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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

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[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).

President: Joseph Borg (Alabama)
President-Elect: Michael Pieciak (Vermont)
Executive Director: Joseph Brady
Secretary: Shonita Bossier (Kentucky)
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Bryan Lantagne (Massachusetts)
Gerald Rome (Colorado)
Melanie Senter Lubin (Maryland)
Tanya Solov (Illinois)

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