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April 9, 2018

Via E-Mail (pubcom@finra.org)

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-06 (Proposed Amendments to Membership Application Program to Incentivize Payment of Arbitration Awards)

Dear Ms. Mitchell,

The Cornell Securities Law Clinic (the “Clinic”) submits this comment to support the proposed amendments (“Proposed Amendments”) to the Financial Industry Regulatory Authority (“FINRA”) Membership Application Program (“MAP”) Rules. The Clinic is a Cornell Law School curricular offering in which law students provide representation to public investors and public education as to investment fraud in the largely rural “Southern Tier” region of upstate New York. For more information, please see: <http://securities.lawschool.cornell.edu>.

The Clinic supports the Proposed Amendments as an important part of an overall scheme to curb the problem of unpaid investor arbitration awards.

The Proposed Amendments create incentives for the timely payment of arbitration awards. Creating incentives to pay arbitration awards is important because investors typically are compelled to arbitrate by FINRA member firms. Data collected by FINRA between 2012 and 2016 shows that approximately 30% of cases in which the investor was awarded damages went unpaid.¹ Over the five-year period the aggregate unpaid amount was \$199 million with an additional \$1.4 million in dispute at the time of publishing.²

If adopted, the Proposed Amendments would impose supervisory review obligations on firms with regard to representatives with pending investment-related arbitration claims (“Covered Pending Arbitration Claim”) and prevent FINRA member firms with Covered Pending Arbitration Claims from shifting assets in customer accounts, managers or owners to

¹ FINRA, Statistics on Unpaid Customer Awards in FINRA Arbitration, (Feb. 2018), <https://www.finra.org/arbitration-and-mediation/statistics-unpaid-customer-awards-finra-arbitration>.

² *Id.*



another firm then closing down. As such, the Proposed Amendments advance investor protection.

I. We Support the Proposed Amendment to Rules 1014(a) and (b)

The proposed amendments to Rules 1014(a) and (b) will create a rebuttable presumption of denial of a New Member Application (“NMA”) if there is an unpaid arbitration award, unpaid arbitration settlement, pending arbitration claims³ or other unpaid customer settlement on the part of the applicant, its control persons, principals, registered representatives, other associated persons (“Associated Persons”), any lender of five percent or more of the applicant’s net capital and any other member with respect to which these persons were a control person or a five percent lender of net capital for an NMA. This is a welcome addition to the rules because it will likely incentivize potential members and Associated Persons to pay off these obligations knowing that failure to do so will result in presumptive denial of the NMA.

This proposed amendment is also efficient because the presumption of denial does not apply to member firms which are required to file a Continuing Membership Application (“CMA”), since the CMA collects all of the information necessary for FINRA to determine whether the member firm or its Associated Persons are likely to pay their covered pending arbitration claims.⁴ This will likely have a balancing effect of not in itself chilling business expansion activity for member firms with an obligation to report.

Finally, this proposed amendment will allow new member applicants to overcome the presumption by demonstrating that they can pay covered pending arbitration claims via insurance coverage, an escrow account, a clearing deposit, a guarantee, a reserve fund, or the retention of proceeds from an asset transfer, or such other forms that FINRA’s Department of Member Regulation (“the Department”) may determine to be acceptable. These provisions balance any negative effects by not punishing new member applicants with legitimate plans of paying the claims against them should such claims result in arbitration awards.

II. We Support the Proposed Addition of the Business Expansion for Members Rule

This proposed amendment imposes an extra level of review when a member firm that is not required to file a CMA tries to effect a business expansion that involves adding one or more associated persons with a covered pending arbitration claim, unpaid arbitration award or unpaid settlement related to an arbitration, by making the member first seek a materiality consultation

³ The Regulatory Notice uses the term “pending arbitration claim” instead of “covered pending arbitration claim” to describe what is prohibited in this section. The Clinic assumes that “pending arbitration claim” is used to refer to the same concept as “covered pending arbitration claim” elsewhere. If FINRA aims to have “pending arbitration claim” refer to a broader concept than “covered pending arbitration claim” it should make that clear.

⁴ See FINRA, Continuing Membership Guide – CMA Requirements, <http://www.finra.org/industry/continuing-membership-guide-cma-requirements-0315>.



with the Department and requiring the Department to find that the member may effect the contemplated business expansion without a CMA (“Business Expansion for Members”).

The proposed addition of the Business Expansion for Members Rule will likely incentivize members to investigate the covered pending arbitration claims and unpaid awards of new hires, since the proposed amendment will require that the Member have a net capital large enough to cover the individual’s covered pending arbitration awards, unpaid arbitration awards and unpaid settlement amounts. The proposed amendment will assess whether the member firm’s net capital can cover that individual’s covered pending arbitration claims. Thus, it is foreseeable that individuals with large aggregate covered pending claim amounts and unpaid arbitration awards will, at a minimum, be subject to increased supervision and review.

One possible negative effect of this addition may be that individuals with large aggregate unpaid awards and covered pending arbitration claims will be attracted to brokerage firms with large net capitals and those individuals may be attractive to brokerage firms with large net capitals. This may create a situation where some well-capitalized firms have a concentration of individuals with substantial unpaid awards or covered pending arbitration claims.

Another downside is that the proposed addition does not directly prohibit the member firm from conducting a Business Expansion while having covered pending arbitration claims — it merely imposes an extra level of review. While it is certainly helpful to have a Department determination of whether a firm’s proposed Business Expansion is material and a pronouncement that the firm must file a CMA to remain in non-violation of the FINRA Rules, FINRA should consider including a more affirmative prohibitive mechanism in the rule’s language. For example, appropriate language to the effect that failure to file a CMA within 30 days upon a finding of materiality will result in an imposition of fines or suspension.

III. We Support the Proposed Amendments to the Business Expansion for Asset Transfer Rule

This proposed amendment will prevent member firms who are not already required to submit a CMA from effectuating the direct or indirect transfer or acquisition of assets, businesses or lines of operation without seeking a materiality consultation. This proposed amendment will likely effectively address the problem of member firms attempting to dodge liability for covered pending arbitration claims or unpaid arbitration awards by forcing member firms to alert FINRA on both the acquisition and transfer front.

IV. We Support the Proposed Amendments to the New Member Notification Rule and Business Expansion Notification Rule.

This proposed amendment will likely make it easier for FINRA to effectively monitor when pending arbitration claims⁵ are filed, or awards become unpaid during the time that FINRA

⁵ See Footnote 3, above.



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is deciding on the new member's application or the member firm's proposed business expansion activities.

Conclusion

For the foregoing reasons the Clinic supports the Proposed Amendments.

Respectfully submitted,

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