

## Arbitration

### 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

Comment Period Expires: December 18, 2017

#### Summary

When respondents are no longer in business, recovery of arbitration awards against them often is unavailing. Accordingly, FINRA is proposing to amend the 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. In addition, the proposed amendments would allow customers to amend pleadings, postpone hearings and receive a refund of filing fees under these situations.

The text of the proposed amendments can be found at [www.finra.org/notices/17-33](http://www.finra.org/notices/17-33).

Questions concerning this *Notice* should be directed to:

- ▶ Kenneth L. Andrichik, Senior Vice President and Chief Counsel, Office of Dispute Resolution, at (212) 858-3915;
- ▶ Victoria Crane, Associate General Counsel, Office of General Counsel, at (202) 728-8104; or
- ▶ Mignon McLemore, Assistant Chief Counsel, Office of Dispute Resolution, at (202) 728-8151.

October 18, 2017

#### Notice Type

- ▶ Request for Comment

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Senior Management

#### Key Topics

- ▶ Arbitration
- ▶ Associated Person
- ▶ Code of Arbitration Procedure
- ▶ Dispute Resolution

#### Referenced Rules & Notices

- ▶ Code of Arbitration Procedure for Customer Disputes, Rule 12000 Series
- ▶ FINRA Rule 12100
- ▶ FINRA Rule 12202
- ▶ FINRA Rule 12214
- ▶ FINRA Rule 12309
- ▶ FINRA Rule 12400
- ▶ FINRA Rule 12601
- ▶ FINRA Rule 12702
- ▶ FINRA Rule 12801
- ▶ FINRA Rule 12900

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by December 18, 2017.

Member firms and other interested parties can submit their comments using the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ Mailing comments in hard copy to:

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

**Important Notes:** The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments as they are received.<sup>1</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).<sup>2</sup>

## Background & Discussion

FINRA has implemented a number of changes to its arbitration program that expand the options available to a customer when dealing with those member firms or associated persons who are responsible for most unpaid awards—firms and associated persons who are no longer in business either at the time the claim is filed or at the time of the award.<sup>3</sup>

When a customer claimant first files an arbitration claim, FINRA staff alerts, by letter, the customer claimant when the respondent firm or broker is no longer in business. FINRA also informs the customer that awards against such firms or brokers have a much higher incidence of non-payment and that FINRA has limited disciplinary authority over inactive firms or associated persons that fail to pay arbitration awards. Thus, the customer knows before pursuing the claim in arbitration that collection of an award may be more difficult. In addition, upon learning that the respondent firm or associated person is inactive, a customer may determine to amend his or her claim to add other respondents from whom the customer may be able to collect should the claim go to award.

As discussed in more detail below, FINRA is proposing to amend the Code to expand further the options available to customers in situations where a firm becomes inactive during a pending arbitration, or where an associated person becomes inactive either before a claim is filed or during a pending arbitration. FINRA is also proposing to amend the Code to allow customers to amend pleadings, postpone hearings, and receive a refund of filing fees under these situations.<sup>4</sup>

#### **A. Arbitrating Claims Against Inactive Members and Associated Persons**

Currently, under FINRA Rule 12202 (Claims Against Inactive Members), a customer's claim against a firm whose membership is terminated, suspended, cancelled or revoked, or that has been expelled from FINRA, or that is otherwise defunct, is ineligible for arbitration unless the customer agrees in writing to arbitrate after the claim arises. In these situations, the customer is able to evaluate the likelihood of collecting on an award and make an informed decision whether to proceed in arbitration, to file the claim in court or to amend his or her claim to add other respondents from whom the customer may be able to collect should the claim go to award, regardless of whether the customer signed a predispute arbitration agreement.<sup>5</sup> Accordingly, claims against inactive firms proceed in arbitration only at the customer's option.<sup>6</sup>

The Code does not address situations, however, where a member firm becomes inactive during a pending arbitration. In addition, the Code does not provide specific procedures for a customer to withdraw, and file in court, a claim against an associated person whose registration FINRA has terminated, revoked or suspended either before the customer files a claim or during a pending arbitration.

Accordingly, FINRA is proposing to amend FINRA Rule 12202 to expand a customer's option to withdraw a claim to situations where a member becomes inactive during a pending arbitration, or where an associated person becomes inactive either before a claim is filed or during a pending arbitration. Under the proposal, FINRA Rule 12202 would specify that a customer's claim against an inactive associated person, as defined, is ineligible for arbitration unless the customer agrees in writing to arbitrate after the claim arises. In addition, FINRA Rule 12202 would specify that if a member or an associated person becomes inactive during a pending arbitration, FINRA would notify the customer of the status change, and provide the customer with 60 days to withdraw the claim(s) with or without prejudice.<sup>7</sup>

Similar to the current rules and procedures relating to claims filed against inactive members, the proposed amendments would allow the customer to evaluate the likelihood of collecting on an award and make an informed decision whether to proceed in arbitration, to file the claim in court or to amend his or her claim to add other respondents from whom the customer may be able to collect should the claim go to award, regardless of whether the customer signed a predispute arbitration agreement.

In addition, FINRA is proposing to amend FINRA Rule 12100 (Definitions) to add definitions of “inactive member” and “inactive associated person.” Consistent with Rule 12202 today, FINRA is proposing to define an “inactive member” as a member whose membership is terminated, suspended, cancelled or revoked; that has been expelled from FINRA; or that is otherwise defunct.

An “inactive associated person” would be defined as a person associated with a member whose registration is revoked<sup>8</sup> or suspended,<sup>9</sup> or whose registration has been terminated for a minimum of 365 days.<sup>10</sup> Thus, if an associated person’s registration is not revoked or suspended and the individual re-registers within a year, the individual would not be classified as terminated and, therefore, would not be deemed inactive.

### **B. Amending Pleadings**

FINRA Rule 12309 (Amending Pleadings) limits a party’s ability to amend a statement of claim, among other pleadings, after FINRA has appointed a panel to the case. Specifically, once FINRA appoints a panel to a case, a party can amend a pleading only if the arbitrators grant a party’s motion to do so. FINRA Rule 12309 also provides that a party cannot add a new party to the case after arbitrator ranking lists are due to the Director of Arbitration until FINRA appoints the panel and the arbitrators grant a party’s motion to add the new party.

FINRA believes that a customer should be able to change his or her litigation strategy during a pending case once the customer learns that a firm or an associated person has become inactive. Accordingly, FINRA is proposing to amend FINRA Rule 12309 to provide that if FINRA notifies a customer that a firm or an associated person has become inactive during a pending arbitration, the customer may amend a pleading, including adding a new party, within 60 days of receiving such notice.

### **C. Postponing Hearings**

FINRA Rule 12601 (Postponement of Hearings) addresses when a scheduled hearing date can be postponed. The parties can agree to postpone a hearing. Absent an agreed upon postponement, a hearing can be postponed by the FINRA staff in extraordinary circumstances, by the arbitrators at their discretion, or by the arbitrators upon a party’s motion. FINRA is proposing to amend FINRA Rule 12601 to provide that if FINRA notifies a customer that a firm or an associated person has become inactive and the scheduled hearing date is within 60 days of the date the customer receives the notice from FINRA, the customer may postpone the hearing date. Since the proposed amendment would provide a customer with 60 days to determine how to proceed after FINRA notifies the customer of the status change to inactive, it would be appropriate, FINRA believes, to allow the customer to postpone a scheduled hearing that falls within that time period.

In addition, FINRA assesses postponement fees against the parties for each postponement agreed to by the parties, or granted upon the request of one or more parties. FINRA also charges an additional fee of \$600 per arbitrator if a postponement takes place within 10 days of a scheduled hearing date. The additional \$600 per arbitrator fee is paid to the arbitrators to compensate them for the late adjournment.<sup>11</sup> FINRA is proposing to amend FINRA Rule 12601 to provide that if FINRA notifies a customer that a firm or an associated person has become inactive and the scheduled hearing date is within 60 days of the date the customer receives the notice from FINRA, then FINRA would not charge the customer a postponement fee or an additional fee of \$600 per arbitrator if a customer chooses to postpone a scheduled hearing.

FINRA is also proposing to amend FINRA Rule 12214 to make it clear that it would continue to pay the \$600 honoraria to the arbitrators to compensate them for their time if a customer chooses to postpone a scheduled hearing within 10 days before a scheduled hearing session because the customer learns that the firm or associated person has become inactive.

#### **D. Default Proceedings**

FINRA Rule 12801 (Default Proceedings) permits a claimant to request default proceedings against any associated person respondent whose registration is terminated, revoked or suspended, and who failed to file an answer to a claim within the time provided in the Code. A single arbitrator will decide the case based on the claimant's pleadings and other documentation.<sup>12</sup> The claimants must present a sufficient basis to support the making of an award.<sup>13</sup> The arbitrator may not issue an award based solely on the nonappearance of a party.<sup>14</sup>

As noted, the proposed amendments would define an inactive associated person as a person associated with a member whose registration is revoked or suspended, or whose registration has been terminated for a minimum of 365 days.<sup>15</sup> In the context of a default proceeding, FINRA believes that it would be appropriate to continue to allow a customer to request default proceedings against any terminated associated person who fails to answer a claim regardless of how long the associated person has been terminated, consistent with the existing rule.

Accordingly, FINRA is proposing to amend FINRA Rule 12801(a) to specify that a claimant may request a default proceeding against a terminated associated person who fails to file an answer within the time provided in the Code regardless of the number of days since termination. For example, the proposed amendment would make clear that a customer could initiate a default proceeding against an associated person who left a firm, joined a new firm one week later and failed to answer a claim relating to activities at the former firm.

### **E. Refunding Filing Fees**

FINRA Rule 12900 (Fees Due When a Claim is Filed) specifies that if a claim is settled or withdrawn more than 10 days before the date that the hearing is scheduled to begin, a party paying a filing fee will receive a partial refund of the filing fee. The rule also provides that FINRA will not refund any portion of the filing fee if a claim is settled or withdrawn within 10 days of the date that the hearing is scheduled to begin.

FINRA is proposing to amend FINRA Rule 12900 to provide that FINRA will refund a customer's full filing fee if FINRA notifies a customer that a firm or an associated person has become inactive during a pending arbitration, and the customer withdraws the case against all parties within 60 days of the notification. FINRA would refund the filing fee even if the customer withdraws the case within 10 days of the date that the hearing is scheduled to begin.

## **Preliminary Economic Impact Assessment**

### **A. Regulatory Need**

FINRA has adopted rules and procedures that expand the options available to a customer when dealing with those member firms or associated persons that are responsible for most unpaid awards—firms and associated persons who are no longer in business either at the time the claim is filed or at the time of the award. Despite these measures, the rules do not always enable customers to collect awards. Ultimately, it is difficult for customers to collect from firms or associated persons who are no longer in business, whether the customer has an arbitration award or a court judgment.

The proposed amendments are intended to help further address the issue of unpaid customer arbitration awards by expanding the options available to customers when filing a claim in arbitration against an inactive firm or associated person, or if the firm or associated person becomes inactive during a pending arbitration.

### **B. Economic Baseline**

The economic baseline for the proposed amendments is the current rules under the Code that address customer disputes in arbitration. The proposal is expected to affect parties in an arbitration including customers, member firms and associated persons.

The Code currently provides that a customer's claim against a firm whose membership is terminated, suspended, cancelled or revoked, or that has been expelled from FINRA, or that is otherwise defunct, is ineligible for arbitration unless the customer agrees in writing to arbitrate after the claim arises. The Code does not address situations where a firm becomes inactive during a pending arbitration. In addition, the Code does not currently provide specific procedures for a customer to withdraw, and file in court, a claim against an associated person whose registration FINRA has terminated, revoked, or suspended

either before the customer files a claim or during a pending arbitration. The Code also does not currently provide specific procedures for a customer to amend pleadings, postpone hearings, and receive a refund of filing fees where a firm or an associated person becomes inactive during a pending arbitration.

FINRA staff is able to identify 1,328 customer cases closed by hearing or by papers (or by stipulated awards) from 2014 to 2016. Among these cases, FINRA staff is able to identify 278 cases (21 percent) where a firm or an associated person would have been identified as inactive under the proposed amendments either before or during a pending arbitration.

### C. Economic Impacts

The benefit of the proposed amendments arises from the expansion of a customer's options under the Code where a member firm becomes inactive during a pending arbitration, or where an associated person becomes inactive either before a claim is filed or during a pending arbitration. The proposed amendments would enable customers to determine whether to proceed in arbitration or to file a claim in court, regardless of whether the customer signed a predispute arbitration agreement. Customers who withdraw claims would also benefit from the refund of the filing fee. Upon learning that the respondent firm or associated person is inactive, a customer may determine to amend his or her claim to add other respondents from whom the customer may be able to collect should the claim go to award. Customers would also have the ability to postpone hearings without penalty and thereby have additional time to prepare.<sup>16</sup> More generally, the proposed amendments would increase the ability of customers to alter their litigation strategy if they remain in arbitration.

The proposal may impose costs on customers, firms and associated persons. For customers who withdraw their claims in arbitration and file in court, they could incur additional legal expense and time to resolve the dispute. The proposal could also impose costs on firms and associated persons. If customers withdraw their claims and then file them in court, inactive firms and associated persons could incur additional costs to resolve the dispute. If customers remain in arbitration and amend their pleadings, firms and associated persons who remain parties to the arbitration could incur legal expense to alter their litigation strategy.

The magnitude of the aggregate benefits and costs of the proposal depends upon whether customers would exercise the options under the proposed amendments and the resulting outcomes. FINRA believes that few customers would withdraw claims from arbitration in the presence of the proposed rules. In FINRA's experience, customers typically proceed with arbitration even when notified that a firm is inactive at the time of filing and remain in arbitration in the event that a firm or an associated person leaves the industry while the arbitration is pending.

One reason customers remain in arbitration when the named party is inactive may be the additional costs of restarting a case in another venue. Another reason may be the expectation that another venue would not result in a higher likelihood of redress. As discussed above, customers can today confirm an arbitration award in court in order to avail themselves of its judicial authority. Based on this experience, FINRA believes that customers would continue to remain in arbitration and exercise the newly provided options under the proposed amendments relating to amending pleadings and postponing hearings.

The proposed amendments would provide no significant benefits and impose no material costs on customers who would not change their behavior in the presence of the rule, nor on the firms and associated persons who are party to their claims. In the event that a panel would otherwise grant the requests provided under the proposal (e.g., amended pleadings), the benefits to the proposed amendments would be limited to the streamlining of the arbitrators' decisions. In general, however, the use of the options in a limited number of circumstances suggests that the magnitude of the benefits and costs of the proposal are likely to be small.

#### **D. Alternatives Considered**

FINRA exercised discretion in setting the requirement for associated persons to be considered inactive if their registrations have been terminated for a minimum of 365 days. FINRA also exercised discretion by not including a similar requirement for associated persons whose registrations have been revoked or suspended. The 365 minimum day requirement would typically delay the ability of customers to use the options under the proposed amendments. If access to the options under the proposed amendments is beneficial to customers and increases the likelihood of redress, then the requirement could reduce these benefits.<sup>17</sup> FINRA considered the loss of customer benefits in addition to the costs to customers of withdrawing claims or amending pleadings when associated persons only temporarily leave the industry.<sup>18</sup> FINRA also considered the costs to associated persons from the loss of FINRA arbitration as the agreed upon forum for dispute resolution. The 365 minimum day requirement is one alternative. FINRA requests comment below regarding the length of the minimum-day requirement or other alternatives that would provide customers the most benefits while minimizing their costs.

Lastly, FINRA exercised discretion in setting the amount of time from when customers receive notification of the inactive status of a firm or an associated person to when they could exercise their options under the proposed amendments. After 60 days, customers would lose the benefits under the proposed amendments. However, the 60-day timeframe would limit the effect of an inactive firm or associated person on a pending arbitration, and provide certainty that the arbitration would continue in regular order after the time period had elapsed. FINRA believes that 60 days is sufficient for a customer to decide on the proper course of action.



## Request for Comment

FINRA is interested in receiving comments on all aspects of the proposed amendments, including the economic impact of the proposed amendments. FINRA requests data and other quantitative measures in support of comments where possible.

- ▶ Under what scenarios would customers withdraw their claims without prejudice under the proposed amendments? How likely are these scenarios?
- ▶ Does the 365 minimum day requirement properly balance the benefits to customers from the ability to exercise the options under the proposed amendments to the potential costs to customers from exercising the options and having the inactive associated person return to the industry? Should the minimum number of days be more or less than 365? Why?
- ▶ In proposing the 365 minimum day requirement, FINRA considered that approximately 75 percent of individuals who leave the industry return within one year. Are there other factors FINRA should consider in determining whether to include a 365 minimum day requirement for terminated associated persons to be considered inactive?
- ▶ Are there other relevant benefits and costs associated with the proposal that were not discussed in the economic impact analysis? What are the consequences of the benefits and costs, and what are the magnitudes of its effects?
- ▶ Would the proposed amendments impact the incentives of firms and associated persons? If so, how?

## Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members 03-73* (Online Availability of Comments) (November 2003) for more information.
2. See Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
3. Unpaid awards occur in customer cases, those involving an investor, as well as intra-industry cases, those involving industry members only. The proposed amendments relate to unpaid customer arbitration awards only.
4. FINRA is also proposing to amend the Code to update cross-references and make other non-substantive, technical changes to rules impacted by the proposal.
5. If the customer notifies FINRA in writing that he or she does not want to proceed against the inactive firm in FINRA's forum, the staff deems the customer's agreement to submit to arbitration rescinded and sends the customer a full refund of any filing fee remitted.
6. In FINRA's experience, customer claimants almost always decide to pursue arbitration claims. Claimants' counsel has indicated to FINRA staff that they continue to pursue claims against inactive firms and associated persons due to the possibility of collection from various parties, sources and entities not named in the arbitration case, including: (1) bankruptcy trustees; (2) commercial insurance policies; (3) successor firms; (4) fidelity bonds; and (5) control persons.
7. FINRA Rule 12702 (Withdrawal of Claims) provides that before a party answers a statement of claim, the claimant can withdraw the claim with or without prejudice. However, after a party submits an answer, the claimant can only withdraw the claim with prejudice unless the panel or the parties agree otherwise. FINRA is proposing to make a conforming change to Rule 12702 to provide that a customer can withdraw a claim without prejudice if the party that submitted an answer is an inactive member or inactive associated person. Withdrawal without prejudice would allow the customer to re-file the arbitration at a later date.
8. In the Central Registration Depository (CRD®), a "revoked" status of an individual's registration reflects revocation of an individual's license.
9. A "suspended" status in CRD indicates that an individual's registration has been suspended.

10. An associated person's registration may be terminated either fully or partially. A full termination means the termination of registration with all self-regulatory organizations (SROs) and all jurisdictions. A partial termination means the termination of registration or registration category with one or more, but not all, SROs and jurisdictions. For purposes of the proposal, the associated person's registration must be a full termination for at least 365 days.
11. See FINRA Rule 12214 (Payment of Arbitrators).
12. See FINRA Rule 12801(b)(2)(B). No hearings are held in default proceedings unless the customer requests one. See FINRA Rule 12801(c).
13. See FINRA Rule 12801(e)(1).
14. *Id.* If the defaulting respondent files an answer before an award has been issued, the proceedings against this respondent will be terminated and the claim will proceed under the regular provisions of the Code. See FINRA Rule 12801(f).
15. See *supra* note 10.
16. Among the 1,328 customer cases closed by hearing or by papers (or by stipulated awards) from 2014 to 2016, FINRA staff is able to identify 145 cases where a firm or an associated person would have been identified as inactive after arbitrator ranking lists were due or FINRA appointed a panel. FINRA staff is also able to identify 63 cases where a firm or an associated person would have been identified as inactive within 60 days of a scheduled hearing.
17. For example, among the 1,328 customer cases closed by hearing or by papers (or by stipulated awards) from 2014 to 2016, FINRA staff is able to identify 84 cases where an associated person had left the industry fewer than 365 days before the arbitration close date. These associated persons may or may not have returned to the industry after the arbitration close date. The customers to these cases would not have been able to avail themselves of the benefits of the new options under the proposed amendments, as a result of the 365 day requirement. The number of such cases decreases to 42 cases if instead a 180-day window is used and 20 cases if instead a 90-day window is used.
18. Among the 1,328 customer cases closed by hearing or by papers (or by stipulated awards) from 2014 to 2016, FINRA staff is able to identify 67 cases where an associated person had left during a pending arbitration but returned to the industry in fewer than 365 days before the arbitration close date. The 365-day window prevents customers from exercising the new options under the proposed amendments and potentially reduces the additional costs to the parties to resolve disputes when the associated person has only temporarily left the industry. The number of such cases decreases to 57 cases if instead a 180-day window is used and 51 cases if instead a 90-day window is used.