Statement of Robin Traxler, Senior Vice President and Deputy General Counsel

Financial Services Institute

before the

SEC Investor Advisory Committee

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Discussion Regarding Unpaid Arbitration Awards

Introduction

Good afternoon to all of the Commissioners and members of the committee. I am Robin Traxler, Senior Vice President and Deputy General Counsel of the Financial Services Institute (FSI) based here in Washington, D.C. FSI members are independent broker-dealers and independent financial advisors. Nearly all of FSI's member are dually registered as RIAs or IARs. We are the only organization advocating solely on behalf of these independent financial services firms and financial advisors. Because of the independent nature of their business, individual financial advisors registered with an independent broker-dealer are contractors as opposed to employees. They own and operate their own businesses and often live in the communities where they maintain their business.

FSI members provide affordable, objective advice to hard-working Main Street Americans. Independent financial advisors help their clients achieve their important financial goals, such as planning for a dignified retirement, saving for their children's education, supporting loved ones in old age, and dealing with unexpected life events, such as healthcare issues.

FSI has nearly 100 independent broker-dealer firms as members. These firms license upward of 160,000 affiliated financial advisors, over 30,000 of whom are also FSI members themselves. FSI's voice is unique in that we are able to bring the perspectives of local independent financial advisors and independent firms to important regulatory issues such as unpaid arbitration awards.

Since 2004, FSI has advocated for a regulatory environment that enhances investor protection and encourages efficient and effective regulation while maintaining investors' access to financial advice and their choice of how to obtain that advice. We do so through constructive

engagement with policymakers and elected officials in Washington, D.C. and the states and we are very appreciative of the opportunity to speak before you today.

You have already heard representatives from PIABA and FINRA talk about the issue, so I will focus my comments on the solutions proposed to-date and FSI's concerns about the potential serious unintended consequences of those proposed solutions. I will then outline suggestions on how to confront this issue in ways that do not create significant unintended consequences. As such, the majority of my comments will focus on bad actors, those who are truly responsible for this problem, and suggestions for ways to hold those bad actors accountable for their actions and make it impossible for them to continue working in any aspect of the financial industry.

Potential Solutions & Their Likely Unintended Consequences

FSI appreciates that this issue is not an easy one to solve. Many approaches have been suggested and, as FINRA stated in their discussion paper, "each of these approaches involves important tradeoffs and policy choices." But in addition to trade-offs and policy choices, the proposed solutions: Senator Warren's proposed bill, mandated insurance coverage, and increased net capital requirements, each come with likely unintended consequences that will not only fail to address the issue but could in fact exacerbate it.

S. 2499 Relief Fund

Senator Warren has proposed S. 2499 "To require the Financial Industry Regulatory Authority to establish a relief fund to provide investors with the full value of unpaid arbitration awards issued against brokerage firms or brokers regulated by the Authority." I'll refer to this as the "Warren Bill." The Warren Bill would require FINRA to create a "relief fund" to pay an investor an arbitration award that has gone unpaid, and the Warren Bill would not allow FINRA to limit the amount paid to the investor.

While FSI believes this solution is well-intended, we are extremely concerned about the likely unintended consequences of creating a pool of money through which investors who receive an arbitration award will be paid if the award otherwise goes unpaid. First, we believe the mere existence of the fund would encourage bad actors to act recklessly, knowing they can defraud investors but not have to pay the consequences beyond losing their FINRA registration. Second, we are very concerned that, again, the mere existence of the fund will encourage arbitration panelists to award damages to investors whether justified or not, out of a sense of wanting to

make the investor whole and knowing that the firm or financial advisor will not have to pay "out of their pocket."

We feel these potential and likely drawbacks far outweigh the good intentions of the bill to ensure no arbitration awards go unpaid, particularly in light of FINRA data that indicates only 2% of all claims filed in the FINRA Dispute Resolution forum go unpaid.

Errors & Omissions Insurance Coverage

FSI has similar concerns about the proposed solution to require financial advisors to carry Errors & Omissions (E&O) insurance to cover arbitration awards. First and foremost, any such coverage would be extremely expensive and unlikely to cover many situations that result in unpaid awards, such as outright fraud. While the cost may seem negligible to large firms, small firms and independent financial advisors who own and operate their own businesses, will certainly feel the pinch of having to obtain expensive coverage. It is hard to make a strong case for requiring this output of money and effort because 2% of FINRA arbitration claims go unpaid.

Furthermore, FSI has working relationships with E&O carriers which puts us in a unique position to speak to them directly about the issue and the viability of this proposed solution. We heard from E&O carriers that they are unlikely to underwrite this type of insurance as it could encourage reckless behavior on behalf of the policyholder, and no insurance company covers fraudulent acts. We therefore believe the idea of requiring insurance coverage for arbitration awards is misguided and highly unlikely to solve the issue and would, in fact, place an unfair financial burden on industry participants doing honest business.

Increased Net Capital Requirements

The other solution presented is to increase net capital requirements for small firms that currently have only a $5,000 net capital requirement. The thought behind this proposed solution is that the increased net capital requirement will make it less likely that a substantial arbitration award against the firm will result in essentially putting the firm out of business. Because the firm would remain in business, they would then be obligated and able to pay the award.

According to the data made available by FINRA, the median unpaid arbitration award is just under $200,000. It would make sense, then, that the net capital requirement be raised to at least $200,000. This is simply not a viable solution and would result in putting numerous small firms out of business. Again, this would be done to address the relative 2% of claims that go

unpaid, which is why FSI is concerned that this potential solution will have severe unintended consequences that outweigh any benefit.

Bad Actors

I did not accept your invitation today to simply raise alarms about proposed solutions to the issue. FSI recognizes that it is imperative for the FINRA Dispute Resolution forum to be fair to investors. But it must also be fair to industry participants. At FSI we hold ourselves to a strict standard: Whenever we must express concern or dissatisfaction regarding proposed regulation or legislation, we formulate and offer an alternative suggestion that we feel will eliminate, or at least mitigate, the concerns we have on behalf of our members. In keeping with our commitment to engage in a constructive and useful manner, we suggest today that the true issue with unpaid arbitration awards is with the bad actors that engage in reckless or intentional activity that results in unpaid arbitration awards in the first place.

FINRA suggests several solutions in their discussion paper that would create further incentives to pay awards, and we believe this is where the solution should start. Specifically, FINRA suggests one potential solution is expanding the definition of "statutory disqualification" under the Exchange Act to include control persons of firms with unpaid awards and to include firms and individuals who failed to pay an award even if the award was lawfully discharged through a bankruptcy. Statutorily disqualifying bad actors who do not pay their arbitration awards results in the firm or individual being unable to maintain their FINRA registration and thus unable to continue operating as a broker-dealer firm or representative.

But disqualification from FINRA is just a start to what needs to result in full disqualification from working in any capacity, in any aspect of the financial services industry. Effective communication of disqualified status along with regulator coordination would allow the SEC and state insurance and securities regulators to efficiently reject registrations for individuals who have been statutorily disqualified for failing to pay an award. This would effectively make it impossible for the bad actors to incur an unpaid award and then simply go work in the investment advisory or insurance industries, where they would continue to have access to investors.

To illustrate why we feel this is a sufficient deterrent, compare these two scenarios: A likely bad actor considers doing harm to their client. The bad actor knows that if their actions result in damage to their client and the client brings an arbitration claim, they can simply walk away from the award without paying it, and the client will be made whole through FINRA's relief fund. Even

if they lose their FINRA registration, they can simply become an investment advisor representative or go into insurance and continue working with investors.

Now imagine scenario two, where that same likely bad actor considers doing harm to their client. However, under this scenario, the bad actor knows that if their actions result in damage to their client and the client brings an arbitration claim, they must pay any award. If they do not pay the award, they will lose their ability to work in any capacity in the financial industry.

We feel that the potential consequences to the bad actor are a truly significant deterrent to engaging in reckless or fraudulent behavior to begin with. As we are trying to solve for an issue that impacts just 2% of all FINRA arbitration claims, FSI feels strongly that this is the preferable solution. It directly impacts the bad actor and protects investors from working with the bad actor in another capacity. In addition, this solution does not punish honest actors by placing unnecessary costs and burdens on them.

Conclusion

FSI stands ready to engage in additional conversations regarding this and other potential solutions. I thank you for the opportunity to share these thoughts and I look forward to the dialogue with you today.