



November 4, 2011

Via E-Mail to Emily.Gordy@finra.org
and pubcom@finra.org

FINRA
Attn: Emily P. Gordy,
Senior Vice President and Chief of Staff
Enforcement Department
1801 K Street, NW
Washington, DC 20006

**Re: Inability-to-Pay Defense in Intra-Industry Cases
Under FINRA Rule 9554**

Dear Ms. Gordy:

The Securities Industry and Financial Markets Association (SIFMA)¹ is writing to express our concerns with the use of the inability-to-pay defense in intra-industry cases under FINRA Rule 9554. We are writing to you because FINRA Dispute Resolution, by letter dated September 19, 2011 (attached hereto), stated that you are FINRA's "point person" on this issue.

Our members' recent experiences, particularly in promissory note cases, indicates that respondents in intra-industry cases are increasingly abusing the inability-to-pay defense, and thereby creating unnecessary regulatory, compliance and investor protection risks. Our research into the rationale and policy objectives that underpinned the prior amendment to Rule 9554 (which prohibits the inability-to-pay defense in customer cases), indicates that the same rational and policy objectives apply with equal force in intra-industry cases. Thus, we urge FINRA to further amend FINRA Rule 9554 to prohibit respondents from raising the inability-to-pay defense in expedited proceedings involving industry claimants.

We would appreciate the opportunity to meet with you either in-person or by phone to further discuss this issue. Following is our summary of the issue:

¹ SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

Currently, Rule 9554 precludes respondents from raising the inability-to-pay defense *only* in cases involving customer claimants. In doing so, the rule unfairly discriminates against industry claimants who are not afforded similar protections and as a result, cannot collect valid arbitration awards. The current rule also conflicts with FINRA policy initiatives, such as promoting just and equitable principles of trade and appropriately addressing member conduct that poses unnecessary risks for customers, firms, and regulators alike.

Background

FINRA Rule 9554 allows for expedited proceedings “to address failures to comply with FINRA arbitration awards and related settlements.”² The rule states generally that if a respondent does not pay an award, the respondent will be suspended or membership will be cancelled.³ Historically, there have been five defenses available to the respondent, including inability-to-pay.⁴ With this defense, the respondent must demonstrate a financial inability-to-pay the award, regardless of the reason.⁵ Prior to July 2010, the inability-to-pay defense applied to expedited proceedings involving both customer and industry members.⁶ However, on March 31, 2010, FINRA filed a proposed amendment to Rule 9554 to preclude a respondent from raising the inability-to-pay defense against a customer claimant.⁷ On June 2, 2010, the SEC approved the amended rule.⁸ The amended rule, however, does not preclude a respondent from continuing to raise the inability-to-pay defense against an industry claimant.

² FINRA Regulatory Notice 10-31 (June 2010). Unlike disciplinary actions, expedited proceedings do not involve FINRA imposing a monetary sanction for inaction; rather, FINRA is “suspending a respondent for failing to pay a previously imposed arbitration award,” which should encourage respondents to comply with the law.

³ See FINRA Rule 9554.

⁴ See 75 Fed. Reg. 32,525-01 (June 8, 2010). In addition to the inability-to-pay defense, a respondent may raise the following four defenses: (i) the member or person paid the award in full or fully complied with the settlement agreement; (ii) the arbitration claimant has agreed to installment payments or has otherwise settled the matter; (iii) the member or person has filed a timely motion to vacate or modify the arbitration award and such motion has not been denied; and (iv) the member or person has filed a petition in bankruptcy and the bankruptcy proceeding is pending or the award payment owed under the settlement agreement has been discharged by the bankruptcy court.

⁵ See *id.*

⁶ See FINRA Rule 9554 (March 25, 2010).

⁷ See 75 Fed. Reg. 21,686 (Apr. 19, 2010). The amendment added only one sentence to the end of Section (a) of FINRA Rule 9554, as follows: “When a member or associated person fails to comply with an arbitration award or a settlement agreement related to an arbitration or mediation under Article VI, Section 3 of the FINRA By-Laws involving a customer, a claim of inability to pay is no defense.”

⁸ 75 Fed. Reg. 32,525-01.

Rationale for the July 2010 amendment to Rule 9554 in customer-related cases

In creating or amending rules, FINRA must follow statutory guidelines. Congress mandated that FINRA's rules must be consistent with relevant provisions of the Securities Exchange Act.⁹ The Exchange Act, in turn, requires that FINRA rules be "designed to ... promote just and equitable principles of trade ... and, in general, to protect investors and the public interest."¹⁰ In defending the amendment to Rule 9554, the SEC noted that FINRA's proposal was consistent with these requirements.¹¹ Specifically, the SEC considered using the inability-to-pay defense to purposefully avoid award payment as "conduct inconsistent with just and equitable principles of trade."¹²

The Exchange Act also requires FINRA to take appropriate action to reprimand members and associated persons who violate provisions of the Exchange Act or FINRA rules.¹³ Failure to honor an arbitration award or comply with a written and executed settlement agreement is a violation under FINRA's Customer Code.¹⁴ Part of the problem with allowing respondents to raise the inability-to-pay defense in customer cases is that it minimized or eliminated any leverage FINRA had in potentially suspending the respondent for his or her inaction. Essentially, the rule as previously written gave respondents a relatively simple means of circumventing award payments to customers, while simultaneously inhibiting FINRA from taking appropriate action to reprimand rule violators. The rule change provided a simple solution. According to the SEC, not only would eliminating the inability-to-pay defense for customers "promote a fair and efficient process for taking action" against such violations, it would also "encourage members and associated persons to pay arbitration awards to customers."¹⁵

In amending rules, FINRA must also adhere to its own regulations. FINRA Rule 2010, states that "a member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."¹⁶ Using the inability-to-pay defense to purposefully evade a valid arbitration award directly conflicts with this rule, since it could hardly be considered honorable behavior for a member to engage in such an act. In fact, part of the criticism of the inability-to-pay defense was that it allowed respondents to easily and intentionally evade payment of a valid arbitration award to a customer.¹⁷ Moreover, even if the member has a *de facto* inability-to-pay, it would hardly be equitable or just to allow such a

⁹ 15 U.S.C.A. § 78o-3(b)(6) (West 2011).

¹⁰ *Id.*

¹¹ See 75 Fed. Reg. at 32,526.

¹² *Id.*

¹³ See 15 U.S.C.A. § 78o-3(b)(7).

¹⁴ See FINRA Rules IM-12000.

¹⁵ 75 Fed. Reg. at 32,526

¹⁶ FINRA Rule 2010 (Dec. 15, 2008).

¹⁷ See 75 Fed. Reg. at 32525.

member – who has a demonstrated issue with managing his or her own financial affairs – to avoid suspension and continuing interfacing with and advising customers. As the SEC has stated, “allowing members or their associated persons that fail to pay arbitration awards to remain in the securities industry presents regulatory risks and is unfair to harmed customers.”¹⁸

**The rationale for further amending Rule 9554
in intra-industry cases is essentially the same**

Currently, Rule 9554 prohibits the inability-to-pay defense only in cases where the respondent fails to comply with an arbitration award or settlement *involving a customer*.¹⁹ Yet, the rule, by allowing respondent to continue to raise the defense in intra-industry disputes, unfairly discriminates against member firms, and is also contrary to the policy objectives set forth in the Exchange Act and FINRA rules. Accordingly, FINRA should expand the prohibition on raising the inability-to-pay defense to intra-industry disputes.

The Exchange Act states that FINRA rules must not be “designed to permit *unfair discrimination* between customers, issuers, brokers, or dealers.”²⁰ While drawing distinctions between customers and firms may be appropriate in certain instances, a problem arises when the distinction puts one group at a disadvantage to the other. In other words, when there is unfair discrimination, the rule must be amended. In proposing the original amendment, and in approving it, neither FINRA nor the SEC, respectively, explained why eliminating the defense should apply only to expedited proceedings involving customers. Rule 9554 currently discriminates against firms by not affording them the same protections as customers against respondents that intentionally evade valid arbitration awards, and/or that legitimately cannot pay their bills, and thereby raise regulatory, compliance, and investor protection risks. As it stands, Rule 9554 precludes member firms (and FINRA) from securing a suspension against a broker, which they otherwise would have obtained if afforded the same protections as customers.

Allowing respondents to raise the inability-to-pay defense in industry cases also unnecessarily undermines FINRA’s ability to discipline respondents who use the defense in bad faith. The SEC requires FINRA to “appropriately discipline” members and associated persons who violate the securities laws or FINRA rules.²¹ Without the leverage of potential suspension, a violating respondent in an industry proceeding can escape reprehension for failing to honor an award. This is, in fact, one of the main reasons the SEC chose to eliminate the defense for customers. The failure to honor an arbitration award or settlement is a violation under both the Industry Code²² and the Customer Code.²³ In fact, the language is exactly the same in both

¹⁸ *Id.*

¹⁹ See FINRA Rule 9554, emphasis added.

²⁰ 15 U.S.C.A. § 78o-3(6) (West 2011), emphasis added.

²¹ See 15 U.S.C.A. § 78o-3(7) (West 2011).

²² See FINRA Rule IM-13000.

codes. Simply put, a violation of either code constitutes a violation of FINRA rules, triggering FINRA's duty to take appropriate action. In this case, that action would involve the threat of suspension if the member failed to pay an arbitration award. As it stands, Rule 9554 prevents FINRA from doing so where the member raises the inability-to-pay defense.

The policy objectives enumerated by the SEC in approving the rule amendment equally support eliminating the inability-to-pay defense in intra-industry cases. The SEC cites several overarching reasons as to why the inability-to-pay defense clashes with the goals of both the SEC and FINRA. For example, FINRA rules "are designed ... to promote just and equitable principles of trade."²⁴ The SEC views using the inability-to-pay defense in bad faith as an unfair means of avoiding payment of a valid arbitration award.²⁵ In fact, the SEC specifically stated that "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."²⁶ If a member avoids paying a valid award to a firm (often times a previous employer), that does not make their action any less reprehensible or more excusable than when the same happens to a customer. In fact, a member who does so and succeeds may be more likely to commit future violations, ultimately creating regulatory risks that demote, rather than promote, "just and equitable principles of trade" in the securities industry.

Even if a member uses the inability-to-pay defense in good faith, FINRA expedited proceedings are not the appropriate forum for deciding the defense's applicability. FINRA believes "that a federal bankruptcy court is the best forum for adjudicating a financial condition defense."²⁷ FINRA also concedes that bankruptcy judges are best at evaluating the financial condition of bankruptcy debtors.²⁸ In addition, unlike FINRA expedited proceedings, bankruptcy filings are more accurate, "are subject to federal perjury charges, and provide greater penalties for hiding assets."²⁹ Even after eliminating the inability-to-pay defense, respondents would still have four defenses available to them, including having filed a petition in bankruptcy.³⁰ Yet, in today's intra-industry cases, respondents continue to raise the inability-to-pay defense, despite FINRA's stated concerns about this practice, and despite the fact that FINRA lacks the "ability to accurately confirm the assets of the firm or person asserting the defense."³¹

For all the foregoing reasons, FINRA should amend Rule 9554 to preclude respondents from raising the inability-to-pay defense in intra-industry cases.

²³ See FINRA Rule IM-12000.

²⁴ 15 U.S.C.A. § 78o-3(6) (West 2011).

²⁵ See 75 Fed. Reg. at 32,525.

²⁶ *Id.* at 32,526.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ See note 3, *supra*, for complete list of defenses.

³¹ 75 Fed. Reg. at 32,525.

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Thank you for giving SIFMA the opportunity to raise this important issue on behalf of our members. If you have any questions regarding this matter, or would like to schedule a meeting, please contact me at 202.962.7382 or kcarroll@sifma.org.

Sincerely,



Kevin M. Carroll
Managing Director and
Associate General Counsel

cc: **Via E-Mail to:**
Linda D. Fienberg, President, FINRA Dispute Resolution
George H. Friedman, Executive Vice President, FINRA Dispute Resolution
Richard W. Berry, Senior Vice President, FINRA Dispute Resolution
James S. Wrona, Associate General Counsel, Office of General Counsel, FINRA