

Discussion Paper— FINRA Perspectives on Customer Recovery

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Customers who pursue civil remedies or arbitration claims against investment professionals cannot always recover on their judgments or awards. Customers encounter this challenge across the forums in which they may pursue action—whether state or federal court, a dispute resolution forum administered by a regulator, a private arbitration venue, or otherwise—and across the range of financial services they may use. When a customer is unable to recover on a judgment or award, the customer may be left without any redress for the harm suffered, and public confidence in the financial services industry and the regulatory framework under which it operates may be diminished.

FINRA has been focused on this important issue for many years in the context of the arbitration forum that FINRA operates for the resolution of disputes between customers and FINRA members or their employees.¹ As with other dispute resolution forums, customers who receive awards in the FINRA forum are sometimes unable to collect on those awards. FINRA has taken a number of steps to address this problem, and has proposed several additional measures that would further mitigate, albeit not eliminate, the issue of unpaid awards.

In considering further steps to improve customer recovery in its own forum, FINRA believes it is important to engage in a collaborative dialogue with other regulators and policy makers, as well as the many other stakeholders in this issue, for several reasons.

First, FINRA has identified several additional steps that could be taken (described below) to address unpaid awards that would require action by, or should be pursued in consultation with, other authorities. Certain of these steps could also raise questions of their impact on, or application to, other segments of the financial services industry outside of FINRA’s jurisdiction. Even actions taken solely by FINRA with respect to unpaid awards can have customer protection or other implications for other regulatory regimes that should be considered—such as when FINRA suspends an individual from the brokerage industry for failing to pay an award, and that individual continues to operate elsewhere in the financial services industry.

In addition, in light of the similarities between some of the services offered by brokers that FINRA regulates and investment advisers, different approaches to dispute resolution as between these two channels require careful consideration to ensure investor protection. Moreover, as a general matter, the issue of unpaid awards is not unique to FINRA’s forum or the broker-dealer industry—customers can have unpaid

claims that arise from other forums or that are against other types of financial firms. A holistic consideration of how customer recovery is or is not addressed across related areas of financial services will better inform what steps to better protect customers would be appropriate in the context of each of these areas, and what consequences action in any one area may have for others.

FINRA is issuing this Paper in order to help inform this broader dialogue by providing FINRA's perspectives on customer recovery in the dispute resolution forum it administers. The Paper provides an overview of the FINRA arbitration forum, makes available additional data about unpaid awards in the forum, describes the steps that FINRA has taken to address those unpaid awards, and identifies additional measures that could be taken to either enhance the resources to pay such awards or provide greater incentives to pay such awards.

The Paper briefly identifies some of the potential issues that may arise for customer recovery in other forums, but it does not provide a comprehensive survey of how the process, policy tools, and results of recovery in the FINRA forum compare with other forums. This Paper is intended to help encourage a continued dialogue about those questions while directly informing the further enhancement of customer recovery in the FINRA forum itself. To that end, FINRA plans to organize discussions with other regulators and policy makers to further address this topic, identify additional data or analysis that may help inform effective decision-making in this area, and consider potential courses of action.

I. Summary – Customer Recovery in FINRA Arbitration

Arbitration is an important means of customer recovery in disputes involving investment professionals. Most broker-dealers and many investment advisers² require customers opening accounts to agree in writing to arbitrate disputes concerning the account. FINRA rules *do not* require customers to arbitrate disputes with broker-dealers, nor does FINRA preclude customers from pursuing relief in state or federal courts; however, FINRA rules do require arbitration if requested by the customer.

In FINRA arbitration, the majority of customer cases—approximately 69 percent—result in settlements reached by the parties;³ typically, approximately 18 percent of cases proceed to award.⁴ When the customer pursues arbitration and obtains a monetary award, the customer can have the award confirmed in court, and thus is in a similar position as a customer who obtains a judgment in court. Arbitration claimants have access to the same collection tools as in a court judgment. In either situation, the award or judgment may not be paid. Thus, a customer's recovery depends on the ability to collect from the respondents, not on whether the customer sought relief in arbitration or in court.

The issues surrounding the ability of customers to collect on awards are not unique to FINRA arbitration or the broker-dealer industry. What is unique to arbitration against broker-dealers is that FINRA suspends individuals and firms from the broker-dealer industry due to non-payment of a FINRA arbitration award. It is important that these similarities and differences be taken into account in considering the issues of customer recovery. For example, investors may obtain similar services from investment advisers who are not FINRA members. Unlike FINRA member broker-dealers, however, investment advisers registered with the Securities and Exchange Commission (SEC) are not subject to disciplinary sanctions or suspension from the investment adviser industry if they do not timely pay arbitration awards assessed against them. In addition, if an individual is suspended from the broker-dealer industry due to the individual's failure to pay a FINRA arbitration award, FINRA is not aware of any federal provisions that would prevent that individual from entering or continuing in another area of the financial services industry, including acting as an investment adviser.

Customer Recovery Across Dispute Resolution Forums			
	FINRA Arbitration	Private Arbitration (e.g., AAA, JAMS)	Court
SEC Oversight of Forum	•		
FINRA Suspension for Non-Payment of Award or Judgment	•		
Awards or Judgments Publicly Available	•		•
Enforcement of Award or Judgment Allowed in Court	•	•	•
Customer Claimant Responsible for Collecting Award or Judgment	•	•	•
Payment of Award or Judgment Ensured or Guaranteed			

FINRA collects certain data on customer recovery in the FINRA arbitration forum. Those data show that FINRA customer arbitration cases decided by award represent a small subset of all cases filed. For example, of the 2,457 arbitration cases involving customer disputes in 2016, only 389 (16 percent of all cases) closed by award; and of those awards, 44 (2 percent of all cases) went unpaid.⁵ FINRA has not been able to obtain similar data regarding customer recovery against non-FINRA members, or in court or other non-FINRA forums. For example, there is no affirmative requirement for an investment adviser to report a failure to pay arbitration awards on Form ADV,⁶ and FINRA is unaware of data on the volume of arbitration or court claims against advisers or the amount of awards that are unpaid.

If a customer is not able to recover monetary damages awarded in the FINRA arbitration forum, that does not always mean that a customer did not receive any monetary payment in connection with the underlying dispute. In many cases that result in unpaid awards, a customer settles with one or more parties pre-award, but proceeds to obtain an award against other parties named in the case, who then fail to pay the award. For example, of the 44 awards that went unpaid in 2016, 13 involved a settlement with one or more firms pre-award.

Although a customer can always enforce an arbitration award in court, FINRA also has taken steps to mandate payment of customer arbitration awards by its members, to restrict those who do not pay awards through suspension from the industry, and to expand options available to customers with claims against respondents who are unlikely to be able to pay. FINRA has also identified other approaches that could be taken to help customers recover monetary damages against FINRA member broker-dealers and associated persons, some of which may also be relevant for financial industry participants who are not FINRA members. These approaches generally would require SEC rulemaking or federal legislation, or present policy issues that should be considered by the SEC or Congress. FINRA recognizes that each of these approaches involves important tradeoffs and policy choices that would require further consideration and analysis by relevant regulators and policymakers before being implemented. The approaches are discussed more fully below and include, among other alternatives:

- ▶ rulemaking by the SEC to require firms to raise or maintain additional capital;
- ▶ legislation by Congress to expand Securities Investor Protection Corporation (SIPC) coverage to include unpaid customer arbitration awards;
- ▶ legislation by Congress or rulemaking by the SEC or FINRA to require firms to carry insurance to cover unpaid arbitration awards;

- ▶ legislation by Congress or rulemaking by the SEC or FINRA to create a second brokerage industry fund, separate from SIPC;
- ▶ amendments to the SEC's Form BD to require disclosure regarding unpaid awards by firms;
- ▶ legislation by Congress to amend the Securities Exchange Act of 1934 (Exchange Act) statutory disqualification definition to include more instances in which a firm or individual fails to pay an arbitration award; and
- ▶ legislation by Congress to amend the Bankruptcy Code so that arbitration awards cannot be discharged in bankruptcy.

II. Background

A. Securities Arbitration

Arbitration in the broker-dealer industry has been subject to oversight by the SEC for many years. In 1976, the SEC established an Office of Consumer Affairs, whose mandate was to explore alternative methods for the resolution of disputes between individual investors and brokers and firms, including the establishment of a single nationwide system for investor dispute resolution.⁷ Ultimately, the SEC concluded that litigation is a burdensome and complex option for investors, as well as cost prohibitive for those investors with small claims.

In light of the fact that several self-regulatory organizations (SROs) maintained separate arbitration forums at the time,⁸ the SEC decided not to impose rules related to investor dispute resolution as long as the SROs took affirmative measures to provide nationwide forums with uniform rules, accessibility for investors, convenient locations, fair fees, and panels that included persons not engaged in the securities business. For the last 40 years, the SEC has overseen the evolution of arbitration to resolve investor disputes against broker-dealers, including through the SRO rule filing process.⁹

B. FINRA's Arbitration Forum

FINRA operates the largest securities arbitration forum in the United States to assist in the resolution of monetary and business disputes involving investors, securities firms, and individual brokers.¹⁰ FINRA's primary role in the arbitration process is to administer cases brought to the forum in a neutral, efficient, and fair manner. In its capacity as a neutral administrator of the forum, FINRA does not have any input into the outcome of arbitrations.

All rules related to the FINRA arbitration program have been filed with and approved by the SEC, after publication in the *Federal Register* and a finding by the SEC that such rules are in the public interest.¹¹ The SEC regularly examines FINRA's arbitration forum. In addition, FINRA has periodically undertaken to enhance the operation of the program, informed by input from external stakeholders.¹²

FINRA's arbitration forum has 71 hearing locations—at least one in every state. Depending on the amount of damages being sought, disputes in the arbitration forum are heard by either a panel of three arbitrators, or by a single arbitrator. Member firms pay for most costs, and FINRA waives fees for investors experiencing financial hardship. The average turnaround time across all arbitration cases is 15 months.

In all cases involving investors, parties have the option to have their case decided exclusively by public arbitrators who have no ties to the securities industry. FINRA maintains a roster of more than 7,300 arbitrators, conducts a comprehensive pre-approval background check on all arbitrator applicants, and provides training and continuing education for arbitrators. In addition, FINRA actively recruits minority and female arbitrators, and publishes data on the diversity of the arbitrator pool on the FINRA website.¹³

FINRA publishes detailed arbitration statistics on its website, including the number of cases filed and their respective outcomes.¹⁴ All arbitration awards are made publicly available.¹⁵ The award provides the names of the parties, the arbitrators, the allegations, the date and location of the hearing, and the arbitrators' rulings.

C. Predispute Arbitration Agreements

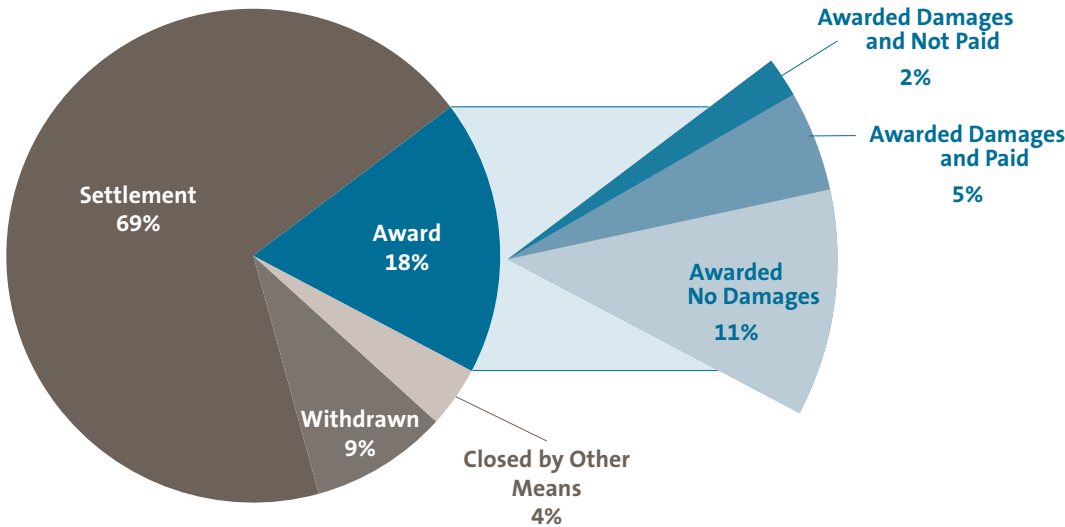
FINRA does not preclude customers from pursuing relief in state or federal courts. Most broker-dealers, however, require customers opening accounts to agree in writing to arbitrate disputes concerning the account.¹⁶ Although FINRA does not require member firms or their customers to enter into predispute arbitration agreements or otherwise use arbitration in lieu of civil litigation, FINRA's rules do establish certain minimum disclosure and related requirements regarding the use of such agreements.¹⁷ In addition, FINRA arbitration is required if there is a written agreement requiring FINRA arbitration or if it is requested by the customer.¹⁸

Even with a predispute arbitration agreement, member firms and customers may elect, by mutual consent, to resolve their disputes in a forum other than at FINRA, such as at a private arbitration forum (e.g., AAA or JAMS) or by civil litigation, after a dispute has arisen between the parties. In addition, if a written agreement to arbitrate at FINRA does not exist or if the customer does not request FINRA arbitration, the parties to a dispute may agree to resolve their disputes at a private arbitration forum or in civil litigation. FINRA rules also protect a customer's rights to pursue class actions in court notwithstanding any predispute arbitration agreement.¹⁹

D. Customer Recovery in FINRA Arbitration

Arbitration cases decided by award represent a small subset of all cases filed.²⁰ For example, there were 2,457 arbitration cases involving customer disputes in 2016, but only 16 percent (389) closed by award. Another 71 percent (1,747) settled prior to award, 9 percent (212) were withdrawn, and 4 percent (109) closed by other means (e.g., stipulated award, bankruptcy of critical party, uncured deficient claim, forum denied, or stayed by court action). This general distribution in how customer disputes are resolved has remained steady in recent years (see chart).

How Customer Arbitration Cases Closed (2012-2016)

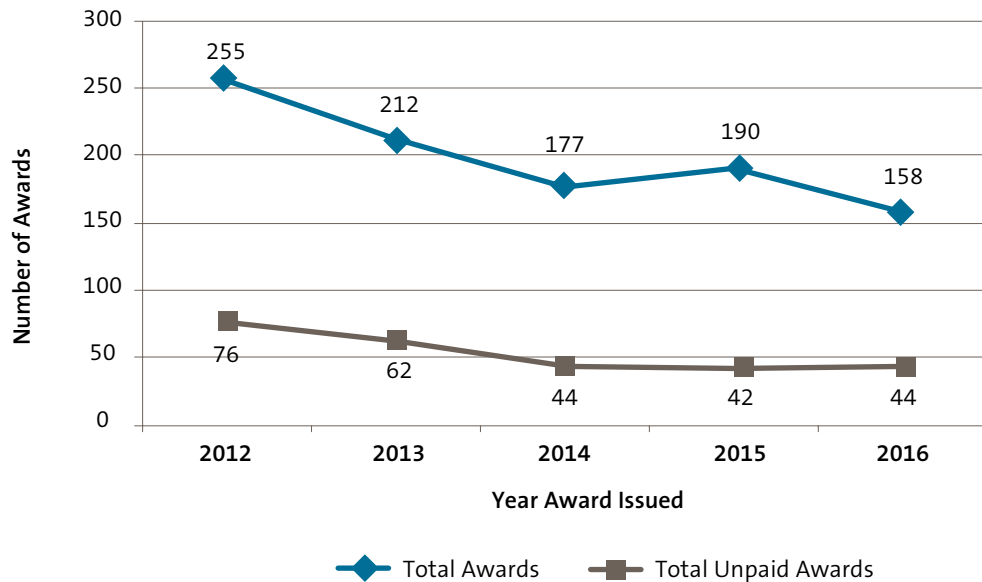


When an arbitration panel awards monetary damages to the customer claimant, the respondent may fail to pay the awarded damages.

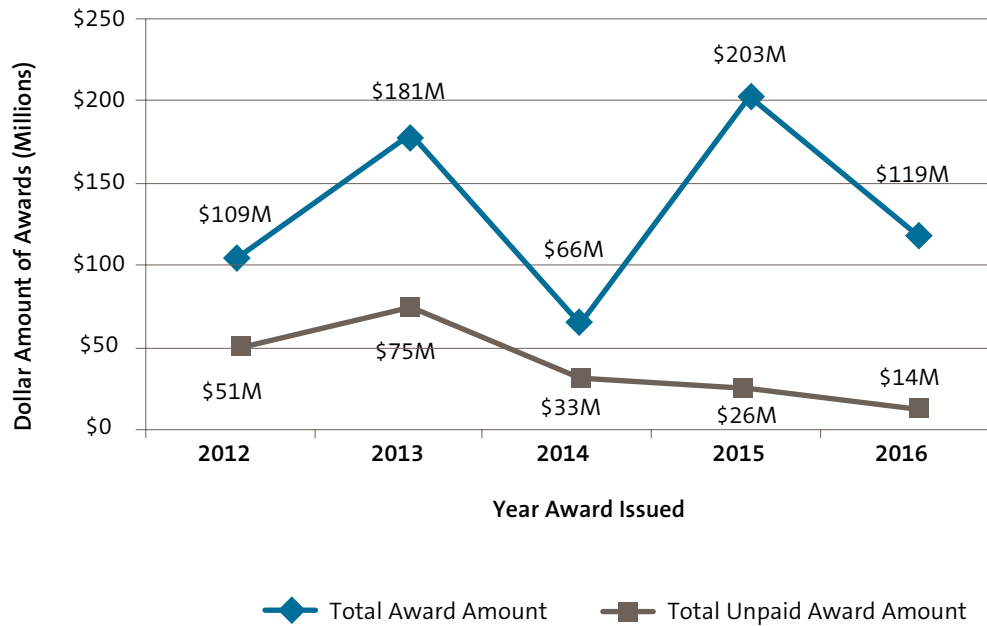
To provide additional transparency about its forum and better inform discussions regarding this topic, FINRA is making data on unpaid customer arbitration awards for the past five years available on its [website](#). FINRA has previously included certain of these data in its annual report to the SEC regarding unpaid customer arbitration awards, including the number of monetary awards, the amount of monetary relief awarded, and the number and amount of unpaid monetary awards.²¹ These data also underlie the graphics presented in this Paper.²² To FINRA's knowledge, this is the first time that a dispute resolution forum has made publicly available this level of data on unpaid awards or judgments.

The number of unpaid awards as a share of the total number of customer arbitration awards has remained relatively stable in recent years, while the share by dollar amount has fluctuated due to variability in the size of awards (see graphs).²³

Number of Unpaid Customer Arbitration Awards by Year



Dollar Amount of Unpaid Customer Arbitration Awards by Year



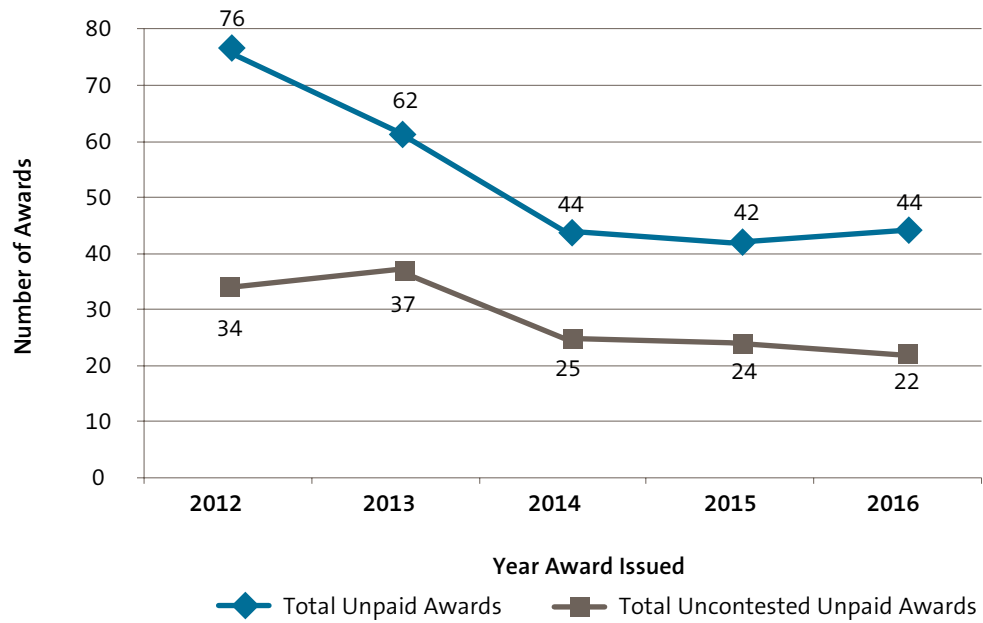
Unpaid customer arbitration awards against firms primarily involve smaller-sized firms.²⁴

Size of Firms With Unpaid Customer Arbitration Awards by Number of Registered Brokers

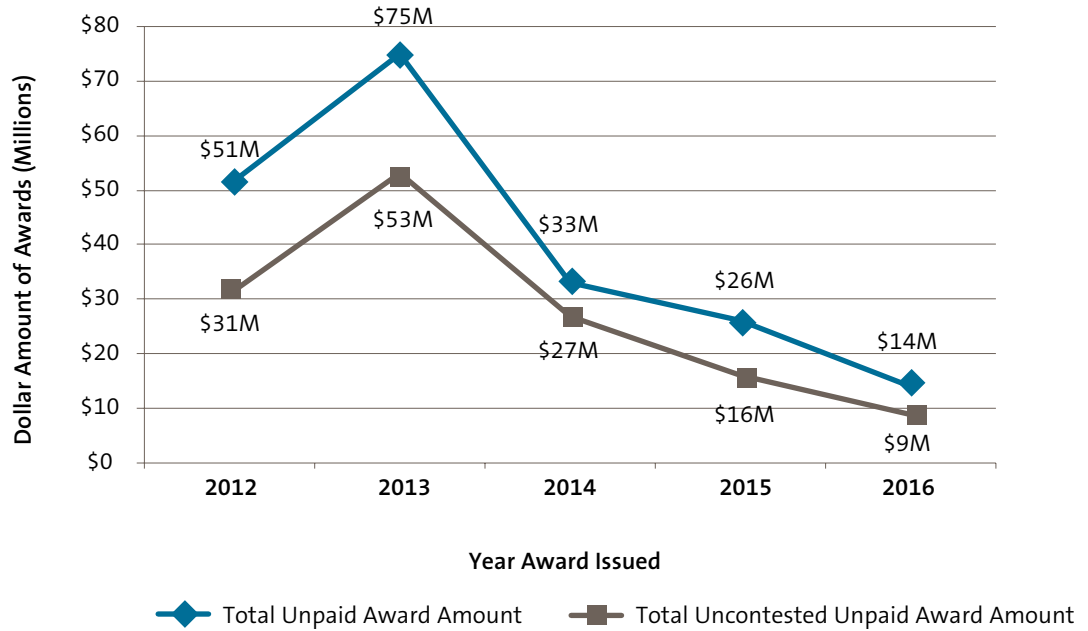
Year Award Issued	Average Firm Size	Median Firm Size
2012	34	25
2013	76	39
2014	70	41
2015	81	56
2016	55	30

Often, an arbitration claim resulting in an unpaid award is uncontested, meaning that the respondent firm or individual does not appear to oppose the customer's claims in the arbitration proceeding. If a respondent firm or individual fails to appear at a hearing, the panel may determine that the hearing may go forward, and may render an award as though all parties had been present.²⁵ If a respondent firm or individual is inactive (as defined below) and fails to file an answer within the required time period, at the request of the customer claimant, the arbitrator may render an award based on the pleadings and other materials submitted, as well as any additional information requested by the arbitrator from the customer claimant.²⁶ In recent years, a large share of unpaid arbitration awards have resulted from uncontested claims, measured by both the number and value of awards (see graphs).

Number of Unpaid Customer Arbitration Awards in Cases That Were Uncontested by Year

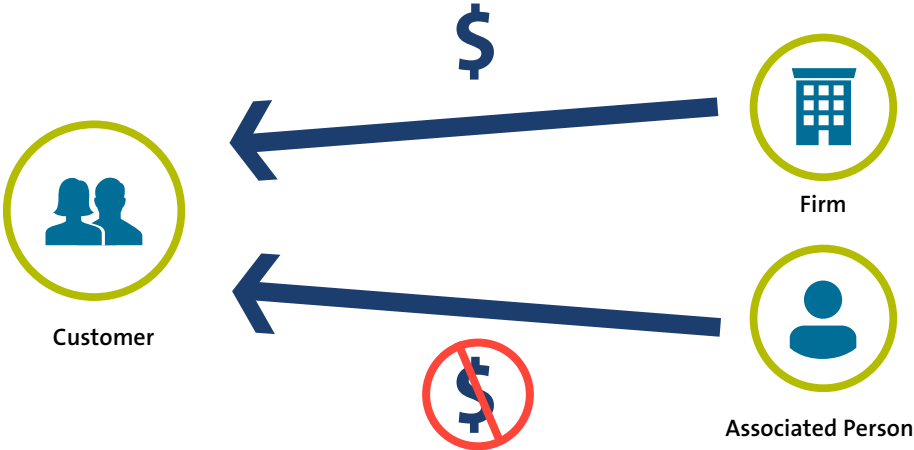


Dollar Amount of Unpaid Customer Arbitration Awards in Cases That Were Uncontested by Year



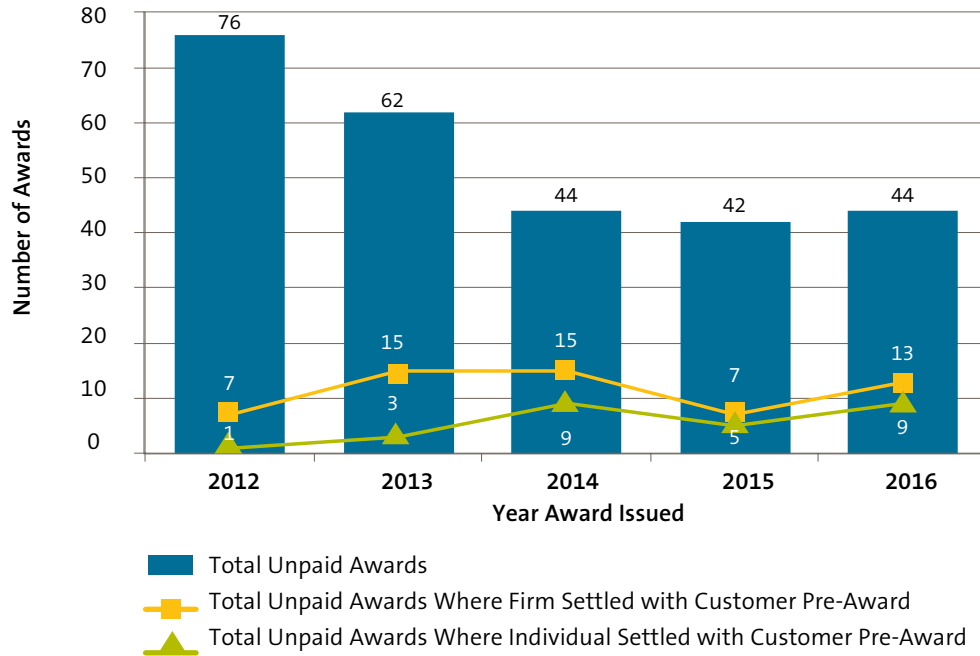
An unpaid award against one party does not always mean that a customer did not receive any monetary payment in connection with the underlying dispute (see graphic). In a number of cases that result in unpaid customer arbitration awards, a customer claimant settles with one or more parties pre-award, but proceeds to obtain an award against other parties named in the case, who then fail to pay the award. In recent years, a significant number of unpaid customer arbitration awards have involved a pre-award settlement with one or more firms or individuals involved in the dispute (see graphs).

An Unpaid Award Does NOT Always Mean the Customer Did Not Receive Any Payment



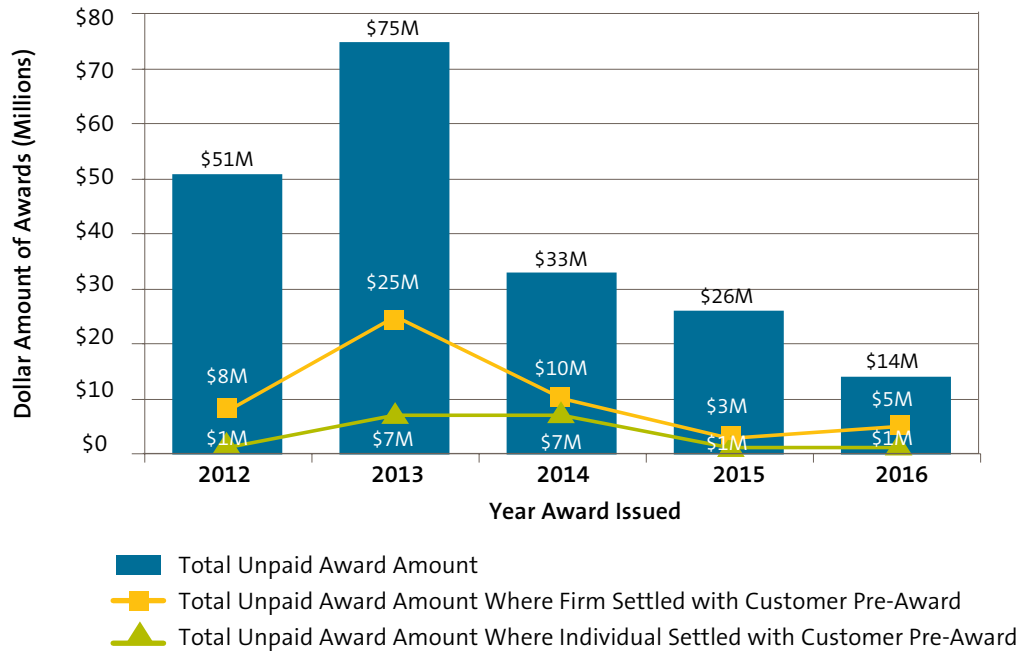
In 2016, 13 of 44 unpaid awards involved a pre-award settlement between the customer and one or more firms.

Number of Unpaid Customer Arbitration Awards With Pre-Award Settlements by Year*



* Because both a firm and an individual who was associated with the firm may have settled in the same case pre-award, figures for firms and individuals may overlap.

Dollar Amount of Unpaid Customer Arbitration Awards With Pre-Award Settlements by Year*



* Because both a firm and an individual who was associated with the firm may have settled in the same case pre-award, figures for firms and individuals may overlap.

III. FINRA Measures Related to Customer Recovery

A claimant in the FINRA arbitration forum is in a similar position as if the claimant had brought an action in court and been awarded the same amount of damages.²⁷ As in a court judgment, the responsibility to collect on an arbitration award lies with the claiming party. Similarly, as is the case with federal and state court systems and other arbitration forums, FINRA's arbitration forum does not ensure payment of damages awarded. Arbitration claimants have access to the same collection tools as in a court judgment: if a respondent fails to pay an arbitration award, the claimant may take the award to court and have it converted to a judgment. The claimant may then attempt to collect on the judgment using the court's collection procedures.

Although a customer claimant can always enforce an arbitration award in court, FINRA also has taken steps to mandate payment of customer arbitration awards by its members, to restrict—through suspension from the brokerage industry—those who do not pay awards, and to expand options available to customers with claims against respondents who are unlikely to be able to pay.

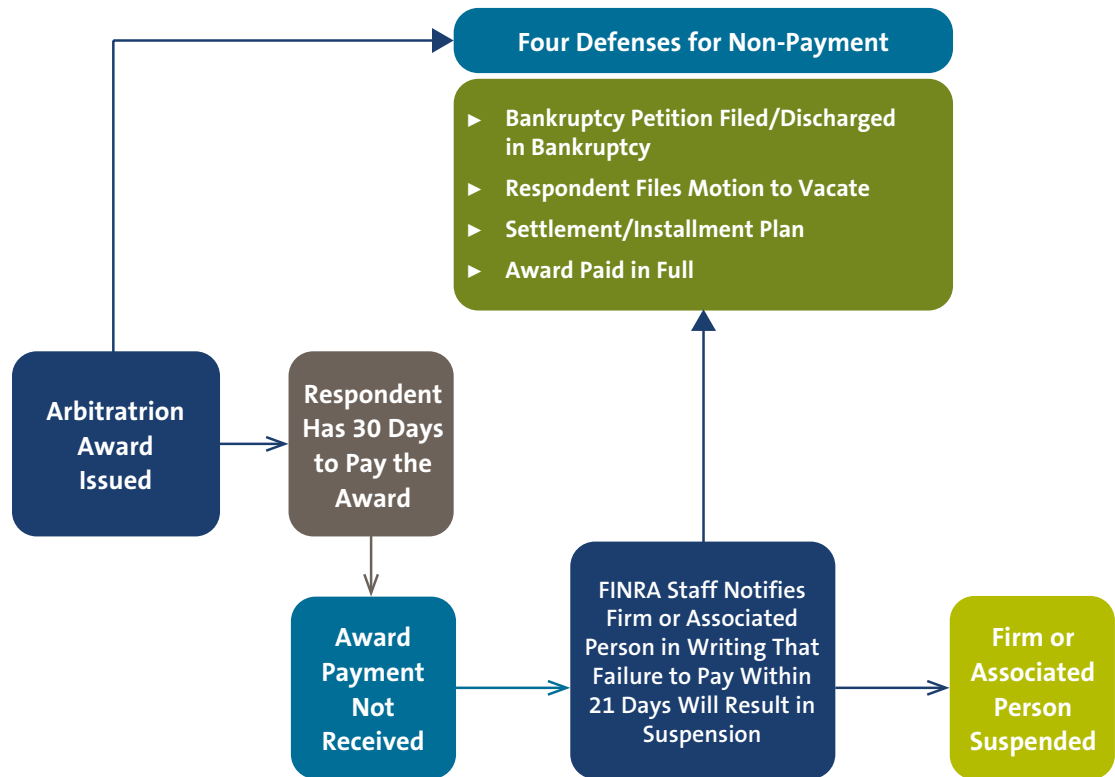
It is important to note that most unpaid customer arbitration awards are rendered against firms or individuals whose FINRA registration has been terminated, suspended, canceled, or revoked, or who have been expelled from FINRA. These firms and individuals are generally referred to as “inactive,” and are no longer FINRA members or associated with a FINRA member, although they may continue to operate in another area of the financial services industry where FINRA registration is not required. Firms and individuals can become inactive prior to an arbitration claim being filed, during an arbitration proceeding, or subsequent to an arbitration award, and this status can be caused by FINRA's action—for example, as described below, when a firm or individual fails to pay an award—or the firm's or individual's own voluntary action. As described below, FINRA is constrained in its ability to help enforce collection of an unpaid award against an inactive firm or individual. Some firms or individuals may remain active notwithstanding an unpaid award because they have a defense to non-payment, such as bankruptcy.²⁸

A. Requirement to Pay and Restrictions for Failure to Pay

Under FINRA's Customer Code, unless a respondent has a defense to non-payment, a respondent must pay a monetary award within 30 days of receipt.²⁹ In order to incentivize member firms or associated persons to pay customer awards, and restrict those who do not, FINRA suspends from the brokerage industry any member firm or associated person who fails to pay an arbitration award. If a member firm or associated person fails to comply with an arbitration award or a settlement agreement related to an arbitration, FINRA staff notifies such firm or associated person in writing that the failure to comply within 21 days of service of the notice will result in a suspension of membership or a suspension from associating with any member.³⁰

Unless a firm or associated person has a valid defense to non-payment,³¹ the threat of suspension directed at active firms and associated persons can be an effective tool to compel payment of an award or settlement.³²

FINRA Suspension for Non-Payment of Customer Arbitration Awards



In 2016, FINRA instituted expedited suspension proceedings against 20 active firms or associated persons in connection with 15 customer awards; 15 firms and associated persons paid the award or reached a post-award settlement.³³

In each suspension action, FINRA creates a record that the firm or associated person failed to demonstrate payment of an arbitration award, and prevents the firm and associated person from being an active FINRA member or associating with a FINRA member until the award has been satisfied. Firms with unpaid awards cannot re-register without satisfying the award.³⁴ Individuals cannot register as representatives of any brokerage firm without paying or discharging the outstanding award.

In considering potential approaches to enhance customer recovery, it is important to note that the restrictions described above are limited to FINRA member broker-dealers and associated persons. For example, unlike FINRA member broker-dealers and associated persons, SEC-registered investment advisers are not subject to similar disciplinary sanctions or suspension from the investment adviser industry if they do not timely pay arbitration awards assessed against them.³⁵ If an associated person of a FINRA member is suspended due to the failure to pay a FINRA arbitration award, FINRA is not aware of any federal provisions that would prevent that individual from entering or continuing in another area of the financial services industry, including acting as an investment adviser.³⁶

B. Expanded Options Where Respondents Are Unlikely to be Able to Pay

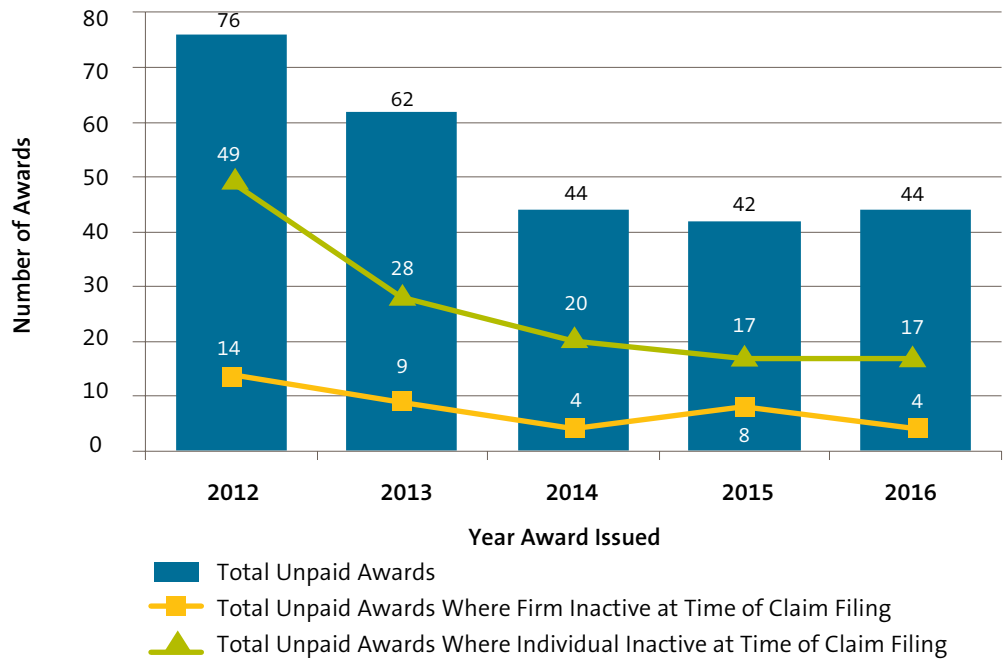
As noted above, most unpaid customer arbitration awards are rendered against member firms or associated persons who are inactive. Inactive respondents are less likely to be able to pay an award, and FINRA is constrained in its ability to help enforce collection. FINRA therefore has adopted other rules and procedures that expand the options available to a customer when dealing with such respondents.

When a customer claimant first files an arbitration claim, FINRA staff alerts the customer if the respondent firm or broker is inactive. 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.

A customer is not required to use an arbitration forum when bringing a claim against a firm that is inactive.³⁷ In these circumstances, 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, regardless of whether the customer signed a predispute arbitration agreement.³⁸ Accordingly, claims against inactive firms proceed in arbitration only at the customer's option.

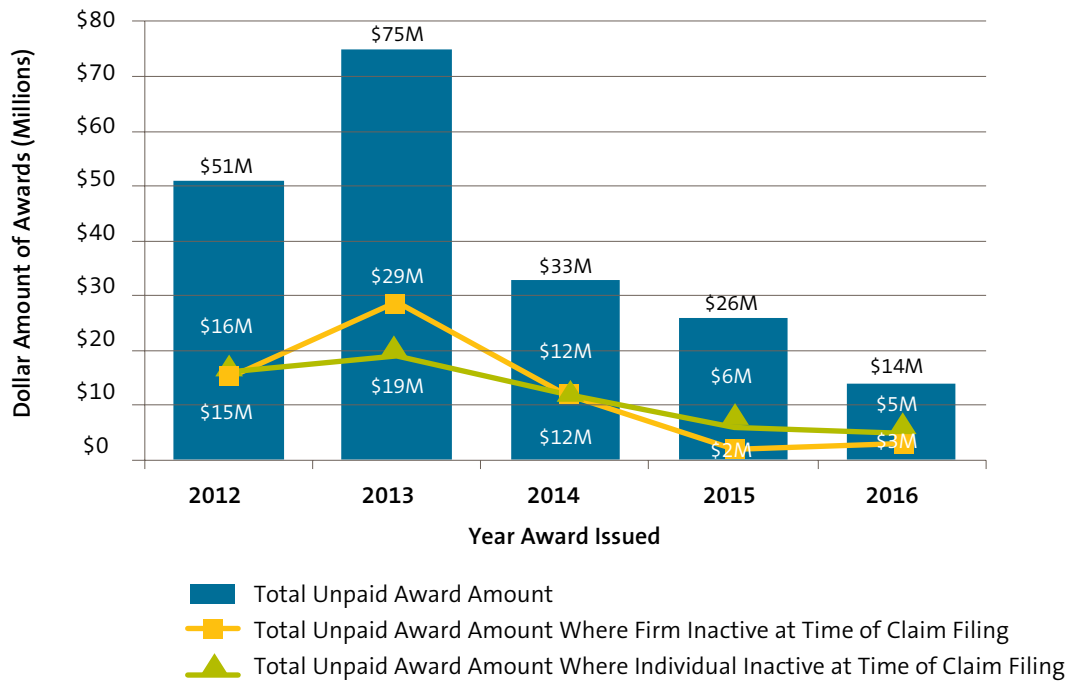
In FINRA's experience, however, customer claimants who have been notified that the respondent is inactive almost always decide to pursue arbitration claims, which can result in unpaid awards.³⁹ For example, in 2016, four of the 44 unpaid customer arbitration awards were in cases where the firm was inactive at the time the claim was filed (comprising \$3 million of \$14 million unpaid that year); 17 of the 44 unpaid customer arbitration awards involved individuals who were no longer associated with a FINRA member at the time the claim was filed (comprising \$5 million of the \$14 million unpaid that year).⁴⁰ Similar shares of unpaid awards have been attributable to inactive firms and individuals in recent years (see graphs). As discussed above, it is important to note that respondent firms and individuals can also become inactive during an arbitration proceeding as well as post-award.

Number of Unpaid Customer Arbitration Awards with Inactive Respondents at Time of Claim Filing by Year*



* Because both a firm and an individual who was associated with the firm may be inactive at the time a claim is brought, figures for firms and individuals may overlap.

Dollar Amount of Unpaid Customer Arbitration Awards with Inactive Respondents at Time of Claim Filing by Year*



* Because both a firm and an individual who was associated with the firm may be inactive at the time a claim is brought, figures for firms and individuals may overlap.

FINRA rules provide streamlined default proceedings for customers where an inactive firm or associated person does not answer or appear.⁴¹ These proceedings are designed to make it easier, faster, and less expensive for customers to obtain an award against an inactive firm or associated person that can be enforced in court. This step is particularly important because inactive firms and associated persons are not necessarily insolvent, and an award is an important precondition for the customer to obtain redress even where FINRA no longer has jurisdiction.

Firms and associated persons may also be less likely—or simply unable—to pay an award because they have entered bankruptcy.⁴² Such firms and individuals may still be active and remain registered with FINRA. However, federal law generally prohibits FINRA from using any measures to help enforce collection of the award against a firm or individual that has entered bankruptcy.⁴³

C. Additional Proposals Under Consideration

The measures described above have helped customers obtain more timely judgments against firms and associated persons, but do not always enable customers to collect awards. Ultimately, it can be difficult for customers to collect from firms or associated persons that are inactive or insolvent, or both, whether the customer has an arbitration award or a court judgment.

Accordingly, FINRA has considered other approaches it can take to further incentivize the payment of customer arbitration awards and expand options for customers where respondents are unlikely to be able to pay. Currently pending proposals include:

- ▶ **Giving investors additional options where respondents are unlikely to pay.** In October 2017, FINRA issued a *Regulatory Notice* seeking comment on proposed amendments to the Customer Code that would permit a customer to withdraw an arbitration claim against an inactive associated person, and file in court, despite the existence of a predispute arbitration agreement.⁴⁴ The proposed amendments would treat claims against inactive associated persons the same in this respect as claims against inactive firms, as described above. The comment period expired on December 18, 2017. FINRA is currently in the process of reviewing the comment letters.
- ▶ **Giving investors more information about unpaid awards.** In May 2017, the FINRA Board approved proposed amendments to Form U4 to elicit information from registered representatives that do not pay arbitration awards, settlements, and judgments in full and in accordance with their terms. The proposed amendments to Form U4 would alert investors to associated persons who have failed to pay customer arbitration awards, settlements, and judgments and, therefore, help them make more informed decisions regarding where to invest.⁴⁵ The development of the uniform registration forms is conducted jointly between FINRA and the North American Securities Administrators Association (NASAA). FINRA is currently in discussions with NASAA regarding the proposed amendments to Form U4.
- ▶ **Enhancing the safeguards to prevent evasion of a payment obligation.** Today, FINRA also issued a *Regulatory Notice* seeking comment on proposed amendments to create further incentives for the timely payment of 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. The amendments would address situations where: (1) a FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down. The comment period expires on April 9, 2018.

IV. Other Approaches to Further Address Customer Recovery

In pursuing these measures, FINRA has identified other approaches that could be taken to further address the issue of unpaid customer arbitration awards, but that would require SEC rulemaking or federal legislation, or present policy issues that should be considered by the SEC or Congress. FINRA recognizes that each of these approaches involves important tradeoffs and policy choices that would require further consideration and analysis by relevant regulators and policymakers before being implemented.

Other Approaches to Further Address Customer Recovery of Unpaid Arbitration Awards			
	Requires Federal Legislation	Requires SEC Rulemaking	Requires SEC Approval of FINRA Rulemaking
Require Firms to Raise or Preserve Additional Capital		•	
Expanding SIPC Coverage	•		
Creation of Second Brokerage Industry Fund *	•	•	•
Other Insurance Options *	•	•	•
Greater Disclosure of Relevant Information on Form BD		•	
Changes to the Statutory Disqualification Definition	•		
Bankruptcy Code Changes	•		

* Implementation of these approaches may require federal legislation, SEC rulemaking, SEC approval of a FINRA-proposed rule change, or some combination of the foregoing.

The primary approaches FINRA has considered can be divided into two categories: (1) those that would enhance resources available to pay awards; and (2) those that would create further incentives to pay awards. The approaches are summarized below.

A. Approaches That Would Enhance Resources to Pay Awards

1. Require Firms to Raise or Preserve Additional Capital

One potential approach that would help ensure that firms have the resources to pay arbitration awards is to raise firms' net capital requirements when they are facing arbitration claims. Among the alternatives for accomplishing this goal are: (1) requiring earlier recognition of potential awards in determining net worth for purposes of net capital calculations; (2) changing the net capital requirements to limit withdrawal of capital when open arbitrations are material; and (3) otherwise changing net capital requirements to reflect arbitration claims. Another alternative is to raise firms' net capital requirements in general, regardless of whether a firm is facing arbitration claims.

Most introducing brokers have a relatively small minimum net capital requirement (\$5,000) because they do not maintain custody of client assets. Although these firms are generally required to also keep capital to cover six and two thirds percent of their aggregate indebtedness (including contingent liabilities like litigation and arbitration claims),⁴⁶ the firms are not required to have assets that fully cover litigation or arbitration claims until they are included on the balance sheet. Under the current rules, these items generally are not included on the balance sheet until the matter is resolved and the actual liability is required to be recorded, often in much greater amount than the firm can absorb through the capital it has available at that time.

Broker-dealer capital requirements have long been set by the SEC, and any of these changes would require amendments to or interpretations of the SEC's net capital rules and would present important implementation issues that would need to be considered. In particular, raising net capital requirements would require careful consideration of the potential impact on smaller firms.

2. Expanded SIPC Coverage/Second Brokerage Industry Fund/Insurance

Other approaches to enhancing the resources available to pay awards would provide customers with some level of compensation for unpaid arbitration awards. Implementation of these approaches may require federal legislation, SEC rulemaking, SEC approval of a FINRA proposed rule change, or some combination of the foregoing.

- ▶ **Expanding SIPC Coverage.** One such approach that has been suggested would be to expand the existing SIPC coverage to include unpaid customer arbitration awards. Congress created SIPC to protect customers' claims for securities entrusted to failed broker-dealers (or for cash entrusted to them in connection with transactions in securities). SIPC has a \$2.5 billion fund raised through assessments on its members,⁴⁷ which it uses to provide each customer of a SIPC member with \$500,000 of protection⁴⁸ against the possibility that the SIPC member will fail and be unable to return its customers' cash and securities. SIPC does not protect customers against losses relating to poor investment recommendations, misrepresentations in the sale of securities, market manipulation, or many other types of fraud, nor does it guarantee payment of arbitration awards relating to such losses; SIPC only protects claims for the return of securities or cash entrusted to a failed broker-dealer (e.g., claims for theft of such securities or funds or conversion of them through unauthorized trading). Expanding SIPC coverage to unpaid arbitration awards would require federal legislation and would raise a number of policy issues to consider.⁴⁹
- ▶ **Creation of Second Brokerage Industry Fund.** Another approach would be to create a second brokerage industry fund, separate from SIPC, to cover unpaid customer arbitration awards. This second fund could be established by Congress through legislation, by SEC or FINRA rulemaking (where any FINRA rules would require SEC approval), or a combination of the foregoing. It could be funded by assessments of brokerage industry participants directly, indirectly through a FINRA funding mechanism, or in some other manner.⁵⁰ The creation of such a fund would raise many of the same questions as an expansion of the SIPC regime, as well as some additional issues.⁵¹ FINRA believes that Congress or the SEC should be involved in any decision to create a second brokerage industry fund for unpaid arbitration awards, especially to the extent it would cover claims that Congress has determined should not be covered by SIPC.⁵²
- ▶ **Other Insurance Options.** Another approach would involve requiring firms to carry insurance to cover unpaid customer arbitration awards. An insurance solution could be in the form of commercial insurance products or a captive insurance program. This approach raises many of the same questions as expanding SIPC coverage or creating a second brokerage industry fund.

B. Approaches That Would Create Further Incentives to Pay Awards

1. Greater Disclosure of Relevant Information on Form BD

Similar to the proposed individual disclosures on Form U4 discussed in Section III.C. above, the SEC could amend its Form BD to elicit information from member firms that do not pay arbitration awards, settlements, and judgments in full and in accordance with their terms. This approach would provide customers with additional information about member firms with unpaid customer arbitration awards, settlements, and judgments.⁵³

2. Changes to the “Statutory Disqualification” Definition

A potential approach to incentivize firms and associated persons to pay arbitration awards would be to expand the “statutory disqualification” definition under Exchange Act Section 3(a)(39) to include more instances in which a member firm⁵⁴ or associated person fails to pay an arbitration award.⁵⁵ Such an amendment to the definition of a “statutory disqualification” could include: (1) firms and individuals that fail to pay an arbitration award, whether or not it is dischargeable or has been discharged in bankruptcy; and (2) a control person that previously controlled a firm whose membership was suspended for failure to comply with an arbitration award. This amendment would better enable FINRA to use one of its strongest tools—denial of registration or membership—to further incentivize payment of awards by a broader group of parties.⁵⁶ Such an amendment might also further incentivize payment because of the potential consequences of a statutory disqualification for the firm or individual in other areas of the securities industry. Amending the statutory disqualification definition would require federal legislation to implement, including potentially changes to the Bankruptcy Code, as discussed below.

3. Bankruptcy Code Changes

Another potential approach to incentivize member firms and associated persons to pay arbitration awards would be to change the Bankruptcy Code such that, among other things, arbitration awards cannot be discharged in bankruptcy. Currently, member firms and associated persons can avoid payment of arbitration awards by filing for bankruptcy protection. Under the Bankruptcy Code, arbitration awards are generally treated as unsecured civil debts that are subject to discharge.⁵⁷ Such amendments would help prevent individuals and firms from filing for bankruptcy to avoid arbitration, confirmation of an award, or liability for a confirmed award. In addition, similar to statutory disqualification, they would allow FINRA to use the prospect of revoking registration or preventing an individual from re-registering with a firm to incentivize payment. These measures would not guarantee that a customer will be paid, only that the customer’s rights to enforce a judgment cannot be extinguished by a bankruptcy. In addition, any consideration of such amendments would need to take into account important potential policy implications of not allowing insolvent individuals to discharge awards against them.

IV. Conclusion

FINRA operates a fair and efficient arbitration program under the supervision of the SEC and in accordance with rules approved by the SEC. FINRA has long been concerned, however, about circumstances in which a customer receives an arbitration award against a firm or individual but is not paid. This result happens not because the customer's claim was brought in the FINRA forum—indeed, by confirming the award in court the customer is in the same position as if the customer had brought the claim in court—but rather because of the respondent's inability or unwillingness to pay. FINRA has taken a number of steps to address the issue of unpaid awards to date, including by suspending member firms or individuals who do not pay their awards from the industry, and FINRA is continuing to pursue a number of proposals to further address this issue within the scope of its jurisdiction.

FINRA also believes, however, that it is important to engage in a broader discussion with other regulators and policy makers, as well as other stakeholders in the issue, about customer recovery more generally. For example, a number of additional steps to address unpaid awards that are identified above would require action by, or raise issues that should be considered by, the SEC or Congress. Many of these steps could also raise questions of their impact on, or application to, other segments of the financial services industry outside of FINRA's jurisdiction. In addition, as noted above, the treatment of unpaid arbitration awards in the FINRA forum can have customer protection implications for other regulatory regimes—such as when FINRA suspends an individual for failing to pay an award, and that individual continues to operate as an investment adviser or in another area of the financial services industry.

Moreover, the problem of customers not being able to collect on an arbitration award or judgment is not unique to the brokerage industry, and it would be useful to consider in a more holistic manner the different dispute resolution systems and related regulatory frameworks applicable to different areas of the financial services industry. Fully addressing the issue of customer recovery requires an approach that takes into account the different channels through which customers receive financial services and prevents regulatory arbitrage between them.

By issuing this Paper and releasing additional data on unpaid awards in the FINRA forum, FINRA hopes to advance the broader dialogue on customer recovery as well as inform the continued enhancement of its own forum. As a next step, FINRA plans to organize discussions with other regulators and policy makers to further address this topic, identify additional data or analysis that may help inform effective decision-making in this area, and consider potential courses of action.

Endnotes

1. While FINRA's arbitration forum is used for both intra-industry and customer disputes, this Paper focuses on customer disputes.
2. See Comments of Comm'r Luis A. Aguilar, *Outmanned and Outgunned: Fighting on Behalf of Investors Despite Efforts to Weaken Investor Protections*, Annual NASAA/SEC 19(d) Conference, Washington, D.C., April 16, 2013, available at <https://www.sec.gov/News/Speech/Detail/Speech/1365171515400> (noting that mandatory predispute arbitration provisions are "now popping-up in the investment advisory industry"); see also Mass. Sec. Div. Staff, *Report on Massachusetts Investment Advisers' Use of Mandatory Pre-Dispute Arbitration Clauses in Investment Advisory Contracts*, at 2, February 11, 2013 (indicating prevalence in use of mandatory predispute arbitration clauses among investment advisers registered in that state), available at <http://www.sec.state.ma.us/sct/sctarbitration/Report%20on%20MA%20IAs'%20Use%20of%20MPDACS.pdf>. There are no specific regulatory requirements governing the use of predispute arbitration agreements by investment advisers.
3. In FINRA's experience, the vast majority of settlements result in monetary relief for the customer claimant.
4. These percentages are based on customer cases closed between 2012-2016. All data provided in this Paper are current as of its publication date, and may change due to subsequent developments.
5. If the parties agree to a post-award settlement, FINRA does not track if the award has not been paid unless a party informs FINRA. Accordingly, FINRA treats such awards as paid in full, unless a party to the award notifies FINRA that a payment has been missed or an award has not been paid in full. If FINRA is later notified that the parties have not complied with a payment plan or post-award settlement, FINRA commences expedited suspension proceedings under FINRA Rule 9554 and will update the unpaid awards data to reflect the full amount of the award as an unpaid award.
6. There is no explicit requirement on Form ADV for SEC-registered advisers to disclose arbitration awards. The SEC has stated, however, that disclosure regarding arbitration awards may be required if the investment adviser considers it to be material information. Form ADV requires disclosure of all material facts by a state-registered adviser if the adviser, a management person or a supervised person has been involved in an award or otherwise found liable in an arbitration claim alleging damages in excess of \$2,500 involving any of the following: (a) an investment or an investment-related business or activity; (b) fraud, false statement(s), or omissions; (c) theft, embezzlement, or other wrongful taking of property; (d) bribery, forgery, counterfeiting, or extortion; or (e) dishonest, unfair, or unethical practices. See Form ADV, Part 2A, Item 19 and Part 2B, Item 7, available at <https://www.sec.gov/about/forms/formadv-part2.pdf>. See also Form ADV Part 1B, Item 2E (requiring disclosure by state-registered advisers if the adviser, an advisory affiliate, or a management person is currently or has been the subject of an arbitration claim alleging damages in excess of \$2,500, involving any of the following: (a) any investment or an investment-related business or activity; (b) fraud, false statement(s), or omissions; (c) theft, embezzlement, or other wrongful taking of property; (d) bribery, forgery, counterfeiting, or extortion; or (e) dishonest, unfair, or unethical practices), available at <http://www.nasaa.org/wp-content/uploads/2012/10/Form-ADV-Part-1B.pdf>.

FINRA member firms use the Uniform Application for Securities Industry Registration or Transfer (Form U4) to register their representatives with the appropriate SROs and jurisdictions by filing the form in the Central Registration Depository (CRD®) system. Most of the information that is reported to the CRD system via Form U4 is made publicly available through BrokerCheck®. Among other things, Form U4 elicits information from a registered representative about any investment-related, consumer-initiated arbitration or civil litigation in which he or she was named as a respondent and which alleged that the representative was involved in one or more sales practice violations, and which: (a) is still pending; (b) resulted in an arbitration award or civil judgment, regardless of amount; (c) was settled, prior to 05/18/2009, for an amount of \$10,000 or more; or (d) was settled, on or after 05/18/2009, for an amount of \$15,000 or more. See Question 14I(1) of Form U4 available at <https://www.finra.org/file/form-u4>. In addition, Form U4 elicits information from registered representatives that have been the subject of an investment-related, consumer initiated arbitration claim or civil litigation which alleged that the representative was involved in one or more sales practice violations, and which: (a) was settled for \$15,000 or more; or (b) resulted in an arbitration award or civil judgment against any named respondents regardless of the amount. See Question 14I(4) of Form U4. Finally, Form U4 elicits information from registered representatives who within the past 24 months have been the subject of an investment-related, consumer-initiated arbitration claim or civil litigation not otherwise reported on Form U4, which: (a) alleged that the representative was involved in one or more sales practice violations and contained a claim for compensatory damages of \$5,000 or more; or (b) alleged that the representative was involved in forgery, theft, misappropriation or conversion of funds or securities. In addition, Form U4 requires the reporting of the total amount of the settlement, award or monetary judgment, and the amount for which the registered representative is responsible. As discussed below, in May 2017, the FINRA Board of Governors (Board) approved proposed amendments to Form U4 to elicit information from registered representatives that do not pay arbitration awards, settlements, and judgments in full and in accordance with their terms.
7. See Exchange Act Release No. 13470 (April 26, 1977), 42 FR 23892 (May 11, 1977).
8. Today, FINRA provides dispute resolution services for several exchanges pursuant to Regulatory Services Agreements. See <http://www.finra.org/arbitration-and-mediation/other-exchanges-using-finras-forum>.
9. The SEC has not directed the establishment of an arbitration forum for customers of investment advisers, and customers of investment advisers do not have the right to require their advisers to resolve disputes in an SEC-regulated forum. See also *infra* note 21.
10. During the past 10 years alone, FINRA's arbitration forum has helped resolve over 46,000 intra-industry and customer disputes through arbitration. Of these, approximately 14,000 involved intra-industry disputes and 32,000 involved customer disputes. Information regarding FINRA's arbitration program is available at <http://www.finra.org/arbitration-and-mediation>.

11. Prior to filing a proposed rule change with the SEC, FINRA typically seeks public comment on the rule proposal through issuance of the proposal and a request for comment in a *Regulatory Notice*. Thus, there is an opportunity for public comment on a FINRA rule proposal prior to filing of the proposal with the SEC and another opportunity for comment once the SEC publishes the proposal in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC.
12. Most recently, FINRA formed a Dispute Resolution Task Force in 2014 to suggest strategies to enhance the transparency, impartiality, and efficiency of FINRA's securities dispute resolution forum for all participants. See *Final Report and Recommendations of the FINRA Dispute Resolution Task Force*, December 2015, available at <http://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf>. The Task Force brought together a diverse group of leading investor advocates, academics, regulators, and industry representatives to help ensure that FINRA arbitration and mediation processes continue to serve the needs of the investing public. The Task Force worked independently, setting its own agendas and topics for consideration, and proactively solicited input from a wide range of interested persons and organizations. Among other things, the Task Force reviewed FINRA's actions against broker-dealers or associated persons who do not pay awards, and discussed whether to recommend that FINRA reconsider an insurance requirement for payment of awards, but reached no consensus. FINRA has taken action on 45 of the 51 recommendations that were ultimately made in the Task Force's report; six are pending. FINRA periodically provides public updates on its progress in addressing the Task Force recommendations. See *Status Report on FINRA Dispute Resolution Task Force Recommendations*, February 2017, available at http://www.finra.org/sites/default/files/DR_task_report_status_020817.pdf.

For other examples of periodic reviews of the arbitration forum, see, e.g., *NASD Dispute Resolution, The Arbitration Policy Task Force Report – A Report Card*, July 27, 2007, available at <http://www.finra.org/sites/default/files/Industry/p036466.pdf>; and *Securities Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors National Association of Securities Dealers, Inc.*, 1996.
13. See <http://www.finra.org/arbitration-and-mediation/diversity-and-finra-arbitrator-recruitment>.
14. See <http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics>.
15. See <http://www.finra.org/arbitration-and-mediation/arbitration-awards>.
16. From 1953 to 1987, the arbitration of federal securities law claims was strictly voluntary, and the courts would not enforce predispute arbitration agreements relating to such claims. In addition, Rule 15c2-2(a) under the Exchange Act provided that: "It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer." The SEC noted that it adopted Rule 15c2-2 "[b]ecause years of informal discussions have failed to correct" the practice of agreements to arbitrate future disputes between broker-dealers and their public customers arising under the federal securities laws. See Exchange Act Release No. 20397 (November 18, 1983), 48 FR 53404 (November 28, 1983).

In 1987, the Supreme Court held that predispute arbitration agreements are enforceable as to claims brought under the Exchange Act, and Rule 15c2-2(a) was rescinded. *Wilko v. Swan*, 346 U.S. 427 (1953), overruled by *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987); Exchange Act Release No. 25034 (October 15, 1987), 52 FR 39216 (October 21, 1987) (Rescission of Rule Governing Use of Predispute Arbitration Clauses in Broker-Dealer Customer Agreements). As a result, firms can today compel arbitration of customer claims through inclusion of predispute arbitration provisions in their agreements with customers.

The SEC is authorized by Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), to limit or prohibit the use of agreements to arbitrate future disputes if it finds that such limitation or prohibition is in the public interest and for the protection of investors.

17. To help ensure that customers understand these predispute arbitration agreements, FINRA Rule 2268 sets forth requirements that apply when firms use them. These requirements include that any predispute arbitration clause must be highlighted in the agreement and immediately preceded by disclosures that the agreement contains such a clause and that describe the consequences of agreeing to arbitration.
18. See FINRA Rule 12200 of the Code of Arbitration Procedure for Customer Disputes ("Customer Code").
19. See FINRA Rules 2268 and 12204.
20. The top controversy types in customer arbitrations include breach of fiduciary duty, negligence, misrepresentation, failure to supervise, suitability, omission of facts, and fraud. See <https://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics#top15controversycustomers>. A single arbitration case may include multiple controversy types.
21. In June 2000, the United States Government Accountability Office (GAO) issued a report expressing concern about unpaid arbitration awards. See GAO Report to Congressional Requesters, *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*, June 2000, available at <https://www.gao.gov/assets/160/156962.pdf>. The GAO recommended that the Chairman of the SEC: (1) require FINRA to adopt procedures for monitoring the payment of arbitration awards, including requesting the parties in an arbitration to notify FINRA by the end of the 30-day payment period about the payment status of any monetary award, so that FINRA can begin timely suspension proceedings against non-paying broker-dealers; (2) require FINRA to develop procedures to address the problem of unpaid awards caused by failed broker-dealers to help reduce costs and increase options for investors; (3) work with SROs to develop and publicize information to focus investor attention on the possibility of unpaid awards and encourage investors to more thoroughly evaluate the backgrounds of broker-dealers and individual brokers with whom they intend to do business; and (4) examine periodically the extent of non-payment of SRO arbitration awards to determine the effectiveness of action taken to improve the payment of awards. In addition, the GAO recommended that to the extent unpaid awards remain a problem, the Chairman should establish a process to assess the feasibility of alternative approaches to addressing the problem. See *id.*, p. 9.

In September 2000, in response to the recommendations in the GAO report, the SEC requested that FINRA provide it with periodic information concerning unpaid arbitration awards. Since then, FINRA has tracked unpaid arbitration awards at the FINRA forum and submitted annual reports to the SEC.

22. The data on the website will be updated periodically and, therefore, over time may differ from the data presented in this Paper. For example, the 2016 data will be updated to reflect the outcome of two currently pending judicial motions to vacate awards totaling \$1.4 million. *See infra* note 23.
23. Under FINRA's Customer Code, FINRA arbitration awards are considered final and not subject to review or appeal through FINRA. However, parties have the right under federal and state law to challenge the award by filing a motion to vacate the arbitration award in a court of competent jurisdiction. The grounds for vacating an arbitration award are extremely limited, and motions to vacate are rarely successful. If a motion to vacate is successful, the underlying award is invalidated and there is no payment obligation. If a motion to vacate is denied, the award stands and the payment obligation is revived. While a motion to vacate is pending, the award payment obligation is stayed and the award is therefore not classified as unpaid. The figures provided for 2016 do not include awards in two customer cases totaling \$1.4 million because there are pending judicial motions to vacate those awards.
24. During 2012 – 2016, there were five “mid-size” firms (as defined by FINRA By-Laws) with unpaid customer arbitration awards. *See* Article I of the FINRA By-Laws (defining a “mid-size” firm to mean any member firm with at least 151 and no more than 499 registered persons).
25. *See* FINRA Rule 12603.
26. *See* FINRA Rule 12801. The arbitrator may not issue an award based solely on the nonappearance of a party. Claimants must present a sufficient basis to support the making of an award. The arbitrator may not award damages in an amount greater than the damages requested in the statement of claim, and may not award any other relief that was not requested in the statement of claim. *See id.*
27. FINRA has not been able to obtain data about court awards to determine how the payment levels for awards at the FINRA arbitration forum compare to the payment levels for awards received in court proceedings in general.
28. *See infra* note 29.
29. *See* FINRA Rule 12904(j). An associated person or firm has four available defenses to FINRA disciplinary measures for non-payment in customer cases: (1) the firm or associated person paid the award in full; (2) the parties have agreed to installment payments or have otherwise settled the matter; (3) the firm or associated person has filed a timely motion to vacate or modify the award and such motion has not been denied; and (4) the firm or associated person has filed a petition in bankruptcy and the bankruptcy proceeding is pending or the award has been discharged by the bankruptcy court. *See Notice to Members 00-55* (August 2000).

In July 2010, FINRA eliminated the “bona fide inability to pay” defense in the expedited suspension proceedings it initiates when a firm or associated person fails to pay an arbitration award to a customer. *See Regulatory Notice 10-31* (June 2010).

Until this change became effective, if a respondent demonstrated a financial inability to pay the award—regardless of the reason—FINRA was limited in its ability to use a potential suspension of membership to incentivize payment. When FINRA's efforts to suspend a respondent who had not paid an award were not successful, a claimant was much less likely to be paid.

30. *See* FINRA Rule 9554(a).
31. *See supra* note 29.
32. FINRA can also institute expedited suspension proceedings against formerly associated persons for failing to pay an award or settlement for a period of two years after the award was rendered or the settlement agreement was entered into. *See* Article V, Section 4(b) of the FINRA By-Laws; *Notice to Members 04-57* (August 2004). During 2016, FINRA instituted expedited suspension proceedings against 46 formerly associated persons in connection with 32 customer awards. As a result, five individuals paid the award or reached a post-award settlement with the customer, and 37 individuals were suspended for non-payment. FINRA was unable to locate four individuals. Some awards cases involved several formerly associated persons, resulting in more suspensions than number of awards.
33. As a result of the expedited suspension proceedings, eight firms paid the award or reached a post-award settlement with the customer and seven individuals paid the award or reached a post-award settlement with the customer. One firm was suspended and four individuals filed for bankruptcy.
34. With respect to new member firms, in accordance with the standards for admission under the rules governing FINRA's Membership Application Program, FINRA can presumptively deny a new membership application if the applicant or its associated persons are subject to an unpaid arbitration award. *See* NASD Rule 1014(a).
35. *See* SEC, Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, at 134, January 2011, available at <https://www.sec.gov/news/studies/2011/913studyfinal.pdf> (“FINRA may suspend or cancel the membership of any member, or suspend any associated or formerly associated person from association with any member, for failure to comply with an arbitration award or with a written and executed settlement agreement obtained in connection with an arbitration or mediation. Investment advisers are not subject to such sanctions, and legislation might be required for the Commission to impose them.”)
36. Some associated persons who failed to pay arbitration awards in 2015 and 2016, for example, were suspended from being associated with a FINRA member, but continue to be registered as investment advisers.
37. *See* FINRA Rule 12202. Typically, the inactive firm will not appear, resulting in the arbitrators basing their ruling on the customer's presentation of the conduct and harm.
38. 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.

39. 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.
40. Because both a firm and an individual who was associated with the firm may be inactive at the time a claim is brought, figures for firms and individuals may overlap.
41. See FINRA Rule 12801.
42. If a firm or individual files for bankruptcy after a claim is filed, but before an award is rendered, the arbitration proceeding will be stayed as to that firm or individual. If a firm or individual files for bankruptcy prior to a claim being filed, there would not be an arbitration proceeding involving that firm or individual.
43. The "automatic stay" under the Bankruptcy Code generally stays any action to collect a debt owed by a person that has filed a bankruptcy petition (or become the subject of a liquidation under the Securities Investor Protection Act (SIPA)). However, in the unusual circumstance where a bankruptcy court determines an arbitration award not to be dischargeable in the bankruptcy (or SIPA liquidation), and the customer claimant notifies FINRA of this fact, FINRA will commence expedited suspension proceedings against the firm or individual under FINRA Rule 9554.

Creditors with claims allowed by the bankruptcy court generally are entitled to receive distributions or payments on their claims from the liquidation of the bankrupt person's assets (or under a plan approved by the court in the case of a bankruptcy under Chapter 11 or 13 of the Bankruptcy Code). Although these payments may be considerably less than the amount of the claim (and may even be zero), they nevertheless generally discharge the claim. Customers with arbitration awards against a firm or associated person that has entered bankruptcy therefore may receive only a fraction of their award, or even nothing, when that award is discharged in bankruptcy.

While SIPC protects customers' claims for funds and securities entrusted to their broker even if the broker is in bankruptcy, SIPC does not protect customers' unpaid arbitration awards unless they are for the return of such funds or securities (e.g., claims for theft of such funds or securities or claims arising out of unauthorized trading).

44. See *Regulatory Notice 17-33* (October 2017).
45. As discussed above, FINRA suspends individuals for non-payment of a customer arbitration award. Among other things, the proposed amendments could provide disclosure where an individual has a defense to non-payment, such as bankruptcy, or where an individual does not have a defense to non-payment, but has not yet been suspended by FINRA. In addition, making this information publicly available could lead to a decrease in unpaid customer arbitration awards as customers may determine not to invest with firms whose associated persons have these disclosures.
46. An introducing firm may also opt out of the requirement to hold capital equal to six and two thirds percent of its aggregate indebtedness by increasing its minimum net capital to \$250,000.

47. SIPC also has a \$2.5 billion line of credit with the U.S. Treasury that SIPC may access if its fund is insufficient.
48. Claims with respect to cash in a customers' account are only protected up to \$250,000.
49. These issues include, for example, the incentives created by, and implications of, such a regime on the behavior of customers, firms and individual brokers; whether increases in SIPC assessments payable by firms would be required; whether the existing caps on SIPC protection would be appropriate; and whether it is appropriate for certain firms (e.g., those that are larger, better capitalized, or have stronger compliance programs) to effectively subsidize other firms that do not pay their arbitration awards.
50. If operated by FINRA, steps would also need to be taken to ensure that such a fund does not compromise FINRA's tax-exempt status.
51. These issues include, for example, the scope of claims covered by the second fund (e.g., whether it would cover only awards from the FINRA forum, or also unpaid awards from non-FINRA forums, or court awards); how the claims process for such a fund would interact with the established SIPC claims process and liquidation proceedings in the case of a firm that is the subject of a SIPC liquidation (e.g., would a claim first be filed in the SIPC liquidation and, only after it is allowed but deemed ineligible for SIPC protection, filed in the forum for the second fund); whether the creation of such a fund would be consistent with Congress' rationale for limiting the scope of claims eligible for SIPC protection; the appropriate caps on payouts by the second fund; whether, like SIPC, the second fund would have access to federal funding as a backstop; how to handle awards arising from uncontested arbitration claims; who would determine the validity of claims made against the fund and otherwise administer the fund; and the distribution of funding costs across the financial industry.
52. Any establishment or operation of such a fund by FINRA could also raise questions regarding FINRA's continued impartiality in operating the arbitration forum.
53. As discussed above, FINRA suspends member firms for non-payment of a customer arbitration award. Among other things, proposed amendments to Form BD could include providing disclosure where a firm has a defense to non-payment, such as bankruptcy, or where a firm does not have a defense to non-payment, but has not yet been suspended by FINRA.
54. Changes to the "statutory disqualification" definition and Bankruptcy Code (as discussed below) could also affect other financial industry professionals providing advice to customers, such as investment advisers.
55. The FINRA By-Laws provide that no person shall be admitted to or continued in membership if it becomes subject to a disqualification; and that no person shall be associated with a member, continue to be associated with a member, or transfer association to another member if such person is or becomes subject to disqualification. FINRA's authority to deny registration or membership of disqualified persons or members is set forth in Exchange Act Section 15A(g)(2). Article III, Section 4 of the FINRA By-Laws states that a person is subject to a "disqualification" with respect to membership, or association with a member, if such person is subject to any "statutory disqualification" as such term is defined in Exchange Act Section 3(a)(39).

56. As discussed in Section III.A. above, FINRA can suspend a firm's membership or suspend an individual from associating with a member if the firm or individual fails to comply with an arbitration award or a settlement agreement related to arbitration. However, bankruptcy is a defense to such non-payment. *See supra* note 29.
57. There are some limited exceptions to discharge, but most arbitration awards do not fall into these exceptions, and even if they do, the process to obtain an exception is cumbersome and expensive for a customer.

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