Submitted Testimony

of the Securities Industry and Financial Markets Association

before the U.S. Senate

Committee on Banking, Housing, and Urban Affairs

Hearing entitled "Legislative Proposals to Examine Corporate Governance"

June 28, 2018

While the Securities Industry and Financial Markets Association (SIFMA)[1] and its member firms have a perspective to offer on many of the legislative proposals that the Committee is evaluating this week, we are writing today specifically to highlight our opposition to S. 2499, legislation recently introduced by Senators Warren (D-MA) and Kennedy (R-LA). If enacted into law, this harmful legislation would force the Financial Industry Regulatory Authority (FINRA) to create a pool of money of infinite size to pay-off unpaid FINRA arbitration awards.

As SIFMA comments on the legislation, it is important to recognize that the problem of unpaid arbitration awards is a challenging one to solve for and our disagreement with the sponsors of the legislation may be more about the best method or methods with which to solve the problem, not that there is a problem. With thousands of brokers operating in the United States today, there are bound to be bad apples, just as you have in any industry. Additionally, it is important to understand that the issue of unpaid awards is not unique to FINRA arbitration or to the securities industry -- the issue is common to all dispute resolution systems and all industries. Investors who recover judgments in court-based proceedings face the same exact issue. FINRA arbitration awards, however, are significantly easier to collect upon than court-based judgments, and in fact, can be converted into court judgments and then enforced using the judicial system.[2] Under the Federal Arbitration Act, the investor may sue in court to enforce the award and the court must confirm the award unless it finds there was corruption, fraud, evident partiality, misconduct, or the arbitrators exceeded their powers (all of which are rare). A court confirmation of a FINRA arbitration award has the same effect as a judgment recovered following a civil trial. Upon a court's confirmation, the investor can use all means available to a successful litigant in a judicial proceeding, including levying against the defendant's assets.

Generally speaking, SIFMA strongly supports exploring reforms to reduce the number of unpaid arbitration awards. An industry-financed pool, however, is a poor public policy choice to achieve that end because it is unfair to the broker-dealers who honor their arbitration award obligations, is essentially a tax on investors, and introduces numerous moral hazards. Specifically, we oppose S. 2499 for the following reasons:

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[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] FINRA rules facilitate the payment of arbitration awards. Within 30 days of receipt of an award, firms must notify FINRA in writing that they have either paid or otherwise complied with the award. FINRA suspends any firm or associated person that fails to comply with an arbitration award. FINRA then records in the Central Registration Depository (CRD) that the firm or associated person failed to pay the award. The CRD reference prevents the firm and associated person from reentering the securities industry until the award has been paid. According to FINRA, suspension or the threat of suspension often forces payment of the award or payment to the satisfaction of investors.

1. **Using Enforcement Penalties to Pay Unpaid Arbitration Awards Creates Inappropriate Conflicts of Interest.**

The legislation currently requires that the recovery pool be funded first from enforcement penalties paid by brokers. By doing so, the bill would create a perverse incentive for FINRA to increase both the number of enforcement actions that it brings, and the dollar amount of penalties that it imposes, in order to ensure that the recovery pool is adequately stocked. The bill would thus introduce a new and significant conflict of interest into enforcement actions brought by FINRA. Our members would be left to wonder whether FINRA's enforcement actions and penalties were based on legitimate regulatory concerns or whether the recovery pool was simply running low.

2. **It is Fundamentally Unfair to Require Good Actors (Who Pay Their Arbitration Awards) to Pay for Bad Actors (Who Do Not).**

If enforcement fines are insufficient to cover unpaid awards, the bill requires FINRA to make-up any shortfall from its other funding sources. Notably, FINRA's other funding sources derive in substantial part from its members (thousands of brokers). Thus, this provision of the bill is fundamentally unfair because it would require the many firms that pay their arbitration awards to pay for the few firms that do not.

3. **An Unbounded Money Pool Will Attract Abuse and Gamesmanship and Will Serve Plaintiffs' Lawyers Over Investors.**

By forcing FINRA to create and maintain a perpetual pool of money to pay unpaid awards, the bill would spur the growth of a cottage industry of plaintiffs' lawyers who would collect, aggregate, and pursue, prior unpaid awards solely for purposes of cashing-in on the free money pool. Plaintiffs' lawyers could pay pennies on the dollar to collect unpaid awards or pursue them only for hefty contingency fees. Ultimately, the recover pool for prior unpaid awards would primarily serve plaintiffs lawyers and their fees, not investors.

Likewise, plaintiffs' lawyers would likely aggressively pursue new arbitration claims – even ones with questionable merits – against smaller or under-capitalized broker-dealers, knowing that the likely result will be a default judgment for the full claimed amount, which will then be paid out of the proposed fund. One would reasonably expect to see the number of arbitration claims, the claim amounts, and the default rate to grow year over year, putting strain on the system and rewarding legal gamesmanship.

4. **FINRA Has Already Taken Numerous Steps to Resolve the Issue Under its Existing Authority and Policymakers Should Give Those Efforts a Chance.**

Finally, and perhaps most importantly, legislation in this area is premature given that FINRA has engaged in a process to address the issue of unpaid arbitration awards. Recently FINRA examined several alternative approaches to address the issue and concluded that the best approach would be to propose several amendments to FINRA rules:

- In February 2018, FINRA requested comment on proposed amendments to its Membership Application Program (MAP) rules to create further incentives for the timely payment of arbitration awards by preventing an individual from switching firms, or a firm from using asset transfers or similar transactions, to avoid payment of arbitration awards while staying in business.[3] In April 2018, SIFMA filed a comment letter in support of FINRA's proposal, stating:

  > "[w]e 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."[4]

  In other words, to the extent that less reputable firms do not have sufficient funds to pay their arbitration awards, the issue is not with the FINRA arbitration system, but with the manner in which firms manage their capital and risk, which can and should be addressed outside the context of FINRA arbitration awards.

- FINRA's proposal would amend the new member application (NMA) and continuing member application (CMA) to impose new restrictions on firms with pending arbitration claims, unpaid arbitration awards, or unpaid settlements relating to an arbitration. The proposal would:

  - presumptively deny an NMA or CMA if the firm or its associated persons are subject to unpaid arbitration awards. The presumption could be overcome by demonstrating the ability to satisfy the claims, whether through an escrow agreement, a clearing deposit, a guarantee, a reserve fund, or otherwise;
  - make unavailable the safe harbor for business expansion if the member has unpaid arbitration awards; and

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

[4] SIFMA Comment re: FINRA Regulatory Notice 18-06 (April 9, 2018), available at http://www.finra.org/sites/default/files/notice_comment_file_ref/18-06_sifma_comment.pdf.

- require firms engaged in asset acquisitions or transfers that have unpaid arbitration awards to file a Form CMA.

- FINRA is reviewing comment letters submitted in response to its proposal and remains engaged in the process of finalizing its proposed changes to the MAP rules.

- When respondents are no longer in business, recovery of arbitration awards against them often is unavailing. For that reason, FINRA has also proposed amendments to its Code of Arbitration Procedure for Customer Disputes (Code) to expand a customer's options to withdraw an arbitration claim if a firm or an associated person becomes inactive before a claim is filed or during a pending arbitration.[5] In addition, the proposed amendments would allow customers to amend pleadings, postpone hearings and receive a refund of filing fees under these situations.[6] As with the MAP proposal, FINRA is also reviewing comment letters submitted in response to this proposal and remains engaged in the process of finalizing its proposed changes.

- Finally, FINRA is considering changes to its Form U4 registration statement for financial advisors in order to add new disclosures about arbitration awards, settlements and judgments that are not paid in full.[7] FINRA's Board of Governors approved such changes in May 2017, but FINRA has not yet issued its rule proposal.[8]

Conclusion

S. 2499 is fundamentally unfair and inappropriately places the burden of unpaid arbitration awards upon the backs of those firms who do pay their awards, and ultimately, their customers. FINRA has all the authority it currently needs to reduce the number of unpaid awards and Congress is better served by fulfilling its oversight function at this time. These proposals should be allowed to run their course -- with policymakers being given a chance to evaluate their efficacy -- before considering more drastic alternatives.

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[5] FINRA Regulatory Notice 17-33 (October 18, 2017), Amendments to the Code of Arbitration Procedure for Customer Disputes to Expand the Options Available to Customers if a Firm or Associated Person Is or Becomes Inactive, available at http://www.finra.org/industry/notices/17-33.

[6] Id.

[7] See FINRA Form U4, available at http://www.finra.org/sites/default/files/form-u4.pdf.

[8] See Update: FINRA Board of Governors Meeting (May 11, 2017), available at http://www.finra.org/industry/update-finra-board-governors-meeting-051017.