and large members of the securities industry) at the expense of FINRA’s stated mission,

In particular, PIABA will cover the following key concerns with FINRA: (1) the independence of the FINRA Board; (2) dispute resolution in the FINRA Arbitration Forum (3) access to justice for investors, (4) senior safeguards and (5) reforms for greater investor protection.

IV. FINRA’s Board of Governors, Investor Protection, and on-going PIABA Concerns

FINRA Board of Governors

PIABA has frequently stated that FINRA plays a vital role in regulating the securities industry. PIABA recognizes FINRA’s stated “mission is to protect investors and safeguard the integrity of our vibrant capital markets to ensure that everyone can invest with confidence.”² We note that this is FINRA’s stated mission because its behavior, especially recently, falls short of this promise.

FINRA has a Board of Governors consisting of “industry” and “public” governors. Its board contains twelve Public Governors, ten Industry Governors, and one seat for its Chief Executive Officer.³ Its by-laws require that its Public Governors have no “material business

¹ FINRA, About FINRA (last accessed March 2, 2025), available at <https://www.finra.org/about>.

² *About FINRA*, FINRA, <http://www.finra.org/about> (last visited February 28, 2026).

³ See FINRA, FINRA Board of Governors, <http://www.finra.org/about/finra-board-governors>, (last visited February 28, 2026) (“FINRA’s Board is currently composed of 23 industry and public members, with 10 seats designated for industry members, 12 seats designated for public members and one seat reserved for FINRA’s Chief Executive Officer”).

relationship with a broker or dealer or a self-regulatory organization registered under the Act.”⁴ In theory, Public Governors sitting on the governing board should counterbalance industry influence and provide an element of investor protection by giving the investing public representation and influence in FINRA’s governance.⁵ Regrettably, FINRA’s Public Governors have often been difficult to distinguish from industry-elected governors. Indeed, FINRA has appointed persons as public governors, who have been formerly elected by the industry to serve in the industry. It has even had public governors that simultaneously served on FINRA’s board and the boards of entities regulated by FINRA.

The board’s composition and integrity matters because it makes significant policy decisions. These decisions “shape the industry and influences the costs the public pays for financial services as well as the protections investors enjoy.”⁶ The Securities and Exchange Commission (SEC) has long recognized “the inherent potential for self-regulation to favor the interests of the securities industry over those of the investing public.”⁷

There have been longstanding concerns about FINRA’s board. Previously, SEC Commissioner Hester Peirce, when she was at the Mercatus Center at George Mason University, and a nominee to the SEC, observed that “FINRA is not subject to mechanisms comparable to those that hold government regulators accountable to Congress, the president, and the public.”⁸ She found that “FINRA’s version of self-regulation embodies a troubling independence from government, industry, and the public.”⁹ This criticism is fair as FINRA often finds itself following its own inscrutable priorities and not behaving in a way that responds to investor needs.

Historically, the SEC has only barely supervised FINRA’s governance. A 2012 Government Accountability Office Report found that the SEC had “conducted limited or no oversight of . . . FINRA’s . . . governance and executive compensation.”¹⁰ More specifically, between 2005 and 2010, the SEC conducted no oversight of FINRA’s transparency of governance.¹¹ With respect to FINRA’s Board of Governors, the SEC told the Government Accountability Office that it “periodically reviewed the composition of FINRA’s board to determine compliance with [self-regulatory organization] board-composition requirements.”¹² The SEC indicated that it had not “examined issues such as conflicts of interest or recusals related to FINRA’s governance.”¹³

⁴ FINRA, BY-LAWS OF THE CORPORATION ART. I, § tt.

⁵ Andrew Stoltmann & Benjamin P. Edwards, *FINRA Governance Review: Public Governors Should Protect the Public Interest* (Public Investors Arbitration Bar Ass’n, Nov. 15, 2017), <https://piaba.org/report-finra-governance-review-public-governors-should-protect-public-interest/>. Attached hereto as Exhibit A.

⁶ *Id.*

⁷ Referencing SEC, Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 7 (1996), <https://www.sec.gov/litigation/investreport/nd21a-report.txt> [hereinafter SEC, 21A Report].

⁸ Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All 21, Mercatus Working Paper, Jan. 2015, <https://www.mercatus.org/system/files/Peirce-FINRA.pdf>.

⁹ *Id.* at 29.

¹⁰ U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-625, SECURITIES REGULATION: OPPORTUNITIES EXIST TO IMPROVE SEC’S OVERSIGHT OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY 7 (2012).

¹¹ *Id.*

¹² *Id.* at 16.

¹³ *Id.*

It is PIABA's position that the FINRA's Board of Governors should be restructured to ensure that FINRA maintains focus on its mission to promote investor protection.

Mandatory Arbitration

Mandatory pre-dispute arbitration clauses are rampant throughout the consumer landscape. Whether a consumer pursues a claim against a credit card company, bank, cryptocurrency exchange, or their mobile service provider, mega-corporations widely impose upon consumers the requirement, without negotiation, of pre-dispute arbitration clauses. These pre-dispute arbitration clauses almost always require arbitration through a private provider of arbitration services like the American Arbitration Association (AAA) or Judicial Arbitration and Mediation Services (JAMS). The consumer arbitration rules used by private forums can *sometimes* provide for an inexpensive solution for consumers but procedurally rob them of critical procedural rights they would have in litigation, especially as it relates to discovery and prehearing dispositive motions. Likewise, the arbitrator pools in AAA and JAMS are the quintessential career arbitrators, who oftentimes have ties to the financial services industry or other large corporate clients and virtually all of whom are either lawyers or retired judges, making those arbitrator pools look far less like a jury of peers a consumer would have access to in a court of law.

There are many instances where consumers, including investors with claims against registered investment advisers (RIA) regulated by the SEC, cannot afford to bring their claims. Some RIAs abuse their privilege to incorporate arbitration clauses in their client agreements by using onerous clauses like requiring arbitration before JAMS, with three arbitrators, in New York. Such a clause would require an investor to commit to out-of-pocket costs of at least \$100,000 just to pay for a forum in which to resolve their claims. This abuse robs investors of their rights to seek recompense and prohibits legitimate and viable claims from being pursued. It is an unfair abuse of contract law in an opaque space not understood by consumers and creates inequitable results to the detriment of investors.

FINRA Dispute Resolution lowers this financial bar, which is important. When an investor brings a dispute against their financial advisor and brokerage firm, those disputes must be brought in arbitration through the FINRA Office of Dispute Resolution. There are important differences between the private arbitration forums like JAMS, the AAA, and FINRA Dispute Resolution. Since the 1990's the NASD, NYSE, and FINRA have worked with PIABA and other stakeholders to level the playing field for investors who are forced to bring their cases in what is essentially the securities industry's trade association forum. For example, PIABA fought for years to end the use of unfair pre-hearing motions to dismiss except under very limited circumstances. PIABA also fought to balance the arbitrator pool by first ending the mandate that all three-member arbitration panels include an industry arbitrator and then worked hard with FINRA to expand the roster of available FINRA arbitrators so that the FINRA arbitrator pool reflected a more diverse population: the investor populace using the forum. PIABA fought for fewer lawyers and CPAs as arbitrators, and more regular folks or "Joe the Plumber" arbitrators who could at least understand the perspective of ordinary, hardworking investors all too often defrauded by bad brokers and unprotected by lazy brokerage firm compliance departments.

These changes over the years have made FINRA arbitration the preferred arbitration forum for most PIABA members and their clients. As the rank and file of FINRA members decreases

with net migration to the investment advisory channel increasing year over year, our members now commonly bring their clients' claims in numerous forums outside of FINRA, often yoked by unfair arbitration provisions containing hedge clauses and onerous fee shifting provisions. The issues related to registered investment adviser arbitration agreements are many and are well documented by the Securities and Exchange Commission.¹⁴

All of this is to say that arbitration through FINRA Dispute Resolution is the lesser of two evils. In particular, arbitration through FINRA still overwhelmingly favors brokerage firms. In 2025, investors prevailed in final arbitration hearings in FINRA less than 30% of time.¹⁵ Said another way, the industry won more than seven out of ten times. Unfortunately, the tilt towards the industry is not an aberration. Investors fared even worse in 2024, winning only 26% of the final arbitration hearings. In 2023, investors won less than one in four arbitrations. Yet, other arbitration forums can be even worse for investors. I would like to provide statistics for you, but that is why industry members require the use of alternative forums: the arbitration outcomes are held secret to avoid the sort of study we can now conduct on FINRA arbitration outcomes.

Arbitration seems to be here to stay, as long as corporate America is allowed to force consumers into private arbitration to resolve disputes. FINRA has at least listened to and adopted some reasonable consumer protections over the years as outlined above, provided some level of transparency, and offers at least the possibility of SEC and congressional oversight. The worst outcome for investors would be that FINRA Dispute Resolution be disbanded, leaving brokerage firms to write their own pre-dispute arbitration provisions forcing investors into even more disadvantageous forums with ever withering rights and protections.

Recent FINRA Changes and Concerns

Over the last year PIABA members have grown increasingly concerned with recent changes by FINRA. Today, FINRA is promoting its FINRA Forward initiative. Unfortunately, FINRA-Forward has chosen the path towards securities industry appeasement and against the best interests of investors, seemingly to weather attacks against it by Project 2025 and as a reaction to litigation filed against it in the federal court system. FINRA-Forward appears to bow to the will of the securities industry in 2025 and early 2026 in ways not seen by PIABA since the 1990s.

The first serious change FINRA made to its arbitration program, which was done without notice or opportunity for public comment, was to change the requirements to serve as an arbitrator, narrowing the available arbitrator pool. The securities industry has long complained of those they deem to be not sophisticated enough being on FINRA arbitration panels, as if juries in courtrooms around America are only comprised of lawyers and accountants. FINRA heeded the message from the securities industry to "professionalize" their arbitrator pool and made material changes in the dark of night. FINRA now requires that arbitrators must possess a four-year college degree and have at least five years of paid professional experience (unless those candidates have served in the

¹⁴ Securities and Exchange Commission: *Response to Congress: Mandatory Arbitration Among SEC-Registered Investment Advisers. As Directed by the House Committee on Appropriations, H.R. Rep. No. 117-393* (June 27, 2023).

¹⁵ FINRA, Dispute Resolution Statistics (last accessed March 1, 2026), available at <https://www.finra.org/arbitration-mediation/dispute-resolution-services-statistics>

financial services industry, in which case the college degree seems optional). PIABA firmly stands by its position which it has maintained for years: investors deserve arbitration panels that more accurately reflect their communities than the candidates industry prefers: the distanced, sterile, set of professional arbitrators unable to see the industry's sales pitches as an ordinary investor would. Likewise, PIABA's position has remained steadfast that it benefits investors to have well-trained arbitrators and, as the sponsor of the forum, that must be one of FINRA's core responsibilities.

Although FINRA has contended these moves aim to increase "arbitrator quality," the reverse may be true. FINRA pays its arbitrators a relative pittance compared to other arbitration forums. To the extent that it narrows the pool toward attorneys and professionals, only the least economically successful attorneys will have any economic incentive to participate as arbitrators. In contrast, sharp firefighters, police officers, and others may have a more rational economic incentive to participate in the forum as arbitrators.

The next favor FINRA extended to the securities industry was in direct response to arbitrators who ruled against brokerage firms. FINRA Rule 12407(a) allows a party to make a request or a motion to the Director of Arbitration to remove an arbitrator from the list of proposed panelists prior to the parties submitting their arbitrator ranking forms under very limited circumstances. Recently, FINRA has *granted requests by brokerage firms to remove arbitrators for the simple reason that those arbitrators issued a singular ruling against those firms previously*. This is a drastic change to the equality of the arbitrator ranking process and allows brokerage firms to remove arbitrators from the pool in a given case without having to use one of their preemptory strikes available for each case. Further, FINRA's interpretation of prior rulings in arbitration as bias is inconsistent with the well-developed case law under the Federal Arbitration Act. The concern here is that there do not appear to be any real circumstances where the liberalization of this rule could favor investors. FINRA's recent execution of this rule only favors repeat players – brokerage firms and registered representatives who appear multiple times in different FINRA arbitrations. This is a one-sided interpretation, and it only benefits brokerage firms to the detriment of investors. It could also serve to decimate the already-thin pool of arbitrators if an arbitrator who ruled against a particular firm was forbidden from ever hearing another case involved that firm.

FINRA's efforts to appease the securities industry to the detriment of investors appears likely to continue. On July 11, SIFMA sent a letter¹⁶ to FINRA which identified roughly a dozen issues that SIFMA had with FINRA Dispute Resolution, with suggestions on how FINRA can "improve." PIABA responded in kind.¹⁷ SIFMA's list of grievances included its desire to limit or eliminate the authority of arbitrators to award punitive damages; to rekindle the broad use of pre-dispute dispositive motions; the reintroduction of the mandatory industry arbitrator; and forum selection to arbitration forums outside of FINRA favoring the securities industry for certain kinds

¹⁶ Securities Industry and Financial Markets Association, *Letter From SIFMA to FINRA re: Recommendations for FINRA Arbitration* (July 11, 2025), available at <https://www.sifma.org/wp-content/uploads/2025/07/SIFMA-Letter-to-FINRA-re-Arbitration-2025.07.11.pdf>.

¹⁷ Public Investors Advocate Bar Association, *Response to SIFMA Recommendations for FINRA Arbitration* (August 4, 2025), available at <https://piaba.org/wp-content/uploads/2025/08/Sifma-Response-842025-FINAL.pdf>.

of cases. Simply put, the industry's "wish list" would be a disaster for public investors putting them at further extreme disadvantage in attempting to pursue recovery for wrongdoing.

FINRA quickly acted on the securities industry's list of grievances reflecting FINRA's intent or willingness to undo thirty years of progress. Just earlier this week, FINRA released Regulatory Notice 26-06, a seventy-page opus containing 275 endnotes, purportedly directed at "modernizing FINRA Arbitration Rules".¹⁸ Despite platitudes about investor protection being at the core of its mission, Regulatory Notice 26-06¹⁹ makes it clear that FINRA will return investor arbitration to the status quo ante from more than a generation ago. This new notice includes convoluted requests for comment directed at stakeholders on issues critical to investor protection and the fairness of FINRA arbitration including but not limited to: 1) Whether certain categories of customer disputes should be resolved through a different arbitration forum altogether; 2) Whether FINRA should expand the use of prehearing motions to dismiss and eliminate the "eligibility rule"; 3) Whether FINRA should bring back the industry arbitrator in all cases; 4) Whether FINRA should restrict discovery beyond that required by the limited Discovery Guide; 5) Whether FINRA should create an arbitration czar to whom arbitrators can to ask questions during the arbitration proceeding; 6) Whether FINRA should eliminate or limit punitive damages to protect the industry at the detriment of the investment public who are victims of egregious misconduct.

FINRA's recent bend towards the securities industry is a real threat to investor rights, the fairness of its industry-sponsored arbitration forum, and presents a level of hypocrisy that is difficult to joust. Regulatory Notice 26-06 represents the securities industry's wish list that would undo a generation of work between the securities industry, FINRA, PIABA, and other stakeholders.

This recent Notice is also emblematic of a trend with FINRA's general regulatory notices and the FINRA Forward initiative. FINRA appears to have a new approach to Rule Making. Starting with FINRA Regulatory Notices 25-04, 25-06 and 25-07, the notices have become lengthy, unwieldy, and ambiguous. In fact, on at least one occasion, PIABA members had to request a meeting with the FINRA general counsel's office to try to determine the responsive information sought by the notice. FINRA has further been forced to extend additional response time on these notices. PIABA Responded to each of these notices.

Simultaneously, FINRA filed Regulatory notice 25-05 dealing with Outside Activities. This notice was lengthy and included multiple attachments including a flow chart to attempt to explain the notice. PIABA also did respond to this notice. FINRA has proceeded to send this rule to the SEC in SR-FINRA-2026-001 with modifications that removed supervisory and recordkeeping requirements for investment adviser activity. The amendments to the Outside Activities rules will gut investor protections and reduce or eliminate requirements for supervision of some of the primary hotbeds of securities and investment fraud, which will likely lead to the proliferation of increased Ponzi schemes and other fraudulent activity. The response to these dramatic changes has been overwhelmingly negative, with the SEC receiving over eighty-five comments last month, and approximately sixty of those comments raising serious investor

¹⁸ <https://www.finra.org/rules-guidance/notices/26-06>

¹⁹ <https://www.finra.org/rules-guidance/notices/26-06>

protection concerns. FINRA has also recently sent SR-FINRA-2026-004 directly to the SEC without providing an additional opportunity for notice and comment in the regulatory notice process with FINRA.

Unpaid Awards

Certain systemic problems have persisted with FINRA members and FINRA Dispute Resolution for decades. One of the most incendiary problems facing investors in forced FINRA arbitration is the scourge of unpaid arbitration awards. For decades, the small number of investors who are lucky enough to prevail in FINRA arbitration have too often received paper awards that are never paid. This is not a theoretical problem. It is documented, persistent, and corrosive to the integrity of our markets.

In 2024, a shocking 37 cents out of every dollar of FINRA Arbitration Awards issued to customers went unpaid, and one out of every four cases where damages were awarded went unpaid.²⁰ To be clear, in 2024, customers won their FINRA Arbitrations only 26% of the time. Out of that small percentage of wins, 37% of the amount awarded to those customers went unpaid. Between 2020 and 2024, approximately \$80 million of FINRA Arbitration awards in favor of customers and retail investors went uncollected.²¹ These statistics are merely the tip of the iceberg as they drastically understate the extent of the problem since most investor claims that would likely go unpaid are never pursued in the first place. Despite this known problem, FINRA and its Board of Governors last year announced that FINRA’s 2024 earnings were “better-than-expected” and issued \$50 million in rebates for FINRA member firms.²² The issue of unpaid FINRA Arbitration Awards has been a persistent problem, and despite its “Investor Protection” mandate, FINRA has proven it is unable to fix the issue by itself despite having the funds and tools to fix the unpaid awards problem.

PIABA has covered this problem for many years, publishing research and reports.²³ FINRA—and its predecessor self-regulatory organizations—have let this problem continue for far too long. A 2000 report from the U.S. General Accounting Office n/k/a Government

²⁰ FINRA, *Statistics on Unpaid Customer Awards in FINRA Arbitration* (last viewed March 1, 2026), available at <https://www.finra.org/arbitration-mediation/dispute-resolution-statistics/statistics-unpaid-customer-awards-finra-arbitration>.

²¹ *Id.*

²² Mari Nicholson, *FINRA Returns \$50 Million in Regulatory Fees to Member Firms*, AltsWire (July 2, 2025), available at <https://altswire.com/finra-returns-50-million-in-regulatory-fees-to-member-firms/>.

²³ See. Hugh D. Berkson, PIABA Report: *Unpaid Arbitration Awards, a Problem the Industry Created — a Problem the Industry Must Fix* (Public Investors Arbitration Bar Ass’n, Feb. 25, 2016), <https://piaba.org/wp-content/uploads/2016/02/Unpaid-Arbitration-Awards-A-Problem-The-Industry-Created-A-Problem-The-Industry-Must-Fix-February-25-2016.pdf>. Attached hereto as Exhibit B; Stoltmann, Andrew, and Hugh D. Berkson. *Unpaid Arbitration Awards: The Case For an Investor Recovery Pool* (Public Investors Arbitration Bar Ass’n March 7, 2018), available at: <https://piaba.org/wp-content/uploads/2024/07/REPORT-Unpaid-Arbitration-Awards-March-7-2018.pdf>. Attached hereto as Exhibit C; Berkson, Hugh D., & Meyer, David P. *PIABA Report: FINRA Arbitration’s persistent unpaid award problem: PIABA’s third report concerning FINRA’s refusal to tackle the unpaid arbitration award problem head-on (third report)* (Public Investors Advocate Bar Association, September 29, 2021). <https://piaba.org/wp-content/uploads/2024/07/PIABA-Report-FINRA-Arbitrations-Persistent-Unpaid-Award-Problem-September-29-2021.pdf>. Attached hereto as Exhibit D.

Accountability Office (“GAO”) found that 49 percent of FINRA arbitration awards in favor of investors in 1998 went entirely unpaid by broker-dealers and an additional 12 percent were only partially paid.²⁴ The GAO recommended that the self-regulatory organizations “develop procedures addressing the problem of unpaid awards caused by failed broker-dealers.”²⁵ We now find ourselves more than twenty-five years later, however, and FINRA still has made no meaningful progress while unpaid FINRA arbitration awards continue to plague investors.

The impact of unpaid awards has been shifted to the American retirees and main street investors. Take for instance the story of Thomas and Diann Elliott a 75 and 72-year-old couple from Liberty, Illinois who operated their family farm for nearly 50 years. After having lost most of their life savings due to misconduct by their small independent broker-dealer, the Elliotts filed a FINRA Arbitration claim and litigated their case for nearly three years all the way through a contested final arbitration hearing. The Elliotts were awarded over \$212,000 in 2025 by a unanimous panel of FINRA Arbitrators. Yet the broker dealer has not paid a penny of the award. There are far too many stories of hardworking families who have been devastated by fraudulent conduct or failures of the broker dealer industry, and when the investors do the right thing, pursue their claim, prevail and then are left with nothing.

I would ask that you consider Darrell and Joan Vincent from Fowler Illinois. They are a retired couple in their 70s who spent their careers working as a boiler operator for a soybean plant and a postal carrier. After being awarded over \$450,000 to reimburse them from being victimized by securities fraud, they have recovered not as much as a single penny of the amount awarded. Kent and Nancy Crow, a couple in their 70s who each spent decades working as a grain farmer and librarian, also pursued a claim in FINRA Arbitration and were awarded over \$978,000. The Crows have recovered nothing from the award.

Take, for another example, Bruce Wilkerson. Mr. Wilkerson, a now 61-year-old retired NFL player who worked as a machinist after a decade of playing football and even winning a Super Bowl. Mr. Wilkerson trusted his hard-earned life savings to a FINRA broker dealer which abused that trust and allowed its representative to steal those funds. Mr. Wilkerson filed an arbitration claim and in March 2015, the arbitrators awarded Mr. Wilkerson his full losses of \$610,000, as well as other statutory damages. Unfortunately, shortly before the award was issued, FINRA cancelled the broker-dealer, Resource Horizon’s registration. The broker-dealer had already failed to pay another arbitration award related to the same misconduct affecting Mr. Wilkerson and then failed to pay Mr. Wilkerson’s award as well.

These victims are investors who have lost their life savings, often retirement funds, and did everything they were supposed to do. They followed the rules, hired a trusted financial advisor, and then found themselves required to file an arbitration claim. They saw the arbitration through to the end, were about the rare few whose arbitration panel agreed that they were wronged or defrauded, and yet they were unable to collect or recover their lost savings.

²⁴ U.S. Gen. Accounting Office, GAO/GGD-00-115, Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards at p. 5 (2000), <https://www.gao.gov/assets/ggd-00-115.pdf>. [“GAO 2000 Report”]. FINRA’s data also shows that nearly \$200 million in awards went uncollected between 2012 and 2016. FINRA, Discussion Paper—FINRA Perspectives on Customer Recovery at p.7 (Feb. 8, 2018), https://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.

²⁵ See GAO 2000 Report, *supra* footnote 5, at 9.

In response to this long term and pervasive scourge, in 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 964, and identified ten specific oversight priorities for the SEC’s oversight of FINRA, one of which was “arbitration services.” The GAO was to periodically report on the SEC’s performance of its oversight. According to a 2021 GAO report, the SEC neglected to perform necessary oversight of FINRA and its arbitration process.

FINRA, to its credit, does track the issue of unpaid awards for FINRA member firms. However, other financial services professionals operate as SEC or state registered investment advisory firms. And, unlike FINRA, there is no uniform tracking or reporting with regards to investment advisory firms, accordingly we find little data regarding the extent of the same issue in the investment advisory space.

Simple solutions, like insurance requirements or an investor recovery pool have long been offered and even acknowledged by FINRA, but FINRA has failed or refused to take action.²⁶ Most investors have no idea that insurance is not required or that there is no backstop protection for brokerage firms that commit misconduct, and most investors are shocked that they have to maintain auto insurance to drive their cars but there is no requirement for the financial professionals who “drive” the management of main street investor’s retirement nest eggs.

Investor Recovery Pool

Regardless of how strong the investor protection rules, regulations, and laws are, they are meaningless absent an investor’s ability to actually recover money when those rules, regulations, and laws are violated. As former SEC Chairman Jay Clayton aptly summarized: “What dollars do you actually collect when somebody has done you harm? Because you can have a really strong standard, but if there are no dollars there, that’s a problem.”²⁷ FINRA recognized the creation of an investor recovery pool as an approach “to cover unpaid customer arbitration awards” noting that the “fund could be established by Congress” and “could be funded by assessments of brokerage industry participants directly” or “indirectly through a FINRA funding mechanism.”²⁸

The Investor Recovery Pool is feasible. FINRA’s fines ordered in every year from 2020-2024 have more than doubled the amount of unpaid awards each year. PIABA has previously estimated that annual assessments as low as \$23 per FINRA-registered broker could cover unpaid FINRA arbitration awards.²⁹ The investor recovery pool’s benefit to aggrieved investors would far outweigh the modest cost to FINRA or its members – or the taxpayers at large who now have to pay for the social services needed for the newly broke retirees. Creation of an investor recovery

²⁶ FINRA Discussion Paper – FINRA Perspectives on Customer Recovery, FINRA (Feb. 8, 2018), https://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.

²⁷ Crypto News, Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission, YOUTUBE (Feb. 6, 2018), https://www.youtube.com/watch?v=NGgg_dXBpq0 (SEC Chair Jay Clayton, testifying before the Senate Banking, Housing and Urban Affairs Committee).

²⁸ FINRA Discussion Paper – FINRA Perspectives on Customer Recovery, FINRA (Feb. 8, 2018), https://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf

²⁹ Andrew Stoltmann & Hugh D. Berkson, *PIABA Report: Unpaid Arbitration Awards – The Case for an Investor Recovery Pool* (Public Investors Arbitration Bar Ass’n Mar. 7, 2018), available at <https://piaba.org/wp-content/uploads/2024/07/REPORT-Unpaid-Arbitration-Awards-March-7-2018.pdf>.

pool would also advance FINRA's investor protection mandate and help restore trust and confidence in the brokerage firm industry. Coupling an investor recovery pool with insurance requirements will also further reduce the cost and or funding burdens on an investor recovery pool.

Insurance

A recent paper tackled this issue finding that the unpaid arbitration award problem has existed for decades across both broker-dealers and registered investment advisers.³⁰ Although bad brokerages might generate more liability than their insurance policy would cover, this does not mean some measure of insurance would not help. Some insurance requirements would offer both increased odds of recovery and market discipline for the riskiest brokerage firms. If no insurance company will write an affordable policy for certain brokerages, it likely means that the brokerage should not be allowed to manage the public's assets. When insurance companies simply will not take the bet, why should the worst brokerages be allowed to gamble with other people's money.

Government studies, state enforcement data, and arbitration outcomes all confirm the same pattern: firms collect fees and commissions from retail customers, but when misconduct leads to liability, some lack sufficient capital or insurance to satisfy awards. The result is devastating for harmed investors. They incur legal costs, prevail after a full evidentiary hearing, and yet receive nothing. A dispute resolution system without a meaningful recovery mechanism undermines public confidence in securities regulation. Mandatory professional liability insurance directly addresses this structural defect.

First, insurance materially increases the likelihood that prevailing investors recover meaningful compensation. It does not guarantee full recovery in every case. It does ensure that arbitration awards are more than symbolic.

Second, insurance creates private market discipline. Insurers assess risk. Firms with repeated misconduct, concentrated supervision problems, or aggressive sales practices face higher premiums or reduced access to coverage. In this way, insurance markets price misconduct and incentivize better compliance before harm occurs. Insurance can operate as a forward-looking risk control mechanism, supplementing regulatory enforcement and arbitration.

Critics often argue that insurance mandates would reduce access to financial advice. The available empirical evidence does not support that claim. For example, when Oregon and Oklahoma required certain state-registered advisers to maintain errors and omissions insurance, there was no material reduction in the number of advisory firms operating in those states. Similarly, when a major custodial platform required insurance from advisory firms, the market adapted without issue.

Professional liability coverage is a manageable cost relative to advisory revenue models. It is common in other professions that handle consumer assets or provide fiduciary services. The securities industry should not be exempt from baseline risk-transfer requirements that protect the public.

³⁰ Adam J. Gana & Benjamin P. Edwards, *The Insurance Solution for Financial Advice Failures*, 14 Mich. Bus. & Entrepreneurial L. Rev. 1 (2025).

Mandatory insurance does not represent punitive regulation. It is a pragmatic safeguard. It ensures that when investors win their cases, they have a realistic opportunity to collect. It strengthens incentives for firms to supervise effectively. And it restores credibility to the arbitration system that Congress has permitted to remain the primary forum for retail securities disputes. Retirement savings, education funds, and lifetime earnings are too important to rest on the solvency of thinly capitalized firms. A financial advice industry that handles trillions of dollars in household wealth should carry baseline professional liability coverage.

The Committee has an opportunity to align investor protection with basic risk management principles. Mandatory broker-dealer insurance and a corresponding investor recovery pool are not radical. These reforms to resolve the pervasive unpaid awards problem are responsible and long overdue.

Holding Companies

FINRA currently permits non-FINRA member holding companies and individual non-FINRA registered control persons to own and control FINRA-registered broker-dealers while remaining outside FINRA’s regulatory jurisdiction and exempt from mandatory customer arbitration. Despite these holding companies, in many cases, owning the majority interest if not being the sole and exclusive owner of broker-dealers, being listed as “Control Persons” on Form BD filings, and exercising complete operational control over member firms, FINRA claims it lacks authority to regulate these entities or compel them to arbitrate customer disputes.

PIABA has met with FINRA and outlined the regulatory gap. This regulatory gap is being systematically exploited through a scheme that operates as follows: (1) a holding company owned by FINRA-registered individuals acquires a broker-dealer; (2) the broker-dealer engages in sales practices that harm customers; (3) the profits derived from those very sales practices are passed from the broker-dealer to its unregulated holding company; (4) as customers’ claims accrue—and even as they file claims in FINRA arbitration—but before awards are paid, the holding company closes the broker-dealer or transfers profitable operations to another entity it controls; (5) investors are left holding uncollectible judgments against the shell broker-dealer while the same individuals continue operating in the securities industry under FINRA membership.

One recent matter illustrates how this scheme operates with apparent FINRA acquiescence. Center Street Securities, Inc. (“Center Street”) was owned by Center Street Holdings, Inc. (“CSH”), which was listed as a Control Person on Form BD. CSH was owned primarily by the firm’s president, Jack Thacker, a FINRA-registered Associated Person. In late 2020/early 2021, Arete Wealth, Inc.—owned and controlled by FINRA-registered individuals including CEO Joshua Rogers—acquired CSH through a stock purchase agreement. Arete issued press releases announcing the firms would “strategically combine their entities” and operate under the Arete Wealth brand. This represented to the market that Arete was assuming responsibility for Center Street’s operations and, by implication, its obligations.

After Center Street faced dozens of FINRA arbitration claims in 2022-2023 for the same unsuitable sales practices FINRA had sanctioned Center Street for in 2014 (FINRA AWC No. 2012034936004), Arete’s registered owners “abandoned” the merger plan. Instead, they

strategically shut down Center Street Securities, filed Form BDW, and placed the firm into a “Delaware Liquidating Trust.”

Center Street ceased defending arbitration cases and refused to comply with discovery orders. This damage was immediate and ongoing, with more than \$2 million in unpaid FINRA Awards in January and February 2025 alone for one such former FINRA Member owned by a holding company. (See FINRA Case Nos. 22-01937, 22-01620, and 22-02391, totaling almost \$2.18 million in awards on which investors cannot collect.) These victims are not sophisticated institutional investors—they are retirees, farmers, and working Americans who relied on the regulatory system to protect them.

Meanwhile, Arete Wealth Management, LLC (CRD #44856) continues operating as a FINRA member with the same controlling individuals. These individuals enjoy all benefits of FINRA membership and registration as Associated Persons while investors who won awards against their affiliated entity received no restitution for the harm they suffered.

FINRA has indicated it will not act without your SEC direction, claiming this involves “control person” definitions that require SEC approval. We have also identified a gap in FINRA Rule 1017, which governs “continuing membership applications” (CMAs) for changes in ownership of broker-dealers. That Rule requires disclosure of unpaid awards and pending settlements but does not address (1) pending arbitration claims that have not yet resulted in awards; (2) corporate restructurings, spin-offs, or asset transfers designed to avoid liability; (3) use of shell companies and non-registered entities to exercise control while avoiding arbitration obligations; or (4) liability of holding companies and owners for awards against affiliated entities.

When FINRA attempts to assert jurisdiction over holding companies under FINRA Rule 1011(b)(3)—which defines them as “associated persons” when they control members—arbitration panels routinely refuse to accept jurisdiction, and holding companies successfully obtain restraining orders in federal court.

FINRA should require all holding companies, control persons, and direct or indirect owners of FINRA members to agree to FINRA jurisdiction over disputes arising from the member firm’s activities. Further, FINRA should establish that holding companies, control persons, and owners with 25% or greater ownership interest are jointly and severally liable for arbitration awards against member firms they own or control.

V. Senior Safeguards

Senior financial exploitation is not a niche problem. It is not a series of isolated incidents. It is a national crisis. The numbers alone should demand action. In 2024, the FBI reported that Americans over the age of 60 lost \$4.8 billion to fraud³¹, a staggering figure that does not take into consideration that sums lost by people too embarrassed to report their experiences. The FTC, in its most recent annual report to Congress, found that older adults' reported fraud losses have

³¹ 2024 IC3 Annual Report, available at https://www.ic3.gov/AnnualReport/Reports/2024_IC3Report.pdf.

quadrupled since 2020, rising from \$600 million to \$2.4 billion in 2024 alone.³² But because most fraud goes unreported, the FTC estimates the true losses experienced by older adults in 2024 may be as high as \$81.5 billion. FinCEN's analysis of Bank Secrecy Act data found \$27 billion in suspicious activity linked to elder financial exploitation in a single year.³³ Investment scams, the category most likely to touch a brokerage account, were the leading driver of losses among older adults, and they are accelerating. These are not abstract statistics. Behind every number is a retired teacher, a widowed grandmother, a veteran who served this country. Americans who did everything right, saved for decades, and had it taken from them.

Older Americans are being targeted at unprecedented levels by increasingly sophisticated fraud schemes. Fraudsters go where the money is, and the wealth of the retirees in this country is held at FINRA-member brokerage firms. The national focus must therefore be placed squarely on responsibilities of these institutions. They hold the assets, employ the personnel, and operate the surveillance systems best positioned to detect and prevent exploitation before it causes irreversible harm. When a senior investor loses a lifetime of savings, it is the brokerage firm that had the clearest opportunity to intervene. They must be given the tools to protect their clients and held accountable when they fail.

Financial exploitation of the elderly is not limited to the unsophisticated or uninformed. Members of our organization represent doctors, engineers, lawyers, business owners, and executives. Many of these individuals held successful careers and built businesses. Yet they, too, fall victim to modern financial scams. The reason is simple: the fraudsters have evolved. Today's schemes are technologically advanced, emotionally manipulative, and highly coordinated. They exploit fear, isolation, urgency, and trust. They impersonate government officials, romantic partners, cryptocurrency experts, financial institutions, and even family members. They use spoofed phone numbers, artificial intelligence, and convincing documentation and replicated platforms that look like the real thing. The result is devastating. Lifetimes of savings can disappear in days or even minutes.

When seniors lose money to financial exploitation, the harm is not solely economic. It strips them of independence, dignity, and security. It can force delayed retirement, diminished healthcare options, and reliance on family members and social services. In some cases, it leads to depression, severe emotional distress, and suicide.

FINRA has taken some steps to address this crisis. Certain rules were adopted in response to mounting concerns about senior investor abuse. These include the general rules of supervision and good faith business practices; supervision rules that work in conjunction with Rule 4512, which addresses trusted contact persons; and Rule 2165, which permits temporary holds on disbursements where financial exploitation is suspected. These rules were well-intentioned and serve as an acknowledgement from our securities regulators that the problem is serious and widespread. However, the FINRA rules as they currently exist do not go far enough.

³² Protecting Older Consumers 2024–2025 A Report of the Federal Trade Commission, available at https://www.ftc.gov/system/files/ftc_gov/pdf/P144400-OlderAdultsReportDec2025.pdf.

³³ Interagency Statement on Elder Financial Exploitation, available at <https://www.fdic.gov/interagency-statement-elder-financial-exploitation.pdf>.

FINRA Rule 4512

Under FINRA Rule 4512, brokerage firms are required to make reasonable efforts to obtain the name and contact information of a trusted contact person for a customer's account. When properly implemented, trusted contacts are one of the most effective tools available to interrupt exploitation before it becomes irreversible. When a member of a firm's fraud department contacts a trusted person to flag a suspicious transaction, it introduces something that fraudsters cannot afford: time. A few hours, even a single phone call between a worried son or daughter and their parent, is often enough to break the psychological hold a scammer has carefully constructed. That brief pause, combined with the voice of a trusted family member or friend, can cut through the fear, urgency, and manipulation that fraudsters rely upon, and give the senior investor the clarity needed to step back from a devastating financial decision.

But trusted contacts cannot protect investors if firms fail to obtain them in the first place. Our members have found that many firms are not making meaningful or consistent efforts to secure trusted contact information. In many instances, accounts are opened or maintained without any trusted contact on file. This is not merely an oversight. It reflects a structural failure in how firms approach the requirement. When trusted contact information appears as an afterthought buried in the fine print of a lengthy account application, with no meaningful explanation offered to the customer, it should come as no surprise that the field is left blank.

Firms must do more than make the form available. They must affirmatively engage their customers in a conversation about what a trusted contact is, why it matters, and how it could one day protect them. If a financial advisor never explains to a customer what a trusted contact is, why it exists, or why naming one could prove critical, it is difficult to see how any firm could credibly claim that "reasonable efforts" were made to comply with Rule 4512. A checkbox on page eleven of an account application is not a reasonable effort. It is the appearance of compliance. That distinction matters enormously when a senior's life savings is on the line. We have not seen FINRA address this with its members. And a rule without robust enforcement does not meaningfully protect investors.

FINRA Rule 2165

PIABA's primary concern with FINRA Rule 2165 is its permissive nature. The rule allows a brokerage firm to place a temporary hold on certain disbursements if it has a reasonable belief that financial exploitation has occurred, is occurring, or will be attempted. The operative word is "allows." Firms may place a hold. They are not required to do so.

PIABA believes this approach is insufficient. Many of today's most devastating schemes (pig butchering, crypto fraud, imposter scams) are orchestrated overseas. Once funds leave the brokerage account, they are often gone permanently. This is a compelling argument for why the *hold* must happen at the firm level *before* funds are disbursed.

When a brokerage firm has a reasonable belief of fraud or abuse, it should have an *affirmative* duty to act. That duty should include placing a temporary hold on suspicious disbursements and contacting a trusted person. Such a requirement would not be without

precedent. It would bring FINRA into alignment with a growing body of state law that already imposes mandatory reporting obligations on broker-dealers and investment advisers. The majority of states have enacted laws specifically requiring broker-dealers and investment advisers to report suspected elder financial exploitation and authorizing them to temporarily delay disbursements. The NASAA Model Act, which has served as the foundation for much of this state-level legislation, goes further than FINRA's current framework by mandating that qualified individuals, including broker-dealer agents and compliance personnel, promptly notify both Adult Protective Services and the state securities regulator upon a reasonable belief of exploitation. Congress has also recognized the value of incentivizing reporting through the Senior Safe Act, which provides immunity to firms that report suspected exploitation in good faith. It would be incongruous to allow the federal self-regulatory framework governing these same firms to remain purely permissive when states, NASAA, and Congress have all moved in the direction of affirmative obligation. FINRA should follow that lead.

Training Frontline Workers

Some brokerage firms dedicate additional personnel and training to elder abuse detection. They have surveillance systems designed to flag unusual activity. They hold themselves out as trusted stewards of their customers' assets. In light of these resources and responsibilities, it is appropriate to require affirmative action when red flags arise.

Training is therefore critical. As far back as FINRA Notice to Members 09-64, firms were warned against falling into a false sense of familiarity and routine in dealing with customers. Consider the long-time client who has walked into the same branch office for years, greeted by the same faces, exchanged the same pleasantries. When that client walked in with wire instructions that would ultimately drain his life savings into the hands of scammers, the employee who took the instructions hesitated to probe further. She knew him. She did not want to seem presumptuous. She did not want to make him uncomfortable. And so she processed the wire. That discomfort, that misplaced deference, cost him over \$3 million, and in the end, his life as well. The quality and depth of training across the industry remains inconsistent. Some firms invest heavily in educating frontline personnel to detect, prevent, and escalate indicia of fraud. Others provide minimal or perfunctory instruction.

Another persistent and troubling failure in frontline training is the assumption held by some that certain clients are simply too sophisticated to be deceived. Our members see this often - an advisor whose client is a physician, an attorney, a retired executive, or a former judge has initiated a large and unusual wire transfer. Rather than pausing to ask questions, the advisor processes the transaction without concern. The client is smart, the advisor reasons. The client knows what he is doing. That assumption is dangerous. And it is wrong.

Sophistication in a profession does not confer immunity from psychological manipulation. Fraudsters do not select their victims based on career achievement. They select them based on vulnerability, isolation, and access to assets. The schemes that reach brokerage accounts today are not crude. They are carefully engineered to bypass rational decision-making. They exploit grief, loneliness, fear, and trust. A retired surgeon who has spent forty years saving lives is no less susceptible to a convincing impersonator than anyone else, and may, in fact, be more susceptible,

precisely because no one around him expects it. Too often, advisors dismiss warning signs because they believe their client is too savvy to be fooled.

Frontline personnel are the first line of defense. They are the individuals who must notice unusual withdrawal patterns, sudden wire requests, changes in demeanor, or the presence of a new third party exerting influence. Without thorough training, those warning signs may go unrecognized or unaddressed.

PIABA urges that greater emphasis be placed on mandatory, meaningful training for all customer-facing personnel. Training should include not only how to recognize red flags, but also how to escalate concerns, document suspicions, and act decisively under supervisory procedures.

In summary, we respectfully recommend the following:

First, FINRA should issue formal regulatory guidance defining what constitutes a "reasonable effort" under Rule 4512. The current standard is undefined, and that ambiguity has allowed firms to treat a buried checkbox on a new account form as sufficient. It is not. FINRA should issue a Regulatory Notice specifying that compliance with Rule 4512 requires, at minimum, an affirmative and documented conversation with the customer explaining what a trusted contact is and how the designation may be used, a record of that conversation retained in the customer's file, and a periodic follow-up no less than every three years to confirm or update the trusted contact information.

Second, FINRA should amend Rule 2165 to convert its permissive "may" language into a mandatory "shall" obligation. Where a member has a reasonable belief that financial exploitation of a specified adult has occurred, is occurring, has been attempted, or will be attempted, the member shall place a temporary hold on the disbursement of funds or securities from the account, and shall notify the trusted contact person designated under Rule 4512, if one has been identified, or shall take other reasonable actions to respond to the attempted exploitation or fraud and to protect their customers. Replacing "may" with "shall" is a targeted, surgical change that transforms a voluntary tool into an enforceable protection.

Third, FINRA should adopt mandatory training requirements for all customer-facing personnel at member firms. FINRA should establish a baseline curriculum, developed in coordination with NASAA and the SEC, that all associated persons with direct customer contact must complete on an annual basis. That curriculum should include recognition of the behavioral and financial red flags identified in FinCEN's 2022 Advisory, internal escalation protocols, documentation requirements when exploitation is suspected, and specific guidance on how to engage customers when a suspicious

VI. Access to Justice

As outlined above, customers of FINRA members are currently required to go to FINRA arbitration to resolve any disputes they may have with their FINRA registered member. In many cases this results in an unfair advantage to the FINRA member.

The investors face limited arbitrator pools that continue to not look like members of their peer group. They also face a potentially lengthy process and at times cannot get all parties into the same forum to litigate. Further, as outlined above, even if an investor wins, their award has a one in four chance of going unpaid.

For these reasons, PIABA supports a prohibition of mandatory arbitration provisions in broker, dealer, or other FINRA-member agreements. Certainly, PIABA recognizes that arbitration can still be a valuable tool and provide some benefits. However, we believe that after a dispute has arisen, the investor should have a right to choose the arbitration, court, or forum they would like to use. This will also act to serve as further accountability for the integrity of the arbitration system.

VII. Reform

Office of Investor Advocate

FINRA should be required to have an independent Investor Advocate that plays a similar role within FINRA as the SEC Investor Advocate performs at the SEC. This office would assist in investor protection issues and view all issues from the perspective of investors. The Investor Advocate role could provide a way to assist investors, review pending rules, and propose meaningful changes within FINRA.

Strengthen SEC oversight

The SEC should be required to provide more consistent oversight of FINRA and the MSRB. This should include public reporting of exam findings. The exams and oversight should be subject to FOIA and allow the investing public confidence in the capital market structure.

Enhance Transparency

BrokerCheck and Unified Database

FINRA maintains the BrokerCheck system. FINRA has adopted rules for “disclosing information about brokerage firms and investment professionals registered with FINRA...to help investors determine whether to conduct, or continue to conduct, business with these brokerage firms and investment professionals.”³⁴ The BrokerCheck system gives you a snapshot of the broker’s employment history, regulatory actions, and investment-related licensing information, arbitrations and complaints.

This is a beneficial resource for the investing public. However, for an accurate picture of financial professionals, individual investors also must review the SEC Action Lookup-Individuals (SALI), Investment Adviser Public Disclosure (IAPD), and contact relevant state securities regulator where a salesperson maybe licensed.

³⁴ About Broker Check, <https://www.finra.org/investors/investing/working-with-investment-professional/about-brokercheck/faq> (Last checked, February 28, 2026).

BrokerCheck, <https://brokercheck.finra.org>, (Last Checked, February 28 2027=6).

Each of these databases can disclose different relevant information about the licensed securities professional. This is an increased burden on the reasonable investor to be required to review and understand all information on these sites.

A combined database with all information should be required. This will assist investors and should assist them in making a decision on utilizing a licensed securities professional.

Expungement

The Financial Industry Regulatory Authority (“FINRA”) works with state securities regulators to maintain a database, known as the Central Registration Depository (“CRD”), of information on individuals working as current and former registered representatives in the brokerage industry. Complaints by investors, for example, are included in the CRD records. Those records can be accessed by the public through FINRA’s BrokerCheck tool on FINRA’s website, as well as obtained from some state securities regulators. FINRA and state and federal securities regulators actively encourage investors to use FINRA’s BrokerCheck tool and look for customer complaints when deciding whether to hire a particular broker to manage the customer’s life savings. Therefore, as FINRA recognizes, it is important that the information on the CRD system, and by extension BrokerCheck, be complete and accurate. To remove customer complaint information from the CRD system, a broker must request that the information be expunged. FINRA instructs arbitrators that customer complaints should be removed from a broker’s CRD only in extraordinary circumstances. FINRA’s rules permit expungement in only a very narrow set of circumstances.

As a result of the advocacy of many entities including NASAA, PIABA, and the PIABA Foundation, FINRA has made significant changes to the broker expungement process. These changes resulted in state securities regulators receiving notification and being allowed to participate in the straight in expungement process. In addition, previous customers now receive notice and can participate in the process. These positive changes should be recognized. However, there is still far more work to do in this area. While the expungement rate for this supposedly “extraordinary” remedy used to be granted 90% of the time it was requested,³⁵ FINRA’s statistics for 2025 indicate that expungements have still been granted more than 68% of the time.³⁶ The brokerage industry prevails at a similar win rate on both expungements and in defeating customer claims. And valuable information regarding customer complaints continues to be erased at alarming rates.

In one recent case example, a registered representative sought to have the case expunged from their CRD record. The original claimant was notified pursuant to the new rules and made the decision to contest the expungement and even bring an expert witness to confirm the accuracy of the claim. The arbitrator panel in this expungement case was reluctant to hear anything about the

³⁵ David P. Meyer, Jason R. Doss & Lisa Bragança, *PIABA & PIABA Found., Updated Study on FINRA Expungements: A Seriously Flawed Process That Should Be Fixed Now to Protect the Integrity of the Public Record*, p. 5 (2021), <https://www.sec.gov/comments/sr-finra-2020-030/srfinra2020030-8815751-238026.pdf>,

³⁶ <https://www.finra.org/rules-guidance/key-topics/expungement-of-dispute-information#statistics> (last reviewed March 2, 2026).

initial matter and prior proceedings. The claimant insisted on being afforded with the opportunity to present evidence and was ultimately allowed to put on testimony from both an expert witness and the claimant after delays by the arbitration panel. The panel still granted the expungement request and appeared irritated that the claimant appeared to contest the matter.

This expungement process should be modified to guarantee a more rigorous process that protects the previous victims and the future investing public. Granting an expungement should be an extraordinary measure.

VIII. MSRB Reforms

PIABA members do not typically take as active a role with the MSRB. However, we do occasionally comment on pending MSRB rules, and PIABA members often utilize resources provided by MSRB including important data and information made available through EMMA. PIABA recognizes that MSRB can serve similarly important functions to FINRA when it operates consistent with its stated purpose. We have found their notice and comment period similar to the traditional FINRA process when we have commented, and MSRB appears to often track similar proposals to those of FINRA.

PIABA would encourage Congress to consider implementing similar structure and procedural changes for MSRB to those of the FINRA changes discussed above.

IX. CONCLUSION

Thank you again for the opportunity to testify. I hope I have provided a helpful overview of the SRO system and the reforms needed to help protect the investing public.

Exhibit

A

*FINRA Governance Review:
Public Governors Should Protect the Public Interest*

Authored by:
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Acknowledgements²

Introduction

The Financial Industry Regulatory Authority (FINRA) plays a vital role in regulating the securities industry. In public materials, FINRA describes itself as “an independent, not-for-profit organization authorized by Congress to protect America’s investors by making sure the securities industry operates fairly and honestly.”³ It also claims to be “dedicated to investor protection and market integrity through effective and efficient regulation of broker-dealers.”⁴ Its stated mission is “to provide investor protection and promote market integrity.”⁵

Although it characterizes itself as “independent,” FINRA’s current governance structure allows the securities industry to exert substantial control over FINRA’s operations. FINRA’s governing board contains 13 Public Governors, 10 Industry Governors, and one seat for its Chief Executive Officer.⁶ FINRA’s by-laws state that its Public Governors may

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Benjamin P. Edwards is an Associate Professor of Law at the University of Nevada, Las Vegas, William S. Boyd School of Law. The views expressed in this report are his own and not made on behalf of the University of Nevada, Las Vegas. He is a member of the PIABA Board of Directors. Portions of this report are drawn from his prior writings on the subject including a law review article advocating for changes in the appointment process for FINRA’s Board of Governors. See Benjamin P. Edwards, *The Dark Side of Self-Regulation*, 85 U. CINN. L. REV. 573 (2017).

² The authors would like to thank Elizabeth Manriquez for her assistance with collecting information for this report. The authors also thank PIABA’s executive director, Robin Ringo, for her continued and significant assistance in pursuing PIABA’s mission of protecting investors. The authors also thank Professor Christine Lazaro, PIABA’s Executive Vice President for her close review and assistance with this report.

³ About FINRA, FINRA, <http://www.finra.org/about> (last visited Oct. 9, 2017).

⁴ *Id.*

⁵ FINRA, Our Mission, <https://www.finra.org/about/our-mission> (last visited Oct. 30, 2017).

⁶ See FINRA, FINRA Board of Governors, <http://www.finra.org/about/finra-board-governors>, (last visited Oct. 24, 2017) (“FINRA’s Board is currently composed of 24 industry and public members, with 10 seats designated for industry members, 13 seats designated for public members and one seat reserved for FINRA’s Chief Executive Officer”).

have no “material business relationship with a broker or dealer or [other] self-regulatory organization.”⁷

The inclusion of Public Governors on the governing board is intended to give the investing public representation and influence in FINRA’s governance.⁸ With 10 governing board seats given to the industry, specifically, FINRA member-firms, the securities industry is more than adequately represented on FINRA’s board. FINRA’s efficacy and legitimacy as an investor protection organization requires the inclusion of Public Governors with a demonstrated commitment to investor protection.

Our review of FINRA’s current and recently departed Public Governors reveal significant conflicts and concerns. Rather than having a “public” (*i.e.*, customer-oriented) bent, FINRA’s Public Governors often provide additional representation for securities industry constituencies. In many instances, FINRA’s Public Governors join the board after long careers in the securities industry. Although some academics and former regulators do serve on FINRA’s board as Public Governors, the Board only infrequently includes persons primarily identified as investor protection advocates. This absence is troubling for an organization that publicly characterizes itself as dedicated to investor protection.

The composition of FINRA’s Board of Governors matters because it makes significant policy decisions that shape the industry and influences the costs the public pays for financial services as well as the protections investors enjoy. Although the public pays transaction costs, these costs create revenues for FINRA’s member firms. This financial dynamic creates the perception, if not the reality, that FINRA is slow to support changes that reduce costs for public investors or increase protections for investors at the expense of industry profits.⁹

This Report examines the extent to which FINRA’s governance structure and selected “public” representatives embody its stated commitment to investor protection. This Report focuses on FINRA’s Board of Governors because FINRA’s governance rarely receives attention and its Board of Governors wields substantial power.¹⁰ Given the

⁷ FINRA, BY-LAWS OF THE CORPORATION ART. I, § tt.

⁸ See CSPAN, Senator Cortez Masto on FINRA Conflicts, July 27, 2017, <https://www.c-span.org/video/?c4678228/senator-cortez-masto-finra-conflicts> (discussing how Public Governor seats are intended to represent the investing public).

⁹ See Susan Antilla, Finance Execs Fill 'Public' Board Seats at Finra, the Regulator that Promises Investor Protection, THE STREET, Aug. 26, 2016, <https://www.thestreet.com/story/13684706/1/finance-execs-fill-public-board-seats-at-finra-the-regulator-that-promises-investor-protection.html> (“if you’re wondering why things don’t always turn out so well for Mom and Pop when they entrust money to a broker, you might ponder the balance of power on Finra’s board”); see also Mark Schoeff Jr. & Bruce Kelly, Finra: Who’s watching the watchdog?, InvestmentNews, Sept. 2, 2017, <http://www.investmentnews.com/article/20170902/FEATURE/170909996> (quoting Barbara Roper as explaining that “They operate in a difficult environment . . . Their incentives for doing anything groundbreaking to advance a pro-investor agenda are non-existent.”).

¹⁰ See Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 HOFSTRA L. REV. 963 (2012) (“Few issues are as poorly understood and under-theorized as the concept of ‘industry self-regulation.’”); Andrew F. Tuch, *The Self-Regulation of*

concerns we identified with FINRA’s existing (or recently departed) Public Governors, this Report proposes governance changes as well as an alternative slate of Public Governors that FINRA should draw upon to increase board independence and advance its stated investor protection goals. We also believe that FINRA would earn substantial goodwill and increase its credibility by continuing to increase transparency into its governance processes.¹¹

The Governance Constraint on Industry Self-Regulation

The Securities and Exchange Commission (SEC) has long recognized “the inherent potential for self-regulation to favor the interests of the securities industry over those of the investing public.”¹² Financial self-regulatory organizations, such as FINRA, pose unique risks because they wield delegated governmental authority without all of the restraints that normally accompany the exercise of state power. To check the risk that the securities industry’s self-regulator will behave like a cartel and prioritize industry over public interests, FINRA’s governance documents require the appointment of a majority of Public Governors.¹³ If FINRA appoints insufficiently independent Public Governors, FINRA’s key investor protection mission suffers.

Background: FINRA Emerges as a Quasi-Governmental Regulator

In 2007, the regulatory arm of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) merged to create FINRA.¹⁴ FINRA is the nation’s largest securities regulator and has responsibility for overseeing the nation’s brokerage firms. FINRA also plays a critical investor protection role for retail investors.¹⁵

Investment Bankers, 83 GEO. WASH. L. REV. 101, 105 (2014) (explaining that FINRA’s “self-regulation of investment bankers has thus far attracted scant scholarly attention”); Saule T. Omarova, *Wall Street As Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 414-15 (2011) (“what is conspicuously absent from the . . . broader debate among academics and policy-makers, is a meaningful discussion of the role and shape of industry self-regulation in the emerging postcrisis regulatory order”).

¹¹*C.f.* Thayla Knight, Transparency and Accountability at ~~the~~^{the} SEC and at FINRA, Heritage Foundation (Feb. 28, 2017), <http://www.heritage.org/markets-and-finance/report/transparency-and-accountability-the-sec-and-finra> (“Neither fish nor fowl, it straddles the line between government and private entity, in many instances taking the worst from both worlds and offering a considerable lack of transparency and accountability overall”).

¹² See SEC, Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 7 (1996), <https://www.sec.gov/litigation/investreport/nd21a-report.txt> [hereinafter SEC, 21A Report].

¹³ See JOHN C. COFFEE ET AL., SECURITIES REGULATION: CASES AND MATERIALS 692 (13th ed. 2015) (“A special study conducted under William Cary, President Kennedy’s chair of the SEC, found that industry self-regulation consistently had been self-interested and self-protective, often failing to produce standards of conduct superior to those that existed before the enactment of the securities laws”).

¹⁴ The consolidation was intended to “streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single set of rules and [a single set of] examiners with complementary areas of expertise [within] a single [SRO].” Self-Regulatory Organizations, Exchange Act Release No. 55,495, 2007 WL 1260858, at *9 (Mar. 20, 2007).

¹⁵ See Barbara Black, *Punishing Bad Brokers: Self-Regulation and Finra Sanctions*, 8 BROOK. J. CORP. FIN. & COM. L. 23 (2013) (explaining that FINRA “plays an important role in protecting investors,

FINRA straddles the line between a public and private entity. Although FINRA officially remains a private, not-for-profit corporation, it exercises governmental power that has been delegated to it in securities regulation.¹⁶ Because of its use of government power and unique role, debates have emerged over whether it should be classified as a state actor.¹⁷ It plays such an essential role that courts have referred to it as a “quasi-governmental agency.”¹⁸

The Inclusion of Public Governors

After past crises, scandals, and governance failures, financial self-regulatory organizations agreed to include public representatives on their boards. The inclusion of public members on the governing board of financial self-regulatory organizations began during the Great Depression. At that time, the NYSE voted to add three “public” members to its thirty-person board, putting the first purportedly public representatives in place.¹⁹ The Maloney Act later authorized broker-dealer firms to create their own self-regulatory organization modeled on the NYSE. The NASD similarly agreed to appoint a majority of “non-industry” representatives in response to the odd-eights scandal.²⁰ In the odd-eights affair, academics pieced together that FINRA members had colluded to increase trading spreads and industry-wide profits.²¹ Afterward, it emerged that FINRA’s precursor, the NASD, had done nothing to protect the public despite knowing about the “facts and circumstances” of the behavior for a substantial time.²² At the time, the SEC acknowledged that “[w]hile self-regulation benefits from the knowledge, insight, and expertise brought by industry participants, it must give primacy to the

especially retail investors, and bolstering investor confidence in the securities industry and capital markets”).

¹⁶ See S. REP. 94-75, 23, 1975 U.S.C.C.A.N. 179, 201 (“Industry organizations, i.e., the exchanges and the NASD, are delegated governmental power in order to enforce, at their own initiative, compliance by members of the industry with both the legal requirements laid down in the Exchange Act and ethical standards going beyond those requirements.”); Jennifer M. Pacella, *If the Shoe of the SEC Doesn't Fit: Self-Regulatory Organizations and Absolute Immunity*, 58 WAYNE L. REV. 201, 202 (2012) (“SROs carry out quasi-governmental functions as delegates of the SEC”).

¹⁷ See William A. Birdthistle & M. Todd Henderson, *Becoming A Fifth Branch*, 99 CORNELL L. REV. 1, 13 (2013) (pointing out that a debate has emerged over whether self-regulatory organizations have become “quasi-governmental organizations”).

¹⁸ See, e.g., *Nat'l Ass'n of Sec. Dealers, Inc. v. S.E.C.*, 431 F.3d 803, 804 (D.C. Cir. 2005) (explaining that FINRA’s precursor “serve[d] as a quasi-governmental agency, with express statutory authority to adjudicate actions against members who are accused of illegal securities practices and to sanction members found to have violated the Exchange Act or [SEC] regulations issued pursuant thereto”).

¹⁹ See WILLIAM O. DOUGLAS, *GO EAST, YOUNG MAN: THE EARLY YEARS: THE AUTOBIOGRAPHY OF WILLIAM O. DOUGLAS* 291 (1974) (claiming that the self-regulating exchanges had become “modern Augean stables . . . fighting for opportunities to exploit the unsuspecting public”).

²⁰ SEC, 21A Report (After the odd-eights scandal, it emerged that industry members had “engaged in a variety of abusive practices to suppress competition and mislead customers” and that the NASD had done nothing about it despite knowing the “facts and circumstances” for a substantial time”).

²¹ See generally William G. Christie & Paul H. Schultz, *Why Do NASDAQ Market Makers Avoid Odd-Eighth Quotes?*, 49 J. Fin. 1813 (1994).

²² SEC, 21A Report, *supra* note 12, at 1 (“The NASD failed over a period of time to conduct an appropriate inquiry into an anticompetitive pricing convention among Nasdaq market makers, even though the NASD knew of facts and circumstances evidencing such matters by 1990”).

fundamental purpose of regulation of the securities markets: the protection of investors and the public interest.”²³ The stated commitment to including public governors continued when the NYSE and NASD merged to create FINRA.²⁴

If they are not conflicted and are truly looking to protect investors, Public Governors would play a key role on FINRA’s board and provide a check against the ever-present danger of industry domination. But, to achieve this goal, a public representative must have actual independence and a true public-interest orientation. If, however, public representatives share the same perspectives, beliefs, and biases as industry members, they may represent the public’s interest with less vigor.²⁵ At worst, industry-aligned public representatives provide only a veneer of investor protection, cloaking industry control over a purportedly independent board.

The Appointment Process and Requirements for Public Governors

The FINRA Board of Governors selects Public Governors “from candidates recommended to the Board by the Nominating Committee.”²⁶ Under the by-laws, the “number of Public Governors on the Nominating Committee shall equal or exceed the number of Industry Governors on the Nominating Committee.”²⁷ Because of this structure, a single industry-aligned Public Governor on the Nominating Committee may amplify the industry’s influence over the Public Governor nominating process.²⁸

FINRA’s by-laws provide few limitations on who may serve as a Public Governor. Its by-laws define Public Governors as:

any Governor or committee member who is not the Chief Executive Officer of the Corporation . . . who is not an Industry Governor and who otherwise has no material business relationship with a broker or dealer or a self regulatory organization registered under the Act (other than serving as a public director of such a self regulatory organization).²⁹

FINRA’s limited “no material business relationship” test for public governors may fail to capture other significant bias-producing conflicts of interest for its Public Governors.

²³ *Id.* at 51.

²⁴ See Self-Regulatory Organizations; Nat’l Ass’n of Sec. Dealers, Inc.; Order Approving Proposed Rule Change to Amend the by-Laws of Nasd to Implement Governance & Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of Nasd & Nyse Regulation, Inc., Release No. 56145, 2007 WL 5185330, *2 n 13 (July 26, 2007) (“A “Public Governor” means any Governor who is not the Chief Executive Officer of the New SRO or, during the Transitional Period, the CEO of NYSE Regulation, who is not an Industry Governor (as defined below) and who otherwise has no material business relationship with a broker or dealer or an SRO registered under the Exchange Act, other than as a public director of such an SRO.”).

²⁵ See Steven Davidoff Solomon, *The Government's Elite and Regulatory Capture*, N.Y. TIMES (June 11, 2010), <http://dealbook.nytimes.com/2010/06/11/the-governments-elite-and-regulatory-capture> (explaining that ideological capture occurs when regulators “share the same beliefs and ideas as their industry”).

²⁶ FINRA, BY-LAWS OF THE CORPORATION ART. VII, § 5.

²⁷ FINRA, BY-LAWS OF THE CORPORATION ART. VII, § 9(b).

²⁸ As explained below, the chair of FINRA’s nominating committee has substantial industry connections.

²⁹ FINRA, BY-LAWS OF THE CORPORATION ART. I, § tt.

Notably, its by-laws do not define what constitutes a material business relationship. For example, it appears that FINRA's Public Governors affiliated (through board service or otherwise) with entities that rely on FINRA-member firms to distribute financial products are not deemed to have a "material business relationship" with FINRA firms. Other financial services firms have significant interests in FINRA's regulation because FINRA's member-firms play an integral role in the financial system. FINRA itself recognized this when it expanded its definition of non-public arbitrators in its Code of Arbitration Procedure to include persons associated with mutual funds, hedge funds, and investment advisers.³⁰

FINRA's by-laws also impose a term limit on Public Governors, limiting their ability to serve indefinitely.³¹ FINRA's website explains that "Governors are appointed or elected for three-year terms and may not serve more than two consecutive terms."³²

The SEC's Past Understanding of "No Material Business Relationship"

When the NASD instituted its requirement that Public Governors have "no material business relationship" with a broker or a dealer, the SEC understood that Public Governors differed from Industry Governors.³³ It recognized that Industry representatives included "all brokers and dealers, their officers, directors, and holding companies, large shareholders of brokers and dealers, as well as many of the people (including professionals) that work for them."³⁴ The NASD also previously categorized some board members as "non-industry" if they were connected in some way to NASDAQ.³⁵

FINRA's Current Conflict of Interest Materials

In addition to its by-laws prohibiting a material business relationship with broker-dealers, FINRA has also created policies and guidelines to address conflicts of interests

³⁰ See FINRA, FINRA Rule 12100 (y), http://finra.complanet.com/en/display/display_main.html?rbid=2403&element_id=4099, (last visited Oct. 24, 2017).

³¹ See FINRA, By-Laws of the Corporation Art. VII, § 5 ("No Appointed Governor may serve more than two consecutive terms. . . . Appointed Governors shall be appointed by the Board for a term of three years to replace those whose terms expire.")

³² FINRA, FINRA Board of Governors, (visited Oct. 11, 2017), <http://www.finra.org/about/finra-board-governors>.

³³ See SEC, *Self-Regulatory Organizations; Nat'l Ass'n of Sec. Dealers, Inc.; Order Approving Proposed Rule Change & Amendment No. 1 to the Proposed Rule Change, Notice of Filing & Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change, & Order Extending Temp. Approval of Sr-Nasd-96-20 & Sr-Nasd-96-29, Regarding Proposed Changes in the by-Laws & Restated Certificates of Incorporation of the Nasd*, Release No. 39326 (S.E.C. Release No.), Release No. 34-39326, 65 S.E.C. Docket 1957, 1997 WL 714065, at *4 (Nov. 14, 1997) ("A Public participant on a board or committee is someone who has no material business relationship with the Association, or with any broker or dealer") [hereinafter NASD Governance Order].

³⁴ *Id.* The NASD Governance order excluded outside directors from its definition of "Industry" participants. *Id.* at n 29. The NASD had a separate category for persons with connections to NASDAQ that were not members of the industry, labeling them as "non-industry" representatives. *Id.* at n 27.

³⁵ *Id.*

for its Board of Governors. Its Code of Ethics and Business Conduct for the Board of Governors of FINRA and the Board of Directors of its Subsidiaries (Code of Ethics) explains that a “conflict of interest exists when our private interests interfere, could interfere, or even *appear* to interfere with the interests of FINRA.³⁶ The Code of Ethics states that Governors should not have “direct or indirect interests in, or relationships with, any organization where these interests or relationships could conceivably: (a) hinder our objectivity, independence of judgment or conduct in carrying out our responsibilities as FINRA Governors and Directors, or (b) embarrass FINRA because of the *appearance* of a conflict of interest.”³⁷

Implicitly recognizing that it plays a critical role in protecting investor confidence, FINRA’s Code of Ethics makes clear that “the appearance of a conflict can be as harmful as an actual conflict.” FINRA’s stated Code of Ethics explains that it is intended “to avoid the appearance of impropriety, as well as situations where independence is actually impaired.”³⁸ To the extent that a business relationship is not explicitly recognized by the by-laws, the Code of Ethics should ensure that Public Governors do not have affiliations with the industry that may create the appearance of conflicts.

Additionally, FINRA’s Code of Ethics recognizes that Governors with multiple board memberships may face potential conflicts. Its Code of Ethics states that Governors should “be sensitive to other commitments or activities (i.e., your duties to another Board) that may interfere with your ability to act in the best interest of FINRA.”³⁹

FINRA also has Corporate Governance Guidelines (Guidelines) that give direction to its Board of Governors.⁴⁰ Those Guidelines make clear that because FINRA serves as “a protector of investors and a guardian of market integrity, FINRA’s Governors have a heightened duty to make certain that they act in the best interest of the company and that their conduct is beyond reproach.”⁴¹ The Guidelines make clear that “actions by a Governor in his or her individual capacity that may cast doubt upon his or her honesty, integrity, fairness and excellence and/or attract adverse publicity may undermine FINRA’s stakeholders’ confidence in the organization.”⁴²

The Securities & Exchange Commission’s Conflicts Guidance for SEC Commissioners

The SEC more closely polices conflicts of interest in its own governance and would prohibit Commissioners from serving in the same types of simultaneous governance positions that FINRA’s Public Governors now occupy. The SEC defines employment as “any form of non–Federal employment or business relationship, involving the provision

³⁶ FINRA, Code of Ethics and Business Conduct for the Board of Governors of FINRA and the Board of Directors of its Subsidiaries (adopted Dec. 3, 2008; amended Sept. 19, 2013) (emphasis in original).

³⁷ *Id.* (emphasis in original).

³⁸ *Id.*

³⁹ *Id.* at 3.

⁴⁰ FINRA, Corporate Governance Guidelines (Updated Aug. 22, 2016).

⁴¹ *Id.* at 3.

⁴² *Id.* at 4.

of personal services by the employee.”⁴³ Notably, the SEC’s definition of employment specifically includes service as an “officer” or as a “director” of another organization.⁴⁴ The SEC prohibits its employees from accepting employment with “any entity regulated by the Commission.”⁴⁵ It also sweeps broadly and bars employment that is “otherwise involved with the securities industry.”⁴⁶

Limited Public Accountability and Oversight

Hester Peirce of the Mercatus Center at George Mason University, and a nominee to the SEC, has observed that “FINRA is not subject to mechanisms comparable to those that hold government regulators accountable to Congress, the president, and the public.”⁴⁷ She found that “FINRA’s version of self-regulation embodies a troubling independence from government, industry, and the public.”⁴⁸

Historically, the SEC has only barely supervised FINRA’s governance. A 2012 Government Accountability Office Report found that the SEC had “conducted limited or no oversight of . . . FINRA’s . . . governance and executive compensation.”⁴⁹ More specifically, between 2005 and 2010, the SEC conducted no oversight of FINRA’s transparency of governance.⁵⁰ With respect to FINRA’s Board of Governors, the SEC told the Government Accountability Office that it “periodically reviewed the composition of FINRA’s board to determine compliance with [self-regulatory organization] board-composition requirements.”⁵¹ The SEC indicated that it had not “examined issues such as conflicts of interest or recusals related to FINRA’s governance.”⁵²

The SEC’s investor protection mission requires that it effectively supervise FINRA’s governance.⁵³ The SEC should devote additional resources to supervising FINRA’s governance.

Longstanding Concerns about FINRA’s Public Governors

Concerns about the public-interest orientation of FINRA’s Public Governors date back to FINRA’s creation in 2007. For example, the Massachusetts Securities Division, one of the most vigilant state securities divisions, argued in 2007 that FINRA would be “fundamentally flawed if the representatives of investors are chosen directly or

⁴³ 5 C.F.R. § 4401.103(a)(2).

⁴⁴ *Id.*

⁴⁵ *Id.*, at (c)(iii)(A).

⁴⁶ *Id.*, at (c)(iii)(C).

⁴⁷ Hester Peirce, *The Financial Industry Regulatory Authority: Not Self-Regulation after All 21*, Mercatus Working Paper, Jan. 2015, <https://www.mercatus.org/system/files/Peirce-FINRA.pdf>.

⁴⁸ *Id.* at 29.

⁴⁹ U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-12-625, *SECURITIES REGULATION: OPPORTUNITIES EXIST TO IMPROVE SEC’S OVERSIGHT OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY* 7 (2012).

⁵⁰ *Id.*

⁵¹ *Id.* at 16.

⁵² *Id.*

⁵³ See SEC, *About the SEC*, <https://www.sec.gov/about.shtml> (last visited Nov. 13, 2017) (“The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC strives to promote a market environment that is worthy of the public’s trust.”).

indirectly by the securities industry or the current” self-regulatory associations.⁵⁴ The Massachusetts Securities Division argued that FINRA’s Public Governors should be appointed by “members of the investing public and their representatives” instead of by existing boards.⁵⁵ This selection mechanism would provide “the best assurance that the views of investors will be heard and their interests will be protected.”⁵⁶ Massachusetts recommended that investor protection organizations like the “North American Securities Administrators Association, the American Association of Retired Persons, and the Consumer Federation of America be among the investor advocates who select the Public Governors.”⁵⁷

Public Representatives on FINRA Advisory Committees

FINRA has recognized the importance of including investor advocates at other levels of its governance. In the past, FINRA has appointed investor advocates to its lower-level Advisory Committees. For example, FINRA has appointed a majority of investor advocates as public representatives on its National Arbitration and Mediation Committee (NAMC).⁵⁸ The NAMC recommends changes to the rules governing the dispute resolution forum. The NAMC recommendations, however, are advisory, and are ultimately approved, amended or denied by the Board of Governors. Without adequate public representation at the Board level, the investor protections recommended by the NAMC may never see the light of day.

The FINRA360 Process

FINRA recently announced its FINRA360 organizational improvement initiative.⁵⁹ The initiative offers an opportunity for FINRA to build upon existing strengths and become a more effective force for investor protection. FINRA’s successes generate widespread public benefits by giving investors the confidence to invest for their futures. Investor protection also plays a vital role in business capital formation—keeping bad actors out of the market increases investor confidence and willingness to invest. Because FINRA’s

⁵⁴ Comment Letter from William F. Galvin, Secretary of the Commonwealth of Massachusetts, to Nancy M. Morris, Secretary, Securities and Exchange Commission (Apr. 18, 2007), <https://www.sec.gov/comments/sr-nasd-2007-023/nasd2007023-73.pdf> (“We specifically recommend that bodies like the North American Securities Administrators Association, the American Association of Retired Persons, and the Consumer Federation of America be among the investor advocates who select the Public Governors”).

⁵⁵ *Id.* at 3.

⁵⁶ *Id.*

⁵⁷ *Id.* at 3-4.

⁵⁸ See FINRA, National Arbitration and Mediation Committee (NAMC), <https://www.finra.org/arbitration-and-mediation/national-arbitration-and-mediation-committee-namc> (last visited Oct. 24, 2017). Like the Board of Governors, the NAMC consists of a majority of public members. “The NAMC members include investors, securities industry professionals and FINRA arbitrators and mediators. A majority of the NAMC members and its chair are non-industry representatives. This diverse composition ensures a neutral approach in the administration of Dispute Resolution’s forum, promoting fairness to all parties.” National Arbitration and Mediation Committee, <https://www.finra.org/about/committees>.

⁵⁹ FINRA CEO & President Robert W. Cook, Remarks at New Special Study Conference (Mar. 24, 2017), <https://www.finra.org/newsroom/speeches/032417-remarks-new-special-study-conference>.

policies and enforcement affect far more than its member firms, the public has a strong interest in its regulatory performance.

Transparency of FINRA's governance structure has received some attention as part of its 360 process.⁶⁰ In response to comments received through this process, FINRA disclosed additional information about its Board of Governors on its website for the first time. We encourage FINRA to maintain these disclosures and increase the availability of information about FINRA's governance. This increased transparency decreases the odds that material conflicts will go undetected and potentially taint FINRA's vital governance processes.

Concerns about FINRA's Public Governors

We reviewed publicly available information about FINRA's current Public Governors as well as Public Governors that served on FINRA's board within the last five years. We found that Public Governors often came to the posts after long industry careers at influential Wall Street firms. We detail particular concerns about some current and recent FINRA Public Governors below.

William H. Heyman

Mr. Heyman now serves as FINRA's Chairman and as one of FINRA's Public Governors.⁶¹ FINRA's biography for Heyman indicates that he served as a FINRA Governor from 2003 to 2016 before becoming FINRA's Chairman in 2017.⁶² Heyman now works as the Chief Investment Officer for The Travelers Companies, Inc. (Travelers).⁶³ PIABA has concerns about Heyman's ability to serve as an effective investor protection advocate. Heyman's presence on the Board in one of the Public Governor seats is problematic for a number of reasons including his past career in the securities industry, his present role at Travelers, exceeding his FINRA mandated term limit as a Public Governor, conflicted memberships on other financial services companies Boards, and overall service to roughly six different boards and committees. In addition, Heyman has a number of different connections to FINRA members, as does his wife. Heyman should not be classified as a Public Governor, taking a spot away from a truly public representative.

Lengthy Industry Career

Heyman has had a lengthy securities industry career. He was a partner in Mercury Securities from 1979 to 1988.⁶⁴ He spent two years at Smith Barney as its "Managing Director & Head of Arbitrage Department" from 1989 to 1991 before joining the SEC for two years as the Director of the Division of Market Regulation from 1991 to 1993.⁶⁵ Heyman rejoined the securities industry in 1993 as the Head of Private Investment at

⁶⁰ See FINRA, FINRA 360, <https://www.finra.org/about/finra360>, last visited Nov. 7, 2017.

⁶¹ FINRA, William H. Heyman, <http://www.finra.org/about/william-h-heyman> (last visited Oct. 11, 2017).

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

Salomon Brothers.⁶⁶ He then joined Citigroup investments in 1995 where he remained until 2002.⁶⁷ Heyman left Citigroup in 2002 and later that year joined St. Paul Cos. which “acquired Travelers’ assets after Citi spun them off.”⁶⁸ Heyman has been “Vice Chairman and Chief Investment Officer” of Travelers since May 2005.⁶⁹ Heyman’s lengthy industry career and his past and present industry connections may lead him to sympathize more with industry over public investor concerns.

Election as an Industry Governor

FINRA’s predecessor, the NASD, did not consider Heyman to be a Public Governor. Heyman first joined the NASD’s Board of Governors as an Industry Governor.⁷⁰ Later, although Heyman remained employed by Travelers continuously, the NASD gradually reclassified him from “Industry” to “Public.” In 2005, the NASD designated Heyman as one of two “non-industry” Governors on its Board of Governors, presumably because Travelers traded on NASDAQ.⁷¹ For reasons which remain unclear, the NASD first designated Heyman as a “Public Governor” in 2006—even though the NASD had previously designated him as an “Industry” and “Non-Industry” Governor.⁷²

Term Limit Violation

FINRA’s by-laws provide that Public Governors may only serve for two consecutive three-year terms.⁷³ Despite this, Heyman has served on FINRA’s Board of Governors for roughly fourteen years, the last eleven as a “Public Governor.”⁷⁴ Heyman’s continued presence on FINRA’s Board of Governors despite the existence of its term limit by-laws raises questions about whether FINRA’s current Board of Governors complies with its own by-laws.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ Nathan Vardi, *Munificent Returns*, FORBES, Mar. 3, 2015, <https://www.forbes.com/sites/nathanvardi/2015/02/11/munificent-returns/2/#6bbe72aa1ad3> (profiling William H. Heyman’s long .

⁶⁹ The Travelers Companies, Inc., Form 10-K, 268 (Feb. 16, 2017), <https://www.sec.gov/Archives/edgar/data/86312/000104746917000695/a2230860z10-k.htm>.

⁷⁰ NASD, 2004 NASD Annual Financial Report 23, <http://www.finra.org/about/annual-reports-financials> (“WILLIAM H. HEYMAN (Industry), St. Paul Travelers, St. Paul, MN”).

⁷¹ NASD, 2005 NASD Annual Financial Report 98, <http://www.finra.org/about/annual-reports-financials> (“William H. Heyman (Non-Industry), The St. Paul Travelers Companies, Inc., St. Paul, MN”). At that time, the NASD Board of Governors contained seven industry governors, two non-industry governors, two staff governors, and seven public governors. *Id.*

⁷² NASD, 2006 NASD Annual Financial Report, 62, <http://www.finra.org/about/annual-reports-financials> (“William H. Heyman (Public), The Travelers Companies, Inc., St. Paul, MN”).

⁷³ FINRA, By-Laws of the Corporation Art. VII, § 5 (“No Appointed Governor may serve more than two consecutive terms. . . . Appointed Governors shall be appointed by the Board for a term of three years to replace those whose terms expire”).

⁷⁴ FINRA, William H. Heyman, <http://www.finra.org/about/william-h-heyman> (last visited Oct. 11, 2017).

Fiduciary Duties to Entities with FINRA Member Subsidiaries

As discussed above, FINRA's by-laws prohibit Public Governors from having "a material business relationship" with any broker or dealer.⁷⁵ Despite this restriction, Heyman also serves as a director for an entity with a FINRA member as a subsidiary. Heyman serves on the board of Bank Leumi USA (Leumi USA).⁷⁶ Leumi Investment Services, Inc. (Leumi Investment) is a FINRA member-firm.⁷⁷ The BrokerCheck report for Leumi Investment reveals that Leumi USA owns 75% or more of Leumi Investment and that Leumi USA directs the management and policies of Leumi Investments.⁷⁸

Marriage to Director of another Firm with FINRA-Member Subsidiaries

There are questions as to whether Heyman's close familial ties generate additional conflicts as well. Heyman's spouse also has had a long securities industry career.⁷⁹ She currently serves as the director of a firm with FINRA member subsidiaries.⁸⁰ This connection generates the appearance of a conflict of interest because of the close familial tie.

Overboarding

Heyman's board membership raises other concerns which should be addressed by FINRA's governance policies. Heyman serves in approximately six different governance and advisory roles simultaneously, raising concerns about his ability to effectively serve as a Director and Chair of FINRA's board. Institutional Shareholder Services (ISS) has expressed concern that Public Company Directors should not serve on excessive numbers of boards. In 2017, ISS advised institutional shareholders to vote against or withhold votes for "individual directors who . . . sit on more than five public company boards" as well as to vote against or withhold votes for directors that are "CEOs of public companies who sit on boards of more than two public companies besides their own."⁸¹

ISS recommends that institutional investors vote against overboarded directors because they may be too busy to serve as effective fiduciaries. Overboarded directors lack sufficient time to devote to their board duties because of other demands on their time

⁷⁵ FINRA, BY-LAWS OF THE CORPORATION ART. I, § tt.

⁷⁶ *Id.*

⁷⁷ See BrokerCheck Report for Leumi Investment Services.

⁷⁸ *Id.*

⁷⁹ Nathan Vardi, *Munificent Returns*, FORBES, Mar. 3, 2015, <https://www.forbes.com/sites/nathanvardi/2015/02/11/munificent-returns/2/#6bbe72aa1ad3> ("He is married to Katherine "Wendy" Dietze, the former chief operating officer of Credit Suisse First Boston's investment bank").

⁸⁰ Cowen Group, Inc., Form 10-K, Feb. 27, 2017, <https://www.sec.gov/Archives/edgar/data/1466538/000146653817000014/a10k12312016.htm#s1A426893AA565BCA8F11956533559A4F>.

⁸¹ INSTITUTIONAL SHAREHOLDER SERVICES, AMERICAS U.S., CANADA, AND LATIN AMERICA PROXY VOTING GUIDELINES UPDATES: 2017 BENCHMARK POLICY RECOMMENDATIONS 5, <https://www.issgovernance.com/file/policy/2017-america-iss-policy-updates.pdf>.

from other boards. Some research has found that large public company performance suffers when directors serve on many boards.⁸²

An overboarded Public Governor may lack the time and ability to adequately focus on vigilantly advocating for and protecting the interests of public investors on FINRA's Board of Governors. FINRA's Public Governors must balance competing demands on their time. Putting to the side conflicts of interest that may bias their behavior, overboarded directors may fail to vigorously protect public investors because they cannot devote sufficient time and attention to all of their responsibilities.

Heyman is an overboarded Public Governor. He faces demands on his time similar to those experienced by a CEO because he serves as the Chief Investment Officer for Travelers as well as the Vice Chairman of its board. Travelers 2016 Annual Report revealed that it has \$70,488,000 in total investments.⁸³ Managing this seventy-billion-dollar portfolio requires substantial time, attention, and effort, compromising Heyman's ability to focus on investor protection. Heyman also serves as a director at Bank Leumi USA, on the Senior Advisory Board of Atlas Merchant Capital, the Advisory Council of the Bendheim Center for Finance at Princeton University, the Economic Club of New York, and on the Investment Committee for the UJA-Federation of New York.⁸⁴ A position with the Investment Committee of the UJA-Federation of New York also entails significant responsibility because the UJA-Federation has \$1,280,118,000 in net assets.⁸⁵

Overboarded directors on FINRA's Board of Governors are also sources of systemic risk. Professor Jeremy Kress of the University of Michigan has argued that overboarded directors at financial institutions could cause the next financial crisis.⁸⁶ Professor Kress found that "overcommitted directors withdraw from corporate decision-making, tend not to challenge management, and experience attention shocks that distract them from company business."⁸⁷ An overboarded Public Governor on FINRA's Board of Governors cannot devote substantial time and attention to mitigating systemic risks or to ensuring that FINRA's management vigorously protects public investors. Although Heyman may have a long history of service with FINRA and its precursor, the NASD, he should not serve as a Public Governor because of his material business and other ties to the

⁸² See Ferris, Stephen P. and Jayaraman, Narayanan and Liao, Min-Yu (Stella), *Better Directors or Distracted Directors? An International Analysis of Busy Boards* (August 2, 2017). Georgia Tech Scheller College of Business Research Paper No. 17-30. Available at SSRN: <https://ssrn.com/abstract=3012820> (finding that "firms with busy boards exhibit lower market-to-book ratios and reduced profitability").

⁸³ THE TRAVELERS COMPANIES, INC., 2016 ANNUAL REPORT 6, <http://investor.travelers.com/interactive/newlookandfeel/4055530/AnnualReport2016.pdf>.

⁸⁴ FINRA, William H. Heyman, <http://www.finra.org/about/william-h-heyman> (last visited Oct. 11, 2017).

⁸⁵ UJA-Federation of New York, 2016 Annual Report, available <https://www.ujafedny.org/who-we-are/annual-reports/> (last visited Oct. 30, 2017).

⁸⁶ Kress, Jeremy C., *Board to Death: How Busy Directors Could Cause the Next Financial Crisis* (June 22, 2017). 59 B.C. L. Rev. ____ (2018 Forthcoming); Ross School of Business Paper No. 1370. Available at SSRN: <https://ssrn.com/abstract=2991142>.

⁸⁷ *Id.*

securities industry. These material relationships may reduce the confidence of many stakeholder communities in FINRA's ability to serve as a truly independent regulator.

Carol Anthony Davidson

Carol Anthony Davidson has served as a Public Governor since 2013.⁸⁸ PIABA has concerns about his ability to serve as an effective investor protection advocate. Like Heyman, Davidson has substantial connections to FINRA members which raise questions about the appropriateness of labeling him as a Public Governor. Additionally, like Heyman, Davidson serves on a number of corporate boards in addition to FINRA.

Fiduciary Duties to Entities with FINRA Member Subsidiaries

Davidson appears to have "a material business relationship" with a FINRA member firm.⁸⁹ Davidson joined the board of Legg Mason Inc. (Legg Mason) in 2014.⁹⁰ Legg Mason is a global asset management firm and has a FINRA member subsidiary, Legg Mason Investor Services, LLC.⁹¹ Davidson's fiduciary duties to Legg Mason may inhibit his ability to act in the public's interest and certainly inhibits the ability of other stakeholder communities to maintain confidence in his independence.⁹²

Conflicts of Interest from Asset Management Activities

Davidson's position as director at Legg Mason complicates his ability to protect public investors because Legg Mason relies on financial adviser commissions to distribute its mutual funds.⁹³ Davidson faces conflicted interests when considering rules that would require brokers to give advice in the best interests of their clients without regard to their

⁸⁸ FINRA, Carol Anthony (John) Davidson, <http://www.finra.org/about/carol-davidson> (last visited Oct. 12, 2017).

⁸⁹ FINRA, BY-LAWS OF THE CORPORATION ART. I, § tt.

⁹⁰ Legg Mason, Press Release: Legg Mason Appoints Carol A. "John" Davidson to its Board of Directors, April 30, 2014, <http://ir.leggmason.com/file/Index?KeyFile=23427561>.

⁹¹ See BrokerCheck Report for Legg Mason Investor Services, LLC.

⁹² Davidson's board position appears in tension with FINRA's own Code of Ethics for its board members. It provides that FINRA Governors should "not have direct or indirect interests in, or relationships with, any organization where these interests or relationships could conceivably: (a) hinder our objectivity, independence of judgment or conduct in carrying out our responsibilities as FINRA Governors and Directors, or (b) embarrass FINRA because of the *appearance* of a conflict of interest." FINRA, Code of Ethics and Business Conduct for the Board of Governors of FINRA and the Board of Directors of its Subsidiaries 2 (adopted Dec. 3, 2008; Amended Sept. 19, 2013) (emphasis in original).

⁹³ See Jacob Hale Russell, *The Separation of Intelligence and Control: Retirement Savings and the Limits of Soft Paternalism*, 6 WM. & MARY BUS. L. REV. 35, 64 (2015) ("Financial advisers, including brokers (who have no fiduciary duty to their clients), make the problem worse. Most of them are compensated based on (entirely legal) kickbacks."); Benjamin P. Edwards, *Conflicts & Capital Allocation*, 78 OHIO ST. L.J. 181, 198 (2017) ("Financial advisor incentives affect which institutional intermediaries receive capital. Before reaching the traditional securities markets, investor assets frequently pass through at least two layers of intermediation: (i) intermediation from a financial advisor selecting an institutional intermediary; and (ii) the institutional intermediary then investing the assets").

personal financial incentives to sell particular funds. Legg Mason relies on these conflicted payments to distribute many of its mutual funds.⁹⁴

Insider Trades & Substantial Stake in Financial Services Firm

Davidson has a financial incentive not to recommend regulatory changes in the interests of public investors because he purchased stock in Legg Mason while on the FINRA Board of Governors.⁹⁵ On July 6, 2016, Davidson purchased 3,000 shares of Legg Mason for \$101,760.00.⁹⁶ In total, as of June 14, 2017, Davidson beneficially owned 14,906 shares in Legg Mason.⁹⁷ At Legg Mason's current approximate stock price, Davidson's 14,906 shares give him a more than \$500,000 stake in Legg Mason. This substantial financial stake in Legg Mason may give him reason to prefer maintaining the profitability of industry firms over investor protection.

Overboarding Concern

Davidson serves on at least five corporate boards in addition to his position on FINRA's Board of Governors.⁹⁸ His FINRA biography reveals that he serves on the boards of Pentair Plc., DaVita Inc., Legg Mason Inc., TE Connectivity Ltd., and the University of Rochester.⁹⁹ As explained above, serving on a large number of boards significantly reduces the time and attention that a director may devote to investor protection.

Davidson's service on FINRA's board requires significant time and attention. The FINRA website explains that he serves on six different FINRA Board Committees including: Finance, Operations & Technology Committee (Chair), Investment Committee, Management Compensation Committee, Audit Committee, Executive Committee, and Regulatory Operations Oversight Committee.¹⁰⁰

Davidson may face too many conflicts of interest and outside commitments to serve as a vigorous and effective advocate for FINRA's core mission of investor protection.

Rochelle B. (Shelley) Lazarus

FINRA categorizes Shelley Lazarus as a Public Governor.¹⁰¹ Lazarus has served as one of FINRA's Public Governors since 2013. PIABA has concerns about Lazarus' ability to

⁹⁴ See Legg Mason, Legg Mason Funds Sales Charge and Breakpoint Information, <https://www.leggmason.com/en-us/site/disclosure/mutual-funds-breakpoints/breakpoint-equity.html> (last visited Oct. 12, 2017).

⁹⁵ See Dividend Channel, *Top Buys by Directors: Davidson's \$101.8K Bet on LM*, FORBES, July 28, 2016, <https://www.forbes.com/sites/dividendchannel/2016/07/28/top-buys-by-directors-davidsons-101-8k-bet-on-lm/#773248327a4b>.

⁹⁶ *Id.* ("directors of a company tend to have a unique inside view into the business, so when directors make major buys, investors are wise to take notice").

⁹⁷ Legg Mason, 2017 Proxy Statement 15, June 14, 2017, <http://ir.leggmason.com/Cache/1500100660.PDF?O=PDF&T=&Y=&D=&FID=1500100660&iid=102761>.

⁹⁸ FINRA, Carol Anthony (John) Davidson, <http://www.finra.org/about/carol-davidson> (last visited Oct. 12, 2017).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ FINRA, Shelley Lazarus, <http://www.finra.org/about/shelley-lazarus> (last visited Oct. 12, 2017).

serve as an effective investor protection advocate due to her diffuse board service and her connections to FINRA members.

Overboarding Concern

In addition to her responsibilities to FINRA, Lazarus discloses ten different entities where she has board service commitments or affiliations, including Merck & Co., Inc. (Director), General Electric, Inc. (Director), Blackstone (Director), Business Board of the Department of Defense, The NYC Partnership (Board Member), The World Wildlife Fund (Board Member), Lincoln Center for the Performing Arts (Board Member), New York Presbyterian Hospital (Trustee), Columbia Business School Board of Overseers, and The Council on Foreign Relations (Member).

These extensive commitments make it difficult for her to devote substantial time, thought, and attention to investor protection as a member of FINRA's board. Her current board responsibilities at FINRA include four different committees, including the Executive Committee, Nominating & Governance Committee (Chair), Management Compensation Committee, and Finance, Operations & Technology Committee.¹⁰²

Lazarus faces so many conflicts of interest and other obligations that she may not serve as an effective chair for FINRA's Nominating & Governance Committee. Because the Nominating committee plays a significant role in selecting future Public Governors, the Chair of this committee should have the time and attention to devote the task.

Fiduciary Duties to Entities with FINRA-Member Subsidiaries

Lazarus serves on the Board of Directors of The Blackstone Group, "a leading global alternative asset manager, with Total Assets Under Management of \$366.6 billion as of December 31, 2016."¹⁰³ The Blackstone Group has multiple FINRA member subsidiaries, including Blackstone Advisory Partners L.P.¹⁰⁴ Her position with the Blackstone Group seemingly creates a "material business relationship" with brokerage firms.

Conflicts of Interest from Asset Management Activities

Lazarus also faces conflicts of interest related to her service on Blackstone's board of directors because Blackstone relies on FINRA's broker-dealer firms to distribute its fund offerings—giving rise to material business relationships with FINRA member-firms that are not Blackstone subsidiaries. Blackstone's Annual Report explained that its business faces risks from improper sales of its funds by FINRA's member-firms:

in some cases we seek to distribute our unregistered funds to such retail investors indirectly through feeder funds sponsored by brokerage firms
. accessing retail investors and selling retail directed products exposes us to

¹⁰² *Id.*

¹⁰³ See Blackstone Group, Form 10-K, at 5, Feb. 24, 2017, <https://www.sec.gov/Archives/edgar/data/1393818/000119312517056300/d280098d10k.htm>.

¹⁰⁴ See BrokerCheck Report for Blackstone Advisory Partners, L.P.

new and greater levels of risk, including heightened litigation and regulatory enforcement risks. . . . to the extent that our investment products are being distributed through third parties we are exposed to reputational damage and possible legal liability to the extent such third parties improperly sell our products to investors¹⁰⁵

As a Public Governor, Lazarus enjoys substantial influence to shape Blackstone's regulatory environment, including setting the standards for evaluating whether FINRA's member-firms "improperly sell" Blackstone's "products to investors."¹⁰⁶ As the primary securities regulator for brokerage firms, FINRA's rules determine whether member-firms "improperly" sell investors interests in Blackstone funds. Lax standards and enforcement decrease the risks that Blackstone faces.

Substantial Financial Stake in Financial Services Firm

In addition to her other connections to Blackstone, Lazarus also directly owns 35,343 shares in the Blackstone Group as of July 21, 2017.¹⁰⁷ Lazarus owns an additional 2,950 Blackstone shares indirectly.¹⁰⁸ Her most recent acquisition of Blackstone stock came on July 9, 2017, when she acquired an additional 4,567 shares as a part of a Blackstone incentive compensation plan.¹⁰⁹ At the Blackstone Group's current stock price, this gives Lazarus a direct and indirect ownership stake of approximately \$1.3 million.

Lazarus' ownership of Blackstone creates the appearance of a conflict which may diminish the vigor with which she seeks investor protections.

Lazarus's connection to FINRA

Lazarus has been an executive at Ogilvy & Mather from 1995 through 2012. She now serves as the Chairman Emeritus of Ogilvy. In 2015, Ogilvy created FINRA's BrokerCheck advertising campaign.¹¹⁰ The financial connection between Ogilvy and FINRA may negatively impact public confidence in Lazarus's ability to closely supervise FINRA's management.

Joshua S. Levine

FINRA's website reveals that Joshua S. Levine serves as a Public Governor while working as a Managing Director affiliated with Kita Capital Management, LLC.¹¹¹ Levine's LinkedIn profile makes clear that he co-founded Kita Capital Management, LLC

¹⁰⁵ See Blackstone Group, Form 10-K, at 41, Feb. 24, 2017, <https://www.sec.gov/Archives/edgar/data/1393818/000119312517056300/d280098d10k.htm> (describing regulatory risks for improper sales to retail investors).

¹⁰⁶ *Id.*

¹⁰⁷ Rochelle B. Lazarus, Form 4 (July 12, 2017), <https://www.sec.gov/Archives/edgar/data/1393818/000120919117044903/xslF345/doc4.xml>.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ See FINRA Launches National Ad Campaign Promoting BrokerCheck, (June 1, 2015), <http://www.finra.org/newsroom/2015/finra-launches-national-ad-campaign-promoting-brokercheck>.

¹¹¹ FINRA, Joshua S. Levine, <http://www.finra.org/about/joshua-levine> (last visited Oct. 13, 2017).

and that it provides “capital, operations and advice to technology-driven organizations.”¹¹² Levine has extensive connections with FINRA members, as well as serving on a number of boards.

Overboarding Concern

In addition to his position as a Public Governor at FINRA, Levine’s “Board Service and Affiliations” includes six different entities: Fresh Direct, LLC, OPAQ Networks, Inc., Fantex Holdings, Inc., NPower Inc., Classroom Inc., and MSTERIO Inc.¹¹³ His position as a Managing Director at Kita Capital Management as well as his extensive commitments to other boards may diminish his efficacy as a Public Governor and significantly impede his ability to devote time, attention, and thought to investor protection issues.

Fiduciary Duties to Entities with recently registered FINRA Member Subsidiaries

Levine serves on the board of directors of Fantex Holdings, Inc. (Fantex Holdings). As of 2016, Fantex Holdings owned Fantex Brokerage Services, LLC (Fantex Brokerage), a previously registered FINRA member-firm.¹¹⁴ Although Fantex Brokerage has withdrawn its registration, Levine’s role with Fantex Holdings creates an incentive for him to focus on industry profitability over investor protection.

Long Industry Career

Like many Public Governors, Levine has had a long industry career. He served as a Managing Director at Morgan Stanley from 1985 to 1997 before joining Deutsche Bank as a Managing Director from 1997 to 1999.¹¹⁵ He became the Chief Technology and Operations Officer for E*TRADE Financial from 1999 to 2005.¹¹⁶ Although his current FINRA profile indicates that he has served as a Managing Director for Kita Capital Management without interruption since 2005,¹¹⁷ past FINRA Annual Reports characterized him as “retired.”¹¹⁸ The inconsistent disclosures raise questions about the quality of FINRA’s past disclosures and governance.

Eileen Murray

FINRA recently appointed Eileen Murray to serve as a Public Governor beginning in 2016.¹¹⁹ Murray serves as the co-CEO of the world’s largest hedge fund, Bridgewater

¹¹² See LinkedIn, Joshua S. Levine, available www.linkedin.com.

¹¹³ FINRA, Joshua S. Levine, <http://www.finra.org/about/joshua-levine> (last visited Oct. 13, 2017).

¹¹⁴ See BrokerCheck Report for Fantex Brokerage Services, LLC, available <https://brokercheck.finra.org>.

¹¹⁵ FINRA, Joshua S. Levine, <http://www.finra.org/about/joshua-levine> (last visited Oct. 13, 2017).

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ See FINRA, 2016 Annual Report 63 (“Joshua S. Levine (Public), Retired, New York, NY”), available <http://www.finra.org/about/annual-reports-financials>; FINRA, 2015 Annual Report 65, available <http://www.finra.org/about/annual-reports-financials> (“Joshua S. Levine (Public), Retired, New York, NY”).

¹¹⁹ FINRA, Eileen Murray, <http://www.finra.org/about/eileen-murray> (last visited Oct. 13, 2017).

Associates.¹²⁰ Murray is not appropriately categorized as a Public Governor because of her extensive and on-going connections to the industry.

Long Industry Career

Murray has also had a long industry career, increasing the risk that she may more naturally sympathize with industry over public investor perspectives.¹²¹

Current Securities Industry Affiliation

Murray has a strong, current securities industry affiliation. Under FINRA's own rules for arbitrator classifications, Murray would not qualify as a public arbitrator because of her employment by the world's largest hedge fund.¹²²

Randal K. Quarles (Recent Governor)

FINRA had Randal K. Quarles as one of its recent Public Governors.¹²³ He served as a Public Governor while working as the Managing Partner & Co-founder of the Cynosure Group.¹²⁴ Quarles co-founded the Cynosure Group in 2014.¹²⁵ It has invested in several registered investment adviser firms.¹²⁶ After being nominated by the Trump administration, Mr. Quarles was recently confirmed as a Federal Reserve Governor.¹²⁷

Securities Industry Affiliation

Quarles has a long securities industry affiliation. Under FINRA's own rules for arbitrator classifications, Quarles would not qualify as a public arbitrator because of affiliation with a registered investment adviser firm.¹²⁸

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² See FINRA, FINRA Rule 12100 (y), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4099, (last visited Oct. 24, 2017).

¹²³ FINRA, Randal K. Quarles

¹²⁴ *Id.*

¹²⁵ See PR Web, *Eccles Family Backs New Investment Firm, The Cynosure Group*, June 5, 2014, <http://www.prweb.com/releases/the-cynosure-group/private-equity-investors/prweb11916306.htm> (last visited Oct. 24, 2017) (noting that "Quarles spent many years working as a partner at the Wall Street law firm of Davis Polk & Wardwell, where he was the co-head of the firm's Financial Institutions Group and advised on transactions that included a number of the largest financial sector mergers ever completed").

¹²⁶ See e.g. Jeff Benjamin, *Private equity investors zero in on the RIA business*, INVESTMENTNEWS, Aug. 9, 2017, <http://www.investmentnews.com/article/20170809/FREE/170809925/private-equity-investors-zero-in-on-the-ria-business> (describing a Cynosure investment into Savant Capital Management).

¹²⁷ Binyan Appelbaum, *Randal Quarles Confirmed as Federal Reserve Governor*, N.Y. TIMES, Oct. 5, 2017, https://www.nytimes.com/2017/10/05/us/politics/randal-quarles-confirmed-as-federal-reserve-governor.html?_r=0.

¹²⁸ See FINRA, FINRA Rule 12100 (y), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4099, (last visited Oct. 24, 2017).

Membership in Industry-Funded Lobbying Organization

Quarles also served as a member of the Board of the U.S. Chamber of Commerce (U.S. Chamber).¹²⁹ The U.S. Chamber describes itself as the “world’s largest business organization representing the interests of more than 3 million businesses.”¹³⁰ FINRA-regulated firms have contributed substantial sums to the U.S. Chamber.¹³¹ Serving these interests, the U.S. Chamber has filed a lawsuit attempting to block a proposed rule that would require many financial advisers to give advice in the best interests of their clients.¹³²

Quarles faced a conflict of interest to the extent that his duties to represent business perspectives and the public interest conflicted. For an example of a debate that has split business and public advocacy groups, consider the Department of Labor’s new rule imposing a fiduciary duty on financial advisers giving advice in connection with retirement accounts.¹³³ The American Association of Retired Persons strongly supports the rule because it wants to close “loopholes in the law that allow some financial advisers to give investment advice that earns them a higher fee — even if it’s not the best advice.”¹³⁴ The U.S. Chamber opposes the rule and has filed a lawsuit seeking judicial action to strike it down.¹³⁵

Shedding some light on Mr. Quarles’s views, the U.S. Chamber led a particularly aggressive lobbying campaign opposing the rule. According to a report published by *Public Citizen*, the U.S. Chamber created “astroturf” opposition to the rule.¹³⁶ In one instance, a person that the U.S. Chamber featured on a website showcasing small

¹²⁹ See U.S. Chamber, Board of Directors, <https://www.uschamber.com/about/board-directors> (last visited Oct. 13, 2017).

¹³⁰ *About the U.S. Chamber*, U.S. CHAMBER OF COMMERCE, <https://www.uschamber.com/about-us/about-the-us-chamber> (last visited July 6, 2016).

¹³¹ For example, in 2014, Prudential Financial contributed \$185,000 to the U.S. Chamber with \$75,000 earmarked for lobbying. *2014 Political Activities and Contributions Report*, PRUDENTIAL 21 (April 2015), http://www.prudential.com/media/managed/public/PAC_Annual_Report_14-Final.pdf.

¹³² See Andrew Ackerman & Leslie Scism, *Obama Retirement-Savings Rule Faces Industry-Led Court Battle*, WALL ST. J. (May 31, 2016), <http://www.wsj.com/articles/industry-groups-prepare-lawsuit-over-obama-retirement-rule-1464704230> (“Big business and financial industry trade groups are taking to the courts”).

¹³³ See U.S. Dep’t of Labor, *Conflict of Interest Final Rule*, <https://www.dol.gov/ebsa/regs/conflictsofinterest.html>.

¹³⁴ David Certner, *Why AARP Backs a New Retirement Plan Advice Rule*, AARP BLOG (July 22, 2015), <http://blog.aarp.org/2015/07/22/aarp-files-comments-on-new-retirement-plan-advice-rule/>.

¹³⁵ See Andrew Ackerman & Leslie Scism, *Obama Retirement-Savings Rule Faces Industry-Led Court Battle*, WALL ST. J. (May 31, 2016), <http://www.wsj.com/articles/industry-groups-prepare-lawsuit-over-obama-retirement-rule-1464704230> (“Big business and financial industry trade groups are taking to the courts”).

¹³⁶ PUBLIC CITIZEN, *SACRIFICING THE PAWNS: HOW THE U.S. CHAMBER OF COMMERCE RECRUITS SMALL BUSINESS OWNERS TO LOBBY AGAINST THEIR OWN SELF-INTEREST* 8 (2016), <http://www.chamberofcommercewatch.org/wp-content/uploads/2016/06/Sacrificing-the-Pawns-final.pdf>. The term “astroturfing” refers to manufacturing grass-roots opposition to regulation on behalf of business and industry interests; see also John Kennedy, *Need a Grass-Roots Campaign? Industries Learn How to Hire One*, SUN SENTINEL (Oct. 28, 1996), http://articles.sun-sentinel.com/1996-10-28/business/9610280244_1_legislators-astroturfing-lobbyist.

business opposition to the rule “did not realize he was listed on the webpage as opposing it” and asked *Public Citizen*, “Who do I call to get this down?”¹³⁷

At Quarles’ confirmation hearing, Senator Cortez-Masto questioned him about his concurrent membership on the Board of the U.S. Chamber and on FINRA’s Board of Governors as a “Public Governor.”¹³⁸ Quarles claimed that he had represented the public on the FINRA board “without any influence from or discussion with the Chamber of Commerce.”¹³⁹

Quarles’s past dual roles raised the appearance of a conflict of interest. They also raised questions as to how FINRA selects its Public Governors and whether it gives representation to stakeholders that lack a means of electing representatives to FINRA’s governing board.

Reforms

For FINRA to be effective at its stated investor protection mission, it should welcome reforms to improve its governance. After reviewing FINRA’s existing Public Governors, PIABA recommends that FINRA alter its by-laws to more closely police conflicts of interest at its Board of Governors and that it appoint persons with a history of advocating for investor protections to its Board of Governors.

Address Conflicts of Interest

FINRA’s apparently lax interpretation of its current by-laws permit too many unresolved significant conflicts of interest. FINRA should address the issue in one of two ways: (1) promulgate a stronger interpretation of “material business relationship” in its governance guidelines and adopt policies to address these conflicts; or (2) amend the definition of Public Governor within its by-laws to capture these conflict-producing and confidence-undermining relationships. A “material business relationship” with a FINRA member firm should include serving on the board of a firm that has FINRA member subsidiaries or affiliates, distributes financial products through FINRA members, or accepts donations or contributions from FINRA member firms for lobbying activities. These material business relationships generate the appearance of a conflict and undercut investor and public confidence in FINRA’s responsible exercise of state power. Moreover, Public Governors should not have any type of material business relationship with the financial services industry. FINRA recognized this when it excluded investment company, hedge fund, mutual fund, and other financial services employees from the definition of a public arbitrator. FINRA should adopt a definition of Public Director which excludes the same sorts of affiliations to the financial services industry.

¹³⁷ Daniel Dudis & Bartlett Naylor, *Taking a Hard Look at a Campaign Critical of a Fiduciary Rule*, N.Y. TIMES (June 9, 2016), http://www.nytimes.com/2016/06/10/business/dealbook/taking-a-hard-look-at-a-campaign-critical-of-a-fiduciary-rule.html?smid=tw-nytimesbusiness&smtyp=cur&_r=0.

¹³⁸ See CSPAN, Senator Cortez Masto on FINRA Conflicts, July 27, 2017, <https://www.c-span.org/video/?c4678228/senator-cortez-masto-finra-conflicts>.

¹³⁹ *Id.*

Limit Overlapping Board Service

PIABA remains concerned that FINRA's Public Governors may not have sufficient time to devote to investor protection issues. PIABA recommends that FINRA limit outside board commitments to ensure that Public Governors have adequate time to advance FINRA's investor protection mission. Because FINRA's Board of Governors plays a critical role in financial regulation, it should impose limits on concurrent service on other boards. For persons without other employment, FINRA should limit additional board commitments to four or less additional boards. For persons with full-time employment, FINRA should limit additional board commitments to two or less additional boards

Proposed Alternative Slate

FINRA should move to nominate Public Governors with a demonstrated interest in investor protection issues. FINRA should seek nominations for Public Governors from organizations devoted to investor protection, such as the American Association of Retired Persons, the Consumer Federation of America, the North American Securities Administrators Association, and PIABA. Because Public Governors should also have some familiarity with the securities industry, PIABA suggests that FINRA consider the candidates listed below.¹⁴⁰

Jill I. Gross

Professor Jill I. Gross is a nationally known expert in the field of securities dispute resolution and teaches at the Elizabeth Haub School of Law at Pace University. Professor Gross teaches courses in the areas of dispute resolution, ethics, securities law and lawyering skills. She was Director of the Pace Investor Rights Clinic from 1999-2015. Gross has familiarity with the securities industry and a demonstrated commitment to investor protection.

Phyllis Borzi

Phyllis Borzi served as the Assistant Secretary of Labor for the Employee Benefits Security Administration of the United States Department of Labor from 2009 to 2017. During that time, she directed the Department of Labor's fiduciary duty rulemaking. Borzi has familiarity with the securities industry and a demonstrated commitment to investor protection.

Jordan Thomas

Jordan Thomas is a partner at Labaton Sucharow. He previously served as Assistant Chief Litigation Counsel in the Division of Enforcement at the SEC, where he had a leadership role in the development of the SEC Whistleblower Program. During his time at the SEC, Thomas brought enforcement cases that resulted in monetary sanctions and

¹⁴⁰ No person listed below participated in any way in the drafting of this report.

relief for harmed investors in excess of \$35 billion. Thomas has familiarity with the securities industry and a demonstrated commitment to investor protection.

Robert S. Banks

Robert Banks is an attorney that has spent his career representing investors. In 2017, he received the North American Securities Administrators Association's (NASAA) Investor Champion Award. FINRA appointed Banks to serve three terms as a public member of the NAMC, and he has chaired several of its important subcommittees. He has a demonstrated ability to work well with FINRA while advocating for investor protection. Banks has familiarity with the securities industry and a demonstrated commitment to investor protection.

Teresa J. Verges

Teresa Verges served as the Assistant Director of Enforcement for the Securities and Exchange Commission attorney before launching the University of Miami School of Law's Investor Rights Clinic. She has familiarity with the securities industry and a demonstrated commitment to investor protection.

Conclusion

PIABA questions the appropriateness of FINRA appointing Public Governors which have clear industry ties. PIABA has significant concerns about 5 of FINRA's 13 Public Governors and one recently-departed governor, almost half of the Public Governors. PIABA is concerned that FINRA is not following its own by-laws and is not meeting its obligation to ensure adequate public representation on its Board to ensure protection of investors and the public interest. FINRA's predecessor, the NASD, has seen the harms that may result if the industry has undue influence over its regulation. However, simply calling someone "public" does not solve the problem. If the governors are not truly "public," FINRA risks repeating past scandals, and impairing investor confidence in the industry.

It is essential that FINRA's Board of Governors include investor advocates and representatives. The industry's interests are sufficiently represented by the 10 Industry Governors. The public's interests should be as adequately represented.

Exhibit

B

Public Investors Arbitration Bar Association Report

UNPAID ARBITRATION AWARDS

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

Authored by Hugh D. Berkson, PIABA President¹

Acknowledgements²

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](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

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/vpr/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

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

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

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

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.

“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

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 cancellation "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

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

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 stressor 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 CFTC 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

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.

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/vpr/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/vpr/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

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 must 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

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.

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 than 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. National Recovery Pool – The Short Version

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 any 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. The Pool Must Be National in Scope

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

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

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

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. Legal Authority to Promulgate the Pool

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

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.

[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.

Exhibit

C

Unpaid Arbitration Awards

The Case For An Investor Recovery Pool

Authored by:
Andrew Stoltmann and Hugh D. Berkson¹

Acknowledgements²

Introduction / Executive Summary

“What dollars do you actually collect when somebody has done you harm? Because you can have a really strong standard, but if there are no dollars there, that’s a problem.”³

Those words, uttered by Jay Clayton, SEC Chairman, summarized the long-running problem underlying unpaid FINRA arbitration awards. Regardless of how strong the investor protection rules, regulations, and laws are, they are meaningless absent an investor’s ability to actually recover money when those rules, regulations, and laws are violated. Investors who fall prey to financial advisor misconduct all too often fall victim to a second abuse: the inability to collect an arbitration award issued against the financial advisor and/or firm found liable.

Chairman Clayton’s comments of one month ago address an old problem – one first raised seventeen years ago by the U.S. Government Accounting Office. Unfortunately, little has been done over the past two decades to address the problem. In

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² The Authors would like to thank Daniel Guernsey, and Andrew Zuckerman, of the University of Miami School of Law, and Valerie Hammel, of the St. John’s University School of Law, for their extensive efforts in analyzing the award history data, and broker registration data, utilized in this report. The students worked under the direction of the University of Miami School of Law Investor Rights Clinic Director Teresa Verges, and St. John’s University School of Law Securities Arbitration Clinic Director Christine Lazaro. Professor Lazaro is also PIABA’s executive vice president, and a member of its Board of Directors. Her help, as well as that of Michael Edmiston and Benjamin Edwards, in editing this Update is greatly appreciated by the Authors.

³ Crypto News, *Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission*, YOUTUBE (Feb. 6, 2018), https://www.youtube.com/watch?v=NGgg_dXBpQo (SEC Chair Jay Clayton, testifying before the Senate Banking, Housing and Urban Affairs Committee).

2016, PIABA issued a report (the “PIABA Unpaid Awards Report”) which assessed the problem and offered potential solutions, including a national investor recovery pool (a “Pool”) to compensate those investors who otherwise would recover nothing.⁴ Almost two years later, on February 8, 2018, FINRA published a Discussion Paper (the “FINRA Discussion Paper”), a proposed rule, and updated statistics on unpaid awards. FINRA welcomed discussion on this long running problem, but did not indicate that it is pursuing any particular solution to the problem.

FINRA’s newly updated statistics indicated that, in the five years from 2012 through 2016, a total of 268 awards (27% of the cases where investors were successful) or \$199 million in awards (29% of total damages awarded to investors) have gone unpaid. PIABA studied the 2017 award data, and found that the trend continues: 36% of the investors who won their cases collected nothing, and 28 cents of each dollar awarded have gone unpaid. The data reveal that the problem is not fixing itself, and the steps taken by FINRA thus far have not effectively addressed the problem.

The problem is not a hypothetical one – it has meaningful effects on people from all walks of life. Bruce Wilkerson, a former NFL star, was harmed by a brokerage firm’s wrongful misconduct and awarded his full losses in arbitration. But, since the firm has gone under, Mr. Wilkerson has collected nothing and now must work far longer into his retirement years.

Of the potential solutions outlined by FINRA, several of which were previously discussed by PIABA, a Pool remains the viable and effective solution. FINRA is fully capable of funding the Pool out of fines levied on its members who violate its rules. FINRA member fines have been substantially larger than the unpaid awards for four of the last five years. Alternatively, a Pool could be funded from FINRA’s profits, or an assessment on its members. An annual assessment of between \$23 and \$120 per FINRA-registered broker would have covered the unpaid awards for the last five years. A Pool’s benefit to aggrieved investors would more than outweigh the modest cost to FINRA or its members. PIABA renews its call on FINRA to create such a Pool.

Background

The problem of unpaid awards was first addressed in the U.S. Government Accountability Office’s June 2000 report.⁵ Given the absence of publicly available data, the GAO conducted its own study. It surveyed a random probability sample of 247 of the 855 investors who received monetary awards in cases decided in 1998. Nearly all of the awards were from the NASD (FINRA’s predecessor) arbitration forum. Based on that sample, the GAO concluded that approximately 500 of the NASD awards to investors issued in 1998 were either unpaid, or only partially paid.⁶ It estimated that

⁴ See Hugh D. Berkson, *Unpaid Arbitration Awards, A Problem The Industry Created – A Problem The Industry Must Fix*, PIABA (Feb. 25, 2016), <https://piaba.org/piaba-newsroom/report-unpaid-arbitration-awards-problem-industry-created-problem-industry-must-fix>.

⁵ *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*, U.S. GAO (June 26, 2000), <https://www.gao.gov/products/GGD-00-115>.

⁶ See *id.*

64% of NASD awards were unpaid in 1998.⁷ The GAO also presented an estimate of the dollar amount of the unpaid awards: \$129 million.⁸ Unsurprisingly, the GAO found that the larger awards were less likely to be paid: 44% of the awards under \$100,000 were paid in full while only 5% of the awards in excess of \$1.15 million were paid in full.⁹

The GAO made several recommendations, including that the SEC: “require NASD to adopt procedures for monitoring the payment of arbitration awards;” “develop and publicize information to focus investor attention on the possibility of unpaid arbitration awards;” and, “require NASD to develop procedures addressing the problem of unpaid awards caused by failed broker-dealers to help reduce costs and increase options for investors.”¹⁰ In addition, the GAO recommended that the SEC “periodically examine the extent of nonpayment of SRO arbitration awards to determine the effectiveness of actions taken to improve the payment of awards.”¹¹ The GAO stated that the SEC “should establish a process to assess the feasibility of alternative approaches to addressing this problem,” to the extent unpaid awards remain a problem.¹²

Over the next fifteen years, FINRA did not publicly disclose data relating to the number and dollar amount of awards that went unpaid, thwarting any independent analysis of the problem. In 2013, FINRA disclosed a portion of unpaid award data for 2011 to the Wall Street Journal, but did not offer any additional contextual information.¹³ FINRA simply disclosed that “\$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.” No further context or methodology was provided for FINRA’s calculations.¹⁴ In 2015, FINRA provided unpaid award data for 2013 to its Dispute Resolution Task Force, which was made publicly available when the Task Force filed its report.¹⁵ The Task Force reported that, in 2013, “FINRA issued arbitration awards in 539 investor cases, of which 75 were not paid. The amount of damages awarded and not paid in these cases total \$62.1 million.”¹⁶

In 2016, PIABA issued its Unpaid Awards Report. Using the figures disclosed in the 2015 Task Force Report, PIABA recreated the data, and placed it in further context. PIABA found that one out of three awards went unpaid; and nearly 25% of the total amount awarded to investors went unpaid.¹⁷ Just hours before PIABA’s report was

⁷ See *id.*

⁸ See *id.*

⁹ See *id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ See Jean Eaglesham and Rob Barry, *More than 5,000 Stockbrokers From Expelled Firms Still Selling Securities*, WALL ST. J., Oct. 4, 2013.

¹⁴ See *id.*

¹⁵ *Final Report and Recommendations of the FINRA Dispute Resolution Task Force*, FINRA DISPUTE RESOLUTION TASK FORCE (2015), <https://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf>.

¹⁶ *Id.* (FINRA noted that the statistics did not include 19 unpaid awards that were the subject of judicial motions to vacate.)

¹⁷ PIABA did request more detailed data directly from FINRA, but was told that “compiling the data would require a great deal of staff resources and time,” and that it would take months to determine whether

made public, the Wall Street Journal again reported on unpaid awards, citing FINRA as its source, stating that in 2014, unpaid awards totaled more than \$34 million, which represented “15% of the total awards granted that year.”¹⁸

FINRA’s newly released comprehensive unpaid award data for the five year period from 2012 through 2016 puts the problem into focus. The table below summarizes FINRA’s data:

Summary of FINRA’s Unpaid Award Data 2012-2016

Year Award Issued	# Cases Awarded Damages	# Cases with Unpaid Awards	% Cases Awarded Damages that are Unpaid	Total Amount Awarded	Total Unpaid Award Amount	% Award Amount Unpaid
2012	255	76	30%	\$109,000,000	\$51,000,000	47%
2013	212	62	29%	\$181,000,000	\$75,000,000	41%
2014	177	44	25%	\$66,000,000	\$33,000,000	50%
2015	190	42	22%	\$203,000,000	\$26,000,000	13%
2016	158	44	28%	\$119,000,000	\$14,000,000	12%

In addition to FINRA’s newly released data, PIABA reviewed the arbitration awards issued in 2017, and determined that investor awards totaled \$73,280,880.¹⁹ PIABA then determined that \$20,649,164 of those awards were issued against brokers or firms which were no longer registered, a characteristic making it probable that the awards went unpaid.²⁰ Using this rule of thumb, PIABA concluded that 35.92% of

additional data would be made available. However, FINRA did make additional data available to the Wall Street Journal at about this same time.

¹⁸ Jean Eaglesham, *Arbitration Awards Against Stockbrokers Go Unpaid*, Wall St. J., Feb. 25, 2016.

¹⁹ PIABA has not included awards that have been the subject of vacature motions.

²⁰ In anticipation of drafting this report, and in the absence of data from FINRA, PIABA spent considerable time pulling every award issued in 2016 and 2017. FINRA has since reported the 2016 unpaid award experience, but the authors thought it important to describe the methodology used in PIABA’s analysis of the 2017 data.

All awards were pulled, and investor cases were then isolated for analysis and grouped into four categories: (1) those in which no respondent was suspended by or expelled from FINRA membership; (2) those in which all respondents were suspended by or expelled from FINRA membership; (3) those for which a motion to vacate the award was filed in court after the rendering of the award; and, finally (4) those in which some of the respondents were suspended/expelled and some were not.

FINRA promptly revokes the registration for respondents who fail to pay arbitration awards. With that in mind, if no respondent was expelled or otherwise lost its FINRA membership, we considered that award paid. If all the respondents were expelled, we considered that award unpaid. If only some of the respondents were expelled, we attempted to determine whether any collectible respondents remained. If there appeared that at least one collectible defendant maintained its FINRA membership, we considered

investor awards went unpaid (51 of 142 investor arbitration awards) and 28.18% of the dollars awarded to investors in 2017 were unpaid. PIABA anticipates these figures will be substantially similar to FINRA's official statistics for 2017, when those statistics are published.

Concerns about the Unpaid Award Problem

Shortly after PIABA released its Unpaid Awards Report, FINRA's then-CEO, Richard Ketchum, testified before a Senate subcommittee on Capitol Hill. When questioned by Senator Warren on the topic of unpaid awards, he acknowledged that "Something should be done about it."²¹ Senator Warren continued her questioning and Ketchum offered the following: "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."²²

The Securities Industry and Financial Markets Association ("SIFMA"), described as "the voice of the U.S. securities industry,"²³ has also expressed its consternation over the availability of data related to unpaid awards. While SIFMA's principal concern appears to lie with brokers who are unable to repay the loans their firms made to them, the securities industry's trade group has suggested that FINRA publish and track annual data on unpaid arbitration awards.²⁴ Specifically, SIFMA stated that FINRA should publish the total number of cases in which claimants won awards, the total dollar amount of those awards, the total number of awards paid, and the total amount of the awards paid.²⁵ FINRA responded to SIFMA's concerns, with the statement that it had heard the industry's concerns "loud and clear," and was considering the best course of action.²⁶

Since PIABA published its Unpaid Awards Report, FINRA made some efforts to address concerns related to unpaid awards. For example, FINRA discussed unpaid arbitration awards at its May 2017 Board meeting.²⁷ The FINRA Board authorized the publication of a Regulatory Notice seeking comment on proposed arbitration rule changes that would allow an investor to pursue claims in court, rather than arbitration, when a member firm becomes inactive during a pending arbitration, or when a broker became inactive before or during an arbitration proceeding. The Board also discussed other changes to the arbitration rules that would increase the options available to

that award paid (even though that respondent may have only paid the portion of the award attributable to it, and the balance of the award remained unpaid). Finally, we ignored all awards that were the subject of motions to vacate since no payment would be due while the award was under appeal. PIABA considered this the most conservative approach to the analysis.

²¹ Ann Marsh, *FINRA May Create Fund for Unpaid Arbitration Awards*, FINANCIAL PLANNING (Mar. 16, 2016), <https://www.financial-planning.com/news/finra-may-create-fund-for-unpaid-arbitration-awards>.
²² *Id.*

²³ See generally SIFMA, www.sifma.org (SIFMA's home page).

²⁴ Rita Raagas De Ramos, "Unpaid Finra Arbitration Awards are a Big Problem," Financial Advisor (Nov. 8, 2017), available at: <https://financialadvisoriq.com/c/1781883/208993>.

²⁵ See *id.*

²⁶ See *id.*

²⁷ Update: FINRA Board of Governors Meeting, FINRA (May 11, 2017), <http://www.finra.org/industry/update-finra-board-governors-meeting-051017>.

investors if a firm or broker became inactive during the arbitration process like, for example, permission to amend pleadings to name additional parties.²⁸ The Board additionally approved a change to the Form U4 to elicit information regarding brokers who did not pay arbitration awards, settlements, or judgments in full. In October 2017, FINRA finally issued the Regulatory Notice seeking comment on those proposed changes to the arbitration rules.²⁹

FINRA's measures called for greater transparency regarding associated persons who had not fully satisfied awards, settlements, or judgments; and provided investors with certain options if a broker or firm became inactive during the arbitration process. The measures did not, however, provide any relief to investors who went through the entire process and were given an award that went unpaid and therefore became worthless. The Board closed the "Unpaid Arbitration Awards" section of its May 2017 Board Meeting Update with the statement: "The Board also discussed additional steps to address unpaid arbitration awards that will be considered at a subsequent Board meeting."³⁰ No detail was provided, and no mention of *any* potential cure (i.e., increased net capital requirements, insurance requirements, or a national investor recovery pool) was made.

FINRA once again discussed "unpaid arbitration awards" at its July 2017 Board meeting; however, there appears to have been no discussion of any steps to get investors recovery if an award went unpaid. FINRA did focus on the "cockroaching" problem, looking to scrutinize more closely asset transfers that left behind a significant number of pending arbitration claims, unpaid arbitration awards, or settlements.³¹ In February 2018, FINRA filed a Regulatory Notice seeking comment on these proposed changes to the membership rules.³²

FINRA has reason to focus on these issues: unpaid awards undercut FINRA's legitimacy as a self-regulatory organization credibly committed to investor protection. Self-regulation works best when the industry bears the costs of industry misconduct. When the industry internalizes the costs of misbehavior, it is incentivized to police its own ranks efficiently. If the industry does not internalize the true cost of misbehavior and instead allows arbitration awards to go unpaid, FINRA itself may not be incentivized to devote sufficient resources to address the issue.³³ Conceptually, each

²⁸ See *id.*

²⁹ See FINRA Regulatory Notice 17-33, *Amendments to the Code of Arbitration Procedure for Customer Disputes to Expand the Options Available to Customers if a Firm or Associated Person Is or Becomes Inactive*, FINRA (Oct. 2017), <http://www.finra.org/industry/notices/17-33>.

³⁰ *Update: FINRA Board of Governors Meeting*, FINRA (May 11, 2017).

³¹ "Cockroaching" is the term commonly used to describe a situation in which a brokerage firm gets in trouble thanks to the improper conduct of its brokers and those supervising them. The firm is shut down, and the brokers scurry to find employment at other firms.

³² See FINRA Regulatory Notice 18-06, *FINRA Requests Comment on Proposed Amendments to Its Membership Application Program to Incentivize Payment of Arbitration Awards*, FINRA (Feb. 2018), <http://www.finra.org/industry/notices/18-06>.

³³ See Edwards, Benjamin, *The Dark Side of Self-Regulation* (September 14, 2016). UNIVERSITY OF CINCINNATI LAW REVIEW, Forthcoming. Available at SSRN: <https://ssrn.com/abstract=2829592> or

unpaid award is an instance where FINRA failed to fully achieve its stated investor protection mission.

Initiatives To Promote Payment

FINRA's efforts to date focused on increasing investor awareness of the potential for an unpaid award, as well as increasing investor litigation options if there is an increased likelihood of an unpaid award. Unfortunately, FINRA continues to avoid addressing the GAO's recommendation to improve award payments themselves if unpaid awards remained a problem. Based on FINRA's own data, the problem has continued.

FINRA's Discussion Paper identifies three possible initiatives to discourage unpaid awards: greater disclosure on the firm's Form BD, changes to the "statutory disqualification" definition, and Bankruptcy Code changes.³⁴ PIABA encourages all efforts to promote broader disclosure of unpaid awards. PIABA also supports the efforts to end the practice of brokers moving from firm to firm to avoid the import of significant complaints against them and unpaid awards from their former firms. There is a meaningful problem of the concentration of brokers with a long history of complaints concentrating in certain firms, raising the risk for *all* customers of those firms.³⁵

Greater disclosure, while a good thing in the abstract, will not incentivize brokers and firms who are no longer registered to pay outstanding arbitration awards. PIABA applauds FINRA's focus on recidivist brokers, and its suggestion to strengthen its member rules to ensure principals are held accountable for the misconduct of failed firms. However, more must be done to ensure investors actually collect when somebody has done them harm.

Helping Investors Victimized By Industry Misconduct Recover

The PIABA Unpaid Awards Report spent considerable time addressing a number of possible remedies to the unpaid award problem: expanding SIPC coverage, increasing net capital requirements, imposing insurance requirements, and/or creating an investor recovery pool. FINRA's Discussion Paper addressed each of these, but did not discuss any in detail, and failed to make any recommendation as to the viability of any option.

Expanding SIPC:

<http://dx.doi.org/10.2139/ssrn.2829592> ("When contractual relationships do not transfer the costs of misbehavior back to the industry, this incentive to self-police diminishes").

³⁴ *Discussion Paper – FINRA Perspectives on Customer Recovery*, FINRA (Feb. 8, 2018), http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.

³⁵ See Craig McCann, Chuan Qin, and Mike Yan, *How Widespread and Predictable is Stock Broker Misconduct*, SLCG (2016),

<http://www.slcg.com/pdf/workingpapers/McCann%20Qin%20and%20Yan%20on%20BrokerCheck.pdf>.

Both PIABA and FINRA noted that SIPC, as it is currently statutorily constructed, does not have the power to combat fraud, or to address investment losses from negligence. Rather, its mission is to ensure that investors do not lose securities from their accounts when the brokerage firms holding those accounts close.³⁶ What FINRA's Discussion Paper did *not* note, however, is the problem associated with the concern that SIPC's fund is in constant jeopardy of depletion. SIPC has long been criticized for its refusal to pay investor claims.³⁷ It is unlikely SIPC will adequately address the problem of unpaid awards.

Insurance:

The FINRA Discussion Paper identifies "other insurance options" as a possible remedy to unpaid awards. FINRA simply states that insurance could be required, perhaps in the form of commercial insurance products or a captive insurance program. What FINRA's Discussion Paper omits, and what PIABA pointed out in its Unpaid Awards Report, is the fact that FINRA has gone on record a number of times stating that insurance is too expensive and is therefore not a viable option. FINRA also fails to address fundamental coverage issues: specifically, that intentional fraud cannot be covered by insurance. Thus, fraud, selling away, and Ponzi schemes would be nearly impossible to cover under insurance policies.³⁸ While insurance requirements would offer investors some additional protections, it is unlikely required insurance will solve the problem of unpaid awards.

Investor Recovery Pool:

PIABA spent considerable time discussing the details of a Pool in its Unpaid Awards Report. Now, two years later, FINRA indicates that a Pool is one possible remedy. In its Unpaid Awards Report, PIABA discussed possible ways to structure a Pool and addressed concerns that would likely be raised about a Pool. Of the options PIABA and FINRA have set forth, a Pool is the most viable option available to address the payment of awards. Accordingly, PIABA again recommends that FINRA establish a Pool.

Funding A Pool

Investors who have taken their cases all the way through the arbitration process, won at their arbitration hearing, confirmed their awards with a court of competent jurisdiction, and have been unsuccessful in their collection efforts would be entitled to a recovery from a Pool, after assigning the unpaid award to the Pool. These steps address the main objections to a Pool; that specious claims would be made and paid, and that firms would be incentivized to walk away from pending claims without any fear of being held responsible for those claims.

³⁶ See generally SIPC, <http://www.sipc.org/about-sipc/sipc-mission>.

³⁷ See PIABA Unpaid Awards Report at 12 – 14 (contains more detailed discussion of the issues associated with SIPC coverage).

³⁸ See *id.* at 19 – 21 (contains a full discussion of the issues surrounding an insurance remedy).

The question then arises: how would a Pool be funded? There are three ready sources to fund a Pool. They are, in decreasing order of appeal: FINRA's fines levied against its rule-breaking members; FINRA's profits; and, an assessment made against *all* FINRA members. Each of these options is addressed below.

The most appealing source of funds for a Pool is the fines FINRA levies against its members who violate its rules. There is an undeniable logic to using the fines assessed against FINRA's bad actors to ensure that investors who fall victim to those violations are made whole. Focusing on the data available since PIABA's Unpaid Awards Report was released, the fines FINRA has collected are more than sufficient to fund a Pool. FINRA's report of unpaid awards and fines collected is summarized:

Year	Unpaid Awards (in millions)	Fines (in millions)
2014	\$33	\$132.6
2015	\$26	\$93.8
2016	\$14	\$173.8

The fines FINRA collected would have covered the unpaid awards, in full, sometimes by an order of magnitude.³⁹

FINRA is also capable of funding a Pool, and ensuring that every arbitration award is paid in full, simply out of its net profits. FINRA's report of unpaid awards and its annual net income is summarized:

Year	Unpaid Awards (in millions)	Net Income (in millions)
2014	\$33	\$129.0
2015	\$26	(\$39.5)
2016	\$14	\$57.7

FINRA's annual profits would have more than covered the unpaid awards for 2014 and 2016. While the SRO suffered a rare operating loss in 2015, the overwhelming profit from 2014 would have more than covered *all* the unpaid awards for 2014 through 2016. FINRA has not released its 2017 annual report, so PIABA is unable to determine whether it maintained a sufficient profit to cover the 2017 unpaid awards.

Finally, FINRA could fund a Pool with a modest assessment made on its members. FINRA boasts that more than 630,000 brokers are registered with the SRO.⁴⁰ Ignoring the administrative costs, a fee of \$23.24 per broker would ensure that a Pool covered every 2016 unpaid arbitration award. Turning to 2017, a fee of \$32.78 per broker would cover the unpaid arbitration awards. The highest amount of unpaid awards in the past five years was in 2013: \$75 million. Yet a fee of only \$119.05 per

³⁹ See *Statistics on Unpaid Customer Awards in FINRA Arbitration*, FINRA, <http://www.finra.org/arbitration-and-mediation/statistics-unpaid-customer-awards-finra-arbitration> (contains data concerning the unpaid awards); see also *Annual Reports & Financials*, FINRA, <https://www.finra.org/about/annual-reports-financials> (data concerning FINRA's fines levied against its members is found in its annual financial report).

⁴⁰ See *Statistics*, FINRA, <http://www.finra.org/newsroom/statistics>.

broker would cover that sum. Thus, based on the last five years of FINRA reported data, if FINRA chose to assess its brokers a fee to cover a Pool, that fee would not have exceeded \$120 per year, and could have been as low as \$23.25 per year.

While the Industry will undoubtedly claim it would be inequitable to force good brokers to pay for the wrongful conduct of bad brokers, the fact remains that the industry on the whole has chosen to require no safety net of any type thanks to its minimal net capital requirements and lack of insurance requirements for membership, leaving investors to bear the full risk of the industry's financial recklessness. A broker-funded Pool would serve to protect those investors where the industry has no other protection mechanisms.

Unpaid Awards Cause Real Harm to Investors

Investors suffering the dire effects of unpaid FINRA arbitration awards come from all walks of life. Take, for example, Bruce Wilkerson. Mr. Wilkerson, now 54 years old, is an accomplished former NFL player. After an All-SEC senior year at the University of Tennessee in 1986, he was drafted by the Los Angeles Raiders in the second round of the 1987 NFL Draft. He spent a decade playing football for the Raiders, the Jacksonville Jaguars, and the Green Bay Packers. After retiring from football, Mr. Wilkerson went to work as machinist at an Alcoa facility in Tennessee, where he has worked since.

Mr. Wilkerson trusted his hard earned life savings to his financial advisor, Robert A. Gist of Resource Horizon Group LLC. Gist gained Mr. Wilkerson's trust, and his investment portfolio, on the fraudulent pretense that he would invest conservatively in corporate bonds and other securities. In reality, Gist used the funds for a variety of improper purposes. He used Mr. Wilkerson's funds to pay his own personal expenses, to pay the expenses of a company he controlled, and to pay "dividends" and "proceeds" to other investors for false securities transactions he claimed to have made their behalf. In 2013, Gist entered into a \$5.4 million settlement with the SEC, after it alleged he converted funds from at least 32 investors.⁴¹

Mr. Wilkerson filed an arbitration claim against Resource Horizon for the actions of its broker, Gist.⁴² In March 2015, the arbitrators awarded Mr. Wilkerson his full

⁴¹ See SEC Litigation Release No. 22710, *Securities and Exchange Commission v. Robert A. Gist, et al.*, Civil Action No. 1:13-cv-01833-AT (N.D.Ga., May 31, 2013), <https://www.sec.gov/litigation/litreleases/2013/lr22710.htm>.

⁴² One of Resource Horizon's principals escaped being named in Mr. Wilkerson's arbitration claim thanks to her personal bankruptcy filing. That principal, Kelly Miller, settled one arbitration claim brought by a Gist victim, and lost an arbitration filed by another Gist victim. She filed for bankruptcy roughly one month after the arbitration award was issued against her. Immediately following Resource Horizons' closing, and contemporaneously with her bankruptcy filing, Miller joined Kovack Securities. Kovack Securities' principal, Brian Kovack, was elected to FINRA's Board of Governors later that year. In June of 2017, Reuters reported that 34% of Kovack Securities, Inc.'s brokers had a history of FINRA red flags See Benjamin Lesser and Elizabeth Dilts, *Wall Street's Self-Regulator Allows Safe Havens for Tainted Brokers* (June 12, 2017) <https://www.reuters.com/article/usa-finra-brokers/wall-streets-self-regulator-allows-safe-havens-for-tainted-brokers-idUSL1N1J91C3..>

losses of \$610,000, as well as other statutory damages.⁴³ Unfortunately, shortly before the award was issued, FINRA cancelled Resource Horizon's registration.⁴⁴ It turns out that it had already failed to pay another arbitration award related to the same misconduct affecting Mr. Wilkerson. No longer registered, Resource Horizon has failed to pay Mr. Wilkerson's award as well. Now 53 years old, Mr. Wilkerson, who thought he had smartly prepared for his golden years, has lost a substantial portion of his net worth. He will likely find himself working many years to make up those lost funds.

Conclusion

The landscape regarding unpaid arbitration awards remains largely unchanged since the GAO first addressed the issue in 2000. The publication of unpaid award data demonstrates that the figures are not improving. In 2013, nearly \$25 out of every \$100 awarded to investors went unpaid, and in 2017, more than \$28 out of every \$100 awarded to investors went unpaid. While 33 out of 100 investors who won their arbitrations in 2013 went unpaid, nearly 36 out of 100 investors who won their arbitrations in 2017 went unpaid.

While FINRA has stated it is "important to engage in a broader discussion with other regulators and policy makers, as well as other stakeholders in the issue, about investor recovery more generally,"⁴⁵ it is time for FINRA to take action. The best workable solution remains a simple one: a national investor recovery pool to be maintained and administered by FINRA. The SRO remains the best party to implement and maintain the system for several reasons: (i) it sets the standards for membership, including the financial responsibility required for its members; (ii) its members are the ones who are found to have engaged in the wrongdoing; (iii) it administers the arbitration system and has first-hand knowledge of the data generated by those arbitrations; and (iv) it is the one levying fines against its members for misconduct.

PIABA's call for the creation of a Pool remains unchanged since its 2016 Unpaid Awards Report. Unpaid awards must be verified, and there must be measures in place to ensure fraudulent claims against firms are not eligible for payment by a Pool. It must be designed to avoid the hoarding problem that SIPC suffers, and therefore exhaust its resources on an annual basis (aside from the funds needed for ongoing operations.) A Pool should be funded out of FINRA's fines it collects from its members, or FINRA's profits. Alternatively, a Pool should be funded by levying an assessment against each of FINRA's registered brokers.

PIABA welcomes FINRA's invitation to discuss this issue further, however, little has been done since PIABA outlined the scope of this problem in 2016. PIABA is encouraged that FINRA is seeking active engagement on this topic; however, FINRA has had decades to study this problem. Investors' experience collecting awards is not improving, and action must be taken without further delay. In the absence of any viable

⁴³ See *Wilkerson v. Resource Horizons Group LLC*, FINRA Case No. 14-00904 (Mar. 11, 2015).

⁴⁴ See Resource Horizons Group LLC's BrokerCheck Summary, <https://brokercheck.finra.org/firm/summary/104368>.

⁴⁵ FINRA Discussion Paper, at 19.

solution other than a national investor recovery pool, FINRA must be required to enact such a Pool either voluntarily or as a matter of legislative requirement.

Exhibit

D

FINRA ARBITRATION'S PERSISTENT UNPAID AWARD PROBLEM

PIABA'S¹ THIRD REPORT CONCERNING FINRA'S REFUSAL TO TACKLE THE UNPAID ARBITRATION AWARD PROBLEM HEAD-ON

Authors: Hugh Berkson and David P. Meyer²

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.

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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David P. Meyer, managing principal of the Meyer Wilson law firm based in Columbus, Ohio, is the current PIABA President and serves on PIABA's Board of Directors. The authors offer their deepest thanks to Robin Ringo, PIABA's Executive Director, as well as Tiffany Zachary and Ashley Ringo, whose research and analysis of arbitration awards was critically important in developing this report. The authors also thank the members of PIABA's Executive Committee, including Sam Edwards, Michael Edmiston, Darlene Pasieczny, and Christine Lazaro, for their input and editorial suggestions.

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 and 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 advisers (“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%202018%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.

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%20Quin%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 disproportionately 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.

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.

PROPOSED REMEDIES

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.

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.