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February 11, 2020

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

**RE: File No. SR-FINRA-2019-027 (Proposed Rule Change to Amend
FINRA Rule 12000 Series to Expand Options Available to
Customers if a Firm or Associated Person is or Becomes
Inactive)**

Dear Ms. Countryman:

This letter responds to comments received by the Securities and Exchange Commission (“SEC” or “Commission”) to the above-referenced rule filing related to proposed amendments to the Code of Arbitration Procedure for Customer Disputes (“Code”) to expand a customer’s options to withdraw an arbitration claim if a member or an associated person becomes inactive before a claim is filed or during a pending arbitration.¹ In addition, the proposed amendments would allow customers to amend pleadings, postpone hearings, request default proceedings and receive a refund of filing fees in these situations.

The Commission published the proposed rule change for comment in the *Federal Register* on November 22, 2019 and received five comments in response to the rule filing.² Four of the commenters expressed general support for the proposed

¹ See Securities Exchange Act Release No. 87557 (November 18, 2019), 84 FR 64581 (November 22, 2019) (Notice of Filing of File No. SR-FINRA-2019-027).

² See Letter from Steven B. Caruso, Maddox Hargett & Caruso, P.C., to Vanessa Countryman, Secretary, SEC, November 19, 2019 (“Caruso”); letter from Benjamin P. Edwards, Associate Professor of Law, University of Nevada, Las Vegas, to Jill M. Peterson, Assistant Secretary, SEC, December 11, 2019 (“Edwards”); letter from Kevin Carroll, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, to Vanessa Countryman, Secretary, SEC, December 12, 2019 (“SIFMA”); letter from Samuel B. Edwards, President, Public Investors Arbitration Bar

rule change,³ but some of these commenters also raised concerns or suggested modifications to the proposed rule change.⁴ Edwards opposed the proposed rule change.⁵ The following are FINRA's responses to the concerns and suggestions raised by the commenters.

Preserve Existing Motion Requirement for Adding a Party or Amending a Pleading

Under the proposed rule change, if FINRA notifies a customer that a member or associated person has become inactive, the customer may amend its pleading to add a claim or new party without prior approval by a panel. FSI expressed concern that if the amended pleading to add a party occurs after panel appointment, a newly-added party would not be able to participate in the arbitration panel selection process. FSI stated that all claimants and respondents should be afforded the opportunity to participate in the arbitration panel selection process, and respondents should be afforded the opportunity to object to being added. In its view, the proposed rule change "should not eliminate the existing motion requirement for adding a party or amending a pleading."

Participation in Panel Selection Process

Currently, Rule 12309 permits a party to amend a pleading at any time before the panel is appointed.⁶ Once a panel is appointed, a party may only amend a pleading if the panel grants a motion to amend.⁷ If a panel grants a motion to amend a pleading to add a new party, the party to be added does not get to participate in the panel selection process.⁸ The proposed amendments would not change who gets to participate in the panel selection process under the current rules. As stated in the rule

Association, to Jill M. Peterson, Assistant Secretary, SEC, December 13, 2019 ("PIABA"); and letter from Robin M. Traxler, Senior Vice President, Policy & Deputy General Counsel, Financial Services Institute, to Vanessa Countryman, Secretary, SEC, December 13, 2019 ("FSI").

³ See Caruso, SIFMA, PIABA, and FSI.

⁴ See SIFMA, PIABA, and FSI.

⁵ See Edwards (stating that the proposed rule change is an example of "illusory rulemaking activity").

⁶ See FINRA Rule 12309(a).

⁷ See FINRA Rules 12309(b) and (c).

⁸ See generally Part IV of the Code (Appointment, Disqualification, and Authority of Arbitrators). See also Arbitrator Selection, <http://www.finra.org/arbitration-and-mediation/arbitrator-selection>.

filing, in this scenario, FINRA would provide the arbitrator disclosure reports⁹ of the sitting panelists to the parties and permit the parties to raise any conflicts they find with the panel.¹⁰ If a party discovers a conflict, the party may file a motion to recuse the arbitrator.¹¹ The arbitrator who is the subject of the motion to recuse would consider whether to withdraw¹² from the case and rule on the motion.¹³ The party may also request removal of the arbitrator by the Director, under certain circumstances.¹⁴

⁹ An arbitrator disclosure report is a summary of the arbitrator's background and is provided to the parties to help them make informed decisions during the arbitrator selection process.

¹⁰ Arbitrators must make a reasonable effort to learn of, and must disclose to the Director, any circumstances which might preclude the arbitrator from rendering an objective and impartial determination in the proceeding, including, for example, any existing or past financial, business, professional, family, social, or other relationships or circumstances with any party, any party's representative, or anyone who the arbitrator is told may be a witness in the proceeding, that are likely to affect impartiality or might reasonably create an appearance of partiality or bias. See FINRA Rule 12405(a). The duty to disclose any relationship, experience and background information that may affect, or even appear to affect, the arbitrator's ability to be impartial and the parties' belief that the arbitrator will be able to render a fair decision, is an ongoing duty. See FINRA Rule 12405(b). Thus, if a party is added under proposed FINRA Rule 12309(c)(2), the panelists must update their disclosures or review them to ensure that further updates are not warranted.

¹¹ See FINRA Rule 12406.

¹² The Code of Ethics for Arbitrators in Commercial Disputes ("Canon of Ethics") applies to arbitrators on FINRA's arbitrator rosters. See Canon of Ethics, <http://www.finra.org/arbitration-and-mediation/code-ethics-arbitrators-commercial-disputes>. Canon II provides additional guidance to arbitrators when requested to withdraw by fewer than all of the parties. See Canon II (An Arbitrator Should Disclose Any Interest Or Relationship Likely To Affect Impartiality Or Which Might Create An Appearance Of Partiality), Section G.

¹³ See FINRA Rule 12406.

¹⁴ Before the first hearing session begins, the Director will grant a party's request to remove an arbitrator if it is reasonable to infer, based on information known at the time of the request, that the arbitrator is biased, lacks impartiality, or has a direct or indirect interest in the outcome of the arbitration. The interest or bias must be definite and capable of reasonable demonstration, rather than remote or speculative. See FINRA Rule 12407(a)(1). After the first hearing session begins, the Director may remove an arbitrator based only on

Ability to Respond to Amended Pleading

As FSI noted, under the proposed amendments, because a customer would not have to file a motion to amend a pleading after panel appointment if the customer is notified that a respondent member firm or associated person has become inactive, the party to be added would not be able to respond to such a motion prior to being added as a party. FINRA notes, however, that the proposed amendments would not change the current ability in Rule 12309(d) for a party, whether existing or newly-added, to respond to an amended pleading after it is filed by filing an answer and raising any available defenses.¹⁵ Thus, under the proposed amendments, a newly added party would be able to respond to a pleading that adds it as a party. In addition, FINRA believes that it is appropriate to remove the requirement that a customer file a motion to amend a pleading after panel appointment if a respondent member firm or associated person has become inactive to help avoid additional costs and delay to the customer.

Expand the Proposal to Intra-Industry Cases

SIFMA requested that FINRA expand the proposed rule change to intra-industry cases (*i.e.*, disputes between or among members and associated persons).¹⁶ SIFMA stated that unpaid arbitration awards result from both customer and intra-industry cases and, therefore, “the same arguments that FINRA makes in favor of expanding the options available to a customer claimant when dealing with inactive firms and associated persons apply equally to industry claimants.”

As stated in the rule filing, although FINRA acknowledges SIFMA’s concerns, at this time FINRA has decided to apply the proposed amendments to customer cases only because providing customers with more control over the arbitration process when faced with a respondent that likely will not be able to pay an award furthers FINRA’s goal of investor protection.

Other Concerns

PIABA stated that the proposed amendments are insufficient to remedy unpaid arbitration awards because it does not address a “major problem faced by victims of thinly capitalized broker-dealer firms: the judgments against them are often rendered

information required to be disclosed under Rule 12405 that was not previously known by the parties. See FINRA Rule 12407(b).

¹⁵ See FINRA Rule 12303(a).

¹⁶ See FINRA Rule 13000 Series.

valueless.”¹⁷ As such, PIABA concluded that FINRA should create and administer a national investor recovery pool.

The proposed rule change is intended to expand the options available to a customer when dealing with those members or associated persons that are inactive at the time a claim is filed or become inactive during a pending arbitration. The proposed rule change is one of the ways FINRA is proceeding to implement additional steps to strengthen its rules relating to the important but complex topic of customer recovery.¹⁸

In addition, FINRA notes that to help encourage a continued dialogue about addressing the challenges of customer recovery across the financial services industry while directly informing the further enhancement of recovery in FINRA’s forum, FINRA issued a White Paper and additional data regarding the circumstances under which awards may be unpaid, along with a discussion of potential regulatory and legislative responses.¹⁹ Although PIABA’s suggestion regarding a national investor

¹⁷ See also FSI (stating that the proposed amendments do not directly address the issue of unpaid arbitration awards) and Edwards (stating that the proposed rule change does not do enough to address unpaid arbitration awards).

¹⁸ In a separate rule filing, FINRA is proposing amendments to its Membership Application Program (“MAP”) rules designed to create further incentives for the timely payment of awards. This rule change would prevent a member firm with substantial arbitration claims from avoiding 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 or owners, to another firm and closing down. The proposed rule change would also address situations in which member firms are considering hiring individuals with pending arbitration claims where there are concerns about payment of those claims should they go to award or result in a settlement, as well as concerns about the adequacy of the supervision of those individuals by the hiring member firm. See Securities Exchange Act Release No. 87810 (December 20, 2019), 84 FR 72088 (December 30, 2019) (Notice of Filing of File No. SR-FINRA-2019-030).

¹⁹ See FINRA’s White Paper entitled *FINRA Perspectives on Customer Recovery*, https://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf. To provide additional transparency about the FINRA arbitration forum and better inform discussions regarding customer recovery, FINRA also makes available additional data on unpaid arbitration awards arising in the forum for the past five years. This data is available on the FINRA website. See <https://www.finra.org/arbitration-mediation/statistics-unpaid-customer-awards-finra-arbitration>. In addition, FINRA has published a list of firms and associated persons responsible for unpaid arbitration awards. See

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recovery pool is outside the scope of this proposal, FINRA welcomes continued engagement to discuss further ways to enhance customer recovery.

* * * *

FINRA believes that the foregoing responds to the commenters to the rule filing. If you have any questions, please contact me on 202-728-8151, email: Mignon.McLemore@finra.org.

Sincerely,

/MM/

Mignon McLemore
Assistant General Counsel
Office of General Counsel

<https://www.finra.org/arbitration-mediation/member-firms-and-associated-persons-unpaid-customer-arbitration-awards>. This information also appears on a firm's or individual's BrokerCheck[®] record.