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April 9, 2018

Submitted electronically to pubcom@finra.org.

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

RE: FINRA Regulatory Notice 18-06: Membership Application Program – Proposed Amendments to Incentivize Payment of Arbitration Awards

Dear Ms. Mitchell:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I hereby submit the following comments in response to FINRA Regulatory Notice 18-06 (the "Proposal").[2] NASAA members regulate FINRA-registered broker-dealers and agents, contributing to the longstanding and multifaceted collaborative regulatory relationship between NASAA and FINRA. NASAA and its members are committed to a well-regulated securities industry, including the implementation and availability of robust investor protection rules.

Unpaid arbitration awards remain an unresolved and well-documented investor protection concern. In failing to pay arbitration awards, broker-dealers fail to comply with their legal, regulatory and ethical obligations. NASAA has been a longstanding proponent of measures to redress this problem.[3] While the Proposal is an improvement, it will not resolve the problem of unpaid arbitration awards. NASAA looks forward to working with FINRA and other stakeholders in finding a solution that will ensure that no investor awards or settlements go unpaid. Until such time, the Proposal is a well-considered step in the right direction and should help ensure more

[1] NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as a forum for these regulators to work with each other to protect investors at the grassroots level and promote fair and open capital markets.

[2] FINRA Regulatory Notice 18-06: *Membership Application Program – Proposed Amendments to FINRA Membership Application Program to Incentivize Payment of Arbitration Awards* (Feb. 8, 2018), *available at* http://www.finra.org/industry/notices/18-06.

[3] *See, e.g.*, Letter from NASAA President Joseph Borg to March E. Asquith regarding FINRA Regulatory Notice 17-33 (Dec. 20, 2017).

awards get paid. NASAA also appreciates FINRA's disclosure of arbitration information through the FINRA discussion paper that accompanied release of the Proposal.[4]

NASAA wholeheartedly supports the Proposal's goal of incentivizing timely payment of arbitration awards by individuals or firms in connection with FINRA's new membership application ("NMA") or continuing membership application ("CMA") processes. NASAA also supports the proposed rule amendments, though we offer below recommended revisions to the Proposal and responses to three of the Proposal's six specific requests for comment.

Recommended Revision to Rule 1011 as Proposed

The Proposal creates a new definition, "Covered Pending Arbitration Claim," as Rule 1011(c). NASAA recommends expressly stating that this definition includes all investment-related arbitration claims wherever filed – *i.e.*, FINRA arbitrations as well as any investment-related private arbitrations, such as JAMS or AAA proceedings. NASAA also suggests that this definition should be expanded to include any investment related claims pending in a judicial forum – *i.e.*, in a state or federal court. Without these important clarifications, the Proposal could be open to abuse. For example, absent these clarifications, an investment adviser representative subject to a pending private arbitration claim or a pending investment related civil action who subsequently sought to join the brokerage industry and become associated with a FINRA member firm might conclude that the private proceeding or pending court case need not be disclosed under the Proposal. This would be unfortunate; the Proposal should be clearly understood as applying to all pending investment-related claims, wherever filed.

In addition, NASAA recommends the term "claim amount" in Rule 1011(c) be defined more broadly. The term as currently proposed is open to abuse. For example, the Proposal is unclear as to its treatment of pending claims for which there may be joint liability between more than one person or for which an associated person reasonably expects to be indemnified. (In our opinion, pending claims with joint liability should be assessed to each respondent maximally, as if no other person could be potentially liable.)

With these considerations, NASAA respectfully recommends the following revisions to proposed Rule 1011(c)[5]:

> *(c) "Covered Pending ~~Arbitration~~ Claim"*
> *The term "Covered Pending ~~Arbitration~~ Claim," means:*
>
> *(1) For purposes of a business expansion as described in IM-1011-2:*

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

[5] If this change is adopted other portions of the Proposal would need to be revised to account for the addition of customer-initiated, investment-related claims pending in judicial forums.

(A) An investment-related, consumer initiated claim filed against the Associated Person ***in any arbitral or judicial forum*** *that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital.*

(2) For purposes of an event described in Rule 1017(a)(4):
(A) An investment-related, consumer initiated claim filed against the transferring member or its Associated Persons ***in any arbitral or judicial forum*** *that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the transferring member's excess net capital.*

For purposes of this definition, the claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees ***[.], and shall be the maximum amount for which the Associated Person is potentially liable regardless of whether the claim was brought against additional persons or the Associated Person reasonably expects to be indemnified, share liability or otherwise lawfully avoid being held responsible for part or all of such maximum amount.***

Recommended Revision to IM-1011-2 as Proposed

The Proposal creates new IM-1011-2, *Business Expansions and Covered Pending Arbitration Claims*, to provide additional guidance on business expansions and acquisitions involving unpaid arbitration awards. NASAA recommends deleting the phrase "involved in sales" from this interpretive material. The Proposal should be understood as applying to any associated person (defined in Rule 1011(b)) who is subject to a pending civil claim or unpaid arbitration award or settlement and who seeks to join a FINRA member firm. The nature of an associated person's employment at the firm should not matter. IM-1011-2 as drafted, however, suggests that the Proposal only applies to associated persons who are *involved in sales.* This would be a mistake. Were the Proposal seen as limited to sales professionals only, it would incentivize firms to evade the Proposal by simply assigning persons with unpaid pending claims or unpaid awards into administrative, non-sales roles.

Recommended Revision to Rule 1013 as Proposed

The Proposal would create a new subparagraph (c) in Rule 1013. NASAA recommends including this additional text within existing Rule 1013(a)(1)(H), rather than as new standalone subparagraph (c). Rule 1013(a)(1)(H) already identifies disciplinary events that must be disclosed in a new member application. The disclosure obligation outlined in proposed Rule 1013(c) could reasonably be inserted as new subparagraph (vi) within Rule 1013(a)(1)(H). FINRA could also

remind readers in the Proposal that all the disclosure obligations under Rule 1013(a)(1)(H) must be updated as necessary throughout the pendency of the membership application in accordance with Article IV, Section 1(c) of FINRA's Bylaws.[6]

NASAA accordingly recommends that, rather than the existing proposed amendments to Rule 1013, the following provision be inserted as new Rule 1013(a)(1)(H)(vi):

> . . .
>
> ***(vi) any arbitration claim that is filed, awarded or becomes unpaid before a decision constituting final action of FINRA is served on the Applicant;***
>
> . . . .

Recommended Revision to Rule 1014 as Proposed

NASAA recommends FINRA expressly state in the Proposal that, in reviewing a new or continuing membership application with disclosures of unpaid arbitration awards or settlements, FINRA may in its discretion contact the claimants of such awards or settlements to confirm the accuracy of the information provided by the Applicant. The Proposal does not express this. We believe FINRA generally should verify this information with claimants and, accordingly, should provide notice to members that it may do so.

In addition, the Proposal should be revised to state that FINRA may require an expert's opinion to support an Applicant's assertion that it can satisfy an unpaid award or settlement obligation it intends to assume. The Proposal as drafted indicates an Applicant may provide such an opinion but does not expressly give FINRA authority to require it. This should be made explicit. On the other hand, we do not believe such an expert opinion necessarily needs to be from an "independent" source. The Proposal should give FINRA staff the authority to assess the veracity and reasonableness of an offered expert opinion on a case-by-case basis and to require such qualifications and degree of independence from the Applicant as the staff reasonably believes warranted in each instance. We therefore suggest the following revisions to proposed Supplementary Material .01 of Rule 1014.

> *. . . Such documentation may include an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund or the retention of proceeds from an asset transfer, or such other forms that the Department may determine to be acceptable.* ***[~~The~~***

[6] Article IV, Section 1(c), states:

> "(c) Each applicant and member shall ensure that its membership application with the Corporation is kept current at all times by supplementary amendments via electronic process or such other process as the Corporation may prescribe to the original application. Such amendments to the application shall be filed with the Corporation not later than 30 days after learning of the facts or circumstances giving rise to the amendment."

> ~~***Applicant may provide a written opinion of an independent, reputable U.S. licensed counsel knowledgeable as to the value of such arbitration claims.]***~~ ***The Department may require that the Applicant obtain a written opinion of a legal or financial expert satisfactory to the Department in support of the Applicant's claimed ability to satisfy such awards, settlements or claims.*** *Any demonstration by an Applicant of its ability to satisfy these outstanding obligations will be subject to a reasonableness assessment by the Department.*

Response to Request for Comment #1 in the Proposal

NASAA believes it is appropriate for the Proposal to distinguish NMAs from CMAs with respect to whether a presumption of denial should apply to pending arbitration claims. Applying a presumption of denial to NMAs with pending awards is appropriate given that these firms will lack operating histories with FINRA. New applicants should be required to affirmatively demonstrate to the Department's satisfaction that they can meet any arbitration obligations they would be bringing with them as new FINRA members. In contrast, existing FINRA members have operating histories the Department can review and consider in any CMA request. FINRA rules should incentivize member firms to pay arbitration awards, including awards they assume in the process of acquiring other members or lines of business. But presumptively denying CMAs with pending claims would be unnecessarily disruptive to existing members and would raise the costs of the CMA process for FINRA members while providing no informational benefit to the Department. This would disincentivize FINRA members from taking-on potential liabilities through business acquisitions and, consequently, could result in more, not fewer, arbitration awards ultimately going unpaid. This would be counterproductive. The materiality consultation process for asset acquisitions and transfers as currently described in the Proposal appears entirely appropriate.

Response to Request for Comment #2 in the Proposal

When an applicant designates the funds to be used for payment of a pending arbitration, unpaid award, or unpaid settlement, the applicant should be required to guarantee that those funds will remain available for such payment. However, NASAA recognizes that circumstances sometimes change during the pendency of a planned business transaction and that applicants may need to reallocate the prior designated funds. To account for potentially changing business circumstances and given the fungibility of money, applicants should not be duty bound necessarily to satisfy an arbitration award or settlement from the funds they may have initially identified. Instead, FINRA's rules should allow an applicant the flexibility to amend its application and designate a different source of available funds to satisfy pending claims or unpaid arbitration awards or settlements if necessary.

Response to Request for Comment #3 in the Proposal

We interpret the Proposal as applicable to any person who seeks to become associated with a FINRA member. The proposal thus incorporates by reference the definition of "associated person" in Rule 1011(b). This broad scope is appropriate. The Proposal should not be structured more narrowly, such as by making it applicable only to principals, control persons or officers. A narrower scope such as this would undermine the goals of the Proposal and open it up to potential abuse. For example, if the Proposal were limited to only certain categories of associated persons, members could avoid the Proposal by simply staffing such individuals temporarily in administrative or other positions that fell outside the scope of the Proposal. Keeping the Proposal applicable to all "associated persons" will minimize the risks of such gamesmanship by member firms.

In summary, NASAA supports the Proposal but believes certain revisions discussed above are warranted. NASAA also offers the preceding comments in response to three of the Proposal's six requests for comment. NASAA welcomes an opportunity to discuss this letter and confer with FINRA staff on further steps that can be taken to resolve the problem of unpaid arbitration awards. If you have any questions about this letter please contact me or NASAA General Counsel A. Valerie Mirko, at vm@nasaa.org or (202) 737-0900.

Sincerely,

Joseph Borg
NASAA President
Alabama Securities Commissioner

I am writing to you about Regulatory Notice 18-06;
Here is what a small broker dealer must deal with in the real world. You work seventy hours per week to build a company. You don't make a bunch of money, in my case about 150k per year. You keep a close relationship with FINRA and your coordinators.
Lawyers monitor companies that fail and solicit clients to sue if they lost money. The client agrees and files an arbitration. Cost to the B/D is 3k to 10k. By the time you reach discovery you have another 5 to 10k in legal costs. In many occasions the client made money while at your firm. However, the reality is that the lawyers who solicited the claim know that you will settle because even if your right, it does not matter, it is a cost issue. Arbitration has nothing to do with the law it is about feelings.
The position I am in is that I spend money on FINRA and Lawyers until it no longer makes sense. Who are we helping here FINRA and Lawyers or clients. If you don't want small broker dealers then just shut us down and be done with it. Instead you drag out the process and bleed us dry and we wind up with nothing, except we had a dream of building a business and helping people and lose everything we worked for.
You have the control to change the industry. However, you don't. As an introducing BD we must follow the same rules as Merrill Lynch without the resources. I truly believe that we need two FINRA's one for small introducing BDs and one for larger firms. I would love to have a conversation. I will survive however I am sure I will spend everything I own to survive all these bogus claims and wind up having to sell out anyway. Screwing all the good reps that have been with me for years. All this work to do nothing but benefit all the mega firms that do more to harm clients than small firms than all ever thought of doing.

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sifma
Invested in America

April 9, 2018

Via E-Mail to pubcom@finra.org

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

Re: Regulatory Notice 18-06 (proposed amendments to Membership Application Program to incentivize payment of arbitration awards)

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on Notice 18-06 (the "Notice" or the "Proposal").[2] We applaud FINRA's efforts to amend its Membership Application Program rules to help ensure that arbitration claims, awards, and settlements are paid in full.

We have long held that the issue of unpaid awards originates with the integrity and quality control standards that FINRA establishes for membership. That is the most appropriate juncture and means to address the issue, rather than viewing the issue as requiring some form of post-award collection pool, insurance, or guaranty. We offer the following comments and recommendations for your consideration.

1. **Membership applications are presumptively denied if there are pending arbitration claims.**

NMA. SIFMA supports the presumption of denial for a new membership application ("NMA") if the applicant or its associated persons are subject to pending arbitration claims. We likewise support

[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] Notice 18-06, available at http://www.finra.org/industry/notices/18-06.

the applicant's ability to overcome the presumption of denial upon showing its ability to satisfy the pending arbitration claims through an escrow agreement, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer.

If the applicant designates a clearing deposit or the proceeds from an asset transfer for purposes of demonstrating its ability to satisfy a pending arbitration claim, unpaid award, or unpaid settlement, then it would be appropriate for FINRA to require the applicant to provide some sort of written guaranty that the funds would be applied for that purpose.

We do not support overcoming the presumption of denial upon a showing of insurance coverage. It is erroneous to conflate insurance coverage with a respondent's ability to pay an award. Most insurance policies do not in fact provide coverage for FINRA arbitration claims.

Most relevant insurance coverages generally exclude, for example, fraud claims and conduct outside the scope of employment (e.g., selling away). In addition, determining whether an insurance policy "may" apply to a claim (in terms of subject matter, policy limits, and coverage determinations) is often difficult based on the Statement of Claim and other information available during the pendency of a case. Thus, in many cases, it would be unclear whether the policy may cover the claim.

Moreover, even if the claim may be covered, it is uncertain whether the insurance company would make an affirmative coverage determination, much less one that would cover the full prospective arbitration award. In many cases, even at the time an award is made, many insurers have not yet provided an opinion on whether their policy would apply. For all the foregoing reasons, insurance policies should not be allowed to demonstrate an applicant's ability to satisfy pending arbitration claims.

CMA. SIFMA agrees that the presumption of denial for pending arbitration claims should not apply to a continuing membership application ("CMA"). Instead, consistent with current practice, FINRA should consider pending arbitrations in determining if the applicant meets the standards for admission.

2. Business expansions require a materiality consultation for unpaid arbitration claims.

SIFMA supports the Proposal to not permit a member to effect a business expansion that involves adding one or more associated persons with a "covered pending arbitration claim,"[3] unpaid arbitration award, or unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, unless the member first seeks a materiality consultation with FINRA and FINRA determines that the member may effect the contemplated business expansion without a CMA.

The definition of "covered pending arbitration claim" should include only those pending arbitration claims filed prior to public announcement of the contemplated transaction.

[3] "Covered pending arbitration claims" means: (1) an investment-related, consumer-initiated claim filed against the associated person that is unresolved; and (2) whose claim amount (either individually or in the aggregate) exceed the member's excess net capital. The claim would include only claimed compensatory loss, not requests for pain and suffering, punitive damages, or attorneys' fees.

3. <u>Direct or indirect acquisitions or transfers of assets</u> <u>require a materiality consultation for unpaid arbitration claims</u>.

SIFMA supports the Proposal to not permit any direct or indirect acquisitions or transfers of a member's assets or any asset, business or line of operation where the transferring member or one or more of its associated persons has a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, unless the member first seeks a materiality consultation and FINRA determines that the member is not required to file a CMA for approval of the acquisition or transfer.

* * *

If you have any questions or would like to further discuss these issues, please contact the undersigned.

Sincerely,

Kevin M. Carroll
Managing Director and
Associate General Counsel

cc: ***via e-mail to*:**
Robert L.D. Colby, Chief Legal Officer, FINRA
Richard W. Berry, Executive Vice President and Director, FINRA-DR

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April 9, 2018

VIA EMAIL to pubcom@finra.org

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

Re: Comments Concerning FINRA Regulatory Notice 18-06
Membership Application Program

To whom it may concern:

Thank you for the opportunity to comment on Regulatory Notice 18-06 and its proposed changes to the Membership Application Process. We work in the Georgia State College of Law's Investor Advocacy Clinic where we represent small investors who cannot afford legal representation. Because we work closely with investors, we understand the hard work it takes to reach a settlement or award and the value of funds to those investors. For these reasons, we support changes that improve the likelihood that settlements or awards are paid. We support stringent guidelines for new and continuing membership applications from firms with pending or unpaid awards. We also support the proposals to incentivize payments because investors need additional protections from those who have wronged them. Claimants in arbitration with new member applicants may be at a greater risk for nonpayment of awards or settlements and are therefore in need of greater protection.

Thus, we believe that firms should show that they can pay a pending arbitration claim before being approved as a new member. FINRA should have the final decision in approving a member's decision to hire problematic brokers with pending or unpaid awards or settlement. A firm should not be able to actively avoid its obligations to investors by shifting assets and resurfacing under a new entity identity. We also recommend carrying out the alternative suggestion in the notice by reducing the 25% threshold to file a Continuing Membership Application (CMA) for asset acquisitions and transfers to 10%. We also support including the presumption of denial for CMAs as well as new members.

A. A Firm Should Show Its Ability to Pay a Pending Arbitration Claim Before Being Approved as a New Member.

FINRA should deny new applications for applicants or their associated persons who have pending arbitration claims until the applicant shows how those claims would be paid should they go to award.[1] Showing an ability and intent to pay pending claims is an important factor to the public. If the claims go to award, the firms or associated persons will need to pay them. Requiring members to show their ability to do so engenders trust. As the notice itself states, this new requirement would "shine a spotlight on the individuals with the pending arbitration claims and the firm's supervision of such individuals."[2]

Additionally, we recommend that this presumptive denial also apply to CMAs for members who have pending arbitration or unpaid settlement claims for amounts greater than $15,000. Investors with existing brokers should have at least the same amount of protection as those with new brokers. Limiting the required showing to claims over $15,000 will provide some balance to this rule, only requiring a presumption of denial for claims that would be reported.

B. FINRA Should Have the Final Decision, Using A Materiality Consultation, to Approve a Member's Decision to Hire Problematic Brokers With Pending or Unpaid Awards or Settlements.

We support the second proposed amendment that would require members, who do not otherwise have to file a CMA, to apply for a materiality consultation to approve or deny a business expansion when taking on new associated members with pending or unpaid arbitration claims or settlements.[3] Currently, hiring brokers with pending or unpaid arbitration claims is not considered a material change. However, this is a material business change since these persons could affect future claims and liability owed by the member firm. In accordance with the proposed requirement, firms would have to abide by FINRA's determination in the materiality consultation and file a CMA if they intend to proceed with the hiring of problematic brokers. This change prevents firms from taking advantage of the business expansion safe harbor when adding new members. Not only would FINRA be able to assess the impact these persons would have on firms, it would also incentivize firms' scrutiny of brokers with a bad record of paying claims, adding an additional layer of supervision. Additionally, brokers would know that having claims against them would be problematic when trying to move to a different firm, which would

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[1] *See* FINRA, REGULATORY NOTICE 18-06, MEMBERSHIP APPLICATION PROGRAM 4–5 (2018) ("One factor [already] considered in [existing] Rule 1014(a)(3)(C) to be considered by [FINRA's Department of Member Regulation], and that creates a presumption of denial, is whether the applicant . . . is subject to unpaid arbitration awards . . . or unpaid arbitration settlements. The rebuttable presumption does not apply, however, to pending arbitration claims." Therefore, "FINRA is proposing to amend Rules 1014(a) and (b) to specify that a presumption of denial exists if the new member applicant or its associated persons are subject to pending arbitration claims.")

[2] *Id.* at 4.

[3] *See id.* at 5 ("FINRA is proposing not to permit a member to effect a business expansion that would involve adding one or more associated persons with a 'covered pending arbitration claim,' unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA, unless the member first seeks a materiality consultation for the contemplated expansion with the Department and the Department determines that the member may effect the contemplated business expansion without a CMA.")

hopefully deter bad actions. If such claims exist, this proposal incentivizes brokers to resolve and pay them.

We recommend that the proposed amendment be applicable to the hiring of anyone who is involved in direct customer sales, and also to principals, control persons, or officers. Occasionally, associated persons from problematic firms go on to become officers at larger firms, taking their poor business practices with them. FINRA should use these amendments as an opportunity to prevent these individuals from moving to firms where they can create a culture of misconduct.

Additionally, we believe that the applicability of a presumptive denial in a CMA for those with pending or unpaid arbitration awards or settlements is crucial. A firm should be aware that taking on a problematic broker would impose stricter membership approval standards. If they take on such a risk, they should take steps to ensure the public is protected.

C. A Firm Should Not Be Able to Actively Avoid Its Obligations to Investors by Shifting Assets.

We support preventing acquisitions or transfers without a materiality consultation where the member or any of its associated persons have pending or unpaid awards.[4] Large transfers should be prevented until the firm files a CMA while some smaller transfers could still be permitted. A 10% safe harbor would still be small enough to allow the occasional transfer of customer accounts from one firm to another. However, it would not allow an associated person to move a meaningful percentage of his accounts to another firm. While we understand that this would overall result in more CMAs, adding costs to member firms, the added rigor of CMAs will help prevent problematic transfers.

We agree with this change because it would allow FINRA's Department of Member Regulation to determine how the claims will be paid before approving the transfer or acquisition. This will prevent firms with unpaid or pending claims from closing down and opening back up under a different name, or shifting their assets to other firms. This change would protect investors by preventing firms from actively avoiding their obligation to pay settlements or claims. By ensuring that firms are not engaging in business expansions or asset acquisitions as a means of avoiding payment of claims, investors would be better protected against these practices.

CONCLUSION

In conclusion, new members or brokers with pending or unpaid arbitration claims should bear the burden of showing how they will resolve these issues before having their application accepted. These changes would help contribute to FINRA's integrity, and hopefully ensure that more claims are paid. The costs incurred by firms are outweighed by the benefits of protecting

[4] *See id.* at 7 ("FINRA believes that member firms engaging in asset acquisitions or transfers that have covered pending arbitration claims, unpaid arbitration awards or unpaid settlement agreements related to an arbitration should be required to seek a materiality consultation for the contemplated acquisition or transfer.")

investors and maintaining industry integrity. The changes would serve as an incentive to treat investors fairly.

Thank you for this opportunity to share our comments.

Best regards,

/s/ Benjamin Dell'Orto	*/s/ Esmat Hanano*	*/s/ Alisa Radut*
Benjamin Dell'Orto	Esmat Hanano	Alisa Radut
Student Intern	Student Intern	Student Intern
Student Reg. No. SP001565*	Student Reg. No. SP001567*	Student Reg. No. SP001351*

/s/ Nicole G. Iannarone
Nicole G. Iannarone
Assistant Clinical Professor

* All student interns in the Investor Advocacy Clinic, including this signatory, perform all work under the Georgia Student Practice Rule contained in Rules 91-95 of the Rules of the Supreme Court of Georgia as registered law students under the supervision of a licensed Georgia attorney.

Colorado Financial Service Corporation
MEMBER FINRA · SIPC

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APRIL 4, 2018

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

RE: Proposed Rule Amending Membership Application Program

Thank you for the opportunity to comment on the referenced issue.

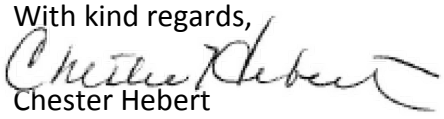
I support the intent of the proposed changes.

The proposed changes, I believe, would go a long way towards cleaning up the industry and memorializing a best practice. However, I would caution that the proposed regulation take into consideration due process and assumption of innocence for the representative who may be affected by such a rule.

A rule that requires all Broker-Dealers to operate on the same page would not allow a broker-dealer to be pressured, for whatever reason, to take-on a representative who perhaps should not be in the industry. More importantly if a representative or Firm skips on an arbitration award, that should be grounds enough for FINRA to deny registration until such time as the Firm and the representative, if jointly liable, cure the award. This a case of rules based regulation being necessary.

Thanks again for the opportunity to comment.

With kind regards,



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April 9, 2018

Via E-Mail (pubcom@finra.org)

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

Re: Regulatory Notice 18-06 (Proposed Amendments to Membership Application Program to Incentivize Payment of Arbitration Awards)

Dear Ms. Mitchell,

The Cornell Securities Law Clinic (the "Clinic") submits this comment to support the proposed amendments ("Proposed Amendments") to the Financial Industry Regulatory Authority ("FINRA") Membership Application Program ("MAP") Rules. The Clinic is a Cornell Law School curricular offering in which law students provide representation to public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, please see: http://securities.lawschool.cornell.edu.

The Clinic supports the Proposed Amendments as an important part of an overall scheme to curb the problem of unpaid investor arbitration awards.

The Proposed Amendments create incentives for the timely payment of arbitration awards. Creating incentives to pay arbitration awards is important because investors typically are compelled to arbitrate by FINRA member firms. Data collected by FINRA between 2012 and 2016 shows that approximately 30% of cases in which the investor was awarded damages went unpaid.[1] Over the five-year period the aggregate unpaid amount was $199 million with an additional $1.4 million in dispute at the time of publishing.[2]

If adopted, the Proposed Amendments would impose supervisory review obligations on firms with regard to representatives with pending investment-related arbitration claims ("Covered Pending Arbitration Claim") and prevent FINRA member firms with Covered Pending Arbitration Claims from shifting assets in customer accounts, managers or owners to

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[1] FINRA, Statistics on Unpaid Customer Awards in FINRA Arbitration, (Feb. 2018), https://www.finra.org/arbitration-and-mediation/statistics-unpaid-customer-awards-finra-arbitration.
[2] *Id.*

another firm then closing down. As such, the Proposed Amendments advance investor protection.

I. We Support the Proposed Amendment to Rules 1014(a) and (b)

The proposed amendments to Rules 1014(a) and (b) will create a rebuttable presumption of denial of a New Member Application ("NMA") if there is an unpaid arbitration award, unpaid arbitration settlement, pending arbitration claims[3] or other unpaid customer settlement on the part of the applicant, its control persons, principals, registered representatives, other associated persons ("Associated Persons"), any lender of five percent or more of the applicant's net capital and any other member with respect to which these persons were a control person or a five percent lender of net capital for an NMA. This is a welcome addition to the rules because it will likely incentivize potential members and Associated Persons to pay off these obligations knowing that failure to do so will result in presumptive denial of the NMA.

This proposed amendment is also efficient because the presumption of denial does not apply to member firms which are required to file a Continuing Membership Application ("CMA"), since the CMA collects all of the information necessary for FINRA to determine whether the member firm or its Associated Persons are likely to pay their covered pending arbitration claims.[4] This will likely have a balancing effect of not in itself chilling business expansion activity for member firms with an obligation to report.

Finally, this proposed amendment will allow new member applicants to overcome the presumption by demonstrating that they can pay covered pending arbitration claims via insurance coverage, an escrow account, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer, or such other forms that FINRA's Department of Member Regulation ("the Department") may determine to be acceptable. These provisions balance any negative effects by not punishing new member applicants with legitimate plans of paying the claims against them should such claims result in arbitration awards.

II. We Support the Proposed Addition of the Business Expansion for Members Rule

This proposed amendment imposes an extra level of review when a member firm that is not required to file a CMA tries to effect a business expansion that involves adding one or more associated persons with a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, by making the member first seek a materiality consultation

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[3] The Regulatory Notice uses the term "pending arbitration claim" instead of "covered pending arbitration claim" to describe what is prohibited in this section. The Clinic assumes that "pending arbitration claim" is used to refer to the same concept as "covered pending arbitration claim" elsewhere. If FINRA aims to have "pending arbitration claim" refer to a broader concept than "covered pending arbitration claim" it should make that clear.

[4] *See* FINRA, Continuing Membership Guide – CMA Requirements, http://www.finra.org/industry/continuing-membership-guide-cma-requirements-0315.

with the Department and requiring the Department to find that the member may effect the contemplated business expansion without a CMA ("Business Expansion for Members").

The proposed addition of the Business Expansion for Members Rule will likely incentivize members to investigate the covered pending arbitration claims and unpaid awards of new hires, since the proposed amendment will require that the Member have a net capital large enough to cover the individual's covered pending arbitration awards, unpaid arbitration awards and unpaid settlement amounts. The proposed amendment will assess whether the member firm's net capital can cover that individual's covered pending arbitration claims. Thus, it is foreseeable that individuals with large aggregate covered pending claim amounts and unpaid arbitration awards will, at a minimum, be subject to increased supervision and review.

One possible negative effect of this addition may be that individuals with large aggregate unpaid awards and covered pending arbitration claims will be attracted to brokerage firms with large net capitals and those individuals may be attractive to brokerage firms with large net capitals. This may create a situation where some well-capitalized firms have a concentration of individuals with substantial unpaid awards or covered pending arbitration claims.

Another downside is that the proposed addition does not directly prohibit the member firm from conducting a Business Expansion while having covered pending arbitration claims — it merely imposes an extra level of review. While it is certainly helpful to have a Department determination of whether a firm's proposed Business Expansion is material and a pronouncement that the firm must file a CMA to remain in non-violation of the FINRA Rules, FINRA should consider including a more affirmative prohibitive mechanism in the rule's language. For example, appropriate language to the effect that failure to file a CMA within 30 days upon a finding of materiality will result in an imposition of fines or suspension.

III. We Support the Proposed Amendments to the Business Expansion for Asset Transfer Rule

This proposed amendment will prevent member firms who are not already required to submit a CMA from effectuating the direct or indirect transfer or acquisition of assets, businesses or lines of operation without seeking a materiality consultation. This proposed amendment will likely effectively address the problem of member firms attempting to dodge liability for covered pending arbitration claims or unpaid arbitration awards by forcing member firms to alert FINRA on both the acquisition and transfer front.

IV. We Support the Proposed Amendments to the New Member Notification Rule and Business Expansion Notification Rule.

This proposed amendment will likely make it easier for FINRA to effectively monitor when pending arbitration claims[5] are filed, or awards become unpaid during the time that FINRA

[5] See Footnote 3, above.

is deciding on the new member's application or the member firm's proposed business expansion activities.

Conclusion

For the foregoing reasons the Clinic supports the Proposed Amendments.

Respectfully submitted,

/William A. Jacobson/

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Clinical Professor of Law
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/Mercedez M. Taitt-Harmon/

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April 9, 2018

By email to pubcom@finra.org
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K. Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-06
Membership Application Program

Dear Ms. Mitchell:

On behalf of the Investor Protection Clinic ("Clinic") at the William S. Boyd School of Law at the University of Nevada, Las Vegas, I write to comment on FINRA Regulatory Notice 18-06. Our Clinic represents investors who suffered losses because of unsuitable financial advice, and provides pro bono assistance to investors who cannot secure private legal representation because of the size of their claims. Our Clinic's clients have a direct interest in the rules promulgated by the Financial Industry Regulatory Authority ("FINRA").

Thank you for the chance to comment on proposed changes to FINRA's rules governing its Membership Application Program. Below are our Clinic's comments on two of the questions.

Request for Comment No. 1. *Should FINRA consider proposing to apply a presumption of denial in connection with pending arbitration claims and CMAs? If so, under what circumstances?*

FINRA should presumptively deny Continuing Membership Applications (CMAs) from member firms that face pending arbitration claims.[1] This

[1] Under FINRA's rules, the member firm that must file a CMA after a merger or acquisition depends on the specific transaction. For example, if one firm faces an acquisition or merger with another firm, both firms may have to file a CMA because FINRA Rule 1017(a)(3) requires any member firm to file a CMA application for "direct or indirect acquisitions or transfers of 25% or more in the aggregate of the member's assets or any asset." By contrast, if one large firm transfers a relatively small portion of its assets, but those assets go to a much smaller firm, then under FINRA Rule 1011(k) it is likely

presumption should only apply, however, in the limited circumstance of a "covered pending arbitration claim" as defined in Regulatory Notice 18-06—meaning, where there is: "(1) an investment-related, consumer-initiated claim filed against the associated person that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital." [2]

A presumption of denial in that specific circumstance would limit member firms' ability to dissipate their assets to escape liability. By some reports, this happens quite often. For example, one experienced securities lawyer recently explained that "[t]here's literally a playbook that owners of brokerage firms follow to shield their assets when things go wrong."[3]

Additionally, FINRA should consider proposing a rule to protect investors when FINRA members try to convert themselves into another area of the securities industry while facing covered pending arbitration claims or outstanding unpaid arbitration awards. Section 2 of this Response to Request for Comment No. 1 discusses the need for FINRA to propose this rule.

1. FINRA Should Create a Presumption of Denial for CMAs with Covered Pending Arbitration Claims.

From January 2015 to December 2016, FINRA staff received 35 CMAs that involved a pending arbitration claim or unpaid arbitration award.[4] Of those 35 CMAs, only "*seven member firms* reported excess net capital greater than the total compensatory damages that customers requested."[5] In other words, twenty-eight of the thirty-five member firms did not have enough assets to satisfy the arbitration claims that they faced, yet these firms still sought to reorganize or transfer their firms' assets.

This statistic seems puzzling. Why do so many firms frequently reorganize or transfer their assets when they face crushing liability? The answer is likely simple: current legal principles of successor-in-interest liability favor firm

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that only the smaller firm would have to file a CMA, because only that smaller firm underwent a "material change" in business operations by receiving those assets.

[2] *See* FINRA Regulatory Notice 18-06, *Membership Application Program* 13, www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-06.pdf (last visited Feb. 22, 2018) (defining a "covered pending arbitration").

[3] Andrew Osterland, *Wronged Investors Win Cases over Brokers but Never Collect*, CNBC (Mar. 7, 2016, 7:59 AM), https://www.cnbc.com/2016/03/07/wronged-investors-win-cases-over-brokers-but-never-collect.html (quoting Andrew Stoltmann, a Chicago-based securities lawyer).

[4] FINRA Regulatory Notice 18-06, *supra* note 1, at 11.

[5] *Id.* at 11 n.10 (emphasis added).

reorganization when there are pending claims or awards.[6] Put differently, when one member firm transfers or sells its assets to another firm, the firm that receives those assets can potentially disclaim the other firm's liability from pending arbitrations.[7] These successor-in-interest principles exist because the firm that receives another firm's assets generally does not gain the previous member firm's "customers" in the legal liability sense. Instead, the liability from customers of the selling/transferring firm likely remains legally with that original member firm.[8] Further, when those sales/transfers occur, *courts* generally control an arbitrator's power to award damages for pre-transfer liabilities, not FINRA arbitrators.[9] So, investors with the initial member firm are often left without a full remedy in FINRA's arbitration process due to that initial firm's insolvency or a discharge of owed funds through, for example, bankruptcy.[10]

Unfortunately, FINRA rules have not eliminated its members' ability to dissipate assets. In fact, the central FINRA rule on CMA requirements, Rule 1014(a), now only looks at pending arbitration claims as one factor in many to grant or deny an application.[11] Further, no single factor presumptively controls FINRA's decision; nor does any factor weigh heavier than others. This means that if one firm has a covered pending arbitration claim, yet still applied for a CMA, FINRA could nonetheless grant that firm's CMA. FINRA would do so by

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[6] Courts generally impose successor-in-interest liability only if: (1) the purchaser agreed to assume the debt, (2) there was a de facto merger of the two corporations, (3) the purchaser was a mere continuation of the seller, or (4) the transaction was fraudulent. *See* Wheat, First Sec., Inc. v. Green, 993 F.2d 814, 821 (11th Cir. 1993); Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415, 425 n. 56 (2003).

[7] *See* Black, *supra* note 6, at 426 (discussing a prominent federal court case, which found that, in some circumstances, "it would be unfair to require the purchaser to arbitrate claims against someone who was never its customer").

[8] The previous court decisions that created this legal "customer" distinction relied on the NASD Rule 10301 definition of "customer," which is now superseded by FINRA rules. These cases are still relevant to this discussion, however, because the same definition of "customer" exists under current FINRA rules. *See* FINRA Rule 12100 ("A customer shall not include a broker or dealer."). Likewise, court rulings differ over whether "customer" includes investors who were part of a firm that existed prior to a merger or asset sale. *See Who is a "Customer,"* THE GUILIANO LAW FIRM, P.C., https://securitiesarbitrations.com/who-is-a-customer/ (last visited Feb. 21, 2018) (discussing the several federal circuit court cases on this topic).

[9] *See Wheat, First Sec., Inc.*, 993 F.2d at 820 (enjoining the arbitrator from hearing claims prior to the transfer of the account, but allowing arbitration of the post-transfer claims).

[10] *See* Hugh D. Berkson, *Unpaid Arbitration Awards: A Problem the Industry Creates—A Problem the Industry Must Fix*, PUB. INV. ARB. B. ASS'N 4 (Feb. 25, 2016), https://piaba.org/piaba-newsroom/report-unpaid-arbitration-awards-problem-industry-created-problem-industry-must-fix (discussing generally the outcomes of bankruptcy with member firms).

[11] *See* FINRA Rule 1014(a) (stating that FINRA can consider a request for CMA by looking to several factors alongside pending arbitration claims including, but not limited to: whether the application and all supporting documents are complete and accurate; whether the applicant can comply with federal securities laws; and if the applicant poses a threat to public investors).

finding that other factors outweighed the covered pending arbitration claims' potential for harm to investors.

FINRA can solve this issue, however, by implementing a presumption of denial for CMAs involving covered pending arbitration claims. This presumption could eliminate the potential for member firms to escape liability because it would condition FINRA's grant of a CMA on firms' ability to satisfy any pending arbitration claim. That is, firms could only overcome this presumption by executing an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, the retention of proceeds from an asset transfer, or such other methods that FINRA may determine to be acceptable—the same circumstances that FINRA currently wishes to use based on its proposal in Regulatory Notice 18-06 for New Membership Applications. Consequently, the successor-in-interest scheme would be impractical, because a firm would need to prove that it would pay any arbitration award before its firm underwent any transfers or sales of assets to escape paying damages.

Additionally, a presumption of denial for CMAs from firms facing covered pending arbitrations would align with FINRA's current rules, and, at the same time, improve the accountability of the securities industry. FINRA already uses a presumption of denial for CMAs when the "applicant, its control persons, principals, registered representatives . . . [are] subject to unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements."[12] By expanding these current principles to covered pending arbitration claims, FINRA would only marginally extend its current presumption-of-denial procedures. Likewise, investors who know that they are more likely to be paid in the event of wrongdoing have an added incentive to participate in the industry.[13]

A. Responses to FINRA's Concerns in Regulatory Notice 18-06

This Comment's proposed solution satisfies FINRA's central concerns about a presumption of denial in CMAs for firms that face covered pending arbitration claims. Specifically, FINRA's central concerns are: (1) member firms would incur costs to demonstrate their ability to satisfy the claims, as well as the opportunity costs associated with setting aside funds that could otherwise be used for other business opportunities; and (2) customers may have a new incentive to file an arbitration claim for the sole purpose of disrupting a contemplated transaction,

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[12] FINRA Rule 1014(a)(3)(C).

[13] *See* Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 YALE L. REV. 963, 971 (2012) (discussing FINRA duties to "protect investors and the integrity of the market").

which would increase the number of member firms required to seek a materiality consultation to file a CMA.[14]

Though the first worry may still exist under this Comment's solution, the costs to member firms would be minimal because only member firms that have *covered pending arbitration claims* are affected. All other pending arbitration claims would not suffer any additional costs from a more burdensome procedure. Also, as to FINRA's second concern, customers that are represented by counsel may not file an arbitration claim without any basis for their damages allegations.[15] So, they could not know with certainty that their claim would be a "covered" claim.

Naturally, this Comment's proposed solution may have some adverse industry impact. For instance, a presumption of denial in the CMA context could slow the growth and expansion of member firms in the broker-dealer industry. That is, if the presumption of denial reduces the number of CMAs that FINRA grants, then other firms could not buy or receive the denied firm's assets; nor could other firms merge with the denied firm to expand their practice. But FINRA should not consider this slowed-growth effect as undesirable. Instead, as further explained below, this outcome benefits the industry because it prevents brokers with a record for misconduct from joining and concentrating within other firms with a record for misconduct.

B. Advantages of this Comment's Proposed Solution

A recent study by Mark Egan, Gregor Matvos, and Amit Seru found that "[associated persons] with misconduct switch to firms that employ more [associated persons] with past misconduct records."[16] The explanation for this phenomenon is that firms with already poor misconduct records have a higher tolerance for misconduct, and are less likely to discipline their associated persons through termination or strong action—thus attracting other associated persons who are more likely to engage in future wrongdoing.[17]

This dynamic creates member firms with higher-than-normal misconduct records. As an example of this current concentration, consider Oppenheimer & Co., Wells Fargo Advisors Financial Network, and First Allied Securities—

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[14] FINRA Regulatory Notice 18-06, *supra* note 1, at n.14.
[15] *See* Am. B. Assoc. Rule 3.1.
[16] Mark Egan, Gregor Matvos, and Amit Seru, *The Market for Financial Adviser Misconduct*, J. POL. ECON. 1–2 (forthcoming) (referring to "advisors" as "registered representatives" with FINRA).
[17] *Id.* at 4.

where more than one in seven associated persons have a record of misconduct.[18] By contrast, in most other firms the ratio is less than one in thirty-six.[19] This means that the concentration of brokers with records of misconduct is not a statistical anomaly; it instead may be a product of the current market conditions, where there is a specific market for broker misconduct.[20]

FINRA can inhibit this activity by implementing a presumption of denial in the CMA process for firms facing covered pending arbitration claims, which would limit the rate at which member firms dissipate their firms' assets. To illustrate, say FINRA were to implement the presumption of denial that this Comment advocates. This would likely reduce the number of CMAs that FINRA grants, because firms facing covered pending arbitration claims could not reorganize through this revised CMA process. Those firms would then be removed from the acquisition market.[21] And by removing those firms from the market, FINRA would check the expansion of firms "specializing" in misconduct "and catering to unsophisticated consumers."[22]

Altogether, if FINRA were to propose a rule that would create a presumption of denial for "covered pending arbitration claims," that rule would help ensure that no member firm can sidestep liability. Similarly, that rule would likely have the added benefit of reducing concentrations of associated persons with prior misconduct at particular firms.

2. FINRA Should Propose a Rule That Would Allow It to Collect Unpaid Arbitration Awards from Member Firms That Convert Themselves into Another Area of the Financial Services Industry While Concurrently Facing Pending Arbitration Claims or Have Unpaid Arbitration Awards.

Unpaid awards and pending arbitration claims may also be a large problem when broker-dealer firms restructure themselves into a different part of the

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[18] *Id.* at 3, 42 (showing that 19.60% of associated persons with Oppenheimer & Co. had a history of misconduct, 17.72% First Allied Securities, and 15.30% at Wells Fargo Advisors Financial Network).
[19] *Id.*
[20] *Id.* ("If firms had identical tolerance toward misconduct, such rehiring [of advisors with a history of misconduct] would not take place. We find that advisers with misconduct switch to firms that employ more advisers with past misconduct records. . . . Thus the matching between firms and advisers on misconduct partially undermines the disciplining mechanism in the industry, lessening the punishment for misconduct in the market for financial advisers.").
[21] *Id.* at 3–4.
[22] *Id.* at 1 (stating how firms with a "clean reputation" would already steer clear of firms facing misconduct claims. So, only firms with a higher tolerance for misconduct would be in the market for additional assets with misconduct).

financial industry.[23] FINRA recognized in a 2018 Discussion Paper that "if an associated person of a FINRA member is suspended due to the failure to pay a FINRA arbitration award, FINRA is not aware of any federal provisions that would prevent that individual from entering or continuing in another area of the financial services industry, including acting as an investment adviser."[24] Accordingly, a broker-dealer firm with a pending arbitration claim could convert itself into an advisory firm, continue to profit in another business, and potentially avoid any future arbitration award. This outcome challenges the integrity of the securities industry.

FINRA should consider preventing this problem by proposing a rule along these lines:

> If a member firm seeks to restructure itself into another area of the financial services industry not regulated by FINRA while concurrently facing a pending arbitration claim, FINRA will, under appropriate circumstances, require the member firm to create an escrow account that will secure the potential damages that the member firm may have to pay if the member firm were to be found liable.
>
> If a member firm does not escrow assets, FINRA may immediately seek a court order that freezes the firm's assets prior to that firm's transfer into a different area of the financial sector.

This proposed rule essentially allows FINRA to do two things: (1) preemptively require that a member firm set aside funds for a pending arbitration claim; and (2) act to freeze assets if the member firm does not comply with the request to create an escrow account.

Additionally, this proposed rule should apply to member firms that restructure themselves into *all areas of the financial services industry* that are not regulated by FINRA—including when a member firm restructures itself into an insurance-focused firm selling insurance products. This rule would then ensure that

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[23] FINRA oversees this type of a change in business under FINRA Rule 1017, which requires that member firms file a CMA for "material changes" in the operations of a firm. Whether a change is "material" depends on many factors, such as: "the nature of the proposed expansion; the relationship, if any, between the proposed new business activity or expansion and the firm's existing business . . . adding business activities that require a higher minimum net capital under SEC Rule 15c3-1."

[24] *Discussion Paper—FINRA Perspectives on Customer Recovery*, FINRA 12 n.36 (Feb. 8, 2018), http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf ("Some associated persons who failed to pay arbitration awards in 2015 and 2016, for example, were suspended from being associated with a FINRA member, but continue to be registered as investment advisers.").

FINRA could, whenever possible, collect arbitration awards from able firms, and that member firms could not unjustly escape liability—even when FINRA would not have direct regulatory jurisdiction.[25]

This change would not overly expand FINRA's role. FINRA already has rules that allow the self-regulatory organization to oversee firms when it would not normally have jurisdiction. FINRA Rule 8210, for example, allows FINRA to require any member firm to provide information, documentation, or to testify on the record during an investigative process.[26] And FINRA's ability to compel a firm's compliance extends for at least two years *after a firm has left the securities industry.*[27] During that extended time-frame of two years, FINRA can impose disciplinary actions against a firm that fails to comply, or even bar a non-complying firm entirely from the brokerage industry.[28] So, FINRA can simply mirror this approach by requiring a firm to set aside assets, and then monitoring that firm's compliance with that action throughout the pending arbitration claim—regardless of whether the firm reorganizes to another part of the financial services industry.

In total, this Comment's proposed rule would advance FINRA's investor protection mission and ensure that no firm could escape liability.

Request for Comment No. 2. *If an applicant designates a clearing deposit or the proceeds from an asset transfer for purposes of demonstrating its ability to satisfy a pending arbitration claim, unpaid award or unpaid arbitration settlement, should FINRA require the applicant to provide some form of guarantee that the funds would be used for that purpose?*

FINRA should require an applicant to provide some form of guarantee that it will use a clearing deposit or the proceeds from an asset transfer to satisfy a

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[25] *See* Article III, Section 1(a), FINRA Manual, By-Laws of the Corporation (stating that FINRA has jurisdiction over "any registered broker, dealer, municipal securities broker or dealer . . . and whose regular course of business consists in actually transacting, any branch of the investment banking or securities business in the United States").

[26] FINRA Rule 8210 (stating that FINRA can "require a member, person associated with a member, or any other person subject to FINRA's jurisdiction to provide information orally, in writing, or electronically (if the requested information is, or is required to be, maintained in electronic form) and to testify at a location specified by FINRA staff, under oath or affirmation administered by a court reporter or a notary public if requested, with respect to any matter involved in the investigation, complaint, examination, or proceeding).

[27] *See* Michael Gross, *Frequently Asked Questions About FINRA Rule 8210*, BROKER-DEALER LAW CORNER (Oct. 3, 2016), https://www.bdlawcorner.com/2016/10/frequently-asked-questions-about-finra-rule-8210/ ("If you are subject to FINRA's retained jurisdiction (which typically extends for a period of two years after you have left the industry), FINRA likely will bring a disciplinary action against you and have you barred.")

[28] *See id.*

pending arbitration claim, unpaid award, or unpaid arbitration settlement. This guarantee may be essential to the actual payment of arbitration awards.

Without any guarantee that member firms will use certain funds to pay for pending or unpaid arbitration claims, firms are free to negotiate their eventual losses and damages—even when firms face an imminent award. The Public Investors Arbitration Bar Association's recent report explains this exact problem by discussing an incident with Securities America in 2010. Securities America was the "fifth largest independent brokerage firm in the country," and it held a net capital of $1,991,058 in the event of any firm liability.[29] Even so, when it faced an impending arbitration award in March of 2011, the firm's CFO testified that if a limited fund class action settlement was not approved, the firm "might have to close."[30] Securities America later asked investors to essentially take a certain amount of money or the firm would file for bankruptcy.[31] Investors then had to decide between accepting the partial remedy or receiving nothing at all.

Luckily, Securities America received help from Ameriprise to pay investors.[32] But what would have happened had Ameriprise not stepped in, or if Securities America decided to transfer assets before or after an award? Would Securities America have simply given an ultimatum to investors, even if they could have paid out more? FINRA should take that ability to manufacture an insolvency constraint out of member firms' hands. One effective way to remove that possibility is to require member firms to set aside certain funds to satisfy pending arbitration claims, unpaid awards, or unpaid arbitration claims. Not only would this improve investors' willingness to use member firms, but it would also improve investors' trust in FINRA's arbitration system.[33]

There is a tradeoff if FINRA were to promulgate this proposed guarantee requirement. By requiring member firms to set aside funding for liability, firms would then have less capital to invest in innovative technologies or seize opportunities to grow their business. That inability to grow or seize an opportunity could be detrimental to an already struggling broker-dealer market—a market facing significant technological change and shifting consumer

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[29] Berkson, *supra* note 10, at 3.
[30] *Id.* (quoting the CFO).
[31] *Id.*
[32] *Id.* ("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 . . . .").
[33] Jebsen, *supra* note 10, at 238 ("a system of investor justice refined to guarantee payment of legitimate claims would highlight the outstanding quality of the U.S. capital markets.").

expectations.[34] Customers of broker-dealer firms might then suffer both direct and indirect costs.

FINRA should be confident, however, that advancing investor protection and market integrity outweighs member firms' need for free capital to keep up with innovation and opportunity. FINRA should stick to its purpose: "to safeguard the investing public against fraud and bad practices."[35] In other words, uncontrolled industry growth with the goal of speculative profits undermines FINRA's values. The public deserves the right to take their own risks in a fair market with full notice of the potential outcomes—outcomes that should not include the possibility of a member firm choosing potential profit over paying for its misconduct.

Altogether, the circumstances involving Securities America illustrate how member firms are generally unprepared to shoulder arbitration awards. And just as bankruptcy deprives an investor of hope for a practical remedy and trust in the securities industry, "so too does a failure to pay investors their adjudicated awards."[36] Thus, FINRA should require member firms to provide some sort of a guarantee that a clearing deposit or the proceeds from an asset transfer will satisfy a pending arbitration claim, unpaid award, or unpaid arbitration settlement.

Respectfully Submitted,

INVESTOR PROTECTION CLINIC
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[34] *See* Hester Peirce, *Dwindling Numbers in the Financial Industry*, BROOKINGS INST. (May 15, 2017), https://www.brookings.edu/research/dwindling-numbers-in-the-financial-industry/ ("Technology has given rise to new forms of competition for traditional retail" brokerages).
[35] *See What We Do*, FINRA, https://www.finra.org/about/what-we-do.
[36] Jebsen, *supra* note 11, at 216 ("Generally, a failure to pay investors their adjudicated awards undermine[s] general confidence in entrusting broker-dealers with capital.").

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April 9, 2018

Via email to pubcom@finra.org
Jennifer Piorko Mitchell
Office of the Corporate Secretary FINRA
1735 K Street, NW
Washington, DC 20006-1506

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

Dear Ms. Mitchell:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Paragraphs 5 and 6 will be addressed together below.

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

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

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

Respectfully submitted,

Andrew Stoltmann
PIABA President

FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

April 9, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
The Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-06 | FINRA Requests Comment on Proposed Amendments to its Membership Application Program to Incentivize Payment of Arbitration Awards (Notice)

Dear Ms. Mitchell:

On February 8, 2018, the Financial Industry Regulatory Authority, Inc. (FINRA) published its request for public comment on its proposed amendments (Proposed Amendments) to FINRA's membership application program (MAP) rules.[1] The Proposed Amendments seek to incentivize FINRA members to pay arbitration awards, and settlements related to arbitrations by, among other things, requiring firms to file materiality consultations (MatCons) prior to adding associated persons with "covered pending arbitration claims" (as defined in the Proposed Amendments). The Proposed Amendments also require firms that are transferring their assets, to file a MatCon if: i) the firm, or its associated persons, is the subject of a covered pending arbitration claim; and ii) a continued membership application would not, otherwise, be required. Further, in certain enumerated circumstances, the Proposed Amendments, if adopted, would require firms to evidence an ability to pay pending arbitration claims prior to consummating specified transactions and allowing firms to demonstrate the value of pending claims *vis a vis* an opinion of outside counsel.[2]

The Financial Services Institute[3] (FSI) appreciates the opportunity to comment on the Proposed Amendments. FSI applauds FINRA for dedicating organizational resources, and devoting rulemaking efforts, to finding a solution to unpaid investor arbitration awards. FINRA's February 8, 2018, discussion paper – FINRA Perspectives on Customer Recovery (Paper) – provided the industry with important contextual data and transparency into FINRA's efforts in this space.[4] The Paper was a promising first-step in starting a productive discussion among industry stakeholders.

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[1] *See, generally*, FINRA Regulatory Notice 18-06 (Feb.8, 2018) (Notice).
[2] *Id.*
[3] The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.
[4] *See* Discussion Paper – FINRA Perspectives on Customer Recovery, (Feb. 8, 2018), available at http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.

Moreover, FSI supports the intent of the Proposed Amendments. FSI also supports certain aspects of the current proposal, such as requiring firms filing new member applications to report any arbitration claims that are filed, awarded or that become unpaid while the application is pending. Nonetheless, FSI is concerned that, other aspects of the Proposed Amendments, may have the unintended consequences of giving undue consideration to pending, but not yet substantiated, arbitration claims. Since these are merely claims, it is important to keep in mind that the underlying allegations have not been proven and, thus, are not an indication of any wrongdoing on the part of a firm or an advisor.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.[5] These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).[6]

FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate $48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly $6.8 billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U.S. economic activity.[7]

Discussion

FSI appreciates the opportunity to comment on the Proposed Amendments to FINRA's membership rules. Again, while FSI commends FINRA's efforts in addressing unpaid investor arbitration awards, FSI is concerned that certain aspects of the Proposed Amendments have the unintended consequences of giving undue consideration to pending, yet unsubstantiated, arbitration claims.

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[5] Cerulli Associates, Advisor Headcount 2016, on file with author.

[6] The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

[7] Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

In particular, the Proposed Amendments appear to require firms to file a MatCon seeking permission to hire a single advisor who has a pending investor arbitration claim. Thus, FSI is concerned about this MatCon requirement, and the additional weight the Proposed Amendments, in general, give to unsubstantiated claims. These concerns are discussed in greater detail below.

Background

FINRA's MAP group assesses both new member applications (NMAs) and continuing member applications (CMA) to ensure that applicants meet FINRA's admission standards.[8] As part of this process, MAP evaluates applicants' financial vitality, as well as their operational and supervisory structures.[9] Currently, the NMA and CMA processes can be long and, at times, arduous for applicants. Thus, FSI members are pleased that FINRA's Board of Governors has approved further proposed amendments to the membership application rules that would, reportedly, "restructure and streamline the rules, strengthen investor protections with respect to changes of control, and codify current practices to reduce the application review period, among other changes."[10] FSI is concerned, however, that the Proposed Amendments promulgated in this Notice would not streamline the membership application process but, instead, in certain respects, would add complexities to the process. Moreover, these complexities appear to do little to facilitate the investor protection interests they are designed to assist, e.g., diminishing the number of unpaid investor arbitration awards.

a. Existing Rule

NASD Rule 1013 sets forth the membership application requirements to become a new FINRA member firm. NASD Rule1017 sets forth certain events that would require existing FINRA members to file membership applications, including certain ownership changes, changes in control or in the firm's business operations. In particular, NASD Rule 1017 requires existing FINRA member firms to file membership applications for certain mergers, acquisitions, asset transfers, changes in their equity ownership and control, and other material changes to the member's business.[11]

NASD Rule 1014 sets forth the standards for denying or approving CMAs and NMAs. Pursuant to NASD Rule 1014 (b)(1), a firm's failure to meet certain standards creates a presumption that a membership application should be denied. For instance, the presumption of denial exists if the firm, its control persons, principals, registered representatives or associated persons are the subject of unpaid arbitration awards, other adjudicated customer awards, or unpaid, settled arbitration awards.[12] That presumption is, however, rebuttable. Meaning, firms may offer evidence that, despite the existence of one or more of these events, the firm is still able to meet FINRA's admission standards.[13]

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[8] See Notice at p. 2.
[9] *Id.*
[10] See FINRA News Release, Report from FINRA Bord of Governors Meeting – March 2018 (March 14, 2018), available at http://www.finra.org/newsroom/2018/report-finra-board-governors-meeting-march-2018.
[11] See NASD Rule 1017 (a)(1) – (5); *see also*, NASD Rule 1011 (k) defining "material change in business operations".
[12] See NASD Rule 1014(b)(1); *see also* NASD Rule 1014 (a)(3)(C); *see also*, Notice at p. 4.
[13] See NASD 1014(b)(1).

b. Summary of the Proposed Changes of Concern to FSI Members

i Proposed Requirement to File Materiality Consultations

As an initial matter, the Proposed Amendments would convert the MatCon process from a voluntary process, to one that, under certain circumstances, would be mandatory. Currently, the MatCon process is voluntary and is designed to assist firms in determining whether a contemplated change is material, such that a CMA should be required.[14] The submission requirements for MatCons are largely embodied in FINRA guidance and allow FINRA to request additional documentation as it deems necessary to render a materiality decision. [15]

The Proposed Amendments, if adopted, would make MatCons mandatory in two circumstances. First, unless a CMA is independently required, members would have to file a MatCon prior to adding any associated persons, involved in sales, who are the subject of any of the following:

- "covered pending arbitration claims,"
- unpaid investor related arbitration awards, or
- unpaid, settled investor related arbitration claims.[16]

For the above purposes, the phrase "covered pending arbitration claim" (CPAC) would refer to an investor claim against the associated person that is unresolved and exceeds the member's excess net capital.[17] Upon filing the MatCon, FINRA would determine whether it is in the public's interest that the firm file a CMA.[18]

Moreover, unless a CMA is required, firms transferring their assets, business or a line of operation, would also be required to file a MatCon, where the transferring member, or any of that member's associated persons, have a CPAC, unpaid arbitration award, or unpaid settled arbitration claim.[19] FINRA would, then, assess the MatCon and determine whether the firm is required to file a CMA.[20] For these purposes, CPAC would refer to an investor claim against either the firm, or its associated persons, that is unresolved and exceeds the member's excess net capital.

Critically, absent from the proposal are clear and concise rule-based parameters around the MatCon process. In particular, the Proposed Amendments do not place limitations on FINRA's time to issue a decision regarding a firm's MatCon. They also do not place limitations on FINRA's time to respond to firms' communications during the MatCon process and do not state whether, now that MatCon's would be mandatory, firms would be able to appeal MatCon decisions and, if so, the process for commencing that appeal.

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[14] See Overview of Materiality Consultation Process, available at http://www.finra.org/industry/overview-materiality-consultation-process.
[15] *Id.*; *see, also* FINRA Notice to Members 00-73 (Oct. 2000).
[16] See Proposed FINRA Rule IM-1011-2.
[17] See Proposed FINRA Rule 1011(c)(1)(2).
[18] *Id.* If the business expansion already independently requires an application, then a MatCon would not be required.
[19] See Proposed FINRA Rule 1017 (a)(4).
[20] *Id.*

ii. Allowing Firms to Overcome Rebuttable Presumption By Evidencing Their Ability to Satisfy Unpaid Arbitration Awards, Other Adjudicated Customer Awards, Unpaid Arbitration Settlements or, for New Member Applications, Pending Arbitration Claims

As discussed above, the current iteration of FINRA's membership rules set forth the circumstances that would create a rebuttable presumption that a membership application should be denied. NMAs will, for the first time, be subject to a rebuttable presumption of denial if the applicant, or any of its associated persons, are subject to a pending arbitration claim.[21] Additionally, where the rebuttable presumption is triggered on the basis of a firm's or an associated person's "unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements or, for new member applications, pending arbitration claims," applicants may overcome the presumption by demonstrating their ability to satisfy the award or claim.[22] Sufficient evidence of the firm's ability to pay would include escrow, insurance, or a guarantee.[23] Firms would be able to demonstrate the value of the claim by submitting an opinion of outside counsel.[24]

FSI's Suggested Modifications to the Proposed Amendments

a. IM-1011-2 Should Be Clarified to Exclude Firms' Routine Hiring Decisions

IM-1011-2 should be clarified to indicate that, for this rule to apply, the addition of an associated person must, specifically, be in connection with a merger, acquisition, asset transfer or some other business expansion. Absent that clarification, the proposal may be interpreted to require a MatCon for the simple hiring of a single advisor. In particular, proposed rule IM-1011-2 states, in pertinent part, that:

> "If a member is seeking to add one or more Associated Persons involved in sales and one or more of those Associated Persons has a Covered Pending Arbitration Claim…, and the member is not otherwise required to file a Form CMA in accordance with Rule 1017, the member may not effect the contemplated business expansion unless the member has first submitted a written letter to [FINRA] …seeking a materiality consultation for the contemplated business expansion.

While IM-1011-2 references business expansions, without the requested clarification, IM-1011-2 would appear to equate the act of "adding one of more associated persons involved in sales" and a business expansion. This would, seemingly, require a member to file a MatCon anytime it hires an advisor who has a CPAC.

b. IM-1011-2 and Proposed Rule 1017 (a)(4) Should Exclude Pending Arbitration Claims as a Basis For Requiring Firms to File a MatCon

To the extent that it is FINRA's intent that IM-1011-2 refer to the hiring of any advisor with a CPAC, regardless of the existence of a business expansion, firms should not be forced into participating in membership proceedings so that FINRA can review the firm's decision to hire a single advisor; particularly when this filing requirement is based on an unsubstantiated claim. In

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[21] See Proposed FINRA Rule 1014 (b)(1).
[22] See Proposed FINRA Rule 1014 Supp. Mat. .01.
[23] *Id.*
[24] *Id.*

addition to this provision potentially causing FINRA to overreach into firms' routine hiring decisions, it may also have a negative impact on firms' recruiting efforts in a time where there is already a shortage of advisors.[25]

Along these same lines, firms engaging in asset transfers that would not trigger a CMA under the current iteration of the MAP rules, should not be required to file a MatCon, solely because they, or their associated persons, have a CPAC. If adopted, proposed rule 1017(a)(4) may be interpreted to require firms transferring *any* asset, no matter how immaterial, to file a MatCon where the firm, or any of the firm's, potentially hundreds of associated persons, are the subject of unsubstantiated, pending, investor arbitration claims. This would, consequently, be unduly burdensome, particularly since, in most cases, these claims are subject to other FINRA rules that require disclosure.[26]

Further exacerbating FSI's concerns, is the fact that filing the MatCon may, ultimately, result in the firm having to file a CMA. The CMA may, in turn, result in the firm being prohibited from consummating a minor asset transfer, because one of its associated persons has a pending, and unsubstantiated customer claim. This may have the unintended consequences of forcing firms to terminate associated persons so that the firm can consummate a non-material asset transfer; even though there is no demonstrable evidence that the associated person engaged in any actual wrongdoing.

c. <u>The Proposed Amendments Should Provide Clarity Into the MatCon Process</u>

As stated above, if the Proposed Amendments are adopted, they would convert MatCons from a voluntary process, to a mandatory one. Thus, notwithstanding the concerns set forth above, like the requirements attributable to CMAs and NMAs, the Proposed Amendments should impose clarity regarding, and parameters around, the MatCon process. These parameters may include remedies for firms should they not agree with the MatCon decision, timeframes around FINRA issuing a MatCon decision, limitations on FINRA's time to either issue a decision or ask additional questions, etc..[27] Absent these parameters, firm's may end up in the MatCon process, for indefinite periods of time, for changes that are, arguably, not material to their businesses.

d. <u>The Nexus Between an Associated Person's Pending Claim and the Firm's Net Capital Is Unclear</u>

For the purposes of IM-1011-2, CPAC is defined as follows:

> "An investment-related, consumer initiated claim filed *against the Associated Person* that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) *exceeds the member's excess net capital*."

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[25] *See* Investment News, *Shrinking talent pool puts strain on advisory firms*, (March 20, 2017), explaining that "[b]y 2022, the industry is expected to face a shortfall of at least 200,000 advisers", available at http://www.investmentnews.com/article/20170520/FREE/170529995/shrinking-talent-pool-puts-strain-on-advisory-firms.

[26] See e.g., FINRA Rule 4530; see also, Uniform Application for Securities Industry Registration or Transfer, question 14.

[27] FSI understands that FINRA has published guidance on the MatCon process. *See, e.g.*, Overview of Materiality Consultation Process, available at http://www.finra.org/industry/overview-materiality-consultation-process. However, guidance and rules are different and if the MatCon process becomes a rule-based requirement; rather than a voluntary process, rules regarding the process are seemingly also appropriate.

(*emphasis added*).[28]

This definition appears to interpose a nexus between the associated person's CPAC and the firm's net capital. While firm's may cover arbitration awards against their associated persons, they may elect not to. In that case, the associated person would be responsible for satisfying any award stemming from the claim.

Further, it also interposes a nexus between the individual and the firm hiring the individual. IM 1011-2 speaks to members "seeking to add one or more [a]ssociated [p]ersons". Meaning, these individuals were not formerly associated with the firm that is filing the CMA. Also, presumably meaning, that the acts or omissions giving rise to the customer claim mostly likely occurred while the individual was associated with another firm. Thus, it is likely that if any firm would cover the individual's claim, it would be the firm the individual was associated with at the time the misconduct occurred and not the firm that is obligated to file the MatCon. Consequently, the nexus between the individual's claim and the filing firm's excess net capital is unclear.

e. <u>An Opinion of In-House Counsel Should Be Adequate Under the Supplemental Material to Rule 1014</u>

Obtaining an opinion from external legal counsel can be costly and does not increase the regulatory value of the opinion offered. Firms should, therefore, be allowed to rely on opinions of in-house legal counsel. Regardless of whether the opinion is prepared by internal or external counsel, in both cases, the firm is the attorney's client and the attorney is being paid by the client for his or her services. In the case of external counsel, the fee is larger and is tendered for the specific purposes of drafting an opinion acceptable to the client. Arguably, external counsel has a greater impetus to not act independently. Additionally, in-house counsel is more familiar with the firm and its risk profile. Thus, in-house counsel may be able to provide an opinion that is more informed than an opinion provided by external counsel. This would provide FINRA staff with better intelligence for assessing the membership application and the investor protection issue stemming from the claim. Further, any concerns FINRA would have regarding the attorney's partiality should be satiated by the fact that, both internal and external counsel are bound by rules of professional ethics requiring them to issue an opinion that is truthful and based on the law.

<u>Conclusion</u>

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with the Department on this and other important regulatory efforts.

[28] See Proposed Rule 1011 (c)(1)(A).

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 393-0022.

Respectfully submitted,

Robin M. Traxler
Vice President, Regulatory Affairs & Associate General Counsel