

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-78557; File No. SR-FINRA-2016-015)

August 11, 2016

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Amending Rule 12904 (Awards) of the Code of Arbitration Procedure for Customer Disputes and Rule 13904 (Awards) of the Code of Arbitration Procedure for Industry Disputes to Permit Award Offsets in Arbitration, as Modified by Amendment No. 1

I. Introduction

On May 3, 2016, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to provide that absent specification to the contrary in an arbitration award, when arbitrators order opposing parties to pay each other damages, the monetary awards shall offset, and the party that owes the larger amount shall pay the net difference.

The proposed rule change was published for comment in the Federal Register on May 23, 2016.³ The public comment period closed on June 13, 2016. On July 1, 2016, FINRA extended the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to August 19, 2016. The Commission received nine comment letters in response to the Notice.⁴ On July 15, 2016, FINRA responded to the comment letters received in

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Exchange Act Release No. 77844 (May 17, 2016), 81 FR 32359 (May 23, 2016) (File No. SR-FINRA-2016-015) (“Notice”).

⁴ See Letters from Leonard Steiner, Steiner & Libo, dated May 9, 2016 (“Steiner Letter”); Steven B. Caruso, Maddox Hargett Caruso, P.C., dated May 18, 2016 (“Caruso Letter”); George

response to the Notice and filed an amendment to the proposed rule change (“Amendment No. 1”).⁵

This order provides notice of filing of Amendment No. 1 and approves the proposal, as modified by Amendment No. 1, on an accelerated basis.

II. Description of the Proposed Rule Change

Original Proposal

FINRA Rule 12904 (Awards) of the Code of Arbitration Procedure for Customer Disputes (“Customer Code”) and Rule 13904 (Awards) of the Code of Arbitration Procedure for Industry Disputes (“Industry Code”) (together, “Codes”) address awards issued by arbitrators at the FINRA Office of Dispute Resolution forum. Currently, these rules provide, among other matters, that awards must be in writing and signed by a majority of the arbitrators or as required by applicable law. The rules itemize required elements of awards, including a statement of the damages awarded, and provide that all monetary awards shall be paid within 30 days of receipt unless a motion to vacate has been filed in a court of competent jurisdiction.⁶ Rules 12904 and

H. Friedman, Adjunct Professor of Law, Fordham Law School, and immediate past FINRA Director of Arbitration, dated May 23, 2016 (“Friedman Letter”); James L. Komie, Schuyler, Roche and Crisham, P.C., dated June 7, 2016 (“Komie Letter”); Thomas E. Wall, Attorney at Law and Public Arbitrator for FINRA, dated June 11, 2016 (“Wall Letter”); Kevin Carroll, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated June 13, 2016 (“SIFMA Letter”); David T. Bellaire, Executive Vice President and General Counsel, Financial Services Institute, dated June 13, 2016 (“FSI Letter”); Hugh Berkson, President, Public Investors Arbitration Bar Association, dated June 13, 2016 (“PIABA Letter”); Bev Kennedy, Oakville, Ontario, Canada, dated June 26, 2016 (“Kennedy Letter”). Comment letters are available at www.sec.gov.

⁵ See Letter from Margo A. Hassan, Associate Chief Counsel, FINRA, to the Commission, dated July 15, 2016 (“FINRA Letter”). The FINRA Letter and the text of Amendment No. 1 are available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA, at the Commission’s website at <http://www.sec.gov/rules/sro/finra/2015/34-75655.pdf>, and at the Commission’s Public Reference Room.

⁶ See Notice at 32359.

13904 do not, however, require arbitrators to specify whether opposing parties in a case should offset amounts awarded to each other.

Accordingly, FINRA has stated that when arbitrators order opposing parties in a case to pay each other monetary damages, but do not specify whether the party that owes the higher amount must pay the net difference, the lack of clarity has resulted in parties asking arbitrators to revise an award after a case has closed or in post-award litigation.⁷ For example, arbitrators may award damages to a firm because an associated person failed to pay money owed on a promissory note and award a lesser amount to the associated person on a counterclaim. If the arbitrators do not specify that awards should be offset, the firm may be required to pay the counterclaim even if the associated person refuses or is unable to pay the larger amount.⁸ FINRA states that the offset issue could also arise in customer cases, such as those involving margin account disputes.⁹

FINRA is proposing to amend Rules 12904(j) and 13904(j) to provide that, absent specification to the contrary in an award, when arbitrators order opposing parties to pay each other damages, the monetary awards shall offset, and the party that owes the larger amount shall pay the net difference.¹⁰

FINRA is also proposing to replace the bullets in Rules 12904 and 13904 with numbers in order to make it easier to identify and cite subparts of the rule.¹¹

⁷ See id.

⁸ See id. See also, e.g., UBS Financial Services, Inc. (UBS) v. Thomas A. Mann (Mann), No. 2:2014cv10621, 2014 WL 1746249 (E.D. Mich. Apr. 30, 2014).

⁹ See Notice at 32359.

¹⁰ See id.

¹¹ See id.

Proposal as Modified by Amendment No. 1

In response to comments¹² (discussed below), FINRA is proposing to amend proposed Rules 12904(j) and 13904(j), to provide that, absent specification to the contrary in an award, when arbitrators order opposing parties to make payments to one another, the monetary awards shall offset, and the party assessed the larger amount shall pay the net difference. The proposed amendment would effectively replace the word “damages” with “payments” in order to capture those portions of awards attributable to amounts other than damages (e.g., costs and fees).

III. Comment Summary and FINRA’s Response

As noted above, the Commission received nine comment letters on the proposed rule change¹³ and a response letter from FINRA.¹⁴ As discussed in more detail below, six of the nine commenters expressed support for the proposal;¹⁵ two of the nine commenters expressed opposition to the proposed rule change;¹⁶ and, one commenter did not address the subject matter of the proposal.¹⁷

Default Favoring Award Offsets

Six commenters supported a default in favor of award offsets,¹⁸ stating, among other things, that the proposal “is a fair, equitable and reasonable approach,”¹⁹ “would . . . provide

¹² See SIFMA Letter at 2.

¹³ See supra note 4.

¹⁴ See supra note 5.

¹⁵ See Caruso Letter, Friedman Letter, Komie Letter, SIFMA Letter, FSI Letter, and PIABA Letter.

¹⁶ See Steiner Letter and Wall Letter.

¹⁷ See Kennedy Letter.

¹⁸ See supra note 15.

¹⁹ Caruso Letter.

useful guidance to parties in . . . drafting their pleading,²⁰ “would promote the finality of arbitration awards by reducing the need for post-award court litigation seeking to modify awards to provide for offset,”²¹ “is a positive step forward in enhancing and improving the FINRA Dispute Resolution Process,”²² “is fair and appropriate and offers an important clarification,”²³ and “makes common sense.”²⁴

Two commenters opposed providing a default in favor of award offsets on the basis that parties already have the ability to request, and do request, that panels “offset the competing claims in rendering their final awards.”²⁵ In addition, one of these commenters stated that “[i]f the panel decides not to do an offset, it is not for FINRA to mandate one.”²⁶

In its response, FINRA stated its belief “that the proposed rule change will eliminate ambiguity and reduce the risk of post-award disputes.”²⁷ FINRA further responded that the proposed change “would likely reduce legal expenses to the party owed greater damages by eliminating the need to apply for the reopening of the case or going to court to seek award offsets, or seek other redress.”²⁸ Finally, FINRA noted that the “proposed rule does not override arbitrator discretion” and stated that if the proposal is approved, “FINRA will alert arbitrators to

²⁰ Friedman Letter.

²¹ Komie Letter.

²² FSI Letter.

²³ SIFMA Letter.

²⁴ PIABA Letter.

²⁵ See Steiner Letter; see also Wall Letter.

²⁶ Steiner Letter.

²⁷ See FINRA Letter at 2.

²⁸ See id.

the amendment and will revise the Award Information Sheet to inform arbitrators of the offset default when arbitrators are silent on the issue.”²⁹

Amendment Requests

Two of the six commenters supporting FINRA’s proposal suggested that FINRA also address additional related concerns.³⁰ One commenter generally in support of the proposal urged FINRA to also address the issue of unpaid arbitration awards for investors by implementing a national recovery pool.³¹ In response to this suggestion, FINRA stated that the “issue of unpaid awards is beyond the scope of the proposed rule change.”³² Another commenter “strongly supported” the proposal, but noted that the proposal as drafted would have the effect of limiting the default in favor of offset to only those awards specifically characterized by arbitrators as “damages.”³³ The commenter noted that arbitration awards, in addition to damages, may “consist of, and be characterized as, damages, costs, fees, etc.”³⁴ The commenter expressed its belief that the “[p]roposal was never intended to be strictly limited to ‘damages’ offsets,” and therefore requested that FINRA revise the proposal “so that it is not susceptible to such a narrow reading” by: (i) replacing the phrase “pay each other damages” in the proposal with “make payments to one another,” and (ii) replacing the phrase “that owes” with “assessed.”³⁵ In its response, FINRA agreed “that the proposal was not intended to be strictly limited to ‘damages’

²⁹ See id.

³⁰ See PIABA Letter and SIFMA Letter.

³¹ See PIABA Letter at 3.

³² See FINRA Letter at 2.

³³ See SIFMA Letter at 2.

³⁴ See id.

³⁵ See id.

offsets” and proposed to amend the proposed rule change “for purposes of clarity” as set forth in the previous sentence.³⁶

IV. Discussion and Commission Findings

After careful review of the proposed rule change, as modified by Amendment No. 1, the comment letters, and FINRA’s response to the comments, the Commission finds that the proposal, as modified by Amendment No. 1, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder that are applicable to a national securities association.³⁷ Specifically, the Commission finds that the rule change is consistent with Section 15A(b)(6) of the Exchange Act,³⁸ which requires, among other things, that FINRA rules 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.

As stated in the Notice, FINRA believes that “providing a default in favor of offset when arbitrators fail to address the issue in an award would benefit forum users by eliminating ambiguity and reducing the risk of post-award disputes.”³⁹ More specifically, FINRA believes that the proposed rule change will “mitigate the risk of failure to pay by an opposing party that may arise when multiple parties in a dispute are found to owe non-equivalent awards simultaneously.”⁴⁰ Consequently, FINRA believes that the proposal would “likely reduce legal

³⁶ See FINRA Letter at 3-4.

³⁷ In approving this rule change, the Commission has considered the rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³⁸ 15 U.S.C. 78o-3(b)(6).

³⁹ Notice at 32360.

⁴⁰ Id.

expenses to the party owed greater damages by eliminating the need to apply for the reopening of the case or going to court to seek award offsets, or seek other redress.”⁴¹

The Commission notes that six commenters were generally supportive of the proposal. One of those commenters recommended FINRA amend the proposal to clarify the intent of the proposal – that it was meant to address all payments ordered made to opposing parties in an arbitration and not just damages⁴² – and FINRA agreed.⁴³ The Commission further notes that one of the commenters that generally supported the proposal also recommended that FINRA implement a national recovery pool for unpaid arbitration awards,⁴⁴ which the Commission believes is outside the scope of the current proposal.

The Commission recognizes two commenters’ objections to the proposal on the basis that a default in favor of award offsets is not necessary because the parties may already request offsets.⁴⁵ The Commission also recognizes, however, FINRA’s belief that the proposal will “eliminate ambiguity,” “reduce the risk of post-award disputes,” and “likely reduce legal expenses to the party owed greater damages by eliminating the need to apply for the reopening of the case or going to court to seek award offsets, or seek other redress.”⁴⁶ The Commission further recognizes, as FINRA pointed out in its response, that the proposal “does not override

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Id.

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See SIFMA Letter.

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See FINRA Letter.

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See PIABA Letter.

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See Steiner Letter; see also Wall Letter.

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See FINRA Letter at 2.

arbitrator discretion.”⁴⁷ Arbitrators are thus still free to decline to offset awards if they deem it inappropriate.

Taking into consideration the comments and FINRA’s response and proposed amendment, the Commission believes that the proposal is consistent with the Exchange Act. The Commission believes that the proposal will help protect investors and the public interest by streamlining the payment of arbitration awards in instances where parties are ordered to make payments to one another, without overriding arbitrator discretion. The Commission further believes that FINRA’s response, as discussed in more detail above, appropriately addressed commenters’ concerns and adequately explained its reasons for modifying its proposal to clarify that the default in favor of award offsets would apply to all awards however characterized by the arbitrator. The Commission believes that the approach proposed by FINRA is appropriate and designed to protect investors and the public interest, consistent with Section 15A(b)(6) of the Exchange Act. For these reasons, the Commission finds that the proposed rule change is consistent with the Exchange Act and the rules and regulations thereunder.

V. Solicitation of Comments on Amendment No. 1 to the Proposed Rule Change

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal, as modified by Amendment No. 1, is consistent with the Exchange 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-2016-015 on the subject line.

⁴⁷ See id.

Paper comments:

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

All submissions should refer to File Number SR-FINRA-2016-015. 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 website (<http://www.sec.gov/rules/sro.shtml>).

Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549-1090, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also be available for inspection and copying at the principal office of FINRA. 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-2016-015 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1

The Commission finds good cause to approve the proposed rule change, as modified by Amendment No. 1, prior to the thirtieth day after the date of publication of notice of the amended proposal in the Federal Register. The revisions made to the proposal in Amendment No. 1

changed how amounts ordered by arbitrators to be paid to opposing parties would be calculated for purposes of offsetting payments to one another. In particular, the proposed amendment would effectively replace the word “damages” with “payments” in order to capture those portions of awards attributable to amounts other than damages (e.g., costs and fees).⁴⁸ The Commission believes that this modification responds to one of the primary concerns raised by commenters on the proposal that the proposal was never intended to be strictly limited to offsetting “damages.”⁴⁹ Therefore, the Commission believes that the proposed amendment clarifies the intent of the proposal.

Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Exchange Act,⁵⁰ to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

⁴⁸ See FINRA Letter; see also proposed FINRA Rules 12904(j) and 13904(j).

⁴⁹ See SIFMA Letter; see all FINRA Letters.

⁵⁰ 15 U.S.C. 78s(b)(2).

VII. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2)⁵¹ of the Exchange Act that the proposal (SR-FINRA-2016-015), as modified by Amendment No. 1, be and hereby is approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁵²

Robert W. Errett
Deputy Secretary

⁵¹

Id.

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17 CFR 200.30-3(a)(12).