

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-61938; File No. SR-FINRA-2010-014)

April 19, 2010

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to FINRA Rule 9554 to Eliminate Explicitly the Inability-to-Pay Defense in the Expedited Proceedings Context

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on March 31, 2010, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend FINRA Rule 9554 to eliminate explicitly the inability-to-pay defense in the expedited proceedings context when a member or associated person fails to pay an arbitration award to a customer.

The text of the proposed rule change is available on FINRA’s Web site at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

FINRA Rule 9554 allows FINRA to bring expedited actions to address failures to pay FINRA arbitration awards.³ Once a monetary award has been issued in a FINRA arbitration proceeding, the party that must pay the award, the respondent (i.e., a member or an associated person), has thirty days to do so.⁴ FINRA coordinates between FINRA Dispute Resolution's arbitration forum and FINRA's enforcement program by verifying whether a respondent has paid the monetary award within thirty days. If the respondent has not paid, FINRA initiates an expedited proceeding by sending a notice explaining that the respondent will be suspended unless the respondent pays the award or requests a hearing.

³ Expedited actions allow FINRA to address certain types of misconduct more quickly than would be possible using the ordinary disciplinary process. In general, these actions focus on encouraging respondents to comply with the law or take corrective action rather than on sanctioning them for past misconduct. As discussed in detail below, moreover, the Act uses a different standard of review for expedited actions than it does for disciplinary cases.

⁴ FINRA Rule 10330(h).

A respondent that requests a hearing may raise a number of defenses to the suspension. One of the current defenses is establishing a bona fide inability-to-pay. When a respondent successfully demonstrates a bona fide inability-to-pay, that is a complete defense to the suspension. Consequently, the inability-to-pay defense currently precludes a harmed customer from obtaining payment of a valid arbitration award.

FINRA's expedited proceedings for failure to pay an arbitration award use the leverage of a potential suspension to help ensure that a member or an associated person promptly pays a valid arbitration award. However, if a respondent demonstrates a financial inability-to-pay the award—regardless of the reason—the leverage is removed. When FINRA's efforts to suspend a respondent who has not paid the award have been defeated, a claimant is much less likely to be paid. By eliminating the inability-to-pay defense, FINRA will increase the probability of customers having their awards paid, or, at a minimum, it should prompt meaningful settlement discussions between claimants and respondents. FINRA believes that eliminating this defense would further its goal of investor protection by facilitating the payment of arbitration awards to customers harmed by the actions of members and associated persons. Accordingly, FINRA proposes amending Rule 9554 to eliminate explicitly the inability-to-pay defense in the expedited proceedings context when a member or associated person fails to pay an arbitration award to a customer.⁵

The ability to work in the securities industry carries with it, among other things, an obligation to comply with the federal securities laws, FINRA rules, and orders imposed by the disciplinary and arbitration processes. Allowing members or their

⁵ The rule change would not affect the defenses available in actions that do not involve customers.

associated persons that fail to pay arbitration awards to remain in the securities industry presents regulatory risks and is unfair to harmed customers.

Although FINRA proposes to eliminate the inability-to-pay defense, a respondent would still have available the following four defenses:

- The member or person paid the award in full or fully complied with the settlement agreement;
- The arbitration claimant has agreed to installment payments or has otherwise settled the matter;
- The member or person has filed a timely motion to vacate or modify the arbitration award and such motion has not been denied; and
- The member or person has filed a petition in bankruptcy and the bankruptcy proceeding is pending or the award or payment owed under the settlement agreement has been discharged by the bankruptcy court.⁶

Regarding the last defense, FINRA believes that a federal bankruptcy court is the best forum for adjudicating a financial condition defense. Bankruptcy judges are experts in evaluating whether a debtor's obligations should be legally discharged. The bankruptcy process and associated filings are designed to consider fully and evaluate the financial condition of bankruptcy debtors.⁷ In addition, bankruptcy filings, which are subject to federal perjury charges, provide greater penalties for hiding assets.⁸ FINRA's lack of

⁶ In its order approving changes to the predecessor to Rule 9554, the SEC noted that the issues in these types of cases are narrow and generally limited to determining whether the respondent has proven any of these four defenses or an inability-to-pay the award. See Securities Exchange Act Release No. 40026 (May 26, 1998), 63 FR 30789, 30790 (June 5, 1998).

⁷ See 4 Collier on Bankruptcy, ¶¶ 521.01, 521.09 (15th ed. 2009).

⁸ See 18 U.S.C. §§ 151-58 (2010). Bankruptcy fraud is punishable by a fine, or by up to five years in prison, or both. Id.

subpoena power over banks and other third parties raises practical concerns regarding its ability to confirm accurately the assets of the firm or person asserting the defense.⁹

The inability-to-pay defense emerged from a series of SEC decisions that require FINRA to consider the defense in disciplinary cases (as opposed to expedited actions), including disciplinary cases involving failures to pay arbitration awards and restitution.¹⁰ The legal underpinnings that support the inability-to-pay defense in disciplinary cases are not, however, present in the expedited proceedings context. SEC cases largely rely on the “excessive and oppressive” language in Section 19(e) of the Exchange Act in requiring FINRA to consider inability-to-pay. Section 19(e) of the Exchange Act provides authority to the SEC to review and affirm, modify or set aside any final disciplinary sanctions imposed by FINRA on its members. Section 19(e), however, does not apply to expedited proceedings. Expedited proceedings are reviewed under Section 19(f), which requires that “the specific grounds” on which FINRA based its action “exist in fact,” that FINRA followed its rules, and that those rules are consistent with the Act. The different focus of these two standards and the more limited review for expedited actions are understandable and support eliminating the inability-to-pay defense

⁹ The ability to legally discharge debts, the more thorough and accurate verification of a bankruptcy debtor’s financial condition, and possible criminal prosecution for intentionally inaccurate disclosures, among other aspects, distinguish bankruptcy from inability-to-pay.

¹⁰ See Toney L. Reed, 52 S.E.C. 944 (1996), recons. denied, Securities Exchange Act Release No. 39354 (Nov. 25, 1997); Bruce M. Zipper, 51 S.E.C. 928 (1993). In addition, in an order approving a rule change for a predecessor to Rule 9554, the SEC noted that it had previously recognized that a bona fide inability-to-pay an arbitration award is an important consideration in determining whether any sanction for failing to pay an arbitration award is “excessive or oppressive.” See Securities Exchange Act Release No. 40026 (May 26, 1998), 63 FR 30789 (June 5, 1998). Without further discussion, the order cited the SEC’s decision in Zipper, which was a disciplinary case, not an expedited action.

in expedited actions.¹¹ Unlike disciplinary cases, FINRA is not imposing a monetary sanction in these expedited actions; it is suspending a respondent for failing to pay a previously imposed arbitration award. There also is an explicit procedural mechanism built into these expedited actions that allows a suspension to be lifted once respondents satisfy any of the four defenses highlighted above. The main goal is to encourage respondents to comply with the law or previously imposed orders, not to sanction them for past misconduct.

In sum, members and associated persons that fail to pay arbitration awards to customers should not be allowed to remain in the securities industry by relying on the inability-to-pay defense in expedited actions. This is especially true because they can avoid regulatory action by paying the award, reaching a settlement with the customers (which can include payment plans), moving to vacate the award, or filing for bankruptcy. FINRA believes that, in its expedited actions involving respondents that have failed to pay arbitration awards to customers; the inability-to-pay defense should be eliminated.

¹¹ In William J. Gallagher, Securities Exchange Act Release No. 47501, 2003 SEC LEXIS 599 (March 14, 2003), the SEC emphasized that expedited actions are reviewed under Section 19(f) of the Act not Section 19(e). The SEC stated, “Gallagher misconstrues the applicable review standard when he argues that [FINRA’s] sanction is ‘excessive and oppressive’ and that [FINRA’s] indefinite suspension order is inconsistent with the [FINRA] Sanction Guidelines, standards relevant in the Commission’s review of [FINRA] disciplinary proceedings under Section 19(e) of the Exchange Act.” Id. at *6. The SEC explained that its review is limited to analyzing whether “the specific ground on which [FINRA] based its suspension—failure to pay in full an arbitration award—‘exists in fact[,]’” the “SRO’s determination was in accordance with its rules, and ... those rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.” Id. at *5 & *7. In Gallagher, FINRA and the SEC rejected the respondent’s claim of inability-to-pay on factual grounds. The issue of whether a respondent was permitted to raise the defense as a matter of law was neither raised nor decided.

The proposed rule change will automatically become effective 30 days following Commission approval.

2. Statutory Basis

The proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹² which requires, among other things, that FINRA's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposal also is consistent with Section 15A(b)(7) of the Act,¹³ which provides that FINRA must take appropriate action when members and associated persons violate provisions of the Act or FINRA rules. The proposed rule change is consistent with these purposes because it would promote a fair and efficient process for taking action to encourage members and associated persons to pay arbitration awards to customers.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date

¹² 15 U.S.C. 78o-3(b)(6).

¹³ 15 U.S.C. 78o-3(b)(7).

if it finds such longer period to be appropriate and publishes its reasons for so finding or
(ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2010-014 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2010-014. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Comments are also available for Website viewing

and printing in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-FINRA-2010-014 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁴

Florence E. Harmon
Deputy Secretary

¹⁴ 17 CFR 200.30-3(a)(12).