UNLV | WILLIAM S. BOYD SCHOOL OF LAW

April 9, 2018

By email to pubcom@finra.org
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K. Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-06
Membership Application Program

Dear Ms. Mitchell:

On behalf of the Investor Protection Clinic ("Clinic") at the William S. Boyd School of Law at the University of Nevada, Las Vegas, I write to comment on FINRA Regulatory Notice 18-06. Our Clinic represents investors who suffered losses because of unsuitable financial advice, and provides pro bono assistance to investors who cannot secure private legal representation because of the size of their claims. Our Clinic's clients have a direct interest in the rules promulgated by the Financial Industry Regulatory Authority ("FINRA").

Thank you for the chance to comment on proposed changes to FINRA's rules governing its Membership Application Program. Below are our Clinic's comments on two of the questions.

Request for Comment No. 1. *Should FINRA consider proposing to apply a presumption of denial in connection with pending arbitration claims and CMAs? If so, under what circumstances?*

FINRA should presumptively deny Continuing Membership Applications (CMAs) from member firms that face pending arbitration claims.[1] This

[1] Under FINRA's rules, the member firm that must file a CMA after a merger or acquisition depends on the specific transaction. For example, if one firm faces an acquisition or merger with another firm, both firms may have to file a CMA because FINRA Rule 1017(a)(3) requires any member firm to file a CMA application for "direct or indirect acquisitions or transfers of 25% or more in the aggregate of the member's assets or any asset." By contrast, if one large firm transfers a relatively small portion of its assets, but those assets go to a much smaller firm, then under FINRA Rule 1011(k) it is likely

presumption should only apply, however, in the limited circumstance of a "covered pending arbitration claim" as defined in Regulatory Notice 18-06—meaning, where there is: "(1) an investment-related, consumer-initiated claim filed against the associated person that is unresolved; and (2) whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital." [2]

A presumption of denial in that specific circumstance would limit member firms' ability to dissipate their assets to escape liability. By some reports, this happens quite often. For example, one experienced securities lawyer recently explained that "[t]here's literally a playbook that owners of brokerage firms follow to shield their assets when things go wrong."[3]

Additionally, FINRA should consider proposing a rule to protect investors when FINRA members try to convert themselves into another area of the securities industry while facing covered pending arbitration claims or outstanding unpaid arbitration awards. Section 2 of this Response to Request for Comment No. 1 discusses the need for FINRA to propose this rule.

1. FINRA SHOULD CREATE A PRESUMPTION OF DENIAL FOR CMAS WITH COVERED PENDING ARBITRATION CLAIMS.

From January 2015 to December 2016, FINRA staff received 35 CMAs that involved a pending arbitration claim or unpaid arbitration award.[4] Of those 35 CMAs, only "*seven member firms* reported excess net capital greater than the total compensatory damages that customers requested."[5] In other words, twenty-eight of the thirty-five member firms did not have enough assets to satisfy the arbitration claims that they faced, yet these firms still sought to reorganize or transfer their firms' assets.

This statistic seems puzzling. Why do so many firms frequently reorganize or transfer their assets when they face crushing liability? The answer is likely simple: current legal principles of successor-in-interest liability favor firm

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that only the smaller firm would have to file a CMA, because only that smaller firm underwent a "material change" in business operations by receiving those assets.

[2] *See* FINRA Regulatory Notice 18-06, *Membership Application Program* 13, www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-06.pdf (last visited Feb. 22, 2018) (defining a "covered pending arbitration").

[3] Andrew Osterland, *Wronged Investors Win Cases over Brokers but Never Collect*, CNBC (Mar. 7, 2016, 7:59 AM), https://www.cnbc.com/2016/03/07/wronged-investors-win-cases-over-brokers-but-never-collect.html (quoting Andrew Stoltmann, a Chicago-based securities lawyer).

[4] FINRA Regulatory Notice 18-06, *supra* note 1, at 11.

[5] *Id.* at 11 n.10 (emphasis added).

reorganization when there are pending claims or awards. [6] Put differently, when one member firm transfers or sells its assets to another firm, the firm that receives those assets can potentially disclaim the other firm's liability from pending arbitrations.[7] These successor-in-interest principles exist because the firm that receives another firm's assets generally does not gain the previous member firm's "customers" in the legal liability sense. Instead, the liability from customers of the selling/transferring firm likely remains legally with that original member firm.[8] Further, when those sales/transfers occur, *courts* generally control an arbitrator's power to award damages for pre-transfer liabilities, not FINRA arbitrators.[9] So, investors with the initial member firm are often left without a full remedy in FINRA's arbitration process due to that initial firm's insolvency or a discharge of owed funds through, for example, bankruptcy.[10]

Unfortunately, FINRA rules have not eliminated its members' ability to dissipate assets. In fact, the central FINRA rule on CMA requirements, Rule 1014(a), now only looks at pending arbitration claims as one factor in many to grant or deny an application.[11] Further, no single factor presumptively controls FINRA's decision; nor does any factor weigh heavier than others. This means that if one firm has a covered pending arbitration claim, yet still applied for a CMA, FINRA could nonetheless grant that firm's CMA. FINRA would do so by

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[6] Courts generally impose successor-in-interest liability only if: (1) the purchaser agreed to assume the debt, (2) there was a de facto merger of the two corporations, (3) the purchaser was a mere continuation of the seller, or (4) the transaction was fraudulent. *See* Wheat, First Sec., Inc. v. Green, 993 F.2d 814, 821 (11th Cir. 1993); Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415, 425 n. 56 (2003).

[7] *See* Black, *supra* note 6, at 426 (discussing a prominent federal court case, which found that, in some circumstances, "it would be unfair to require the purchaser to arbitrate claims against someone who was never its customer").

[8] The previous court decisions that created this legal "customer" distinction relied on the NASD Rule 10301 definition of "customer," which is now superseded by FINRA rules. These cases are still relevant to this discussion, however, because the same definition of "customer" exists under current FINRA rules. *See* FINRA Rule 12100 ("A customer shall not include a broker or dealer."). Likewise, court rulings differ over whether "customer" includes investors who were part of a firm that existed prior to a merger or asset sale. *See Who is a "Customer,"* THE GUILIANO LAW FIRM, P.C., https://securitiesarbitrations.com/who-is-a-customer/ (last visited Feb. 21, 2018) (discussing the several federal circuit court cases on this topic).

[9] *See Wheat, First Sec., Inc.*, 993 F.2d at 820 (enjoining the arbitrator from hearing claims prior to the transfer of the account, but allowing arbitration of the post-transfer claims).

[10] *See* Hugh D. Berkson, *Unpaid Arbitration Awards: A Problem the Industry Creates—A Problem the Industry Must Fix*, PUB. INV. ARB. B. ASS'N 4 (Feb. 25, 2016), https://piaba.org/piaba-newsroom/report-unpaid-arbitration-awards-problem-industry-created-problem-industry-must-fix (discussing generally the outcomes of bankruptcy with member firms).

[11] *See* FINRA Rule 1014(a) (stating that FINRA can consider a request for CMA by looking to several factors alongside pending arbitration claims including, but not limited to: whether the application and all supporting documents are complete and accurate; whether the applicant can comply with federal securities laws; and if the applicant poses a threat to public investors).

finding that other factors outweighed the covered pending arbitration claims' potential for harm to investors.

FINRA can solve this issue, however, by implementing a presumption of denial for CMAs involving covered pending arbitration claims. This presumption could eliminate the potential for member firms to escape liability because it would condition FINRA's grant of a CMA on firms' ability to satisfy any pending arbitration claim. That is, firms could only overcome this presumption by executing an escrow agreement, insurance coverage, a clearing deposit, a guarantee, a reserve fund, the retention of proceeds from an asset transfer, or such other methods that FINRA may determine to be acceptable—the same circumstances that FINRA currently wishes to use based on its proposal in Regulatory Notice 18-06 for New Membership Applications. Consequently, the successor-in-interest scheme would be impractical, because a firm would need to prove that it would pay any arbitration award before its firm underwent any transfers or sales of assets to escape paying damages.

Additionally, a presumption of denial for CMAs from firms facing covered pending arbitrations would align with FINRA's current rules, and, at the same time, improve the accountability of the securities industry. FINRA already uses a presumption of denial for CMAs when the "applicant, its control persons, principals, registered representatives . . . [are] subject to unpaid arbitration awards, other adjudicated customer awards or unpaid arbitration settlements."[12] By expanding these current principles to covered pending arbitration claims, FINRA would only marginally extend its current presumption-of-denial procedures. Likewise, investors who know that they are more likely to be paid in the event of wrongdoing have an added incentive to participate in the industry.[13]

A. Responses to FINRA's Concerns in Regulatory Notice 18-06

This Comment's proposed solution satisfies FINRA's central concerns about a presumption of denial in CMAs for firms that face covered pending arbitration claims. Specifically, FINRA's central concerns are: (1) member firms would incur costs to demonstrate their ability to satisfy the claims, as well as the opportunity costs associated with setting aside funds that could otherwise be used for other business opportunities; and (2) customers may have a new incentive to file an arbitration claim for the sole purpose of disrupting a contemplated transaction,

[12] FINRA Rule 1014(a)(3)(C).

[13] *See* Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 YALE L. REV. 963, 971 (2012) (discussing FINRA duties to "protect investors and the integrity of the market").

which would increase the number of member firms required to seek a materiality consultation to file a CMA.[14]

Though the first worry may still exist under this Comment's solution, the costs to member firms would be minimal because only member firms that have *covered pending arbitration claims* are affected. All other pending arbitration claims would not suffer any additional costs from a more burdensome procedure. Also, as to FINRA's second concern, customers that are represented by counsel may not file an arbitration claim without any basis for their damages allegations.[15] So, they could not know with certainty that their claim would be a "covered" claim.

Naturally, this Comment's proposed solution may have some adverse industry impact. For instance, a presumption of denial in the CMA context could slow the growth and expansion of member firms in the broker-dealer industry. That is, if the presumption of denial reduces the number of CMAs that FINRA grants, then other firms could not buy or receive the denied firm's assets; nor could other firms merge with the denied firm to expand their practice. But FINRA should not consider this slowed-growth effect as undesirable. Instead, as further explained below, this outcome benefits the industry because it prevents brokers with a record for misconduct from joining and concentrating within other firms with a record for misconduct.

B. Advantages of this Comment's Proposed Solution

A recent study by Mark Egan, Gregor Matvos, and Amit Seru found that "[associated persons] with misconduct switch to firms that employ more [associated persons] with past misconduct records."[16] The explanation for this phenomenon is that firms with already poor misconduct records have a higher tolerance for misconduct, and are less likely to discipline their associated persons through termination or strong action—thus attracting other associated persons who are more likely to engage in future wrongdoing.[17]

This dynamic creates member firms with higher-than-normal misconduct records. As an example of this current concentration, consider Oppenheimer & Co., Wells Fargo Advisors Financial Network, and First Allied Securities—

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[14] FINRA Regulatory Notice 18-06, *supra* note 1, at n.14.
[15] *See* Am. B. Assoc. Rule 3.1.
[16] Mark Egan, Gregor Matvos, and Amit Seru, *The Market for Financial Adviser Misconduct*, J. POL. ECON. 1–2 (forthcoming) (referring to "advisors" as "registered representatives" with FINRA).
[17] *Id.* at 4.

where more than one in seven associated persons have a record of misconduct.[18] By contrast, in most other firms the ratio is less than one in thirty-six.[19] This means that the concentration of brokers with records of misconduct is not a statistical anomaly; it instead may be a product of the current market conditions, where there is a specific market for broker misconduct.[20]

FINRA can inhibit this activity by implementing a presumption of denial in the CMA process for firms facing covered pending arbitration claims, which would limit the rate at which member firms dissipate their firms' assets. To illustrate, say FINRA were to implement the presumption of denial that this Comment advocates. This would likely reduce the number of CMAs that FINRA grants, because firms facing covered pending arbitration claims could not reorganize through this revised CMA process. Those firms would then be removed from the acquisition market.[21] And by removing those firms from the market, FINRA would check the expansion of firms "specializing" in misconduct "and catering to unsophisticated consumers."[22]

Altogether, if FINRA were to propose a rule that would create a presumption of denial for "covered pending arbitration claims," that rule would help ensure that no member firm can sidestep liability. Similarly, that rule would likely have the added benefit of reducing concentrations of associated persons with prior misconduct at particular firms.

2. FINRA Should Propose a Rule That Would Allow It to Collect Unpaid Arbitration Awards from Member Firms That Convert Themselves into Another Area of the Financial Services Industry While Concurrently Facing Pending Arbitration Claims or Have Unpaid Arbitration Awards.

Unpaid awards and pending arbitration claims may also be a large problem when broker-dealer firms restructure themselves into a different part of the

[18] *Id.* at 3, 42 (showing that 19.60% of associated persons with Oppenheimer & Co. had a history of misconduct, 17.72% First Allied Securities, and 15.30% at Wells Fargo Advisors Financial Network).
[19] *Id.*
[20] *Id.* ("If firms had identical tolerance toward misconduct, such rehiring [of advisors with a history of misconduct] would not take place. We find that advisers with misconduct switch to firms that employ more advisers with past misconduct records. . . . Thus the matching between firms and advisers on misconduct partially undermines the disciplining mechanism in the industry, lessening the punishment for misconduct in the market for financial advisers.").
[21] *Id.* at 3–4.
[22] *Id.* at 1 (stating how firms with a "clean reputation" would already steer clear of firms facing misconduct claims. So, only firms with a higher tolerance for misconduct would be in the market for additional assets with misconduct).

financial industry.[23] FINRA recognized in a 2018 Discussion Paper that "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."[24] Accordingly, a broker-dealer firm with a pending arbitration claim could convert itself into an advisory firm, continue to profit in another business, and potentially avoid any future arbitration award. This outcome challenges the integrity of the securities industry.

FINRA should consider preventing this problem by proposing a rule along these lines:

> If a member firm seeks to restructure itself into another area of the financial services industry not regulated by FINRA while concurrently facing a pending arbitration claim, FINRA will, under appropriate circumstances, require the member firm to create an escrow account that will secure the potential damages that the member firm may have to pay if the member firm were to be found liable.
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> If a member firm does not escrow assets, FINRA may immediately seek a court order that freezes the firm's assets prior to that firm's transfer into a different area of the financial sector.

This proposed rule essentially allows FINRA to do two things: (1) preemptively require that a member firm set aside funds for a pending arbitration claim; and (2) act to freeze assets if the member firm does not comply with the request to create an escrow account.

Additionally, this proposed rule should apply to member firms that restructure themselves into *all areas of the financial services industry* that are not regulated by FINRA—including when a member firm restructures itself into an insurance-focused firm selling insurance products. This rule would then ensure that

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[23] FINRA oversees this type of a change in business under FINRA Rule 1017, which requires that member firms file a CMA for "material changes" in the operations of a firm. Whether a change is "material" depends on many factors, such as: "the nature of the proposed expansion; the relationship, if any, between the proposed new business activity or expansion and the firm's existing business . . . adding business activities that require a higher minimum net capital under SEC Rule 15c3-1."
[24] *Discussion Paper—FINRA Perspectives on Customer Recovery*, FINRA 12 n.36 (Feb. 8, 2018), http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf ("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.").

FINRA could, whenever possible, collect arbitration awards from able firms, and that member firms could not unjustly escape liability—even when FINRA would not have direct regulatory jurisdiction.[25]

This change would not overly expand FINRA's role. FINRA already has rules that allow the self-regulatory organization to oversee firms when it would not normally have jurisdiction. FINRA Rule 8210, for example, allows FINRA to require any member firm to provide information, documentation, or to testify on the record during an investigative process.[26] And FINRA's ability to compel a firm's compliance extends for at least two years *after a firm has left the securities industry*.[27] During that extended time-frame of two years, FINRA can impose disciplinary actions against a firm that fails to comply, or even bar a non-complying firm entirely from the brokerage industry.[28] So, FINRA can simply mirror this approach by requiring a firm to set aside assets, and then monitoring that firm's compliance with that action throughout the pending arbitration claim—regardless of whether the firm reorganizes to another part of the financial services industry.

In total, this Comment's proposed rule would advance FINRA's investor protection mission and ensure that no firm could escape liability.

Request for Comment No. 2. *If an applicant designates a clearing deposit or the proceeds from an asset transfer for purposes of demonstrating its ability to satisfy a pending arbitration claim, unpaid award or unpaid arbitration settlement, should FINRA require the applicant to provide some form of guarantee that the funds would be used for that purpose?*

FINRA should require an applicant to provide some form of guarantee that it will use a clearing deposit or the proceeds from an asset transfer to satisfy a

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[25] *See* Article III, Section 1(a), FINRA Manual, By-Laws of the Corporation (stating that FINRA has jurisdiction over "any registered broker, dealer, municipal securities broker or dealer . . . and whose regular course of business consists in actually transacting, any branch of the investment banking or securities business in the United States").

[26] FINRA Rule 8210 (stating that FINRA can "require a member, person associated with a member, or any other person subject to FINRA's jurisdiction to provide information orally, in writing, or electronically (if the requested information is, or is required to be, maintained in electronic form) and to testify at a location specified by FINRA staff, under oath or affirmation administered by a court reporter or a notary public if requested, with respect to any matter involved in the investigation, complaint, examination, or proceeding).

[27] *See* Michael Gross, *Frequently Asked Questions About FINRA Rule 8210*, BROKER-DEALER LAW CORNER (Oct. 3, 2016), https://www.bdlawcorner.com/2016/10/frequently-asked-questions-about-finra-rule-8210/ ("If you are subject to FINRA's retained jurisdiction (which typically extends for a period of two years after you have left the industry), FINRA likely will bring a disciplinary action against you and have you barred.")

[28] *See id.*

pending arbitration claim, unpaid award, or unpaid arbitration settlement. This guarantee may be essential to the actual payment of arbitration awards.

Without any guarantee that member firms will use certain funds to pay for pending or unpaid arbitration claims, firms are free to negotiate their eventual losses and damages—even when firms face an imminent award. The Public Investors Arbitration Bar Association's recent report explains this exact problem by discussing an incident with Securities America in 2010. Securities America was the "fifth largest independent brokerage firm in the country," and it held a net capital of $1,991,058 in the event of any firm liability.[29] Even so, when it faced an impending arbitration award in March of 2011, the firm's CFO testified that if a limited fund class action settlement was not approved, the firm "might have to close."[30] Securities America later asked investors to essentially take a certain amount of money or the firm would file for bankruptcy.[31] Investors then had to decide between accepting the partial remedy or receiving nothing at all.

Luckily, Securities America received help from Ameriprise to pay investors.[32] But what would have happened had Ameriprise not stepped in, or if Securities America decided to transfer assets before or after an award? Would Securities America have simply given an ultimatum to investors, even if they could have paid out more? FINRA should take that ability to manufacture an insolvency constraint out of member firms' hands. One effective way to remove that possibility is to require member firms to set aside certain funds to satisfy pending arbitration claims, unpaid awards, or unpaid arbitration claims. Not only would this improve investors' willingness to use member firms, but it would also improve investors' trust in FINRA's arbitration system.[33]

There is a tradeoff if FINRA were to promulgate this proposed guarantee requirement. By requiring member firms to set aside funding for liability, firms would then have less capital to invest in innovative technologies or seize opportunities to grow their business. That inability to grow or seize an opportunity could be detrimental to an already struggling broker-dealer market—a market facing significant technological change and shifting consumer

[29] Berkson, *supra* note 10, at 3.
[30] *Id.* (quoting the CFO).
[31] *Id.*
[32] *Id.* ("While there are conflicting reports regarding the actual extent of Ameriprise's participation in the settlement of the claims against Securities America, there is no doubt that Ameriprise did provide some financial means for the settlement . . . .").
[33] Jebsen, *supra* note 10, at 238 ("a system of investor justice refined to guarantee payment of legitimate claims would highlight the outstanding quality of the U.S. capital markets.").

expectations.[34] Customers of broker-dealer firms might then suffer both direct and indirect costs.

FINRA should be confident, however, that advancing investor protection and market integrity outweighs member firms' need for free capital to keep up with innovation and opportunity. FINRA should stick to its purpose: "to safeguard the investing public against fraud and bad practices."[35] In other words, uncontrolled industry growth with the goal of speculative profits undermines FINRA's values. The public deserves the right to take their own risks in a fair market with full notice of the potential outcomes—outcomes that should not include the possibility of a member firm choosing potential profit over paying for its misconduct.

Altogether, the circumstances involving Securities America illustrate how member firms are generally unprepared to shoulder arbitration awards. And just as bankruptcy deprives an investor of hope for a practical remedy and trust in the securities industry, "so too does a failure to pay investors their adjudicated awards."[36] Thus, FINRA should require member firms to provide some sort of a guarantee that a clearing deposit or the proceeds from an asset transfer will satisfy a pending arbitration claim, unpaid award, or unpaid arbitration settlement.

Respectfully Submitted,

INVESTOR PROTECTION CLINIC
THOMAS & MACK LEGAL CLINIC
WILLIAM S. BOYD SCHOOL OF LAW
UNIVERSITY OF NEVADA, LAS VEGAS

Kristopher J. Kalkowski
Student Attorney
Investor Protection Clinic
William S. Boyd School of Law

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[34] *See* Hester Peirce, *Dwindling Numbers in the Financial Industry*, BROOKINGS INST. (May 15, 2017), https://www.brookings.edu/research/dwindling-numbers-in-the-financial-industry/ ("Technology has given rise to new forms of competition for traditional retail" brokerages).
[35] *See What We Do*, FINRA, https://www.finra.org/about/what-we-do.
[36] Jebsen, *supra* note 11, at 216 ("Generally, a failure to pay investors their adjudicated awards undermine[s] general confidence in entrusting broker-dealers with capital.").