NETWORK 1 FINANCIAL
SECURITIES, INC.

Thursday, June 27, 2019

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

Comment Submitted via Email:
pubcom@finra.org

Re: Comment to Regulatory Notice 19-17
Proposed Rule Amendments Relating to Protecting Investors from Misconduct

Dear Ms. Mitchell:

This letter is being timely filed with FINRA in response to certain proposed amendments identified in FINRA Regulatory Notice 19-17.

Regulatory Notice 19-17 proposes to create a new Rule 4111 that would impose "tailored obligations, including financial requirements, on designated member firms that cross specified numerical disclosure-event thresholds". The expressed aim of proposed new Rule 4111 is to "promote investor protection and market integrity and give FINRA another tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards."

Regulatory Notice 19-17 also proposes to create one new rule, Rule 9559, and to amend an existing rule, Rule 9549, to be renumbered as Rule 9560. Both the new rule and amendments aim at creating an expedited proceeding for review of determinations under new Rule 4111, including granting a member the right to challenge any obligation imposed on the member.

FINRA states it "has conducted a thorough analysis of the proposed criteria and thresholds to ensure that the proposed Preliminary Criteria for Identification preliminarily identify the member firms that are motivating this rule proposal." Network 1 concurs in this assessment: FINRA's analysis is indeed thorough. Network 1 also adjudges that FINRA's intention has been to be fair in its reach for solutions to thorny problems that plague our securities industry.

It is with respect for FINRA's comprehensive effort that Network 1 Financial Securities expresses genuine appreciation for this opportunity to offer its assessment of the proposals set forth in Regulatory Notice 19-17. Accordingly, this Comment Letter will analyze these proposals: first, from the perspective of consistency with FINRA's mission; secondly, from the perspective of consistency



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with principles of jurisprudence and other criteria higher than this mission; and lastly, from the perspective of an industry member's concerns. With these concerns in mind, Network 1 will offer recommendations to address what we have identified as shortcomings that have come to light as a result of our analysis.

Network 1 Financial Securities is an industry member that has been engaged primarily in investment banking and secondarily in securities brokerage, since 1983. Network 1's predominant business lines are underwriting, retail sales of OTC equities, proprietary trading, and market making.

## 1. Whether Proposed Rule 4111 (relating to Restricted Firm Obligations) is Consistent with FINRA's Mission.

Under proposed new Rule 4111, member firms that present heightened risk of harm to investors, meeting the criteria for the definition of, and deemed, in the final analysis, to be a "Restricted Firm", would be subject to:

- A "Restricted Deposit Requirement" – a "Restricted Firm" would be obligated to maintain a in a Restricted Deposit Account a Restricted Deposit Requirement calculated at the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year.[1]

- A deposit of cash and/or qualified securities in a segregated account at a bank or clearing firm from which the "Restricted Firm" could make withdrawals only with FINRA's approval.[2]

In support of this proposal, FINRA has set up a well-thought-out process for evaluating whether a potentially problem member firm is actually a firm that presents heightened risk of harm to investors, and therefore is firm that should be classified as a "Restricted Firm". It is quite apparent that the various "numeric, threshold-based criteria and several additional steps"[3] – a multi-step process – utilized by the Rule 4111 process, is aimed at "guard[ing] against misidentification"[4] of a member firm as a "Restricted Firm".

[1] Regulatory Notice 19-17, pp. 15, 19.

[2] Regulatory Notice 19-17, p. 6.

[3] Regulatory Notice 19-17, p. 6.

[4] Regulatory Notice 19-17, p. 6.



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Given that FINRA's mission is "to provide investor protection and promote market integrity";[5] and, because this proposed new Rule 4111 attempts to "identify members that present a high risk" while at the same time "limiting itself from improperly imposing obligations on firms whose risk profile and activities do not warrant such obligations", proposed Rule 4111 is consistent with FINRA's mission and, on the whole, appears to be both balanced and fair on the basis of these two perspectives.

## 2. Whether Proposed Rule 4111 is Consistent with Principles of Fundamental Law.

To answer the question whether these proposals are, *objectively*, truly fair and balanced as defined by higher principles – as distinct from FINRA's stated mission – these proposed amendments must be judged by principles that are fundamental to American jurisprudence.

Perhaps not appreciating the consequences of admitting so, FINRA makes this revealing statement:

> "FINRA has conducted a thorough analysis of the proposed criteria and thresholds to ensure that the proposed Preliminary Criteria for Identification preliminarily *identifying the member firms that are motivating this rule proposal.*"[6] (Emphasis supplied)

Elsewhere, FINRA reaffirms the genesis of *what motivates* FINRA to propose this new Rule 4111:

> " . . . as of year-end 2018, there were 20 small firms (i.e., firms with no more than 150 registered persons) with 30 or more disclosure events over the prior five years, 10 mid-size firms (i.e., firms with between 151 and 499 registered persons) with 45 or more disclosure events over the prior five years, and five large firms (i.e., firms with 500 or more registered persons) with 750 or more disclosure events over prior five years."[7]

And finally, FINRA explains *for whom* this new Rule 4111 is *specifically targeted*:

> ". . .based on recent history FINRA *expects* that its annual calculations *will identify* between 60-98 members that meet the Preliminary Criteria for Identification [as a "Restricted Firm"]."[8]

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[5] https://www.finra.org/about/our-mission.

[6] Regulatory Notice 19-17, p. 11.

[7] Regulatory Notice 19-17, p. 3-4.

[8] Regulatory Notice 19-17, p. 9.



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In other words, the proposed new Rule 4111 is not motivated so much to be a generic rule for the entire membership as it is motivated to be a carefully tailored rule targeted for – indeed, *restricted* to – a specific subset of the membership, intended to solve a regulatory crisis for which traditional enforcement now (apparently) no longer works (according to FINRA).[9] Appropriately enough, this proposed new Rule 4111 is called the "*Restricted* Firm Obligations" rule.

This proposed new Rule is motivated to *identify that specific subset* of the membership that, even before the proposed new rule is submitted to the Securities and Exchange Commission (SEC) for review and approval, FINRA *already* knows falls into the "restricted firm" category.

In short, FINRA *knows as of this writing* which members (those "60-98 members that meet the Preliminary Criteria for Identification") *are already "guilty" of being "Restricted Firms".*

This "governmental"[10] motivation in targeted rule-making, limited to a very specific group, meets the classic definition of a Bill of Attainder, a legislative act that violates constitutional and therefore fundamental law.

## 3. What a Bill of Attainder Is

A Bill of Attainder is a "legislative act which inflicts punishment without a judicial trial."[11]

It was common in early English history that Bills of Attainder – generally originating in Parliament in the sixteenth century – were aimed at "inflict[ing] their deprivations upon relatively large *groups* of people."[12]

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[9] *See e.g.*, Regulatory Notice 19-17, p. 4, where FINRA states: "Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and multiple rounds of appeals, thereby effectively forestalling the imposition of disciplinary sanctions for an extended period. For example, an enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the National Adjudicatory Council (NAC), and a further appeal to the SEC. Moreover, even when a FINRA Hearing Panel imposes a significant sanction, the firm can forestall its effectiveness through the appeals process, because sanctions are stayed during appeals to the NAC and potentially the SEC. And when all appeals are exhausted, the firm may have withdrawn its FINRA membership, limiting FINRA's jurisdiction and *eliminating the leverage that FINRA has to incent the firm to comply with the sanction, including making restitution to customers.*" (Emphasis supplied)

[10] It is understood and fully appreciated that FINRA maintains that it is not a "governmental" agency. This issue is analyzed in depth in Section 9 of this Comment Letter. For the time being, it will be assumed for the sake of argument that FINRA is a "governmental" agency as we work our way through the analysis of the issue, whether proposed new Rule 4111 is a Bill of Attainder.

[11] Cummins v. Missouri, 71 U.S. (4 Wall.) 277, 323 (1866). A bill of attainder includes "legislative acts which take away the life, liberty, or property of particular names [or easily ascertainable] persons [or group of persons] because the legislature thinks them guilty of conduct which deserves punishment." U.S. v. Lovett, 328 U.S. 303, 317 (1946).

[12] U.S. v. Brown, 381 U.S. at 461. (Emphasis supplied)



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Some early English Bills of Attainder "named the parties to whom they were to apply", while "*some simply described them.*"[13]

During the American Revolution, several state legislatures resorted to bills of attainder to punish Tories for their loyalty to the British Crown and, in the course of scrupulously *disregarding* due process rights, confiscated Tory property.[14]

It bears noting that some of these early English Bills of Attainder left the targeted parties a way to escape the penalty, while others did not.[15] That said, the U.S. Supreme Court has held from-the-get-go that "escapability" is not an "absolute prerequisite" to a finding of attainder because "[s]uch an absolute rule would have flown in the face of explicit precedent [referring to *Cummins v. Missouri*] as well as the historical background of the constitutional prohibition."[16]

In *Cummins v. Missouri,*[17] the U.S. Supreme Court decided a pair of cases that establish present day precedent for what constitutes a violation of the constitutional prohibition against Bills of Attainder. In *Cummins,* the Court took up the issue whether the requirement of an oath of loyalty as a prerequisite to practicing one's profession constitutes a violation of the constitutional prohibition against Bills of Attainder. Reaching its decision, the Court found that the fundamental and unusual characteristics of a bill of attainder consists in (1) the deprivation livelihood in connection with one's profession (2) this deprivation being imposed on a person or *group* of persons, and (3) this deprivation being imposed without the safeguards of a judicial trial.[18]

In *United States v. Lovett,*[19] the U.S. Supreme Court took up the issue of the legislature's attempt to weed out "subversives". The Court reviewed the Urgent Deficiency Appropriation Act of 1943[20] and

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[13] U.S. v. Brown, 381 U.S. at 442. (Emphasis supplied)

[14] U.S. v. Brown, 381 U.S. at 442.

[15] Cummins v. Missouri, 71 U.S. (4 Wall.) 277, 324 (1866): "A number of ante-Constitution bills of attainder inflicted deprivations upon named or described persons or groups, but offered them the option of avoiding the deprivations."

[16] U.S. v. Brown, 381 U.S. 437, at 457 n.32.

[17] Cummins v. Missouri, 71 U.S. (4 Wall.) 277, 324 (1866).

[18] Cummins v. Missouri, 71 U.S. (4 Wall.) at 315, the Court holding that an oath of loyalty has "no possible relation to fitness ***"

[19] U.S. v. Lovett, 328 U.S. 303 (1946).

[20] Specifically, The Urgent Deficiency Appropriation Act of 1943 permanently prohibited specifically named individuals from receiving any further compensation from their government jobs, and prevented them from further employment in government service, other than as jurors or soldiers.



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found an extensive legislative history that revealed the true purpose of this piece of legislation: To "*purge*" government agencies of government employees that Congress deemed "*unfit*". In the end, the Court held that the Act was a bill of attainder prohibited by the Constitution.

In *United States v. Brown*,[21] the U.S. Supreme Court reviewed §504 of the Labor-Management Reporting and Disclosure Act of 1959,[22] which made it a crime for a member of the Communist Party to serve as an officer or employee of a labor union. *Brown* utilized a combination of factors to determine that Section 504 of the Act constituted a prohibited bill of attainder. The following two (2) propositions in *Brown* are relevant to Regulatory Notice 19-17:

- "[T]he legislature made a judgment, undoubtedly *based largely on past acts* and associations ... that a given person or group was *likely to cause trouble* ... and *therefore inflicted deprivations* upon that person or group in order *to keep it from bringing about the feared event*."[23]
- The Court, believing that it would be antiquated to limit punishment to only a retributive purpose, found it appropriate to expand the meaning of "punishment" in order to "serve several purposes; retributive, rehabilitative, deterrent – and *preventative*."[24]

Summing things up so far, a Bill of Attainder exists when a law:

A. Passes judgment about who is "*unfit*" to engage in a profession.
B. Bases this judgment largely on the group's "*past acts*" of *causing trouble*.
C. Creates criteria to define who is "unfit" and then targets a "*group*", especially a subset within a given profession, to match such criteria.
D. Deems punishment[25] – e.g., *deprivation of livelihood* – absolutely necessary to keep that group from bringing about events that the legislator fears will recur, again and again– e.g., past acts of causing trouble – *if not prevented.*
E. Punishes without a judicial trial.

[21] U.S. v. Brown, 381 U.S. 437 (1965).

[22] 29 U.S.C. §504 *1958 & Supp. IV).

[23] U.S. v. Brown, 381 U.S. at 458-59.(Emphasis supplied)

[24] U.S. v. Brown, 381 U.S. at 458.(Emphasis supplied)

[25] *See* Nixon v. Adm'r of Gen. Serv., 433 U.S. 425, at 538 (1977) (Burger, C.J., dissenting ("Those two cases [*Cummins v. Missouri* and *Ex Parte Garland*] established more broadly that 'punishment' for purposes of bills of attainder is not limited to criminal sanctions.")



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Any legislation that encompasses these elements is, as per *Cummins v. Missouri, United States v. Lovett,* and *United States v. Brown,* a bill of attainder whenever it inflicts punishment without a judicial trial. All these elements will be discussed in this Common Letter in relation to the elements of proposed new Rule 4111.

## 4. Elements of Proposed New Rule 4111 that Trigger Bill of Attainder Considerations

### 4.A Background Discussion to Proposed New Rule 4111 and the First Element[26] of Bills of Attainder:

FINRA has expressly judged a subset of member firms and their brokers who have engaged in a certain *history of misconduct* to be, by implication, *unfit* to participate in the securities industry:

> "FINRA has been engaged in an ongoing effort to enhance its programs to address the risks that can be posed to investors and the broader market by individual brokers and member firms that have *a history of misconduct*. * * * While these firms may eventually be forced out of the industry through FINRA action or otherwise, these patterns indicate a persistent, if limited, population of firms with *a history of misconduct* that may not be acting appropriately as a first line of defense to prevent customer harm by their brokers. * * * Such firms *expose investors to real risk*. For example, FINRA has identified certain firms that have a concentration of individuals with *a history of misconduct*, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities. * * * [I]ndividuals and firms with *a history of misconduct* can pose a particular *challenge for FINRA's existing examination and enforcement programs*. * * *"[27]

No one can within reason dispute that firms and brokers who exhibit a history of misconduct should be disciplined, even severely when facts surrounding this misconduct support severe measures.

What is disputed is that a new rule that amounts to a Bill of Attainder should be allowed to replace the existing disciplinary process, even when that system evidences difficulties in being as effective as it could be.

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[26] That is, when a Legislator passes judgment about who is "*unfit*" to engage in a profession.

[27] Regulatory Notice 19-17, p. 3, 4. (Emphasis supplied)



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In Regulatory Notice 19-17, FINRA appears to be saying that its disciplinary process is presently experiencing ineffectiveness, and thus justifying proposed new Rule 4111:

> "Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and multiple rounds of appeals, thereby *effectively forestalling the imposition of disciplinary sanctions for an extended period.* * * * Temporary cease and desist proceedings *do not always provide an effective remedy* for potential ongoing harm to investors during the enforcement process. [citation omitted] * * * When FINRA is ready to pursue enforcement action against such a firm, a temporary cease and desist order *may not be available* (since many circumstances are not within the scope of that authority) or *may not enable more rapid intervention* (since the disciplinary complaint must be ready to be filed at the same time). While a disciplinary proceeding will be commenced as soon as possible (with or without a temporary cease and desist proceeding), the firm *can further prolong the disciplinary action* by litigating through the stages described above. * * *"[28]

Because this ineffectiveness or inefficiency (if this is what FINRA is saying) of the present disciplinary process is at the point where no-return-to-"good order and discipline" is possible without imposing an extreme remedy, one gets the sense that FINRA desires this proposed new Rule 4111 to, not only "fix", but to go one step further and *replace* the existing FINRA disciplinary process. The disciplinary problem for which FINRA seeks a practical, albeit draconian, solution is stated succinctly by FINRA:

> "Enforcement actions in turn can *only* be brought *after a rule has been violated*—and any resulting customer harm has already occurred. * * *"[29]

FINRA believes the present disciplinary crisis justifies creating an alternative (emergency?) process for *preventing misconduct before it happens in the future*. But this way of going about righting a wrong violates every established canon in American jurisprudence.

These considerations support the conclusion that proposed new Rule 4111 satisfies the 1st element of a Bill of Attainder, namely, the legislator passing judgment as to who is "unfit" to engage in a

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[28] Regulatory Notice 19-17, p. 4. 5. (Emphasis supplied)

[29] Regulatory Notice 19-17, p. 4. (Emphasis supplied)



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profession. Adjudging an individual or group as unfit for employment – here, employment in the securities industry – is a punitive measure[30] that opens the door for Bill of Attainder consideration.

According, we turn to the second element, legislation that is based largely on a particular group's "past acts" of causing trouble.

### 4.B **<u>Annual Calculation of Preliminary Criteria for Identification as "Restricted Firm [Proposed New Rule 4111(b)]; Initial Department Evaluation [Proposed Rule 4111(c)(1)]and the Second Element[31] of Bills of Attainder:</u>**

Proposed new Rule 4111 will allow FINRA to determine whether certain "past acts" giving rise to a "history of misconduct" – in other words, acts of causing trouble – give FINRA just cause to judge a member firm to be a Restricted Firm, a least preliminarily.

Under the proposed new Rule, FINRA can include nineteen (19) factors in its "preliminary identification" formula: Eleven (11) acts of causing trouble committed by registered representatives[32]

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[30] Such judgment is punitive in nature in the case at hand precisely because the misconduct supporting this regulatory "judgment" is *superimposed* on an individual or group who has already been subjected to an enforcement process that has concluded and has resulted in a punishment (e.g., censure, suspension, fine, etc.) imposed. When misconduct continues, indeed to such level of severity, the appropriate next step, logically, should be proceeding in a *separate* enforcement action against the firm and/or the broker *for termination*. This is the sacrosanct due process path long-established in American jurisprudence. Instead (and we are admittedly jumping ahead of ourselves here) the proposed new Rule 4111 seems to be a substitute for "this logical next step". Indeed, in place of additional fines and even termination, the proposed new Rule 4111 intends to place on those firms having a "history of misconduct" *extraordinary* compliance and financial burdens (beyond existing compliance and financial requirements) that aim at producing the desired effect of motivating firms to take it upon themselves to simply leave the securities industry. This is a kind of "soft" punishment. *See* Alexis de Tocqueville, <u>Democracy in America</u>, "If despotism were to be established among the democratic nations of our days, it might assume a different character; *it would be more extensive and more mild*; it would degrade men without tormenting them." (New York: Alfred Knopf, 1966), vol. 2, book fourth, Ch. 6 (Emphasis supplied). This kind of "soft" punishment opens the door for Bill of Attainder consideration because Rule 4111 appears to be a "legislative act which inflicts punishment without a judicial trial" as per <u>U.S. v. Brown</u>. All elements of the definition of Bill of Attainder will be addressed at length throughout this Comment Letter.

[31] That is, when a Legislator basing its judgment (that a particular subset of a member group is "*unfit*" to engage in a profession) largely on the subset group's "*past acts*" of *causing trouble*.

[32] Registered Representative disclosure events include <u>all</u> of the following:

(i) A final investment-related, consumer-initiated customer arbitration award or civil judgment against the registered person in which the registered person was a named party or was a "subject of" the customer arbitration award or civil judgment.

(ii) A final investment-related, consumer-initiated customer arbitration settlement, civil litigation settlement or a settlement prior to a customer arbitration or civil litigation for a dollar amount at or above $15,000 in which the registered person was a named party or was a "subject of" the customer arbitration settlement, civil judgment settlement or a settlement prior to a customer arbitration or civil litigation.

(iii) A final investment-related civil judicial matter that resulted in a finding, sanction or order.



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and eight (8) acts of causing trouble committed by the member firm[33] in question, regardless whether the acts of trouble in question are adjudicated (final, in other words) or pending.

This is but a partial list of criteria – acts of causing trouble – that proposed new Rule 4111 will allow, indeed will compel – FINRA to include in its "preliminary identification" formula so that FINRA can comply with all the requirements, including the punitive directives, of this proposed new Rule.

In addition to the nineteen (19) acts of causing trouble just mentioned, FINRA can – indeed, "must", in order to comply with the spirit of proposed new Rule 4111 – include two (2) internal review

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(iv) A final regulatory action that resulted in a finding, sanction or order, and was brought by the Commission or Commodity Futures Trading Commission (CFTC), other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization.

(v) A criminal matter in which the registered person was convicted of or pled guilty or *nolo contendere* (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

(vi) A pending investment-related civil judicial matter.

(vii) A pending investigation by a regulatory authority.

(viii) A pending regulatory action that was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization.

(ix) A pending criminal charge associated with any felony or any reportable misdemeanor.

(x) A termination in which the registered person voluntarily resigned, was discharged or was permitted to resign after allegations.

(xi) A pending or closed internal review by the member.

[33] Member firm disclosure events include <u>all</u> of the following:

(i) A final investment-related, consumer-initiated customer arbitration award in which the member was a named party.

(ii) A final investment-related civil judicial matter that resulted in a finding, sanction or order.

(iii) A final regulatory action that resulted in a finding, sanction or order, and was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization.

(iv) A criminal matter in which the member was convicted of or pled guilty or *nolo contendere* (no contest) in a domestic, foreign, or military court to any felony or any reportable misdemeanor.

(v) A pending investment-related civil judicial matter.

(vi) A pending investigation by a regulatory authority.

(vii) A pending regulatory action that was brought by the Commission or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization.

(viii) A pending criminal charge associated with any felony or any reportable misdemeanor.



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events[34] as well as an admittedly open-ended "Registered Person Associated with Previously Expelled Firms" category.[35]

But there is a significant proverbial fly-in-the-ointment. Consider, in regards to this category, "Registered Person Associated with Previously Expelled Firms", a hypothetical Compliance Analyst:

(a) Having no personal history of misconduct on his personal CRD BrokerCheck record who gets hired in "year 1" by a broker/dealer that gets expelled within five months of hire; and,

(b) Who is then hired by a second broker/dealer within the same "year 1" – again, having no personal history of misconduct – finds himself again unemployed because his second firm is expelled within the of the same "year 1" * * *

This Compliance Analyst will in the new year bring with him to his new firm (the third broker/dealer in this hypothetical) two (2) acts of causing trouble – his association with two (2) expelled firms – that can be counted in FINRA's "preliminary identification" formula against the third broker/dealer.[36]

This conceivably could happen even though this individual is just a "compliance person" (as opposed to salesman/broker), having a lily white clean record, having never sold a securities product to a securities customer, and therefore never having experienced a customer complaint or customer related arbitration.

Thus, all told, FINRA can – perhaps, "must" – call into play the "twenty-one-plus (21+) acts of causing trouble" when calculating FINRA's "preliminary identification" formula[37] of a potential "Restricted Firm".[38]

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[34] *See* proposed new Rule 4111(i)(C): "Registered Person Termination and Internal Review Events" means any one of the following events associated with the registered person that are reportable on the registered person's Uniform Registration Forms:

(i) a termination in which the registered person voluntarily resigned, was discharged or was permitted to resign after allegations; or

(ii) a pending or closed internal review by the member.

[35] *See* proposed new Rule 4111(i)(F): "Registered Persons Associated with Previously Expelled Firms" means any registered person registered for one or more days within the year prior to the Evaluation Date with the member, and who was associated with one or more previously expelled firms (at any time in his/her career).

[36] True, the firm for this hypothetical Compliance Analyst can engage in the "rebuttal" process – the Consultation process – of Proposed Rule 4111(d)(1)(A). But it is anything but clear that FINRA has presented in Regulatory Notice 19017 an Economic Impact and Cost Impact *for the member firm*, especially if the member firm finds itself being aggressively, if not unfairly, treated and needing to hire outside legal counsel to represent its interests in this Consultation process. The potential for unfair treatment in the overall process posed by proposed new Rule 4111 is elsewhere treated in this Comment Letter.



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These considerations support the conclusion that proposed new Rule 4111 satisfies the 2nd element of a Bill of Attainder, namely, the legislator passing judgment on a group's "past acts" of causing trouble.

Accordingly, we turn now to the third element of a Bill of Attainder, targeting a Group as being "unfit" to participate in a profession.

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[37] There is a very important concern that should be a legitimate concern for the SEC and member firms, alike, as well as for the SRO attempting to arrive at a solution consistent with constitutional principles and principles of natural justice when the formula being created to determine who is and who is not a bad broker lacks identification of the algorithm being employed in the process. FINRA admits that "[i]n developing the proposal, FINRA considered the possibility of having a transparent formula, based on some of these factors, to determine a maximum Restricted Deposit Requirement. However, given the range of relevant factors and differences in firms' business models, operations, and financial conditions, FINRA decided not to propose a uniform, formulaic approach across all firms." (*See* Regulatory Notice 19-17 at 29). Let's use the example of the just-mentioned Compliance Analyst from an expelled firm. If the algorithm is known only to FINRA, then FINRA is at liberty to assign this Compliance Analyst a "10" (on a scale of 1 to 10, where a 10 is a "really bad" actor) if the Compliance Analysis takes a position with one of the firms that FINRA has already identified as a "high risk" member firm; but if the Compliance Analyst takes a position at a large firm, FINRA is also at liberty to assign this same Compliance Analyst a "1" (We already know from FINRA's Exhibit D-2 to Regulatory Notice 19-17 that no Large Firms have been deemed, preliminarily, to be a "high risk" firm.) The issue here is not so much what FINRA states in the above quoted passage – namely, that relevant factors and differences in firm's business models, operations, and financial conditions prevent the possibility of a uniform formulaic approach – as it is the fact that FINRA justifies this obstacle as *justification* for *not needing* to be transparent to a subject firm about the algorithms employed by FINRA either before or after a preliminary or final determination that the subject firm is deemed by FINRA to be a "Restricted Firm". Not having this information, certainly prior to a subject firm's decision to exercise its right of expedited appeal to the Hearing Officer, will invariably adversely affect the firm's ability to prepare itself and its legal defense team for a hearing on the "expedited appeal". Equally if not more importantly, not having this information will invariably "act as a prior restraint" on the subject firm's decision to exercise its right of expedited appeal – this decision will invariable rest on firm's assessment of the high costs of legal defense, an assessment that needs to be made in conjunction with the firm's being precluded from using a considerable amount of its otherwise available net capital to pay these defense costs because the "deposit" required during the pending appeal will prevent the firm from using all of its net capital resources. If FINRA had not anticipated these possibilities, this alone should be sufficient reason for withdrawing proposed new Rule 4111 at this time. If FINRA has anticipated these possibilities, but built this "chilling effect" into the Rule 4111 process in order to accomplish the regulatory mission of ridding the membership of the problematic firms outside the regular course of Enforcement Proceedings in order to remove "significant time" element that these proceedings involve (e.g., see page 4 of Regulatory Notice 19-17), then this *specific intent* is even more disconcerting.

[38] There is an equally troubling concern that does not appear to be addressed in the "formula" or in Regulatory Notice 19-17: How is the member firm going to be looked at by FINRA when: (1) a broker has "skeletons in the closet" that do not become revealed until the tail end of the running of the six (6) year statute of limitations; (2) the broker has been hired by a member firm that is not otherwise a "high risk" firm; (3) the member firm hired the broker five (5) years prior to the running of the six-year statute of limitations; and (4) the broker has no customer complaints or other red flags during his tenure with the member firm that may now become a subject firm for purposes of proposed new Rule 4111? Will this member firm be penalized under the regime of proposed new Rule 4111 by operation of "looking backwards" instead of "looking forward" in regards to the several DRPs (i.e., Disclosure Reporting Pages) that are at play in Rule 4111?



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**4C. Annual Calculation of Preliminary Criteria for Identification [Proposed Rule 4111(b)]; FINRA's Exhibit "D-2" and the Third Element[39] of Bills of Attainder:**

As stated previously, FINRA is clear *for whom* this new Rule 4111 is specifically targeted:

> ". . .based on recent history FINRA expects that its annual calculations will identify *between 60-98 members* that meet the Preliminary Criteria for Identification [as a "Restricted Firm"]." [40]

The Preliminary Criteria referenced above is justified on an annual calculation of a member firm's "Preliminary Identification Metrics", which, in turn, is itself built on quantitative risk-based thresholds. [41]

These thresholds are indeed "quantitative"; they consist of "the sum of pertinent disclosure events or, for the Expelled Firm Association category, the sum of Registered Persons Associated with Previously Expelled Firms."[42]

"Quantitative" is something that is susceptible of measurement[43] and therefore "quantitative", in the context of proposed Rule 4111, refers to data that FINRA has already collected on its member firms and their brokers in connection with *past events*, even if some of these past events are still *pending*.[44]

Stated differently, FINRA is crafting a new rule that is tailor-made to fit a particular segment of the FINRA member firm population that FINRA intends to identify as "meet[ing] the Preliminary Criteria for Identification" on the path to being ultimately identified as a "Restricted Firm".

FINRA (via proposed new Rule 4111) knows *today* which members (those "60-98 members that meet the Preliminary Criteria for Identification") are already "guilty" of being "Restricted Firms" ... once the rule is *in the future approved* (if approved) by the SEC.

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[39] That is, when a Legislator creates criteria to define who is "unfit" and then targets a "*group*", especially a subset within a given profession, to match such criteria the criteria to convict or find a violation of the rule created by the Legislator.

[40] Regulatory Notice 19-17, p. 9.

[41] Regulatory Notice 19-17, p. 7.

[42] Regulatory Notice 19-17, p. 8.

[43] https://www.vocabulary.com/dictionary/quantitative

[44] Regulatory Notice 19-17, p. 8, 9, 33, 38.



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This assumption is made quite clear in FINRA's Exhibit "D-2" to Regulatory Notice 19-17, which is reproduced immediately below:

**Attachment D-2: Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size***

| Identification Year | Number of FINRA Registered Member Firms | Firms Meeting the Preliminary Criteria for Identification | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | Small | Mid-Size | Large | Total | Small | Mid-Size | Large |
| | | Number of Firms | | | | Percent of Total | | |
| 2013 | 4,140 | 84 | 4 | 1 | 89 | 94% | 4% | 1% |
| 2014 | 4,068 | 92 | 4 | 2 | 98 | 94% | 4% | 2% |
| 2015 | 3,941 | 79 | 5 | 2 | 86 | 92% | 6% | 2% |
| 2016 | 3,835 | 61 | 5 | 1 | 67 | 91% | 7% | 1% |
| 2017 | 3,721 | 54 | 6 | 0 | 60 | 90% | 10% | 0% |
| 2018 | 3,582 | 55 | 6 | 0 | 61 | 90% | 10% | 0% |

* Firm sizes are computed using the number of registered persons at the end of each identification year, e.g. December 31st. FINRA defines a small firm as a member with at least one and no more than 150 registered persons, a mid-size firm as a member with at least 151 and no more than 499 registered persons, and a large firm as a member with 500 or more registered persons. *See* FINRA By-Laws, Article I.

Based on this graphic that FINRA has incorporated into Regulatory Notice 19-17, FINRA has already identified, as of May 2nd 2019,[45] fifty-five (55) small firms and six (6) medium-sized firms being "Restricted Firms", of course subject to all the protections that FINRA sets forth in proposed new Rule 4111 that FINRA believes in earnest cuts constitutional muster.

The constitutional question is this: Did FINRA *blindly* craft proposed new Rule 4111 with its "numeric threshold based criteria and several additional steps that would guard against misidentification"?[46] That is, did FINRA craft its proposed new rule first, *and then after the final draft was completed* undertook an analysis to determine which member firms would be adversely affected by the elements set forth in proposed new Rule 4111? *Or*, was the proposed new Rule crafted with these sixty-one (61) small and medium sized firms *specifically in mind* during the drafting of this Rule?

[45] That is, the date of Regulatory Notice 19-17.

[46] Regulatory Notice 19-17, at 6.



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As an aside, one thing is very clear from FINRA's Exhibit "D-2" to Regulatory Notice 19-17: ***Every large FINRA member firm avoids the enhanced regulatory and financial challenge*s** of proposed new Rule 4111. The important and fair question is: Was this outcome ***intentional or serendipitous***?

Meaningful discussion of Bills of Attainder always begins with the seminal U.S. Supreme Court decision, United States v. Brown.[47] Right out of the gate, the Court quotes Alexander Hamilton, that constitutionalist par excellence and author of the majority of essays in The Federalist Papers:

> "Nothing is more common than for a free people, *in time of heat* and violence, *to gratify momentary passions* by letting into the government *principles and precedents* which afterwards prove fatal to themselves. Of this kind is the doctrine of disqualification, *disfranchisement*, and *banishment* by the acts of the legislature. The dangers consequences of this power are manifest. If the legislature can *disfranchise* any number of citizens at pleasure by *general descriptions*, it may soon confine all the votes to a small number of partisans, and *establish* an aristocracy or *an oligarchy*; it if may banish at discretion all those whom particular circumstances render obnoxious, without hearing or trial no man can be safe, nor known when he may be the innocent victim of *a prevailing faction*. * * *"[48] (Emphasis supplied)

Hamilton's insight has relevance for what small broker/dealer FINRA member firms have been intuiting for quite some time, namely, that the ultimate objective of Regulatory Notice 18-16 and now Regulatory Notice 18-17 as well as other previous rule making efforts, are part of an conscious attempt to eventually drive smaller firms out of the securities business[49] (read: Hamilton's reference to *disenfranchisement*) leaving the large broker/dealers – fewer in number (read: Hamilton's reference to

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[47] 381 U.S. 437 (1965).

[48] 381 U.S. at 444, citing The Federalist Papers, No. 48, pp. 383-384 (Hamilton ed. 1880).

[49] *See* Alan Wolper, FINRA Stats Reveal Horribly Kept Secret: Small Firms Are The Heart And Soul Of The Brokerage Industry, But Dying Off, Nevertheless, (10 August 2018): "* * ****more troubling is the continuing decline in the number of FINRA member firms.*** The [2018 FINRA Industry] Snapshot contains data only going back to 2013, and they show a drop in the total number of firms in excess of 10%. If you think that's scary, how about going back ten years, to 2017. In that ten-year period, FINRA lost 1,273 firms, or fully 25.5% of its members. The oldest figures available are from 2003, when FINRA had 5,261 members. By 2017, that number fell by over 29%. ***There have been lots of articles written about the difficulty of running a small broker-dealer today, what with the high cost of compliance and the sheer number of man-hours required each year just to deal with FINRA and its seemingly incessant requests for documents and information. The resultant migration away from FINRA to the investment advisory world is amply demonstrated by the data in the Snapshot.*** From 2008 – 2017, the number of BD-only firms, i.e., firms only registered with FINRA as broker-dealers, dropped 21.1%, from 3,969 to 3,132. Not surprisingly, the number of dually registered BD/IA firms also fell, and by an even greater percentage, 35.9%. During that same time period, however, the number of investment advisor-only firms, i.e., firms registered with the SEC or with the states only as investment advisors (and not registered with FINRA as BDs), increased 22.6%, from 24,147 to 29,599." (Emphasis Supplied) Source: https://www.bdlawcorner.com/2018/08/finra-stats-reveal-horribly-kept-secret-small-firms-are-the-heart-and-soul-of-the-brokerage-industry-but-dying-off-nevertheless/



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*oligarchy*) than the smaller firms[50] – to become the sole universe with whom investors can choose to invest, making it so much easier for self-regulatory organizations to draft "one-size-fits-all" rules, eliminating the frustration of devising rules that don't (read: Hamilton's reference to *heat of times* and *gratify momentary passions* that become the source of *principles and precedents* as for example Regulatory Notices 18-17 and now 19-17), leading to a membership organization that will finally be one with itself – when the natural synergy between large firms and regulators will become realized.[51]

Hamilton's observation in Federalist No. 44 is the classic statement about the danger that Bills of Attainder pose for representative government, not just at the federal and state level, but also in FINRA governance of its members.

At this point, it is evident that that proposed new Rule 4111 fits the 3rd element of a Bill of Attainder: Targeting a "*group*", especially a subset within a given profession, for punishment.[52]

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[50] *See* Alan Wolper, FINRA Stats Reveal Horribly Kept Secret: Small Firms Are The Heart And Soul Of The Brokerage Industry, But Dying Off, Nevertheless, (10 August 2018): "Yesterday, FINRA went one better and released what it called the 2018 FINRA Industry Snapshot, basically, an enhanced version of the data already available on the website. There are no real surprises here, especially to those who, well, to anyone who knows anything about FINRA and its history. But, for the few readers who need some reminding, here are the central themes of the new report. ***First, the membership of FINRA is predominantly made up of small firms.*** In 2017, there were a total of 3,726 broker-dealers. Of that total, almost half – 48.3% – had ten or fewer registered reps. If you look at firms with 20 or fewer RRs, then it goes up to 65.4% of the total. Using FINRA's own criteria for firm size, the number of small firms relative to the total is even more telling:

| | |
|---|---|
| Small Firms (defined as 1 – 150 RRs): | 90.00% |
| Mid-Size Firms (151- 499 RRs): | 5.20% |
| Large Firms (500+ RRs): | 4.80%" |

(Emphasis Supplied) Source: https://www.bdlawcorner.com/2018/08/finra-stats-reveal-horribly-kept-secret-small-firms-are-the-heart-and-soul-of-the-brokerage-industry-but-dying-off-nevertheless/

[51] *See* Alan Wolper, FINRA Stats Reveal Horribly Kept Secret: Small Firms Are The Heart And Soul Of The Brokerage Industry, But Dying Off, Nevertheless, (10 August 2018): "* * *But, this is not news. FINRA has always looked like this. It has always been dominated by small firms. Unfortunately, despite their numbers, the revenues they generate for FINRA, even in the aggregate, cannot come close to matching those of the large firms. Thus, while FINRA technically remains a one-firm/one-vote organization, don't delude yourself into thinking it's truly democratic. ***The voices of large firms are heard way more loudly than the small firms because that's where FINRA gets its money from.*** It is no surprise, therefore, that when this report discloses the "Aggregate Financial Information" for the member firms, FINRA does not bother to break the numbers down by firm size. Instead, all we are shown is the total revenue for all firms, the total expenses, and the total pre-tax net income. If FINRA were to publish these data points separately for small firms, mid-size firms and large firms, it would demonstrate ***that the top 5% or so of broker-dealers are responsible for the lion's share of the revenues and the profits, as well as FINRA's own revenues. And that is not something FINRA is comfortable revealing."*** (Emphasis Supplied) Source: https://www.bdlawcorner.com/2018/08/finra-stats-reveal-horribly-kept-secret-small-firms-are-the-heart-and-soul-of-the-brokerage-industry-but-dying-off-nevertheless/

*See also* Benjamin P. Edwards, The Dark Side of Self-Regulation, 85 University of Cincinnati Law Review 573 (2017): "This Article examines the purportedly public representative serving on FINRA's Board of Governors. It finds that these public representatives often simultaneously serve on the boards of corporate financial intermediaries, giving rise to conflicts of interest between loyalties to market participants and industry lobbying groups and their roles as protectors of the public interest."

[52] Cummins v. Missouri, 71 U.S. (4 Wall.) 277, 315, 324 (1866).



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**4D. <u>One-Time Opportunity to Reduce Staffing Levels [Proposed Rule 4111(c)(2)]; Determination of Maximum Restricted Deposit Requirement [Proposed Rule 4111(i)(15)] and the Fourth Element[53] of Bills of Attainder:</u>**

FINRA proposes to give a member firm a one-time opportunity to "reduce its staff levels to no longer meet [the Preliminary Criteria for Identification] criteria [as a potential Restricted Firm], within 30 days after being informed by [FINRA's Department of Member Supervision]"[54] that the member firm is at risk for being determined to be a Restricted Firm.

At first glance, this looks like an act of magnanimity on FINRA's part. But as we read later on:

> "If, on the other hand, the Department determines that the member *still* meets the Preliminary Criteria for Identification *even after its staff reductions*, or if the member elects not to use its one-time opportunity to reduce staffing levels, the Department would *proceed to determine the member's maximum Restricted Deposit Requirement*, and the member would proceed to a Consultation with the Department."[55]

In other words, "staff reductions" does <u>not</u> amount to a safe harbor that gives the member firm sanctuary from the "soft" punishments described in footnote 30 to this Comment Letter:

> " . . . in place of additional fines and even termination, the proposed new Rule 4111 intends to place on those firms having a "history of misconduct" *extraordinary* compliance and financial burdens (beyond existing compliance and financial requirements) that aim at producing the desired effect of motivating firms to take it upon themselves to simply leave the securities industry. . ."

And so, even if the member firm timely exercises its "one-time" option and reduces its staff, the member firm does not necessarily avoid this "extraordinary financial burden" that FINRA calls the "maximum Restricted Deposit Requirement".

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[53] That is, when a Legislator deems punishment (e.g., deprivation of livelihood) as being absolutely necessary to prevent a group from bringing about events that the Legislator fears (e.g., past acts of "causing trouble") will recur, if not prevented but will be prevented if this proposed new Rule 4111 is adopted.

[54] Regulatory Notice 19-17, at 11.

[55] Regulatory Notice 19-17, at 12. (Emphasis supplied)

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While the maximum Restricted Deposit Requirement may be barely make an impact to the business of a large firm, it would necessarily be crushing for the small and medium sized firm. Demonstration of this is set forth in FINRA's Exhibit "C" to Regulatory Notice 19-17:

> "* * * the Department would set Firm A's maximum Restricted Deposit Requirement between $500,000 and $1,250,000. Considering the member firm's recent rapid growth through the hiring of persons with disciplinary histories, its primary focus on selling high-risk products,[56] and its ongoing supervisory deficiencies as identified in recent examinations, Firm A's maximum Restricted Deposit Requirement would be set in the high end of the range ($750,000 - $1,250,000)."[57]

While underlying revenue, minimum net capital requirements, and excess net capital will be variable from firm to firm; and while underlying applicable arbitrations awards and settlement may each in their turn may go up, down, or remain steady for any particular firm; and therefore, while these variables may change the maximum Restricted Deposit Requirement outcome for each small to mid-sized firm, the formula of the maximum Restricted Deposit Requirement – "50 % of its restricted deposit requirement or 25% of its average excess net capital over the prior year, whichever is less" – will, in any of these variable scenarios, likely be crushing for a small or mid-sized firm.[58]

In a word, FINRA's Determination of a Maximum Restricted Deposit Requirement (Proposed Rule 4111(i)(15) opens the discussion to whether this proposal serves a legitimate coercive purpose and becomes, instead, punitive in character, giving rise to the argument that proposed new Rule 4111 falls squarely in the category of "vindictive legislation", prohibited by the Constitution[59] and the Courts.[60]

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[56] That is, a broker/dealer whose "predominant business lines are retail sales of OTC equities, underwriting, proprietary trading, and market making."

[57] It is true that in FINRA's example, Firm A's maximum Restricted Deposit Requirement is premised on multifarious factors that may vary from other mid-sized firms. In this scenario, FINRA assumes "revenues [are] derived from self-offerings and private placements. A small percentage of its customers are foreign" and "$175,000 in gross revenues (including $130,000 in commissions) over the past 12 months; ... minimum net capital requirement is $5,000; . . . has maintained excess net capital of $9,000 (average over 12 months). [And] has no unpaid customer arbitration awards or settlements."

[58] This will be true for this sized firm, even after having exercised the "one-time" / "staffing reduction" option, thinking that its Rule 4111 problems will go away.

[59] Article I, Section 9, paragraph 3 provides that: "No Bill of Attainder or ex post facto law will be passed."

[60] Weaver v. Graham, 450 U.S. 24, at 29 (1981): "The ban also restricts governmental power by restraining arbitrary and potentially ***vindictive legislation***. Malloy v. South Carolina, 237 U. S. 180, 237 U. S. 183 (1915); Kring v. Missouri, 107 U.S. 221, at 229 (1983); Fletcher v. Peck, 6 Cranch 87, 10 U. S. 138 (1810); Calder v. Bull, 3 U.S. 386, 395, 396 (Paterson, J.); The Federalist No. 44 (J. Madison), No. 84 (A. Hamilton)." (Emphasis supplied)



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It bears repeating here FINRA's *motivation* for justifying proposed new Rule 4111:

> "Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and *multiple rounds of appeals*, thereby *effectively forestalling the imposition of disciplinary sanctions for an extended period.* * * * While a disciplinary proceeding will be commenced as soon as possible (with or without a temporary cease and desist proceeding), the firm *can further prolong the disciplinary action* by litigating through the stages described above. * * *"[61]

In other words, FINRA appears to be saying that it has lost patience with member firms and their brokers who exercise their legitimate rights, as for example taking appeal from adverse enforcement decisions. But the Supreme Court has weighed in on this, stating that:

> "Motives are complex and difficult to prove. As a result, in certain cases in *which action detrimental to the defendant has been taken after the exercise of a legal right,* the Court has found it necessary to *'presume'* an improper *vindictive motive*."[62]

To this general rule, the Court adding the condition: "Given the severity of such a presumption, however — which may operate in the absence of any proof of an improper motive and thus may block a legitimate response to criminal conduct — the Court has done so only in cases in which a *reasonable likelihood* of vindictiveness exists". Responding to this condition, Justice Brennan forcefully writes:

> " ... [in Blackledge v. Perry, 417 U. S. 21 (1974)] we held that the Due Process Clause is violated when situations involving increased punishment "pose a realistic likelihood of vindictiveness,'" Id. at 417 U. S. 27. In such situations, the criminal defendant's apprehension of retaliatory motivation does not amount to an unreal or technical violation of his constitutional rights. On the contrary, as we recognized in North Carolina v. Pearce, 395 U. S. 711, 395 U. S. 725 (1969), "the *fear of such vindictiveness may unconstitutionally deter a defendant's exercise" of his rights*." [63]

In other words, vindictiveness in the wake of the exercise of one's rights is unconstitutional.

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[61] Regulatory Notice 19-17, p. 4. 5. (Emphasis supplied)

[62] United States v. Goodwin, 457 U.S. 368, at 373 (1982). In other words, the Supreme Court would say that proposed new Rule 4111 is very likely vindictive, as evidences by the motive set forth in Regulatory Notice 19-17, p. 4. 5. (Emphasis supplied)

[63] United States v. Goodwin, 457 U.S. 368, at 389 (1982). (Emphasis supplied)



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FINRA's express motive in crafting proposed new Rule 4111 avoids the necessity to discuss whether the Court's "condition" might apply because, for FINRA, some solution – FINRA's proposed new Rule 4111, which is different from traditional enforcement solution – is needed, because

- "While a disciplinary proceeding will be commenced as soon as possible (with or without a temporary cease and desist proceeding), the firm *can further prolong the disciplinary action* by litigating through the stages described above."[64]

- "Enforcement actions in turn can *only* be brought *after a rule has been violated*—and any resulting customer harm has already occurred."[65]

FINRA seems to be saying that, because member firms and their brokers exercise their legal rights of appeal, FINRA has no choice but to take action detrimental to defendants / respondents in enforcement proceedings who exercise their appellate rights. The solution for righting this injustice is the proposed new Rule 4111(i)(15): Determination of a Maximum Restricted Deposit Requirement.

FINRA's justification is that something is needed *beforehand – before violations occur*. The problem, however, is of a constitutional nature.

Proposed new Rule 4111 is a Bill of Attainder, especially because it is legislation that intentionally targets a subset of the FINRA membership, aims at repairing the injustices that (in FINRA's view) comes about when legitimate rights (e.g., taking of an appeal) are exercised by brokers and their firms.

Proposed new Rule 4111 meets the 4th element of a Bill of Attainder: when the Rule-Maker deems punishment (e.g., deprivation of livelihood) as being absolutely necessary to prevent a group from bringing about events that the Legislator fears (e.g., past acts of "causing trouble") will recur, if not prevented but will be prevented if this proposed new Rule 4111 is adopted.

This kind of rule-making, while surely intended to bring about justice, amounts to *legislation* and, as will be shown in the sections that follow, it is legislation that circumvents constitutional due process.

[64] Regulatory Notice 19-17, p. 4. 5. (Emphasis supplied)

[65] Regulatory Notice 19-17, p. 4. (Emphasis supplied)



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## 5. Rule-Making as Legislation

We anticipate FINRA's objections: FINRA is engaged in Rule-Making (as for example rules made by the SEC and, especially, FINRA); but FINRA Rule-making is not "legislation" – as the layperson understands to be associated with a statute created by a state legislative body or by the Congress of the United States.

But there is ample precedent that supports the proposition that rule-making and legislation are one and the same.
There are two (2) seminal U.S. Supreme Court decisions that support the proposition that rule-making can be tantamount to legislation. The first case is the *Chevron*[66] decision. The second case is the *Mead* decision.[67] When determining whether a rule created by an administrative agency has the "force of law", the courts apply the Supreme Court's *Chevron-Mead* analysis. When all the stars align in this analysis, "force of law" deference is given to the administrative agency's rule-making, and the rules and regulations that result. In short, when an agency's rule has the "force of law" that rule is tantamount to legislation.

For example, when the Supreme Court employed the *Chevron-Mead* analysis to the Internal Revenue Service, the Court held that Internal Revenue rules carry the force of law.[68]

In *Chevron*, the Supreme Court was asked to decide whether an agency's construction of a statute of Congress should be given deference as having the "force of law". The issue centered on silence of a statute and Congressional delegation:

- Whenever a statute "is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."[69]

- If there is an express delegation, "[s]uch *legislative* regulations [i.e., the agency's rule-making] are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."[70]

[66] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc ., 467 U.S. 837 (1984).

[67] United States v. Mead Corp., 533 U.S. 218 (2001).

[68] Mayo Foundation for Medical Education & Research v. United States, 131 S.Ct. 704, 714 (2011). *Accord* Swallows Holding, Ltd. v. Comm'r, 515 F.3d 162, 168-170 (3rd Cir. 2008)(finding general grant of power to Secretary of Treasury to promulgate rules with force of law.)

[69] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc ., 467 U.S. at 844 (1984).



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- If there is an implicit delegation, "a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency."[71]

In *Mead*, the Supreme Court held that when "it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority",[72] then the agency's exercise of rule-making has the force of law. But in reaching this conclusion, the Court set forth the following very relevant guidance:

> "Delegation of such authority may be shown in a variety of ways, as by an agency's *power to engage in adjudication*[73] or *notice-and-comment rule making*, or by some other indication of comparable congressional intent."[74]

The author of an important law review article has made a compelling case for this proposition that Rule-Making equates with Legislation. In *The Bill of Attainder Clauses: Protections From the Past in the Modern Administrative State*[75] the author recites the obvious:

> "It is widely acknowledged that Congress now delegates a significant amount of lawmaking power to executive and other administrative agencies,[76] deferring to an

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[70] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc ., 467 U.S. at 844 (1984). Note the Court's reference to the agency's regulations as "legislative" regulations.

[71] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc ., 467 U.S. at 844 (1984).

[72] United States v. Mead Corp., 533 U.S. 218, at 226-227 (2001).

[73] This element [the power to engage in adjudication] will be addressed separately, elsewhere in this Comment Letter. For our purposes here, there is no disputing that FINRA has (1) an adjudicatory process and (2) proposes rules subject to notice-and-comment and therefor fits squarely within the parameters of *Mead.*

[74] United States v. Mead Corp., 533 U.S. 218, at 227 (2001) (Emphasis supplied).

[75] John J. Cavaliere, III, The Bill of Attainder Clauses: Protections From the Past in the Modern Administrative State, 12:1 Ave Maria Law Review 149 (Winter, 2014).

[76] In support of this proposition, the author cites Humphrey's Ex'r v. United States, 295 U.S. 602, 628–31 (1935) describing Federal Trade Commission as an agency created to exercise "quasi legislative" and "quasi-judicial" functions, and is therefore outside the executive branch); Mistretta, 488 U.S. at 368, 371 (recognizing sentencing commission as an "independent commission in the Judicial Branch of the United States" via 28 U.S.C. § 991(a) (1982) and not finding excessive delegation); cf. id. at 427 (Scalia, J., dissenting) (calling recognition of the independent commission within the Judicial Branch the creation of another branch entirely or a "junior-varsity Congress"); *accord* FTC v. Ruberoid Co., 343 U.S. 470, 487 (1952) (Jackson, J., dissenting) (dubbing agencies "a veritable fourth branch of the Government").



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> agency's expertise in a particular field in order to promote efficient policy outcomes.[77] Often, these administrative rules represent the real substance of legislative action because the statute provides on the most minimal standards for an agency to follow while the administrative action is found to enjoy 'the force of law'. "[78]

As this author points out, the Supreme Court has already concluded that the regulations of the U.S. Treasury and the rules of the Internal Revenue Service – administrative agencies of the federal government – have the "force of law".

As for regulations of the Securities and Exchange Commission, there is likewise no question – at least in the mind of the SEC – that "federal statutes and the *SEC rules and regulations* have the force of law."[79]

According to SEC Chairman Jay Clayton:

> "The mission of the SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. In furtherance of this mission, the Commission promulgates rules and regulations, which generally have the *force and effect of law*, and enforces compliance with its rules and regulations."[80] (Emphasis supplied)

To this statement, the Chairman adds the following footnote: "Such rules and regulations generally take effect only after the Commission publishes a notice of proposed rulemaking in the Federal Register, and adopts a final rule which considers public comments on the proposal in accordance with the Administrative Procedure Act."[81]

[77] In support of this proposition, the author cites Chevron, 467 U.S. at 843–44 (discussing Congress' explicit or implicit gaps left open in legislation for agency to fill, which "necessarily requires the formulation of policy and making of rules" by the agency).

[78] John J. Cavaliere, III, The Bill of Attainder Clauses: Protections From the Past in the Modern Administrative State, 12:1 Ave Maria Law Review 149, at 165 (Winter, 2014). In support of this proposition, the author cites United States v. Mead Corp., 533 U.S. 218, 231–32 (2001) (finding no delegation to Customs to "issue classification rulings with the force of law"), [compare] with Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 714 (2011) (finding Internal Revenue rule to carry force of law), and Swallows Holding, Ltd. v. Comm'r, 515 F.3d 162, 168–70 (3d Cir. 2008) (finding general grant of power to Secretary of Treasury to promulgate rules with force of law).

[79] Researching the Federal Securities Laws Through the SEC Website (4 December 2012). https://www.sec.gov/reportspubs/investor-publications/investorpubssecuritieslawshtm.html.

[80] Statement Regarding SEC Staff Views (13 September 2018). Source: https://www.sec.gov/news/public-statement/statement-clayton-091318#_ftn1

[81] Statement Regarding SEC Staff Views (13 September 2018). Source: https://www.sec.gov/news/public-statement/statement-clayton-091318#_ftn1



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To make binding law through actions in the nature of rulemaking, the agency must use legislative rules, which ordinarily must be made in accordance with the notice-and-comment procedures specified by section 553 of the Administrative Procedure Act (APA).

Although not necessarily bound to follow the APA, FINRA does follows the "notice-and-comment rule making" procedure. Case at hand is Regulatory Notice 19-17.[82] When combined with FINRA's power to engage in adjudications (such as in FINRA's Office of Hearing Office and National Adjudicatory Council enforcement proceedings), it becomes very persuasive that FINRA's rule-making has the "force of law".

Therefore, to resolve any doubt, our analysis proceeds to the next question, which is whether FINRA's rule-making has lineage that traces back to Congress.

If it does, either directly or indirectly, then FINRA's rule-making has the "force of law", and this has implications for the ultimate question, whether proposed new Rule 4111 and amendments to Rule 9559 et al implicates the constitutional prohibition against Bills of Attainder.

## 6. FINRA and Congressional Delegation

In 1934, Congress established the system of regulation over the securities industry through the passing of the Exchange Act signed by President Franklin D. Roosevelt. The Exchange Act included

[82] Regulatory Notice 19-17: "As part of FINRA's ongoing initiatives to protect investors from misconduct, FINRA is *requesting comment* on proposed new Rule 4111 (Restricted Firm Obligations) * * * FINRA is *requesting comment* on: 1. proposed new Rule 4111 (Restricted Firm Obligations), which would authorize FINRA to require "Restricted Firms," identified by a multistep process involving threshold calculations, to make deposits of cash or qualified securities that could not be withdrawn without FINRA's prior written consent, adhere to other conditions or restrictions on the member's operations that are necessary or appropriate for the protection of investors and in the public interest, or be subject to some combination of those obligations; and 2. proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111) (new Rule 9559) and amendments to existing Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series) to be renumbered as Rule 9560 (Rule 9560 or the Hearing Procedures Rule) to create an expedited proceeding that allows a prompt review of the determinations under the Restricted Firm Obligations Rule and grants a member a right to challenge any obligations imposed. * * * FINRA encourages all interested parties to *comment. Comments* must be received by July 1, 2019. * * * FINRA *welcomes comments* on alternative ways of calculating the Restricted Deposit Requirement that would be more predictable while remaining impactful but avoiding disproportionate effects on different types of firms. * * * FINRA *seeks comment* on potential alternatives to the proposed amendments in this Notice and why these alternatives may be more efficient or effective at addressing broker and firm misconduct than the proposed amendments. * * * FINRA *specifically seeks com*ments on alternatives FINRA should consider for the Expelled Firm Association Metric and why these alternatives may be more effective and efficient for identifying the firms that this proposal seeks to address. * * * FINRA *requests comment on all aspects of the proposal.* FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues. * * * In addition to comments responsive to these questions, FINRA *invites comment on any other aspects of the rules that commenters wish to address.* FINRA further requests any data or evidence in support of comments. While the purpose of this Notice is to obtain input as to whether or not the current rules are effective and efficient, FINRA also welcomes specific suggestions as to how the rules should be changed." At pp. 1, 2, 12, 30, 33, 34, and 37.



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provisions for administration of markets and oversight of industry participants by private organizations, such as the New York Stock Exchange.

In 1938, Congress amended the Exchange Act by including provisions to authorize the formation and registration of National Securities Associations (NSAs) that would address conduct of their members under the supervision of the Securities and Exchange Commission (SEC). The amendment authorized the SEC to delegate to NSAs regulatory oversight of broker-dealers that were not members of a national securities exchange.[83] This amendment has come down to us as The Maloney Act.

The Maloney Act added the new section 15A to the Exchange Act to allow any association of brokers or dealers meeting certain statutory requirements to register with the SEC as a national securities association.[84]

In 1964 Congress amended section 15A of the Exchange Act to require, for the first time, that National Securities Associations (NSAs) have standards of financial responsibility for member firms and standards of training, experience, and other qualifications for associated persons.

This amendment also permitted the then sole NSA – the National Association of Securities Dealers (NASD), now the Financial Industry Regulatory Authority (FINRA) – to bring disciplinary proceedings against associated persons without proceeding against their firms.

Preliminary to the 1964 amendment to 15A of the Exchange Act, extensive hearings were held before Senate Committee on Banking and Currency. The Senate issued Report of the Committee on Banking and Currency to Accompany S. 1642, S. Rep. No. 88-379 (1963) ("Committee Report"). The Committee Report emphasized NASD as a regulator acting pursuant to authority delegated to it by Congress:

> "Registered securities associations are no private clubs. They are *organized under statutory authority* to perform, under governmental oversight, regulatory functions in the over-the counter securities market."[85]

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[83] Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o-3 (2006)); Id. § 15A(a) (codified as amended at 15 U.S.C. § 78o-3(a)); *see also* VI Securities Regulation (Louis Loss, Joel Seligman & Troy Paredes) 194-95 (4th ed. 2011).

[84] 15 U.S.C. § 78o-3 (2012).

[85] Securities and Exchange Commission Legislation 1963, S. Rep. No. 88-379, at 42 (1963).



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According to the Committee Report accompanying this legislation, these amendments:

- "[C]ontemplate[d] an even greater degree of reliance upon self-regulation, although under somewhat more intensive [SEC] supervision."[86]

- Essentially repudiated the Maloney Act's concept of a voluntary membership association enforcing through contract its business and ethical standards on its members and instead emphasized that the association was a regulator acting *pursuant to delegated authority.*[87]

This emphasis on delegated government power becomes the dominant theme in subsequent congressional consideration of the concept of securities self-regulation, although lip service is still paid to the Maloney Act's concept of self-regulation.[88]

In an early federal district court decision, shortly following the 1964 Amendments to the Maloney Act, investors instituted a class action for breach of contract against various broker-dealers and the NASD. The NASD and SEC decided that the particular investment program involved was harmful to public investors and, "after extensive consultation with and the express approval of" the SEC, the NASD issued an interpretation barring NASD member securities dealers from participating in the program. The defendant broker-dealers complied, thus repudiating their existing contracts with the plaintiff investors. Plaintiffs argued that the NASD's action was an interference with their contract, a violation of the antitrust laws, and a violation of due process of law.[89] In this case, the issue of Congressional delegation held center stage.

- NASD argued that any interference with plaintiffs' contracts was not wrongful because it *was properly exercising its delegated authority pursuant to the Maloney Act*, that its Interpretation was valid and that it was not retroactive because it merely interpreted a Rule which had been in effect for approximately 26 years, that plaintiffs showed no violation of the antitrust laws and that in any event the antitrust laws do not apply to this situation, and that there was no constitutional infirmity in the Association's actions. NASD disclaimed any position as to liability of Growth Programs or Supervised Investors to the plaintiffs for breach of contract.

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86 Securities and Exchange Commission Legislation 1963, S. Rep. No. 88-379, at 42 (1963).

87 Securities and Exchange Commission Legislation 1963, S. Rep. No. 88-379, at 42 (1963).

88 Barbara Black, Punishing Bad Brokers: Self-Regulation and FINRA Sanctions, 8 Brook. J. Corp. Fin. & Com. L. at 33 (2013). https://brooklynworks.brooklaw.edu/bjcfcl/vol8/iss1/2.

89 Harwell v. Growth Programs, Inc., 315 F. Supp. 1184 (W.D. Tex. 1970), *rev'd on other grounds*, 451 F.2d 240 (5th Cir. 1971), *modified per curiam*, 459 F.2d 461 (5th Cir.), *cert. denied*, 409 U.S. 876 (1972).



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- The Securities and Exchange Commission has filed an amicus curiae brief in which it defended the NASD Interpretation as being *clearly within its power under the Maloney Act* and not promulgated in violation of due process of law. The SEC argued that the issuance of the Interpretation of existing Rules of Fair Practice by NASD, with SEC concurrence, did not constitute a violation of the antitrust laws, and took no position as to the liability of Growth Programs or Supervised Investors to plaintiffs on the breach of contract action.

In its ruling, the Court wrote:

> "It is of course hornbook law that Congress can and often does permissibly delegate "public policy determination" to an administrative agency. *It is quite clear that the Maloney Act empowered the NASD to act subject to pervasive supervision by the SEC* as a quasi-governmental agency[90] charged with the responsibility of promoting, and enforcing, "just and equitable principles of trade" in the over-the-counter markets. *This Congressional delegation of policy-making power to the NASD has been upheld in* both R. H. Johnson & Co. v. S.E.C., 198 F.2d 690 (2nd Cir. 1952), cert. denied 344 U.S. 855, 73 S. Ct. 94, 97 L. Ed. 664 (1952) and in Nassau Securities Service v. S.E.C., 348 F.2d 133 (2nd Cir. 1965)."[91] (Emphasis supplied)

The issue of Congressional delegation of authority to NASD was again raised in 1977.

In *Todd & Co., Inc. v. SEC*,[92] the Third Circuit considered whether Congress's delegation of authority to the National Association of Securities Dealers (NASD) constituted an unconstitutional delegation to a private entity.[93] The plaintiff, a broker/dealer, contested an NASD investigation of its activities on the ground that the Maloney Act constituted an undue delegation to a private entity. The Court found that the Maloney Act *authorized* the self-regulatory entity to *promulgate rules* protecting against

[90] Network 1 is well aware that FINRA has consistently maintained that it is not a "quasi-governmental agency". This question was extensively addressed in Network 1's Comment Letter to Regulatory Notice 18-16 (relating to High Risk Brokers), and will be revisited elsewhere in today's Comment Letter. For the time being, it bears noting that *Harwell* is not being offered for the proposition that FINRA is a "quasi-governmental agency"; *Harwell* is, instead, offered to demonstrate that, as far back 1970, the federal courts have recognized that FINRA (formerly, NASD) ***holds rule-making powers that have been delegated to it by Congress from the time that "National Securities Associations" were created through the Maloney Act, and that this delegation has been reinforced by subsequent amendments to the Maloney Act.***

[91] Harwell v. Growth Programs, Inc., 315 F. Supp. 1184, 1188 (W.D. Tex. 1970). The court entered summary judgment against plaintiffs on all claims. Id. at 1192. The plaintiffs appealed to the Fifth Circuit. While the Fifth Circuit reversed on the grounds that the district court had not fully considered certain factual issues and that parties are not always free from liability on contracts that government regulation renders impossible to perform, the Fifth Circuit did not abrogate the "delegation of authority by Congress" issue raised by both the NASD and SEC.

[92] 557 F.2d 1008 (3d Cir. 1977).

[93] 557 F.2d 1008, at 1011–12.



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fraudulent and unethical practices, and to *discipline members* who failed to conform to the standards promulgated.[94] The Court also found that Congress authorized the SEC to review the NASD's findings upon appeal.[95] But the Court rejected the plaintiff's challenge because the Securities and Exchange Commission (SEC) retained the power "to approve or disapprove the Association's rules," to make additional findings if necessary, and "make an independent decision on the violation and penalty,"[96] and on these grounds found no impermissible exercise of authority by NASD. In other words, the Court agreed that NASD held authority delegated to it by Congress via the Maloney Act, and that this delegation of authority was not unconstitutional.

In addition to direct delegation of powers from Congress, FINRA has been delegated powers by the SEC, which the SEC has directly received from Congress. These two sources of delegation, direct and indirect sources, form the very basis of FINRA's position that it is entitled to absolute immunity in lawsuits. The Second Circuit, as recently as 2011, has affirmed this:

> "There is no question that an SRO and its officers are entitled to absolute immunity from private damages suits in connection with the discharge of their regulatory responsibilities. This immunity extends both to affirmative acts as well as to an SRO's omissions or failure to act.... It is patent that the consolidation that *transferred NASD's and NYSE's regulatory powers to the resulting FINRA* is, on its face, an exercise of the SRO's *delegated regulatory functions* and thus entitled to absolute immunity.... The statutory and regulatory framework highlights to us the extent to which an SRO's bylaws are intimately intertwined with the *regulatory powers delegated to SROs by the SEC* and underscore our conviction that immunity attaches to the proxy solicitation here."[97] (Emphasis supplied)

There is no disputing that Congress has authorized self-regulatory organizations, such as the National Association of Securities Dealers, now the Financial Industry Regulatory Authority (FINRA), to investigate and prosecute violations of federal law.[98] Indeed, various attacks on the NASD's

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[94] 557 F.2d 1008, at 1012.

[95] 557 F.2d 1008, at 1012.

[96] 557 F.2d 1008, at 1012.

[97] Standard Investment Chartered Inc. v. National Association of Securities Dealers, 637 F.3d 112 (2d Cir. 2011), *cert. denied* January 17, 2012.

[98] *See, e.g.*, 15 U.S.C. § 78o-3(b)(7) (2006). Firms wishing to trade securities have no choice but to join a self-regulatory organization. Id. § 78o(b)(8). Firms and individuals disciplined, whether through fines or withdrawal of trading privileges, have a right of appeal to the SEC, but the SEC cannot add any findings to the record. Id. § 78s(e)(1), (f).



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disciplinary authority based on a theory of unconstitutional delegation of legislative authority by Congress have been unsuccessful.[99]

Because this delegation of authority is so amply demonstrated by FINRA's notice-and-comment rule-making in support of enforcing federal securities laws, not to mention the power of FINRA to engage in adjudication of violations of federal securities laws, *FINRA rules enjoy the "force of law"*.

An important comment needs to be inserted here. It is often remarked at the various industry conferences that FINRA is not the only SRO, as if to imply that, because FINRA is but one of forty-one (41) Self-Regulatory Organizations or SROs, the force of FINRA's "laws" (i.e., rules) is no more powerful, and therefore no more invasive of the capitalist spirit, than any of the other SRO rules.

It is true that FINRA is "only one" of 41 SROs.[100] There are twenty-two (22) SROs that are "exchanges".[101] There are five (5) registered securities futures products exchanges.[102] There are eleven (11) registered clearing agencies.[103] The Municipal Securities Rulemaking Board is in a class of its own.[104] And there are two (2) national "registered securities associations": The National Futures

[99] *See, e.g.,* Sorrell v. SEC, 679 F.2d 1323, 1325 (9th Cir. 1982); First Jersey Securities, Inc. v. Bergen, 605 F.2d 690, 697 (3d Cir. 1979), cert. denied, 444 U.S. 1074 (1980); Todd & Co., Inc. v. SEC, 557 F.2d 1008, 1012 (3d Cir. 1977); R. H. Johnson & Co., v. SEC, 198 F.2d 690, 695 (2d Cir.), cert. denied, 344 U.S. 855 (1952).

[100] 15 USC §78c(a)(26): "The term 'self-regulatory organization' means any national securities exchange, registered securities association, or registered clearing agency, or (solely for purposes of sections 78s(b), 78s(c), and 78w(b) [1] of this title) the Municipal Securities Rulemaking Board established by section 78o–4 of this title."

[101] These include: (1) BOX Exchange LLC; (2) CBoe BYX Exchange, Inc.; (3) Cboe BZX Exchange, Inc.; (4) Cboe C2 Exchange, Inc.; (5) Cboe EDGA Exchange, Inc.; (6)Cboe EDGX Exchange, Inc.; (7) Cboe Exchange, Inc.; (8) Investors Exchange LLC; (9) Miami International Securities Exchange LLC; (10) MIAX Emerald, LLC; (11) MIAX PEARL, LLC; (12) Nasdaq BX, Inc.; (13) Nasdaq GEMX, LLC; (14) Nasdaq ISE, LLC; (15) Nasdaq MRX, LLC; (16) Nasdaq PHLX LLC; (17) The Nasdaq Stock Market LLC; (18) New York Stock Exchange LLC; (19) NYSE Arca, Inc.; (20) NYSE American LLC; (21)NYSE Chicago, Inc.; (22) NYSE National, Inc. Source: https://www.sec.gov/rules/sro.shtml.

[102] These include: (1) CBOE Futures Exchange; (2) Chicago Board of Trade; (3) Chicago Mercantile Exchange; (4) OneChicago; and (5) NQLX. Source: https://www.sec.gov/rules/sro.shtml.

[103] These include: (1) Banque Centrale De Compensation; (2) Boston Stock Exchange Clearing Corporation; (3) Chicago Mercantile Exchange LLC; (4) Fixed Income Clearing Corporation; (5) ICE Clear Credit LLC; (6) ICE Clear Europe Limited; (7) National Securities Clearing Corporation; (8) The Options Clearing Corporation; (9) Stock Clearing Corporation of Philadelphia; (10) The Depository Trust Company; and (11) Fixed Income Clearing Corporation. Source: https://www.sec.gov/rules/sro.shtml.

[104] The MSRB was created under §78o–4of the Exchange Act of 1934. The SEC classifies the MSRB as "Other" in its list of Self-Regulatory Organizations. Source: https://www.sec.gov/rules/sro.shtml.



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Association[105] and FINRA. What is often overlooked is the fact that FINRA, formerly NASD (which is the original "registered national securities association" following passage of the Maloney Act), is the only SRO that is a Registered *Securities* Association. A "registered securities association" is "an association of broker dealers" registered as a "national securities association" under Section 15(A) of the Exchange Act.[106]

Being a "registered securities association" is significant:

- *Congress* gives "registered securities associations" the authority and power to deny membership to its association to any person who is not a registered broker or dealer.[107]

- *Congress* gives "registered securities associations" the authority and power to deny membership to any registered broker or dealer, and bar from becoming associated with a member any person, who is subject to a statutory disqualification.[108]

- *Congress* gives "registered securities associations" the authority and power to deny membership or make membership conditional to a broker or dealer that does not meet standards of financial responsibility.[109]

- *Congress* gives "registered securities associations" the authority and power to deny membership or make membership conditional to a broker or dealer that does not meet standards of training, experience, and competency.[110]

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[105] In 1974 Congress established the Commodity Futures Trading Commission (CFTC), a federal regulatory agency with jurisdiction over futures trading. Section 17 of the Commodity Exchange Act (7 U.S.C. 21) authorized the creation of "registered futures associations," giving the futures industry the opportunity to create a nationwide, self-regulatory organization. The National Futures Association (NFA) is the self-regulatory organization (SRO) created pursuant to this mandate. The NFA is the SRO for the U.S. derivatives industry, including on-exchange traded futures, retail off-exchange foreign currency (forex) and OTC derivatives (swaps). The NFA has jurisdiction over "security futures products", but not "securities" - as "securities" is defined under the Section 78c(a)(10) of the Exchange Act. The term "security futures product" means a security future or any put, call, straddle, option, or privilege on any security future. 15 USC §78c(a)(56). The NFA began operations in 1982.

[106] 15 USC §78o-3(b).

[107] 15 USC §78o-3(g)(1).

[108] 15 USC §78o-3(g)(2).

[109] 15 USC §78o-3(g)(3)(A)(i).

[110] 15 USC §78o-3(g)(3)(A)(i).



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- *Congress* gives "registered securities associations" the authority and power to deny membership or make membership conditional when a broker or dealer "has engaged and there is a reasonable likelihood he will again engage in acts or practices inconsistent with just and equitable principles of trade."[111]

- *Congress* gives "registered securities associations" the authority and power to bar a natural person (i.e.,"broker") from associating with a broker or dealer when the "broker" has "engaged and there is a reasonable likelihood he will again engage in acts or practices inconsistent with just and equitable principles of trade."[112]

- *Congress* gives "registered securities associations" the authority and power to restrict its members (brokers and dealers) from dealing with non-members.[113]

For all intents and purposes, because FINRA is the only "registered *securities* association", no broker/dealer or "broker" can professionally buy and securities for another person without being a member of FINRA and without being associated with a member of FINRA. The official comment to Cornell University's Legal Information Institute puts it this way:

> "In addition to securities exchanges, broker-dealer firms who must register under the Exchange Act can only transact in the over the counter market (i.e. securities traded outside of an exchange) if they are members of a registered securities association. (*See* Exchange Act §§ 5(b)(8) and 5(b)(9).) Given that the vast majority of securities are traded over-the-counter and that a securities association can require its

[111] 15 USC §78o-3(g)(3)(A)(ii). At first glance, this Congressional mandate appears to support FINRA's proposed new Rule 4111. It does – broadly speaking, but with this historic qualification: If this Congressional mandate supports Rule 411, then there is no escaping the conclusion that Rule 4111 has the "force of law"; and, because Rule 4111 has the "force of law", then FINRA Rules both generally speaking and this proposed new Rule 4111 in particular are subject to the same constitutional constraints to which all Congressional statutes are subject. In other words, just as a Congressional statute is subject to the constitutional prohibition against Bills of Attainder, then so also are FINRA Rules in general – and this proposed new Rule 4111 – subject to the constitutional prohibition against Bills of Attainder. Indeed, as the balance of Section 6 of this Comment Letter (relating to FINRA and Congressional Delegation) demonstrates, proposed new Rule 4111 is a Bill of Attainder under the *Chevron-Mead* analysis precisely because FINRA rules have the "force of law" as a result of Congressional delegation.

[112] 15 USC §78o-3(g)(3)(B)(ii). The explanation rendered in footnote 113 applies likewise to this provision.

[113] 15 USC §78o-3(e)(1): "The rules of a registered securities association may provide that no member thereof shall deal with any nonmember professional (as defined in paragraph (2) of this subsection) except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public."



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members to trade only with other members, this provision effectively require[s] almost all broker-dealers to register with a securities association [read: NASD, now FINRA]."[114]

Since Exchange Act §§ 5(b)(8) and 5(b)(9) "effectively require[s] almost all broker-dealers to register with a securities association"; and because FINRA is the *only* SRO that is a "registered *securities* association", FINRA ***is*** the only "game in town" when a broker or dealer or an associated person wants to engage in the securities and investment banking business in the United States.

In other words, the FINRA membership agreement that a broker or dealer obtains via the Rule 1013 Membership Application Process, and the "registration" that an associated person obtains when he passes the Series 7 or Series 79 or other FINRA examinations, are, *in effect*, "federal licenses" to engage in the securities or investment banking business – precisely because of the aforementioned *Congressional* delegation of powers to "registered securities associations".

For these reasons, FINRA rules ***do*** have the "force of law"; and, because FINRA ***is*** the only "game in town" – the Keeper of these "federal licenses" - no other SRO rules are more powerful, and therefore potentially more invasive of the capitalist spirit, than FINRA's rules.

And because FINRA rules enjoy the "force of law", FINRA rule-making (as set forth in Regulatory Notice 19-17 (relating to Protecting Investors from Misconduct) is arguably "legislation". And because FINRA rule-making is a legislative act, FINRA rules are subject to the constitutional prohibition against Bills of Attainder under the *Chevron-Mead* analysis.

## 7. Proposed Amendments to Rule 9550 – Expedited Proceedings to Implement Proposed Rule 4111 and the Fifth Element[115] of Bills of Attainder:

FINRA is proposing to establish a new "expedited" proceeding in the Rule 9550 Series (Expedited Proceedings). Under proposed new Rule 9559 (Procedures for Regulating Activities Under Rule

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[114] Cornell University's Legal Information Institute: Self regulatory organization. Source: https://www.law.cornell.edu/wex/self_regulatory_organization.

[115] The fifth element is "punishment without a judicial trial". To restate the definition, a Bill of Attainder is a law that:

A. Passes judgment about who is "unfit" to engage in a profession.
B. Bases this judgment largely on the group's "past acts" of causing trouble.
C. Creates criteria to define who is "unfit" and then targets a "group", especially a subset within a given profession, to match such criteria.
D. Deems punishment – e.g., deprivation of livelihood – absolutely necessary to keep that group from bringing about events that the legislator fears will recur, again and again– e.g., past acts of causing trouble – if not prevented.
E. Punishes without a judicial trial.



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4111), member firms can request a prompt review of the Department's determinations under the Restricted Firm Obligations Rule and challenge the Restricted Deposit Requirement imposed on the member firm as well as any of the "Rule 4111 Requirements".[116] The new expedited proceeding grant affected member firms the right to seek a Hearing Officer's review of those determinations.[117]

Proposed new Rule 9559(a) has a notice provision, but the more significant aspect of Rule 9559(a) for purposes of this Comment Letter's discussion of Bills of Attainder is the "immediate effective[ness]" of any and all Rule 4111 Requirements imposed by FINRA once the member firm has passed from Preliminary Identification to Consultation to Restricted Firm determination by the Department of Member Supervision.

In other words, even when a member firm essentially "appeals" the determination of the Department to a "higher" authority within FINRA, namely, the Hearing Officer, there is *no postponement or deferment*[118]of the "soft punishments" – the Restricted Deposit Requirement as well as any of the other "Rule 4111 Requirements" imposed on the member firm by the Department of Member Supervision. It bears mentioning here that, even if the member firm timely exercises its "one-time" opportunity under Proposed Rule 4111(c)(2) and reduces its staff, the member firm does not necessarily avoid this "extraordinary financial burden" that FINRA calls the "maximum Restricted Deposit Requirement".

It is true that proposed new Rule 9559(a) allows the member firm to request for a hearing in an expedited proceeding within seven (7) days after service of Department's notice. But there is a quid pro quo for requesting an expedited hearing: When a member requests expedited review of the Department determination that imposes a Restricted Deposit Requirement on the member for the first time, the member is required to deposit while the expedited proceeding is pending, the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital over the prior year.

Again, another "soft punishment".

The point is this: Even though a member firm is afforded the right to "appeal" to the Hearing Officer, and even "request expedited hearing" on the decision of the Department of Member Supervision, Rule

[116] Proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111) (new Rule 9559) and amendments to existing Rule 9559 (Hearing Procedures for Expedited Proceedings Under the Rule 9550 Series) to be renumbered as Rule 9560 (Rule 9560 or the Hearing Procedures Rule) to create an expedited proceeding that allows a prompt review of the determinations under the Restricted Firm Obligations Rule and grants a member a right to challenge any obligations imposed. Regulatory Notice 19-17, p. 2.

[117] Regulatory Notice 19-17, p. 18.

[118] " * * *Rule 4111 Requirements imposed in a notice issued under proposed new Rule 9559(a) are immediately effective. In general, a request for a hearing would not stay those requirements." Regulatory Notice 19-17, p. 18.



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9559 (Procedures for Regulating Activities Under Rule 4111) is, in fact, not so member-friendly, but instead is crafted with a silent expectation that the member firm will simply throw its towel into the ring as a token of defeat.

But the constitutional problem that arises from the proposed Rule 9559 structure is twofold:

- Proposed Amendments to Rule 9550 triggers due process concerns.
- Proposed Amendments to Rule 9550 fails to meet the Bill of Attainder test for protections afforded by a "judicial trial".

### 7.A Proposed Rule 9559 (Expedited Proceedings to Implement Proposed Rule 4111) and Due Process Concerns

Proposed amendments to Rule 9559 are built on the quasi-judicial device of having a FINRA Hearing Officer *review*, even on an expedited basis, the "Restricted Firm" determination by the Department of Member Supervision.

But the constitutionality of this device stands or falls on the question whether the FINRA Hearing Officer – as an *Institution Charged with Adjudication* – is without conflict of interest and therefore can be, and in fact is, neutral.[119]

#### 7.A.1 Whether Impartiality Is Built into the Institution?

FINRA states that the "Office of Hearing Officers is an independent office of impartial adjudicators who preside over disciplinary cases brought by FINRA's Department of Enforcement."[120]

This statement about impartiality claimed by FINRA as well as FINRA's assertion about separation of powers (i.e., judiciary and enforcement powers) notwithstanding,[121] it must still be asked: Does the

[119] *See e.g.,* Marshall v. Jerrico, 446 U.S. 238, 242 (1980); Schweiker v. McClure, 456 U.S. 188, 195 (1982): "The neutrality requirement helps to guarantee that life, liberty, or property will not be taken on the basis of an erroneous or distorted conception of the facts or the law. . . . At the same time, it preserves both the appearance and reality of fairness . . . by ensuring that no person will be deprived of his interests in the absence of a proceeding in which he may present his case with assurance that the arbiter is not predisposed to find against him." *See also* Martin H. Redish & Lawrence C. Marshall, Adjudicatory Independence and the Values of Procedural Due Process, 95 Yale L.J. 455, 475 (1986), *supra* note 3, at 475: "*participation of an independent adjudicator*" is the core procedural due process requirement, *more paramount even than* participatory rights to notice and an opportunity to be heard." (Emphasis supplied)

[120] FINRA, Office of Hearing Officers, http://www.finra.org/industry/oho.



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soil from which Hearing Officers are appointed support a presumption of impartiality in the Hearing Officer? It is in the light of this question that proposed new Rule 9559 – the Hearing Officer's review of the "Restricted Firm" determination by the Department of Member Supervision – must be judged in light of well-established principles of fundamental justice that are fixed in American jurisprudence.[122]

Therefore, who qualifies to be a Hearing Officer? Stated differently, are their conflicts of interest grounded in the very eligibility requirements qualifying an individual to become a Hearing Officer?

### 7.A.2 Whether Conflicts of Interest are Ingrained in the Institution?

According to FINRA Rule 9120(r), a Hearing Officer is "an employee of FINRA, or former employee of FINRA who previously acted as a Hearing Officer, who is an attorney and who is appointed by the Chief Hearing Officer to act in an adjudicative role and fulfill various adjudicative responsibilities and duties" that are part and parcel of the process set forth in the Rule 9200 series, which relates to enforcement and adjudication of violations of FINRA rules, *but now also plays a very special role in the operation of proposed new Rule 4111 (relating to Restricted Firm Obligations).*

It is not be unreasonable or unfair to question the impartiality of a Hearing Officer who will be charged with the vital role of reviewing, *impartially*, the "Restricted Firm" determination by the Department of Member Supervision.

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[121] FINRA states: "The Office of Hearing Officers maintains strict independence from FINRA's regulatory and enforcement programs, and is physically separated from other FINRA departments. Hearing Officers are not involved in the investigative process. Furthermore, employment protections exist for Hearing Officers to ensure their independence. Only FINRA's Chief Executive Officer can terminate a Hearing Officer, and the termination can be appealed to the Audit Committee of FINRA's Board of Governors." Source: http://www.finra.org/industry/guide-disciplinary-hearing-process.

[122] The following constitutionally recognized principles need to be in play in order for proposed amendments to Rule 9550 to be judged consistent with principles of fundamental justice:

- As enshrined in the traditional statement of due process: "No man shall be a judge in his own cause", and therefore a decision-maker cannot act as both a party and a neutral, because the two roles are fundamentally incompatible. See Arnett v. Kennedy, 416 U.S. 134, 197 (1974) (White, J., concurring in part and dissenting in part) (quoting Dr. Bonham's Case, 77 Eng. Rep. 646, 652 (King's Bench, 1610). (Emphasis supplied)

- A neutral decision-maker is not simply a person without a financial interest in the outcome of the case, but more broadly a person who is not affiliated with, or biased in favor of or against, one side or the other. *See, e.g.,* Morrissey v. Brewer, 408 U.S. 471, 486 (1972). (Emphasis supplied)

- The decision-maker must be scrupulously neutral - neither biased in favor of either side, nor charged with responsibilities that would interfere with his ability "to hold the balance nice, clear and true" between the parties. Tumey v. Ohio, 273 U.S. 510, 532 (1927). *See, e.g.,* Hamdi v. Rumsfeld, 542 U.S. 507, 535 (2004) (O'Connor, J., plurality opinion) (noting that due process requires an "impartial adjudicator"). (Emphasis supplied)



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The reason for asking this question should be self-evident: For the small and medium sized member firm, the decision of the Hearing Officer has enormous financial consequences for these firms and their ability to continue to meet net capital requirements because, whenever a broker-dealer's net capital drops below its minimum net capital requirements, SEC requires the broker-dealer to cease operations immediately and get additional capital to come into capital compliance or liquidate its operations.[123]

It is noted that Regulatory Notice 19-17 does not specifically address whether the Restricted Deposit Requirement of proposed new Rule 4111 impacts the net capital requirements of the SEC's uniform net capital rule (15c3-1).[124] Hence, the consequence of the Hearing Officer's review and upholding of

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[123] The "early warning notice" levels that require the broker-dealer to give notice to the SEC are as follows:

- Under the basic method, the broker-dealer's ratio of aggregate indebtedness to net capital is greater than 1,200 percent.
- Under the alternative method, the broker-dealer's net capital is less than 5 percent of customer-related receivables.
- The broker-dealer's net capital is less than 120 percent of its required minimum dollar net capital.

Source: https://www.sec.gov/about/offices/oia/oia_market/key_rules.pdf

[124] *See* Regulatory Notice 19-17, at 17: "These account restrictions would impact how a Restricted Firm calculates its net capital levels. As explained in proposed Rule 4111.01, a deposit in the Restricted Deposit Account would be an asset of the member firm that could not readily be converted into cash, due to the restrictions on accessing it. Accordingly, the member would be required to deduct deposits in the Restricted Deposit Account when determining its net capital under Exchange Act Rule 15c3-1 and FINRA Rule 4110." This is the extent of FINRA's guidance. It is almost seems as if FINRA saying to broker/dealers: "we here at FINRA approved this rule impacting your net capital, now you member firms figure out *how* it impacts your net capital computation and *what* you must do to avoid giving "early warning notice" to the SEC; and, if you have to shut down your securities business, then so be it." In other words, "tag ... you're it." There is no hint that the SEC had any a priori input on the FINRA mandate that member firms "deduct deposits in the Restricted Deposit Account when determining its net capital" and whether this mandate is consistent with the letter and spirit of Rule 15c3-1. For example, a ***broker/dealer could maintain errors and omissions insurance that cover the liability equal to the Restricted Deposit Account amount; in such a scenario, a broker/dealer arguably should not need to deduct deposits in the Restricted Deposit Account when determining its net capital.*** Errors and Omissions insurance as an alternative to "deducting deposits in the Restricted Deposit Account amount when determining net capital" is ignored in Regulatory Notice 19-17. There is another important scenario that is relevant but has gone unnoticed by Regulatory Notice 19-17. When a member firm is subject to a civil litigation, the member firm is required by SEC Regulation 17 CFR 240.15c3-1(c)(2) to secure a "reasoned opinion", i.e., a written expression of an independent lawyer's professional judgment that addresses the facts of the member firm's business and regulatory circumstances with respect to the lawsuit at issue, and its potential effect on the firm's financial condition. Based the independent professional's assessment, the member firm sets aside a dollar amount – deducts this amount – from the firm's assets otherwise available for net capital computation. FINRA is proposing through rule 4111 to use as part of its quantitative analysis to determine a potential "Restrictive Firm" pending civil cases. This could lead to classifying the member firm as a "preliminarily" determined firm to be a "Restricted Firm" and therefore decides to take an expedited appeal, the member firm "would be required to deposit [in the Restricted Account that the member firm cannot use for business purposes], while the expedited proceeding was pending, the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital over the prior year." But the member firm has *already* "reserved" the amount that the independent professional (independent law firm) has assessed pursuant to SEC Regulation 17 CFR 240.15c3-1(c)(2). Proposed new Rule 4111 does not appear to account for this 15c3-1(c)(2) assessment. In other words, it does not appear that the member firm is allowed to deduct the 15c3-1(c)(2) assessment against the "the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital over the prior year." Accordingly, proposed new Rule 4111, as currently drafted, amounts to a "double penalty" against the firm.



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the Department of Member Supervision's determination that a member firm is a "Restricted Firm" can be mammoth for the small to mid-sized member firm.

Therefore, what is the soil from which conflicts of interest might spring?

Hearing Officers are employees of FINRA.[125]

Right out of the gate, the Hearing Officer has a "financial interest" in being loyal and continuing to be loyal to FINRA's mission, which is "to provide investor protection and promote market integrity":

> "Our Mission
>
> "We're *one team with one mission.*
>
> "Our mission is clear—to provide investor protection and promote market integrity * * * ") [126]

The Hearing Officer must be one who is committed, first and foremost, to FINRA's mission – as distinct from being committed, first and foremost, to member issues in the competitive market place, as originally conceived by the Maloney Act, as amended,[127] that gave rise to National Securities Associations, followed by the National Association of Securities Dealers, and finally the Financial Industry Regulatory Authority.

While both commitments should and must ultimately center on justice,[128] the immediate question that is the concern in this Comment Letter is whether the soil from which a Hearing Officer is cultivated[129] and appointed truly lends itself to the appointment of one who is without conflict of interest.

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[125] *See* FINRA, Revolving Door Rules, FAQs, General Questions, Question & Answer No. 1, http://www.finra.org/about/revolving-door-rules#general.

[126] http://www.finra.org/about/our-mission (Emphasis supplied)

[127] The Maloney Act required, as a condition for registration of a securities association, that the association's rules be designed "to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges." 15 U.S.C. § 78o-3(b)(8) (1970), as amended, 15 U.S.C.A. § 78o-3(b)(6) (Supp. 4, 1975). The Maloney Act "limits a securities association's authority to promulgate restrictive regulations and provides that a securities association shall not be registered by the SEC if its rules regulate 'matters not related to the purposes of this chapter or the administration of the association.' " Securities Exchange Act of 1934 § 1SA(b)(6), 15 U.S.C.A. § 78o-3(bX6) (Supp. 4. 1975). Finally, pursuant to the Maloney Act as amended by Congress, "the SEC may not register a securities association whose rules "impose any burden on competition not necessary or appropriate in furtherance of the purposes of this chapter." Id. § 15A(bX9), 15 U.S.C.A. § 78o-3(b)(9) (Supp. 4, 1975).

[128] The fundamental understanding of justice in Western Civilization is grounded in the maxim: *Justitia suum cuique distribuit* - Justice renders to everyone his due. *See e.g.*, Plato, The Republic, 4.433; Aristotle, Nichomachean Ethics, 1131 a 29 ("distributive" or proportionate justice); Cicero, De Legibus (c. 43 BC), I, 15; Justinian, Corpus Juris Civilis, book 1, title 1; Aquinas, Summa Theologica,



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In 2011, the U.S. Supreme Court emphasized in *Free Enterprise Fund v. Public Co. Accounting Oversight Board* that at-will removal directly affects whether an official is in fact independent: "[O]ne who holds his office only during the pleasure of another cannot be depended upon to maintain an attitude of independence against the latter's will."[130] Stated otherwise, the ability to discipline, remove, or affect the salary of an adjudicator also creates an unconstitutional appearance of partiality.

We have scoured the FINRA website and could find nothing that dispels the assumption that Hearing Officers are at-will employees of FINRA. The only item referencing termination of Hearing Officers on the FINRA website is that they can only be terminated by the FINRA Chief Executive Officer.[131] This only serves to drive home the point that the Hearing Officer is not simply an employee of an ordinary not-for profit organization – the Hearing Officer is an employee whose bias is, naturally, tied-at-the-hip with its very important, very focused mission: FINRA's mission being "to provide investor protection and promote market integrity".[132]

This opens the discussion to whether the Hearing Officer – charged with the responsibility of independently reviewing the "Restricted Firm" determinations by the Department of Member Supervision - can truly be independent and neutral and impartial when the Hearing Officer reviews the Department's determination of a member firm's preliminary status as a "Restricted Firm"?

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IlalIae58. Justice comes down to "giving to each his due". Thus, justice from a FINRA perspective is focused on the investor and giving to the investor protection from bad brokers. From a FINRA member's perspective justice is focused devising just rules that level the playing field for brokers so that good brokers are not disadvantaged by the actions of bad brokers in a super competitive marketplace. *Accord* William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, at pages 9 – 12, and 33 – 35: "In a world in which investors cannot readily distinguish between "good" and "bad" brokers before choosing one, perversely good brokers are worse off and better brokers are better off. But if good brokers can somehow differentiate themselves in advance, they can charge more for their services. This discrimination might be hard to effectuate without a neutral third party [e.g., an SRO committed to effecting this justice?] to serve as a credible source of enforcing regulation that distinguish between the two." Id. at 34.

[129] FINRA's espoused purpose in keeping the Hearing Officer all-in-the-family is to tap into the advantage of having "experienced, licensed attorneys who have previously acted in the same adjudicative role and fulfilled the same adjudicative responsibilities and duties for FINRA" as well as taking "advantage of the expertise of former Hearing Officers who remain well-versed in the typical law violations that are resolved in FINRA disciplinary proceedings." Securities and Exchange Commission, Release No. 34-72543, Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend the Definition of Hearing Officer to Include Former FINRA Employees Who Previously Worked as Hearing Officers (3 July 2014), at page 3.

[130] 561 U.S. 477, 493 (2010) [quoting Humphrey's Ex'r v. United States, 295 U.S. 602, 629 (1935)].

[131] *See* FINRA, Office of Hearing Officers: "Employment protections exist for hearing officers to further ensure their independence; they may not be terminated except by the FINRA Chief Executive Officer, with a right to appeal to the Audit Committee of FINRA's Board of Governors." https://www.finra.org/industry/oho.

[132] https://www.finra.org/about/our-mission.

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Like the Hearing Officer, the members of the Department of Member Supervision are likewise *employees* (as opposed to independent contractors) of FINRA. And like the Hearing Officer, the member of the Department of Member Supervision is not simply an employee of an ordinary not-for profit organization – the members of the Department of Member Supervision are employees whose bias is, naturally, tied-at-the-hip with its very important, very focused mission: FINRA's mission being "to provide investor protection and promote market integrity".

In a word, financial interest derived from employment, itself rooted in the desire to avoid termination, are all ultimately united in "all ships sailing in the same direction" of FINRA's mission.[133]

Consider the recent controversy involving a former SEC administrative law judge who came under fire for ruling against the SEC.[134]

True, FINRA will contest that FINRA is not the SEC; but then again, FINRA's adjudicatory system so much closer to the SEC adjudicatory system than it is to the judiciary or "court system", where the judiciary is truly separated from the legislative and executive branches of government.

Additionally, if the SEC administrative proceedings have been challenged successfully in the courts on separation-of-powers grounds, where the complaint is that regulated parties are afforded limited protections and procedures at that those proceedings, how much more compelling is the case against FINRA's adjudicatory system? FINRA has consistently maintained that, while it may do so, it is *not* compelled as a matter of law to recognize constitutional protections because FINRA is a non-profit organization and is not a government or quasi-government agency and therefore is immune from these obligations.[135]

But we have strayed from the main point. The appointment of a Hearing Officer whose employment is essentially guaranteed unless he/she runs afoul of FINRA's Chief Executive Officer reinforces the

[133] https://www.finra.org/about/our-mission.

[134] *See* Jean Eaglesham, SEC Wins with In-House Judges, WALL ST. J. (May 6, 2015, 10:30 PM), (referring to former SEC ALJ Lillian McEwen, who complained of coming "under fire" *for finding in favor of regulated parties*). http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

[135] Department of Enforcement v. Mark C. Cohen, OHO Order 18-01 (2014040761001) *citing* Epstein v. SEC, 416 Fed. Appx. 142, 148 (3d Cir. 2010) (unpublished opinion) ("Epstein cannot bring a constitutional due process claim against [FINRA], because [FINRA] is a private actor, not a state actor."); D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., 279 F.3d 155, 162 (2d Cir. 2002) ("It has been found, repeatedly, that [FINRA] itself is not a government functionary."); Desiderio v. NASD, 191 F.3d 198, 206 (2d Cir. 1999) ("[T]he fact that a business entity is subject to 'extensive and detailed' state regulation does not convert that organization's actions into those of the state."); U.S. v. Solomon, 509 F.2d 863, 869 (2d Cir. 1975) (SRO testimony does not implicate fifth amendment protections because "NYSE's inquiry ... was in pursuance of its own interests and obligations, not as an agent of the SEC.")."



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"common perception [that] administrative adjudicators [read: Hearing Officers] are likely to be *too committed* to the agency's [read: FINRA's] positions" and "imbued with the agency's [read: FINRA's] *culture,*" according to the highly respected Law Professor and former attorney at the U.S. Department of Agriculture, the Antitrust Division of the Department of Justice and the Federal Trade Commission, Charles H. Koch, Jr. [136]

In light of Professor Koch's important insight into the danger to justice posed by conflicts of interest that impact impartiality, consider the analogous situation of a prosecutor; and, in view of that situation, consider the mission statement of the Manhattan District Attorney's Office: "Moving Justice Forward". What does "moving justice forward" likely mean for a prosecutor? One former prosecutor answers this question this way, demonstrating *why it became so easy for him to become too committed to his agency's position*:

> "Just as the brotherhood of prosecutors was premised on shared experience, it was also premised on shared fear. As a defense attorney, I fear that I'll fail my client and they will be unjustly imprisoned. But as a prosecutor, the culture taught me to fear that I'd make a mistake and a guilty defendant would go free to wreak havoc on society. That fear constantly colored my assessment of legal issues."[137] (Emphasis supplied)

And, being so *imbued with his agency's culture*, the same former prosecutor pointedly explains how agency culture informs and eventually directed his work ethic:

> "Three types of culture—the culture of the prosecutor's office, American popular culture, and the culture created by the modern legal norms of criminal justice—shaped how I saw the rights of the people I prosecuted. If you had asked me, I would have said that it was my job to protect constitutional rights and strike only what the Supreme Court once called "hard blows, not foul ones." But in my heart, and in my approach to law, I saw rights as a challenge, as something to be overcome to win a conviction. Nobody taught

[136] Charles H. Koch, Jr., Policymaking by the Administrative Judiciary, 56 ALA.L.REV. 693, 702-703 (2005); 25 J. Nat'l Ass'n Admin. L. Judges (2005) *available at* https://digitalcommons.pepperdine.edu/naalj/vol25/iss1/2. William & Mary Law School Bill of Rights Journal Bio: http://wm.billofrightsjournal.org/wp-content/uploads/2012/11/Koch_bio.pdf

[137] Ken White, Confessions of an Ex-Prosecutor: Culture and law conspire to make prosecutors hostile to constitutional rights. (June 23, 2016) Source: http://reason.com/archives/2016/06/23/confessions-of-an-ex-prosecutor. *Accord* Christine Alice Corcos, Prosecutors, Prejudices, and Justice: Observations on Presuming Innocence in Popular Culture and Law, 34 University of Toledo Law Review 793, 794 (2003), where this law review commentator writes: "[W]e do not find the presumption of innocence easy or natural to adopt, particularly in times of crisis. It runs counter to our intuition and makes us uncomfortable. If the individual on trial might be innocent, then the guilty person is still "out there" and leads to the conclusion that the legal system is not infallible. Therefore, an innocent person could be accused and convicted. If the innocent can be convicted and the guilty go free, where is justice? And of what use is the legal system." Source: https://digitalcommons.law.lsu.edu/cgi/viewcontent.cgi?article=1254&context=faculty_scholarship.



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> me that *explicitly*—nobody had to." [138] (Emphasis via underlining, supplied; italics in original)

Conflicts of interest of a material nature – financial interest, job security, compliance with organizational culture – exist for the Hearing Officer, and these may not be overcome by institutional devices such as physical separation from other FINRA departments. The "ability to discipline, remove, or affect the salary of an adjudicator also creates an unconstitutional appearance of partiality"[139] will eventually prove stronger than physical barriers:

> "This is a significant problem for regulated parties and agencies because, in light of one of the Supreme Court's most recent impartiality decisions (*Caperton v. A.T. Massey Coal Co.*) and one of its most recent separation-of-powers decisions (*Free Enterprise Fund v. PCAOB*), there is a compelling, unacknowledged argument that agency control over AJs [read: Hearing Officer] creates an unconstitutional appearance of partiality under the Due Process Clause and thereby renders invalid tainted agency proceedings. Moreover, even without a due process violation, the perception of partiality — as the SEC's current litigation demonstrates[140] — leads to wholesale resistance from regulated parties and perhaps even courts (as partiality concerns over Immigration Judges did in the mid-2000s) and Congress for agency initiatives."[141] (Emphasis supplied)

These legitimate concerns give rise to a serious doubt that the proposed new Rule 9559 (relating to Expedited Proceedings to Implement Proposed Rule 4111) is consistent with *fundamental law* – Due Process, in other words. *Free Enterprise Fund* establishes the following: (1) the agency's [read:

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[138] Ken White, Confessions of an Ex-Prosecutor: Culture and law conspire to make prosecutors hostile to constitutional rights. (June 23, 2016) Source: http://reason.com/archives/2016/06/23/confessions-of-an-ex-prosecutor (Retrieved 8 June 2018).

[139] Kent H. Barnett, Why Bias Challenges to Administrative Adjudication Should Succeed, 81 Mo. L. Rev. 1023, at 1027 (2016).

[140] The New York Times and The Wall Street Journal have reported that the Securities and Exchange Commission ("SEC") prevails much more frequently — sometimes 100% of the time in a given year — in its in-house enforcement proceedings than in court. Jean Eaglesham, SEC Wins with In-House Judges, WALL ST. J. (May 6, 2015, 10:30 PM), http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803. Gretchen Morgenson, At the S.E.C., a Question of Home-Court Edge, N.Y. TIMES (Oct. 5, 2013), http://www.nytimes.com/2013/10/06/business/at-the-sec-a-question-ofhome-court-edge.html. (contrasting SEC's 88% win rate in ALJ hearings to its 63% win rate in district courts). For instance, the SEC prevailed in all agency proceedings in 2012, and in more than 75% in 2011, 2013, and 2014. In comparison, it prevailed in less than 75% of similar judicial proceedings. *See* id. In several recent judicial proceedings, defendants have challenged — and have had enjoined — those SEC administrative proceedings on separation-of-powers grounds, complained of the limited protections and procedures that those proceedings afford them, and emphasized the *partiality concerns* that arise from the SEC's higher win rate before its own judges than before Article III courts. See, e.g., Gray Fin. Group, Inc. v. SEC, No. 1:15-cv-00492-LMM (N.D. Ga. Aug. 4, 2015); Timbervest v. SEC, No. 1:15-cv-02106-LMM (N.D. Ga. Aug. 4, 2015); Tilton v. SEC, No. 15-cv-02472-RA (S.D.N.Y. June 30, 2015); Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Oct. 1, 2014); Hill v. SEC, 114 F. Supp. 3d 1297, 1320-21 (N.D. Ga. 2015) (granting preliminary injunction based on substantial likelihood of Appointments Clause violation); *accord* Duka v. SEC, No. 1:15-cv-00357, 2015 WL 4940083, at *1 (S.D.N.Y. Aug. 12, 2015).

[141] Kent H. Barnett, Against Administrative Judges, 49 University of California, Davis 1643, at 1649-50 (2016). Kent Barnett is Assistant Professor, University of Georgia School of Law.



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FINRA?] power to remove (or transfer) and affect AJs' [read: FINRA Hearing Officer?] pay gives agencies [read: FINRA] *control*, and (2) that control *impacts impartiality* [read: impartiality of the Hearing Officer].[142]

Elsewhere the U.S. Supreme Court has written: The decision-maker must be scrupulously neutral - neither biased in favor of either side, *nor charged with responsibilities that would interfere with his ability* "to hold the balance nice, clear and true" between the parties.[143]

On the basis of these factors, proposed new Rule 9559 (relating to Expedited Proceedings to Implement Proposed Rule 4111) triggers serious Due Process concerns – the concern for *material* conflicts of interest (financial interest, job security, and pressure to comply with organizational culture) giving rise to a strong suspicion of a real likelihood of *partiality* in favor the employer's mission.[144]

The matter of conflict of interest created by *financial interest for* FINRA when a Hearing Officer decides *in favor of* the Department of Supervision Management and *against* the "Restricted Firm" in the "appeal" process[145] cannot reasonably be discounted.

FINRA's budget is largely supported by fines imposed on its member firms. According to ***Investment News***:

> "The Financial Industry Regulatory Authority Inc. will not raise member fees for the sixth straight year, *but depending how much it raises through fines* and market performance, the broker-dealer regulator could draw up to $185 million from its cash reserves this year. That aspect of the 2019 Finra budget summary released Thursday was a sticking point to some critics of the strategy. While Finra members might be able to appreciate the fee news, Todd Cipperman, principal at Cipperman Compliance Services,

[142] Kent H. Barnett, Against Administrative Judges, 49 University of California, Davis 1643, at 1667 (2016).

[143] Tumey v. Ohio, 273 U.S. 510, 532 (1927). *See, e.g.*, Hamdi v. Rumsfeld, 542 U.S. 507, 535 (2004) (O'Connor, J., plurality opinion) (noting that due process requires an "impartial adjudicator").

[144] https://www.finra.org/about/our-mission.

[145] *See* Regulatory Notice 19-17, at 18: "FINRA is proposing to establish a new expedited proceeding in the Rule 9550 series (Expedited Proceedings), specifically proposed new Rule 9559 (Procedures for Regulating Activities Under Rule 4111), that would allow member firms to request a prompt review of the Department's determinations under the Restricted Firm Obligations Rule and grant a right to challenge any of the "Rule 4111 Requirements," including any Restricted Deposit Requirements, imposed. [citation omitted] The new expedited proceeding would govern how the Department provides notice of its determinations and afford affected member firms the right to seek a Hearing Officer's review of those determinations."



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Member FINRA/SIPC

said *members should be wary of an increased focus on revenue through fines.* The potential budget shortfall of $185.8 million, up from $138.1 million a year ago, is 'problematic for members,' Mr. Cipperman said. '*Finra has a significant financial incentive to bring enforcement cases and impose fines in order to close its budget shortfall*,' he said. 'In 2017, Finra assessed over $170 million in fines, an 82% increase over the prior year. Finra needed these fines to close a significant funding gap.' * * * Daniel Nathan, partner at Orrick, Herrington & Sutcliffe and *a former Finra vice president and director of regional enforcement*, also cited the *potential incentive to rely on fines for revenue*. 'There appears to be some inconsistency,' he said. 'On one hand, they say they are excluding fine monies from budgetary needs, but on the other hand *Finra's stated guiding principles are that the fines will be used to promote compliance and improve markets. It does appear to create an incentive to collect fines, notwithstanding their claims otherwise*.' "[146]

If fines are in fact the driving force behind determining whether a member firm does or does not meet the criteria for "preliminarily" being a "Restricted Firm", then ***the***[147] Hearing Officer charged with reviewing the challenge brought by a member firm against the Department of Supervision Management must be presumed to be conflicted for all the reasons enumerated throughout this Section 7.A.2 (relating to Whether Conflicts of Interest are Ingrained in the Institution?)

The Hearing Officer in an expedited hearing can, out of loyalty to FINRA's mission, unwittingly become the instrument of targeting a broker/dealer for effective termination of membership; when lacking independence in the determination that a member firm should be a "Restricted Firm", the Hearing Officer is participating in a Bill of Attainder targeting the member firm for draconian "soft" punishment that is the *enhanced regulatory and financial challenges* of proposed new Rule 4111.

The Hearing Officer holding the office of adjudicator in an expedited hearing unites, in his person, both the power of the sword and the power of the purse.[148] This power is literally the power of life

[146] Jeff Benjamin, Finra budget to keep fees steady in 2019: Critics worry the regulator might be sending mixed messages about any dependence on fines, (Investment News - Mar 21, 2019 @ 2:30 pm). (Last visited Monday, June 24, 2019 @ 2:21:17 PM) (Emphasis supplied) Source: https://www.investmentnews.com/article/20190321/FREE/190329981/finra-budget-to-keep-fees-steady-in-2019.

[147] It is especially noted that "Hearings in expedited proceedings under proposed new Rule 9559 would be presided over by ***a*** Hearing Officer * * * ***instead of a Hearing Panel***." Regulatory Notice 19-17, p. 37 (Emphasis supplied) In other words, adjudication by a single Hearing Officer, not a panel of Hearing Officers.

[148] *Compare* James Madison, Helvedius No. 1: " * * * [It is that] great principle in free government * * *which ***separates the sword from the purse, or the power of executing from the power of enacting laws***." (24 August 1793)



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and death over a broker/dealer. But it was never the intent of Congress to give this kind of power to a regulator that claims to be a "not for profit organization".[149]

The membership is therefore very reasonably concerned that the Hearing Officer, being imbued with FINRA's culture, will give automatic approval or authorization to the decisions of others, without proper consideration, because of the pressure to be committed to the FINRA mission. Accordingly, the membership is legitimately hesitant to agree with FINRA that its Hearing Officer can and should review the Department of Member Supervision's determination that a firm is a "Restricted Firm". The consequences of the Hearing Officer's decision in this determination is, as we have stated, *mammoth* especially for the small to mid-sized member firm because of the "soft" financial punishment that these firms will suffer if the Hearing Officer is not impartial: The member is required to deduct deposits[150] in the Restricted Deposit Account when determining its net capital under Exchange Act Rule 15c3-1, potentially causing the member to go under net capital, triggering "early warning notice" to the SEC, effectively forcing the member to go out of business within three days. This is too important to ignore these Due Process concerns.

This brings this Comment Letter back to the point of origin, concern that Regulatory Notice 19-17 and its proposed new and amended rules, amount to Bills of Attainder.

### 7.B. <u>Rule 9550 (Expedited Proceedings to Implement Proposed Rule 4111) and the Prohibition against Bills of Attainder Not Protected by "Judicial Trials"</u>

It is expected that FINRA will say that its adjudicatory system is equivalent to a "judicial trial". But, before we address this point, let's summarize the relevant points of law.

The Constitution of the United States, Article I, Section 9, Paragraph 3 provides that: "No Bill of Attainder or ex post facto Law will be passed."

Chief Justice William H. Rehnquist writes:

149 FINRA's standard disclosure is: "FINRA is a not-for-profit organization dedicated to investor protection and market integrity. It regulates one critical part of the securities industry – brokerage firms doing business with the public in the United States." *See e.g.*, http://www.finra.org/newsroom/2019/report-finra-board-governors-meeting-may-2019.

150 It bears noting that the requirement to deduct deposits in the Restricted Deposit Account when determining net capital has another consequence: It amounts to freezing the firm's assets that, in turn, can prevent the firm's ability to finance an appeal from the Hearing Officer's negative finding. In short, "deducting deposits" is likely to obstruct a Smaller Firm ability to finance its appeals during the expedited hearing process and, if necessary, thereafter to the National Adjudicatory Council. In short, Rule 4111 operates to take away the firm's ability to defend itself.



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> "These clauses of the Constitution are not of the broad, general nature of the Due Process Clause, but refer to rather precise legal terms which had a meaning under English law at the time the Constitution was adopted. A bill of attainder was a legislative act that singled out one or more persons and imposed punishment on them, *without benefit of trial*. Such actions were regarded as *odious* by the framers of the Constitution because it was *the traditional role of a court, judging an individual case, to impose punishment*."[151]

To restate Chief Justice Rehnquist, a Bill of Attainder is a law by means of which the Legislator punishes a targeted individual or group of individuals without the protection of a judicial trial.

Long before Chief Justice Rehnquist stated this classic statement about the nature of a Bill of Attainder, earlier justices of the Supreme Court had written:

> "The Bill of Attainder Clause was not intended as a narrow, technical and soon to be outmoded prohibition, but rather as an implementation of the doctrine of "separation of powers," a safeguard against legislative exercise of the judicial function as to prevent trial by legislature."[152]

In short, the prohibition against a Bill of Attainder is centered on preventing the Legislator from acting as judge, jury, and executioner. It should now be clear from the discussion above, especially in Sections 7.A., 7.A.1, and 7.A.2 of this Comment Letter, that the *impartiality* of the Hearing Officer as final arbiter of the "Restricted Firm" determinations of the Department of Member Supervision is highly suspect, if not compromised, because of the *conflicts of interest* inherent in the FINRA adjudication system.

Because of this, the "separation of powers" function that is so fundamental to "preventing trial by legislature", and so clearly evident in the federal and state governmental systems of checks and balances, is plausibly absent in the FINRA system.

Member firms, especially small to mid-sized firms are hard pressed to take it on FINRA's word that there is a wall of separation between the rule-making body of FINRA and the adjudicatory body, i.e., the Office of Hearing Officers, that will be charged with reviewing the "Restricted Firm" determination of FINRA Department of Member Services, which, in the context of proposed new Rule

[151] William H Rehnquist, The Supreme Court: How It Was, How It Is, at p. 82, New York: William Morrow & Co. (1987). (Emphasis supplied)

[152] United States v. Brown, 381 US 437, 442 (1965).



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4111 is itself actually functioning as a quasi-judicial body. For example, in the "consultation" process that is part of the Preliminary Criteria for Identification process:

> "The proposed rule would give each affected member firm several ways to affect outcomes, including * * * a consultation with the Department at which the member could *explain why it should not be subject* to a Restricted Deposit Requirement * * * "[153]

In other words, the member firm goes before the Department of Member Services to argue its case as to why a "Restricted Firm" case should not be brought against the member firm. The Department, then, makes its determination (which, of course, the member firm can appeal to the Hearing Officer). This consultation with the Department is a hearing in its own right – a kind of preliminary hearing, to borrow a term from criminal procedure. This gives the Department of Member Services a quasi-judicial function.

At the same time, the Department of Member Services operates as "internal investigator", *in addition to* being a quasi-judge, in this "preliminary hearing":

> "For each member firm that meets the Preliminary Criteria for Identification, the Department would conduct, pursuant to proposed Rule 4111(c)(1), an initial internal evaluation to determine whether the member does not warrant further review under Rule 4111."[154]

Significantly, the Department is the "internal investigator" that decides for itself whether its assessment that the member firm preliminarily meets the criteria of being a "Restricted Firm" was a correct determination; and, if the member firm throws in the towel deciding not to appeal to the Hearing Officer,[155] then the Department is the single – *investigatory and adjudicatory* – body having the final say.

The equivalent in the court system goes something like this: The judge who sits in a preliminary hearing gets to decide whether there is a *prima facia* (a more likely than not likely) case against the

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[153] Regulatory Notice 19-17, p. 7.

[154] Regulatory Notice 19-17, p. 11.

[155] It may seem obvious but the following does need to be said. Notwithstanding FINRA's expressed intent is not to burden member firms when they claim the right to an expedited hearing – "the proposed rule is anticipated to reduce the costs associated with obligations imposed on misidentified firms by the proceeding's expedited nature" – the fact is that the cost of taking an appeal to the Hearing Officer in the expedited process is a significant and expensive burden that can bankrupt a Smaller Firm. (The quotation cited in this footnote is taken from page 30 of Regulatory Notice 19-17.)



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defendant; the judge holds the defendant for trial; and then this preliminary hearing judge is the same judge who sits in a bench trial on the merits of the case.

There is no material "separation of powers" here, any more than there is a material "separation of powers" when the Hearing Officer reviews the "Restricted Firm" determination of the Department of Member Supervision.

Because of this, the FINRA adjudication system – from which the Hearing Officer would serve as "appeals judge" from "Restricted Firm" determination made by the Department – is plainly not a "judicial trial" or any process equivalent to a "judicial trial".

Accordingly, proposed new Rule 4111 meets the 5th element of a Bill of Attainder: legislation lacking the benefit of a judicial trial.

## 8. <u>Other Constitutional Concerns: Rule 4111(i)(14) Constitutes a Regulatory Taking in Violation of the Fifth Amendment</u>

Proposed new Rule 4111(i)(14) would require the previously discussed Restricted Deposit Account to deposit a Restricted Deposit Requirement calculated at the lesser of 50% of its Restricted Deposit Requirement or 25% of its average excess net capital during the prior calendar year;[156] this deposit account will be subject to the member firm's bank or clearing firm agrees:

> "*not to permit withdrawals from the account absent FINRA's prior written consent*; to keep the account separate from any other accounts maintained by the member with the bank or clearing firm; that the cash or qualified securities on deposit will *not be used directly or indirectly as security* for a loan to the member by the bank or the clearing firm, and will not be subject to any set-off, right, charge, security interest, lien or claim of any kind in favor of the bank, clearing firm, or any person claiming through the bank or clearing firm; that if the member becomes a former member, the Restricted Deposit Requirement in the account must be maintained, and *withdrawals will not be permitted without FINRA's prior written consent*; that F*INRA is a third party beneficiary to the agreement*; and the agreement may *not be amended without FINRA's prior written consent.* In addition, the account could not be subject to any right, charge, security interest, lien, or claim of any kind granted by the member."[157]

[156] Regulatory Notice 19-17, pp. 15, 19.

[157] Regulatory Notice 19-17, pp. 17.



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The aforementioned *restrictions on a member firm's assets* need to be read in light other restrictions set forth in proposed new Rule 4111.01:

> " * * * a deposit in the Restricted Deposit Account would be an asset of the member firm that could *not readily be converted into cash,* due to the restrictions on accessing it. Accordingly, the member would be required to *deduct deposits* in the Restricted Deposit Account when *determining its net capital* under Exchange Act Rule 15c3-1 and FINRA Rule 4110."[158]

These restrictions, simply stated, amount to a "taking" – specifically, a "non-categorical regulatory taking", to use the language of the Courts.[159]

A "regulatory taking" is one in which a government regulation is "so onerous that its effect is tantamount to a direct appropriation or ouster."[160]

According to the Second Circuit U.S. Court of Appeals: "The gravamen of a regulatory taking claim is that the state regulation goes too far and in essence 'effects a taking.' "[161]

When determining whether a regulation "goes too far", Courts utilize the so-called *Penn Central*[162] factors:

(1) Economic impact of the regulation on the party claiming a "taking" of his property.[163]

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[158] Regulatory Notice 19-17, at 17.

[159] Sherman v. Town of Chester, 752 F.3d 554 (2nd Cir. – 2014): "Regulatory takings are further subdivided into categorical and non-categorical takings. * * * regulatory taking * * * occurs "when the government acts in a regulatory capacity * * *"

[160] Lingle v. Chevron U.S.A. Inc., 544 U.S. 528, 537 (2005).

[161] Buffalo Teachers Fed'n v. Tobe, 464 F.3d 362, 374 (2d Cir.2006) cited in Sherman v. Town of Chester, 752 F.3d 554 (2nd Cir. – 2014).

[162] Penn Central Transportation Co. v. New York City, 438 U.S. 104 (1978). *See* Ruckleshaus v. Monsanto Co., 467 U.S. 986, 1000–01, 1005 (1984). In determining how far is too far, we consider several factors, including "the character of the governmental action, its economic impact, and its interference with reasonable investment-backed expectations." Id. at 1005 (quoting PruneYard Shopping Ctr. v. Robins, 447 U.S. 74, 83 (1980). *But see* Gary Lawson, Katharine Ferguson & Guillermo A. Montero, "Oh Lord, Please Don't Let Me Be Misunderstood!": Rediscovering the Matthews v. Eldridge and Penn Central Frameworks, 81 NOTRE DAME L. REV. 1, 32 (2005): "[T]o the extent that the Court in *Penn Central* identified discrete factors for consideration, it identified two, rather than three, such factors: (1) the impact of the challenged regulation on the claimant, viewed in light of the claimant's investment-backed expectations and (2) the character of the governmental action, viewed in light of the principle that actions that closely resemble direct exercises of eminent domain are more likely to be compensable takings than are garden-variety land use regulations. Someone who knew nothing of modern takings law would be, to say the least, hard pressed to distill a discrete three-factor analysis from the opinion in *Penn Central*." (Emphasis supplied)



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(2) Character of the governmental action.[164]

### 8.A <u>"Economic Impact" of Rule 4111(i)(14) on a Member Firm's Assets</u>

Because the Restricted Deposit Account amount must be *deducted* from the member firm's available assets for calculating net capital, the member firm will need to *increase sales in order to increase profitability in order to increase capital* just to make up the "difference" – i.e. the amount placed into reserve in the Restricted Deposit Account – in order to meet the firm's SEC net capital requirements.

But, proposed new Rule 4111(i)(14) creates a kind of Scarlet Letter once FINRA identifies a member as a "Restricted Firm" that will adversely affect the firm's ability to make up this "difference":

- The "Restricted Firm's" salesmen that are not "bad brokers" will leave the firm.
- The "Restricted Firm's" customers will transfer their accounts out of the firm to a new broker/dealer.
- The "Restricted Firm" will find it difficult, if not nearly impossible, to recruit new brokers to replace the brokers – both "good" and "bad" – that leave the firm.

Consider these additional restrictions piled onto the member firm's burden:

- The assets in the Restricted Deposit Account – it needs to be <u>emphasized</u> here, these are the *member firm's assets* – cannot be used by the member firm for otherwise routine business purposes, namely, used as collateral for financing day-to-day business operations.
- The assets in the Restricted Deposit Account – again, it needs to be <u>stressed</u> here, these are the *member firm's assets* – are now ultimately controlled by FINRA because withdrawal of funds from this Account cannot be effected without FINRA's prior written approval.

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[163] <u>Buffalo Teachers Fed'n v. Tobe</u>, 464 F.3d at 375 (2d Cir.2006).

[164] <u>Buffalo Teachers Fed'n</u>, 464 F.3d at 375.



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- The legal ownership of assets in the Restricted Deposit Account – and once again, it needs to be underscored that these assets are, at law, supposed to be the *member firm's assets* – can pass to FINRA by virtue of the "third party beneficiary" requirement – a contract of adhesion[165] precisely because this is "third party beneficiary" contract is not an arms-length meeting of the minds agreement between two equal parties. Indeed, "the agreement may *not be amended without FINRA's prior written consent.*"[166]

- FINRA requires the "Restricted Firm" to reserve money for pending lawsuits – despite the fact that many firms do have Errors and Omissions (E&O) insurance that covers customer civil lawsuits (as well as arbitrations); yet, FINRA appears to be silent on the question whether E&O insurance can be taken into account when calculating the amounts needed to be set aside in the Restricted Deposit Account.

Surely FINRA appreciates the business reality that the member firm is deliberately being placed on the horns of a dilemma: *Either increase sales in order to increase profitability in order to increase capital* to meet SEC net capital and increase even more regulatory scrutiny by FINRA. *Or* allow sales to run flat, risk failing to meet net capital, and go out of business.

In a word, proposed new Rule 4111(i)(14) therefore operates as a self-fulfilling prophecy that decidedly has an "economic impact" on a firm that FINRA identifies as a "Restricted Firm".

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[165] Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991). Courts traditionally have reviewed with ***heightened scrutiny*** the terms of ***contracts of adhesion***, form ***contracts offered on a take-or-leave basis by a party with stronger bargaining power to a party with weaker power.*** Some commentators have ***questioned whether contracts of adhesion can justifiably be enforced at all*** under traditional contract theory because the adhering party generally enters into them without manifesting knowing and voluntary consent to all their terms. See, e. g., Rakoff, Contracts of Adhesion: An Essay in Reconstruction, 96 Harv.L.Rev. 1173, 1179-1180 (1983); Slawson, Mass Contracts: Lawful Fraud in California, 48 S.Cal.L.Rev. 1, 1213 (1974); K. Llewellyn, The Common Law Tradition 370-371 (1960). *See also* Monsanto Company v. McFarling, No. 01-1390 (U.S. Court of Appeals, Federal Circuit – 2002): "To be sure, the Supreme Court has yet to hold that adhesion contracts are ineffective to surrender rights granted by the Due Process Clause. ***But the Court's assessment of such surrenders has hardly been favorable.*** In Fuentes v. Shevin, 407 U.S. 67, 92 S.Ct. 1983, 32 L.Ed.2d 556 (1972), the Court considered an alleged waiver by an adhesion contract of the right to a prior hearing, another aspect of the personal liberty conferred by the Due Process Clause."

[166] Not even the SEC can do this. In order to get its hands on a bad party's assets (e.g., disgorgement of profits), the SEC must go to federal court in a preliminary injunction proceeding, obtain a temporary order that effectively places the party's assets in escrow, subject to a permanent injunction hearing. Only then, with a permanent Order of the Court in hand can the SEC take possession of its opponent's property. Even then, the SEC only acts as temporary custodian of these funds, holding the funds for injured investors and wait for these investors to come forward to reclaim their property. The SEC never becomes a "third party beneficiary" of these funds. Indeed, not even the Courts can take possession of a citizen's property *for the Court's own purposes*. In other words, no federal, state, or local court can sue a civilian in the court's name for the court's purpose. That is, no court has the power to become a "third party beneficiary" of any civilian's property. At best, a court can only hold contempt proceedings, criminally and civilly, against a party who has submitted to the court's jurisdiction. Even then, the court does not become a "third party beneficiary" of the civilian's property.



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The "economic impact" of proposed new Rule 4111(i)(14) is self-evident: Close the Doors – in the first instance, down the road; in the second instance, immediately. It is inconceivable that the Courts would not judge this to be a "taking" of a broker/dealer's private property.

That said, we move on to the element of "character of governmental action".

### 8.B "Character of Government Action" and Rule 4111(i)(14) and Regulatory Taking:

In determining "character of governmental action", Courts have considered these factors:

(1) Reciprocity of Advantage.

(2) Retroactivity.

### 8.B.1 "Reciprocity of Advantage" and Rule 4111(i)(14) and Regulatory Taking:

*Reciprocity of advantage* focuses on the distributional impact of the challenged governmental action. Regulations that impose burdens and confer benefits on all property owners generally have a neutral distributional impact. Everyone loses but everyone gains.[167] In contrast, regulations that impose burdens exclusively on some owners while generating benefits for others have a skewed distributional impact. The most extreme form would be a law that takes from A and gives to B, often cited as something that would violate the public use requirement of the Takings Clause.[168]

As we have previously pointed out, FINRA explains *for whom* this new Rule 4111 is *specifically* targeted:

> ". . .based on recent history FINRA *expects* that its annual calculations *will identify between 60-98 members* that meet the Preliminary Criteria for Identification [as a "Restricted Firm"]."[169]

The motivation behind identifying these member firms for the Restricted Deposit Account is evidenced in the following FINRA statement:

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[167] Mark W. Cordes, The Fairness Dimension in Takings Jurisprudence, 20 KAN. J.L. & PUB. POL'Y 1, 21 (2010).

[168] Kelo v. City of New London, 545 U.S. 469, 477 (2005).

[169] Regulatory Notice 19-17, p. 9.



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> "The underlying policy for the proposed account requirement is that, to make a deposit requirement effective in creating appropriate incentives to members that pose higher risks to change their behavior, the member must be restricted from withdrawing any of the required deposit amount, even if it terminates its FINRA membership."[170]

Courts favor broad-based laws that offer reciprocity of advantage but find suspect laws that *single out* particular owners for *severe burdens* while conferring benefits on others.[171]

Proposed new Rule 4111 – particularly, subsection (i)(14) creating restrictions on the assets of "members that pose higher risks" – is suspect because it *singles out* these member firms. But upon closer inspection, this "singling out" is not broad-based at all and appears to be "class based", that is based on the three (3) categories of firm size: Small, Mid-Size, and Large.

This is amply demonstrated in the matrix in FINRA's Exhibit "D-2" to Regulatory Notice 19-17. For convenience, this matrix is (again) produced below:

**Attachment D-2: Distribution of Firms Meeting the Preliminary Criteria for Identification by Firm Size***

| Identification Year | Number of FINRA Registered Member Firms | Firms Meeting the Preliminary Criteria for Identification | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | Small | Mid-Size | Large | Total | Small | Mid-Size | Large |
| | | Number of Firms | | | | Percent of Total | | |
| 2013 | 4,140 | 84 | 4 | 1 | 89 | 94% | 4% | 1% |
| 2014 | 4,068 | 92 | 4 | 2 | 98 | 94% | 4% | 2% |
| 2015 | 3,941 | 79 | 5 | 2 | 86 | 92% | 6% | 2% |
| 2016 | 3,835 | 61 | 5 | 1 | 67 | 91% | 7% | 1% |
| 2017 | 3,721 | 54 | 6 | 0 | 60 | 90% | 10% | 0% |
| 2018 | 3,582 | 55 | 6 | 0 | 61 | 90% | 10% | 0% |

* Firm sizes are computed using the number of registered persons at the end of each identification year, e.g. December 31st. FINRA defines a small firm as a member with at least one and no more than 150 registered persons, a mid-size firm as a member with at least 151 and no more than 499 registered persons, and a large firm as a member with 500 or more registered persons. *See* FINRA By-Laws, Article I.

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[170] Regulatory Notice 19-17, p. 9.

[171] Hendler v. United States, 36 Fed. Cl. 574, 588 (1996).

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While there are fifty-five (55) small and six (6) mid-size firms that FINRA has preliminarily identified as "members that pose higher risks", there are zero (0) large firms so identified. FINRA's Exhibit "D-2" to Regulatory Notice 19-17 throws into question that proposed new Rule 4111 is a broad-based regulation that offers reciprocity of advantage precisely because *every large FINRA member firm avoids the enhanced regulatory and financial challenges* of proposed new Rule 4111.

At the same time, these enhanced regulatory and financial challenges create a burden that is *severe* for the smaller firms (small to mid-sized firms). As we previously stated in Section 8.A (relating to "Economic Impact" of Rule 4111(i)(14) on a Member Firm's Assets), the "economic impact" of proposed new Rule 4111(i)(14) on these smaller firms is self-evident: The only option is to shut down the business – either immediately or down the road.

Proposed new Rule 4111 – particularly, subsection (i)(14) creating restrictions on the assets of "members that pose higher risks" [read: small to mid-sized firms only] – imposes burdens on the smaller firm that work (wittingly[172] or unwittingly, it does not matter) to confer benefits on large firms.

"Reciprocity of advantage" is akin to equal protection under the law because, in implementing limitations to freedom for the benefit of the common good (which is what regulations do), a regulation is "just" when it creates a "*neutral* distributional impact" where *everyone* loses but *everyone* gains. This concept – "reciprocity of advantage" – is at the heart of the meaning of "just laws".[173]

But, singling out or targeting an individual or class of individuals or groups within the universe of membership members in order to impose a burden on that individual or group thereby benefiting the rest removes equality from the equation. Proposed new Rule 4111(i)(14), if adopted, will do precisely this: remove equality among member firms.

"Reciprocity of advantage" therefore has no play in proposed new Rule 4111(i)(14); and, for this reason, proposed new Rule 4111(i)(14) violates the public use requirement of the Takings Clause of the Fifth Amendment.

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[172] There is a strong suggestion that conferring this benefit to large firms may be intentional. *See* Alan Wolper, FINRA Stats Reveal Horribly Kept Secret: Small Firms Are The Heart And Soul Of The Brokerage Industry, But Dying Off, Nevertheless, (10 August 2018): "****The voices of large firms are heard way more loudly than the small firms because that's where FINRA gets its money from.* ***"

[173] "[J]ust laws * * *promise *equal protection* to all who abide by them." Ex Parte Kumenzo Kawato, 317 U.S. 69, 72 (1942).



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### 8.B.2 "Retroactivity" and Rule 4111(i)(14) and Regulatory Taking:

Lower court cases hold that *retroactive* regulations are to be assessed with greater skepticism under the character factor.[174]

One court, interpreting the character factor adopted by Justice O'Connor's plurality opinion in *Eastern Enterprises v. Apfel*,[175] specifically stated that where "the action is retroactive in effect" and "is targeted at a particular individual," this supports a finding of a "taking".[176]

We have already amply demonstrated that proposed new Rule 4111 is "action [that] is retroactive in effect".

By its own admission, FINRA has looked to historical past conduct of member firms[177] during the process of drafting regulatory criteria that will line-up with histories of misconduct so that FINRA can, once Rule 4111 is implemented, "convict" those "members that pose higher risks" – who have already been identified even before the comment period for Regulatory Notice 19-17 has expired – so that, in the end, *the enhanced regulatory and financial challenges* of proposed new Rule 4111 can be imposed on these "members that pose higher risks" in order to bring about the end game: Shut down the business of these firms – either immediately or down the road.

We have previously pointed out that FINRA explains *for whom* this new Rule 4111 is *specifically* targeted:

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[174] Lost Tree Vill. Corp. v. United States, 100 Fed. Cl. 412, 438 (2011); Brace v. United States, 72 Fed. Cl. 227, 356 (2006); Carolina Power & Light Co. v. United States, 48 Fed. Cl. 35, 49 (2000).

[175] E. Enters. v. Apfel, 524 U.S. 498 (1998) (plurality opinion).

[176] Am. Pelagic Fishing Co. v. United States, 49 Fed. Cl. 36, at 50 (Fed. Cl. 2001) rev'd on other grounds, 379 F.3d 1363 (Fed. Cir. 2004).

[177] See Regulatory Notice 19-17 p. 3, 4: "FINRA has been engaged in an ongoing effort to enhance its programs to address the risks that can be posed to investors and the broader market by individual brokers and member firms that have *a history of misconduct*. * * * While these firms may eventually be forced out of the industry through FINRA action or otherwise, these patterns indicate a persistent, if limited, population of firms with *a history of misconduct* that may not be acting appropriately as a first line of defense to prevent customer harm by their brokers. * * * Such firms *expose investors to real risk.* For example, FINRA has identified certain firms that have a concentration of individuals with *a history of misconduct*, and some of these firms consistently hire such individuals and fail to reasonably supervise their activities. * * * [I]ndividuals and firms with *a history of misconduct* can pose a particular *challenge for FINRA's existing examination and enforcement programs*. * * *"(Emphasis supplied)



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> ". . .based on recent history FINRA *expects* that its annual calculations *will identify between 60-98 members* that meet the Preliminary Criteria for Identification [as a "Restricted Firm"]."[178]

In 2014, the Second Circuit found "targeting" to be a critical factor when determining whether a regulatory taking did take place. The Court stated:

> "[T]the Town *singled out* Sherman's development, *suffocating him with red tape to make sure he could never succeed in developing* MareBrook [Sherman's real estate and proposed development]. The Town's alleged conduct was *unfair, unreasonable, and in bad faith.* Though the precise contours of the "character" factor may be blurry, we can nevertheless conclude that the Town's conduct in this case falls safely within its [i.e., regulatory taking] ambit."[179] (Emphasis supplied)

Paraphrasing the Court's decision in *Sherman v. Town of Chester*, it is easy to see how proposed new Rule 4111 fits squarely within the Second Circuit's description of "regulatory taking":

> "[T]the Town [read: FINRA] *singled out* Sherman's development [read: smaller member firms], *suffocating him* [read: smaller member firms] *with red tape* [read: Rule 4111, and especially subsection (i)(14)] *to make sure he* [read: smaller member firms] *could never succeed in developing* MareBrook [read: smaller member firms developing their businesses]."

Because proposed new Rule 4111(i)(14) violates *Eastern Enterprises'* prohibition against "retroactivity" in conjunction with "targeting", Rule 4111, and especially subsection (i)(14), "falls safely within the 'regulatory taking' ambit" formula set forth in *Sherman v. Town of Chester.*

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[178] Regulatory Notice 19-17, p. 16.

[179] Sherman v. Town of Chester, 752 F.3d 554 (2nd Cir. – 2014) finding that regulatory taking had taken place: "Regulatory takings are further subdivided into categorical and non-categorical takings. * * * regulatory taking * * * occurs "when the government acts in a regulatory capacity * * * Balancing the Penn Central factors, we conclude that Sherman stated a non-categorical [regulatory] takings claim."



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### 8.B.3 Regulatory Taking & Rule 4111(i)(14)

To sum things up thus far, proposed new Rule 4111(i)(14) amounts to "government action" [180] that amounts to a "taking" of a broker/dealer's private property because FINRA's action "goes too far" and also because the "character" of FINRA's action:

- Violates the principle of "Reciprocity of advantage" because proposed new Rule 4111(i)(14) create restrictions on the assets small to mid-sized firms, imposing burdens on the smaller firm that work to confer benefits on large firms, thereby removing equality among member firms; and,

- Is "retroactive in effect" and "targeted at a particular" members firms – firms that FINRA has prejudged to be a "Restricted Firm" even before the comment period for Regulatory Notice 19-17 has expired and before proposed new Rule 4111(i)(14) has been reviewed and approved by the SEC and implemented and officially imposed on member firms.

Justice Holmes, writing for the majority in Pennsylvania Coal Co. v. Mahon,[181]stated that *"[t]he general rule at least is that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking."* This "going too far" in regards to proposed new Rule 4111(i)(14) is demonstrated by:

- FINRA's deliberate decision to craft a regulation with criteria that is not general in nature but instead specifically lines up with the history of misconduct of certain smaller firms that FINRA has targeted for voluntary or involuntary termination from membership *by operation of the "economic impact"* of proposed new Rule 4111, is a regulation that "goes too far".

- FINRA's deliberate decision to "single out" or "target" a small segment of the FINRA membership population that FINRA knows or reasonably knows *in advance of implementation* will be identified as a "Restricted Firm" ("preliminarily" and ultimately "determined" and even "re-determined" to be a "Restricted Firm"), is a regulation that "goes too far".

[180] Network 1 is aware that FINRA takes the position that FINRA is a private non-profit, not a government agency or a "state actor". Proposed rule changes, both in Regulatory Notice 18-16 and again here in Regulatory Notice 19-17, stretch the limits of this stance. Network 1 has amply demonstrated that the proposed rule changes in Regulatory Notice 18-16 "crossed the line" into "state action". In Section 9 of this Comment Letter, Network 1 will demonstrate that Regulatory Notice 19-17 likewise crosses the line into "state action". With that in mind, we hold firm that the statement that proposed new Rule 4111 constitutes, FINRA's "government action" on FINRA's part and, as such, amounts to a "taking" of a broker/dealer's private property.

[181] 260 U.S. 393 (1922) (Emphasis added).



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- FINRA's deliberate decision to *retroactively* apply this "Restricted Firm" criteria to certain smaller firms in order to impose the *enhanced regulatory and financial challenges* of proposed new Rule 4111, *before the proposed rule has been reviewed and approved by the SEC*, is a regulation that "goes too far".

- FINRA's deliberate decision to "single out" or "target" a small segment of the FINRA membership population that FINRA knows or reasonably knows in advance will fit the category of being "preliminarily" and ultimately "determined" and even "re-determined" to be a "Restricted Firm" so that the "Restricted Firm" will be subject to the *enhanced regulatory and financial challenges* of proposed new Rule 4111 likewise "goes too far".

- FINRA's deliberate plan to impose these burdens on member firms that FINRA alone judges, without review by either the SEC or the Courts, to be "members that pose higher risks", is a regulation that "goes too far".

- FINRA's deliberate plan to craft a regulation that has as its "end game" the goal of encouraging these firms to simply shut their doors because the cost of compliance and over-regulation makes staying in the securities business no longer desirable or profitable, is a regulation that "goes too far".

- FINRA's deliberate plan to single out smaller firms with *enhanced regulatory and financial* burdens in order to benefit larger firms, is a regulation that simply "goes too far".[182]

For these reasons, proposed new Rule 4111(i)(14) "falls safely within the 'regulatory taking' ambit" formula set forth in *Sherman v. Town of Chester*. It is inconceivable that, with this targeted

[182] Consider this interesting omission from Regulatory Notice 19-17. At page 10, FINRA displays a matrix that gives examples of "the point at which a member firm's Preliminary Identification Metrics would meet the Preliminary Identification Metrics Thresholds in proposed Rule 4111(i)(11)". In this matrix, FINRA sets for examples for (A) member firms that have 1 to 4 registered persons; (B) member firms that have 20 to 50 registered persons; and (C) member firms that have 51 to 150 registered firms. ***Noticeably absent is any demonstration of the point at which a Large Firm would meet the Preliminary Identification Metrics Threshold.*** Is the inference that FINRA does not elaborate on Preliminary Identification risk to Large Firms because this risk does not exist for Large Firms? That said, if we attempt to imagine this risk to Large Firms, might we see something like the following: Large Firms with 3,000 brokers can have 400 brokers and hundreds of adjudicated and pending events, but there is either no triggering event for the Large Firm worth analyzing because the Large Firms have sufficient capital to handle the "Maximum Restricted Deposit Requirement" or Large Firms are simply "too big to fail" - or, that Rule 4111 was created, with such understanding of Large Firm broker histories of misconduct that the criteria of Rule 4111 would never trigger a Preliminary Identification Metrics Threshold for Large Firms. In contrast, a Smaller Firm with 100 brokers and 25 restricted brokers invariably risks "the death penalty". Hypothetically speaking, Large Firms can have pending arbitrations with potential losses of $500 million and without needing to set up a reserve, whereas Smaller Firms with $100 thousand in losses or potential losses will have to set up a reserve, effectively forcing the Smaller Firm out of business. If this is the reality, then this reality strongly points to the conclusion that the ultimate objective of Rule 4111 is to favor the Large Firm at the expense of the Smaller Firm, eventually eliminating the Smaller Firms.



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deliberation on the part of a regulator that claims not to be a "government agency" yet possess the "force of law" every day, the Courts would not judge FINRA's "government action" to be a "taking" of a broker/dealer's private property.

## 9. Whether the Proposed New Rule 4111 That Amounts to a Bill of Attainder and a Regulatory Taking of Member Property Makes FINRA a "State Actor".

One Law Commentator has recently queried: "Under current case law, it is unclear what it would take to make FINRA a state actor subject to constitutional claims."[183]

Previously in Regulatory Notice 18-16, FINRA proposed to amend NASD Rule 1010 Series affecting the MAP rules, that amounted to dictating *whom* member firms are permitted hire, and also *how many* brokers a firm may hire.[184]

The "employment" initiative set forth in Regulatory Notice 18-16 appears, at this time, to be put on hold for the time being. That said, FINRA appears to be revisiting this "employment" issue through an alternative strategy in proposed new Rule 4111(c)(2) (relating to the One-Time Opportunity to Reduce Staffing Levels).

The One-Time Opportunity to Reduce Staffing Levels is explained in Regulatory Notice 19-17 as follows:

> "If the Department determines, after its initial evaluation, that a member that meets the Preliminary Criteria for Identification warrants further review under Rule 4111, such member—if it would be meeting the Preliminary Criteria for Identification for the first time—*would have a one-time opportunity to reduce its staffing levels to no longer meet these criteria*, within 30 business days after being informed by the Department. The member would be required to demonstrate the staff reduction to the Department by *identifying the terminated individuals. The proposed rule would prohibit the member from rehiring any persons terminated pursuant to this option, in any capacity, for one year*. A member that has reduced staffing levels at this stage may not use that staff-

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[183] *See* Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 23-24, citing Michael Deshmukh, Is FINRA a State Actor? A Question That Exposes the Flaws of the State Action Doctrine and Suggests a Way to Redeem It, Vanderbilt Law Review 67, no. 4 (2014), at 1173.

[184] *See* Network 1 Financial Securities Comment Letter (29 June 2018), Section 4.B (relating to "Whether the Proposal to Amend the NASD Rule 1010 Series [MAP Rules] Amounts to Taking of Property Making FINRA a "State Actor") at pp. 28-41. Source: https://www.finra.org/sites/default/files/notice_comment_file_ref/18-16_Netw1_Comment.pdf. The legal arguments made in the 29 June 2018 Comment Letter are hereby incorporated by reference into Network 1's Comment Letter of 1 July 2019 because of the close interworking between the proposals in Regulatory Notice 18-16 and Regulatory Notice 19-17.

> reduction opportunity again * * * If * * * the Department determines that the member still meets the Preliminary Criteria for Identification *even after its staff reductions*, or if the member elects not to use its one-time opportunity to reduce staffing levels, *the Department would proceed to determine the member's maximum Restricted Deposit Requirement*, and the member would proceed to a Consultation with the Department."[185]

Notwithstanding the previous attempt in Regulatory Notice 18-16 to dictate *whom* member firms are permitted hire and how many brokers a firm may *hire*, FINRA does not, as yet, interfere with whom a member hires and fires. But proposed new Rule 4111(c)(2) will change this. This time FINRA's focus is not on hiring, but on *firing*.

Traditionally, both hiring and especially *firing* – "reducing staff", to use FINRA parlance – has been a business decision that belongs exclusively to the employer. To date, no government (state, federal, or municipal) or its agencies *or its delegates* have ever crossed the line to presume the power to dictate when and under what circumstances an employer must *fire* its employees *or else face economic / financial consequences*.[186]

At common law, the role of government is to enforce, not interfere, with contracts. This means that, at common law, an employer should not be prohibited from hiring, firing, promoting, or demoting whomever he wants and for whatever reason he wants.[187] Fundamentally, this is a question of property rights, according to common law. Common law respects and reinforced the principle that, "if another person owns a business, I do not have a right to interfere with his choices as to what he does with his

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[185] Regulatory Notice 19-17, p. 11-12 (Emphasis supplied).

[186] Regulatory Notice 19-17, p. 12: "* * * If * * * the Department determines that the member still meets the Preliminary Criteria for Identification *even after its staff reductions*, or if the member elects not to use its one-time opportunity to reduce staffing levels, *the Department would proceed to determine the member's maximum Restricted Deposit Requirement*, and the member would proceed to a Consultation with the Department." (Emphasis supplied) There is another important consequence that appears to have been overlooked, wittingly or unwittingly. And that is this: Not only can the Department proceed to determine the member's maximum Restricted Deposit Requirement, but the Department can utilize the proposed new Rule 4111 system to start further investigations from which FINRA could then institute an enforcement action.

[187] *See* Clyde W. Summers, Employment At Will in the United States: The Divine Right of Employers, 3.1 U. PA. Journal of Labor and Employment Law 65 (2000): "The Tennessee Supreme Court articulated the employment at will doctrine in 1884, thus endowing employers with divine rights over their employees. This doctrine has been, and still is, a basic premise undergirding American labor law. The United States, unlike almost every other industrialized country and many developing countries, has neither adopted through the common law or by statute a general protection against unfair dismissal or discharge without just cause, nor even any period of notice." Source: https://www.law.upenn.edu/journals/jbl/articles/volume3/issue1/Summers3U.Pa.J.Lab.&Emp.L.65(2000).pdf *And see* Howard Johnson Co. v. Detroit Local Joint Executive Board, 417 U.S. 249 (1974) where selling-company, or transferor, had a collective agreement which prohibited discharge without cause and provided for arbitration of discharges. When the buying-company, or transferee, refused to continue to employ many of the employees, the union sought arbitration of their discharge. The Supreme Court held that the transferee (i.e., the new employer) had the right not to hire any of the transferor's (i.e., the former employer's) employees, and that the transferee/new employer was not bound by the transferor/old employer's collective agreement to arbitrate.



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property".[188] That said, today we know that this principle has been whittled away by the condition, "so long as the employer does not interfere with statutes and regulations of the government regulating the labor market."

And so, today we know that government can and does step in when an employer discriminates, at hiring, based on race, color, religion, sex, or national origin.[189] As a result, an employer cannot fire an employee because of an employee's inability to work on Saturdays when the employee chooses to honor Saturday as a Sabbath on religious conviction.[190] Employers can suffer liability for damages when failing to promote an employee because of her gender, despite qualifications.[191] And more recently, state governments have entered into the "hiring, firing, promoting, or demoting" arena, with at least 25 States having passed one form or another of "right-to-work" laws.[192]

The point here is that, *interfering* with an employer's traditional common law prerogative of "hiring, firing, promoting, or demoting" *is precisely what state and federal governments do* these days. Interfering with an employer's traditional common law prerogative of "hiring, firing, promoting, or demoting" is an accepted action of the state. It is "state action" pure and simple.

Thus, proposed new Rule 4111(c)(2) has ramifications that change the course of the economic freedom inherited from our common law and therefore transform the status of FINRA as a "self-regulatory organization" to "government regulator".

One Law Commenter, who is now a Commissioner for the U.S. Securities and Exchange Commission, states the case better than anyone to date has stated the case:

> "As FINRA expands its regulatory reach beyond broker-dealer oversight, it will look even less like an SRO and more like a governmental regulator."[193]

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[188] *See* David J. Mitchell, Government Intervention in Labor Markets: A Property Rights Perspective, 33 Villanova Law Review 1043, 1051 (1988). https://digitalcommons.law.villanova.edu/cgi/viewcontent.cgi?article=2620&context=vlr

[189] 42 U.S.C. Section 200003-2 (1982).

[190] Drazewski v. Waukeegan Dev. Center, 651 F.Supp. 754 (N.D. Ill. 1986).

[191] Thurber v. Jack Reilly's, Inc., 521 F.Supp. 238 (D.Mass. 1981), *aff'd*, 717 F.2nd 633 (1st Cir. 1983), *cert. denied*, 466 U.S. 904 (1984).

[192] *See* National Conference of State Legislatures, Right-to-Work Resources, http://www.ncsl.org/research/labor-and-employment/right-to-work-laws-and-bills.aspx#chart.

[193] Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 24. https://www.mercatus.org/system/files/Peirce-FINRA.pdf



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FINRA has consistently maintained that it is not a "state actor" – despite the fact that, in *Standard Investment Chartered Inc. v. National Association of Securities Dealers*, NASD (now FINRA) affirmatively argued and the Second Circuit U.S. Court of Appeals agreed that FINRA and its predecessor organization (NASD and NYSE) *are government actors* on grounds that ". . . The statutory and regulatory framework highlights to us the extent to which an SRO's bylaws are intimately intertwined with the regulatory powers delegated to SROs by the SEC ..."[194] (Emphasis added).

It should be noted that, in *Standard Investment*, FINRA wanted the Court to hold that FINRA is a "government actor" because, in that lawsuit, FINRA wanted immunity from private lawsuits. This benefit notwithstanding, FINRA has consistently maintained that it is not a "state actor".[195]

But the proposed new Rule 4111(c)(2) would change this, decisively.

Until now, hiring, *and most especially firing*, has been the exclusive province that belongs to the private sector. Right now it is the member firm that is in charge of *whom* it fires. If the SEC approves the proposed new Rule 4111(c)(2), FINRA – not the member firm – will hold the *effective* power to fire. This makes FINRA "it will look even less like an SRO and more like a governmental regulator".[196]

Commissioner Peirce is not the only SEC Commissioner who has expressed concerns over FINRA ventures into "government action" territory. Former SEC Commissioner Daniel M. Gallagher raised similar concerns about the true nature of today's FINRA, as well as its perhaps too-close-relationship with the SEC. Former Commissioner Gallagher writes:

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[194] 637 F.3d 112 (9th Cir. 2012). But this is not the only case in which NASD (now FINRA) argued that it should be treated as if it were a "government actor". *And see* Ross v. Bolton, 106 F.R.D. 315 (S.D.N.Y. 1984). NASD argued that ***when it is exercising its law enforcement functions, NASD acts as a governmental body***. *See also* the 2017 Eleventh Circuit decision, Turbeville v. FINRA, 2017 WL 4938821 (11th Cir. Nov. 1, 2017), where a panel of the Eleventh Circuit held that a former registered representative's purported state-law claims against FINRA were properly dismissed because there exists no private right of action against FINRA, a self-regulatory organization ("SRO"). The Court held that "When exercising these [disciplinary and disclosure action] functions, ***SROs act under color of federal law as deputies of the federal government.*** To sue these actors, a litigant must obtain permission from the federal sovereign; otherwise, any state-law claims asserted against them for carrying out their federally mandated duties crash headlong into the shoals of preemption" citing McCulloch v. Maryland, 4 Wheat. 316, 317 (1819). (Emphasis supplied)

[195] *See e.g.* D'Alessio v. N.Y. Stock Exch., Inc., 258 F.3d 93, 105 (2d Cir. 2001); *see also* Scher v. Nat'l Assoc. of Sec. Dealers, Inc. (NASD),, 218 Fed. App'x 46 (2d Cir. 2007) (holding that NASD actions were actions within the scope of regulatory authority and were correspondingly entitled to immunity); Barbara v. N.Y. Stock Exch., 99 F.3d 49 (2d Cir. 1996) (concluding that NASD had absolute immunity from liability arising out of administration of its disciplinary function).

[196] Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 24. https://www.mercatus.org/system/files/Peirce-FINRA.pdf



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"This decrease in the "self" aspect of FINRA's self-regulatory function has been accompanied by an exponential increase in its regulatory output. As FINRA acts more and more like a "deputy" SEC, concerns about its accountability grow more pronounced."[197] (Emphasis supplied)

Respected law commenters like Professor Roberta S. Karmel have correctly assessed:

"Although FINRA may not be a government entity,[198] in all or virtually all of its activities, it can be viewed as exercising powers delegated to it by the SEC."[199]

Finally, Professors Birdthistle and Henderson argue that FINRA is a subordinate agency of the SEC:

"SROs do not enjoy full and independent control of their regulatory authority but rather now exist as subordinate agents of the governmental entities that ultimately control their activities."[200]

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[197] Hon. Daniel M. Gallagher, U.S. Broker-Dealer Regulation, Chapter 6. Reframing Financial Regulation: Enhancing Stability and Protecting Consumers. Arlington, VA: Mercatus Center at George Mason University, 2016, p. 149. Source: https://www.mercatus.org/system/files/peirce_reframing_ch6.pdf. Daniel M. Gallagher served as a Commissioner of the U.S. Securities and Exchange Commission (SEC) from November 7, 2011 to October 2, 2015. Commissioner Gallagher was appointed to the SEC by President Barack Obama. Former Commissioner Gallagher is currently President of Patomak Global Partners, LLC.

[198] It is worth mentioning that another federal government agency – the Internal Revenue Service of the U.S. Treasury Department – concurs that "***FINRA is a corporation serving as an agency or instrumentality of the United States***" for purposes of determining whether FINRA fines are deductible expense as a business expense. *See* Internal Revenue Service, Memorandum No. 201623006, Office of Chief Counsel, 3 June 2016. https://www.irs.gov/pub/irs-wd/201623006.pdf: "FINRA has been delegated the right to exercise part of the sovereign power of a government, it performs an important governmental function, and it has the authority to act with the sanction of government behind it. Moreover, FINRA has absolute immunity with respect to actions taken in furtherance of its regulatory duties. Lobaito v. Fin. Indus. Regulatory Auth., Inc., 599 Fed. Appx. 400 (2d Cir. 2015), *cert. denied*, 193 L. Ed. 2d 445 (2015); Santos-Buch v. Fin. Indus. Regulatory Auth., Inc., 591 Fed. Appx. 32 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 43 (2015). Therefore, under the *Guardian Industries* test, ***FINRA is a corporation serving as an agency or instrumentality of the government*** of the United States for purposes of section 1.162-21(a)(3) when it is performing its federally-mandated duties under the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq., of conducting enforcement and disciplinary proceedings relating to compliance with federal securities laws, regulations, and FINRA rules promulgated pursuant to that statutory and regulatory authority. We note that section 162(f) would not apply to a fine paid to FINRA solely for a violation of a "house-keeping" rule that is a matter of private contract between FINRA in its capacity as a professional association and its members. It should be noted that, ***because FINRA is a quasi-governmental agency (i.e., a corporation serving as an agency or instrumentality of the United States),*** a penalty paid to FINRA – and therefore to a government for the violation of any law – is not a deductible expense under IRC Section 162(f)." (Emphasis supplied)

[199] Roberta S. Karmel, Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?, 14.1 Stanford Journal of Law & Finance, 151, at 196 (Fall 2008). Professor Karmel asks this question: "Have the SEC's dictates regarding board composition and governance for FINRA and NYSE Regulation transformed these SROs into government agencies?" Professor Karmel answers in the affirmative, stating: "FINRA was created in large part to further the SEC's objectives regarding self-regulation, and the SEC structured its board. So FINRA comes very close to being an organization that would qualify as a government agency." Id. at 168. Source https://brooklynworks.brooklaw.edu/cgi/viewcontent.cgi?article=1376&context=faculty

[200] *See* William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, pp.. https://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=4613&context=clr



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Former SEC Commissioner Gallagher has, on a separate occasion, asked the incisive question: *Is FINRA becoming a "deputy SEC"?*[201] Regulatory Notice 19-17 in conjunction with Regulatory Notice 18-16 answers this question in the affirmative.

As a "deputy SEC" having power and authority to dictate whom member firms are permitted hire (assuming FINRA goes forward with proposed new Rule 4111, especially subsections (c)(2) and (i)(14) discussed extensively elsewhere in this Comment Letter, and assuming the SEC approves these rule proposal), FINRA arguably crosses the threshold of "Becoming a Fifth Branch" of government[202] - the Fourth Branch being the administrative agencies (as for example, the SEC) of the federal government.

There is no debating whether the proposed new Rule 4111 and the proposal to create one new rule, Rule 9559, amending existing rule Rule 9549 to be renumbered as Rule 9560 are consistent with FINRA's mission.

The debate is whether FINRA crosses the "state actor" threshold by interjecting itself into the constitutionally protected common law property right of an employer to "hire, fire, promote, or demote" in the name of protecting the investing public.

One State Securities Administrator hits the bull's eye:

> "Congress should refrain from considering expansion of the SRO model until such time as FINRA correctly interprets the state actor issue, or until the issue is adequately addressed by legislation. Settling the question of whether or not FINRA or any other SRO is or is not a "state-actor" is of vital importance to effective regulation."[203]

This "state actor" issue was brought to a head by Regulatory Notice 18-16 and is again resurrected in Regulatory Notice 19-17. Interfering with employment relationships between employer and employee crosses that line that separates "private sector" from "state action", transforming private club

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201 Hon. Daniel M. Gallagher, Comm'r, Sec. & Exch. Comm'n. Market 2012: Time for a Fresh Look at Equity Market Struction and Self-Regulation, Speech to SIFMA's 15gh Annual Market Structure Conference (Oct. 4, 2012): https://corpgov.law.harvard.edu/2012/10/19/time-for-a-fresh-look-at-equity-market-structure-and-self-regulation/

202 *See* William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, pp. 36, citing 15 U.S.C. § 78s (2012) (requiring registration of SROs with the SEC).

203 Testimony of Steven D. Irwin Pennsylvania Securities Commissioner and Chairman, Federal Legislation Committee North American Securities Administrators Association, Inc. Before the House Subcommittee on Capital Markets and Government Sponsored Enterprises "Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight, (September 13, 2011), at p. 7. https://financialservices.house.gov/uploadedfiles/091311irwin.pdf (Emphasis supplied)



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membership rulemaking into "government action". When it does, constitutional prohibitions against Bills of Attainder and Regulatory Taking are triggered.

**10. Factors Important to Smaller Firms but Overlooked by FINRA in Crafting Regulatory Notice 19-17 and Proposed New Rule 4111:**

**10.A FINRA's Determination of a Maximum Restricted Deposit Requirement [Proposed Rule 4111(i)(15)] without regard for E&O Insurance**

FINRA writes:

> "* * * As provided in proposed Rule 4111(i)(15), the Department would consider the nature of the member's operations and activities, *annual revenues*, *commissions*, *net capital requirements*, the number of offices and registered persons, the nature of the disclosure events counted in the numeric thresholds, *the amount of any "covered pending arbitration claims" or unpaid arbitration awards*, and concerns raised during FINRA exams. * * * FINRA's intent is that the maximum Restricted Deposit Requirement should be significant enough to change the member's behavior *but not so burdensome that it would force the member out of business solely by virtue of the imposed deposit requirement.*"[204]

Network 1 accepts as true and believes to be genuine FINRA's representation that its intent in crafting proposed Rule 4111(i)(15) is be "not so burdensome that it would force the member out of business solely by virtue of the imposed deposit requirement."

Therefore, Network 1 believes that it is must be an oversight that the matter of Errors and Omissions (E&O) Insurance was not included in the discussion about "annual, commissions, net capital requirements" in connection with "the amount of any 'covered pending arbitration claims' or unpaid arbitration awards".

Accordingly, Network 1 respectfully requests that FINRA take into account that many firms have E&O insurance that covers a broker/dealer's payment of awards entered in favor of customers by FINRA arbitrators. Yet this "insurance" factor has not been taken into account by FINRA when

[204] Regulatory Notice 19-17, p. 12.



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considering the amount that FINRA requires to be set aside for either the minimum or maximum Restricted Deposit Requirement in proposed new Rule 4111(i)(15). Network 1 respectfully requests that E&O Insurance reduce, dollar for dollar, the amount that a member firm would be required to segregate from its net capital and deposit into the Maximum Restricted Deposit Requirement.

### 10.B FINRA's Determination of a Maximum Restricted Deposit Requirement [Proposed Rule 4111(i)(15)] without regard for "Bona Fide" Nuisance Claims Brought in Arbitration

Again, FINRA writes:

> "* * * As provided in proposed Rule 4111(i)(15), the Department would consider * * * the nature of the disclosure events counted in the numeric thresholds, *the amount of any "covered pending arbitration claims"*[205] * * *"[206]

In its Comment Letter to Regulatory Notice 18-16, Network 1 devoted three (3) sections[207] to the issue of "nuisance value" lawsuits and arbitrations brought by customers, especially through the aegis of non-attorney representatives.[208] As an appendix to these two sections, Network 1 presented a ten (10) page matrix summarizing the fact that an overwhelming number - **71.428%** - of these arbitration cases brought by these non-attorney representatives were "nuisance value" cases.

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[205] Footnote 10 to Regulatory Notice 19-17: "The term 'covered pending arbitration claim' is defined in proposed Rule 4111(i)(2) to mean an investment-related, consumer initiated claim filed against the member or its associated persons that is unresolved; and whose claim amount (individually or, if there is more than one claim, in the aggregate) exceeds the member's excess net capital. The claim amount includes claimed compensatory loss amounts only, not requests for pain and suffering, punitive damages or attorney's fees. This term also is proposed in Regulatory Notice 18-06 (February 2018). FINRA anticipates that the term would be amended in proposed Rule 4111(i)(2) to conform to any final definition adopted under the proposal in Regulatory Notice 18-06. For purposes of this Notice, the term "unpaid arbitration awards" also includes unpaid settlements related to arbitrations."

[206] Regulatory Notice 19-17, p. 12.

[207] *See* Network 1 Financial Securities Comment Letter (26 June 2018): Section 4.A (relating to Whether FINRA Should Exclude Certain Arbitration Settlements Entirely From "Materiality" Considerations in the Proposal to Amend the NASD Rule 1010 Series [MAP Rules]) and Section 6.B (FINRA Should Exclude Certain Arbitration Settlements Entirely From "Materiality" Considerations in the Proposal to Amend the NASD Rule 1010 Series [MAP Rules]) and Section 6.C (relating to 6.C FINRA Should Exclude Certain Arbitration Settlements Entirely BrokerCheck Disclosure.) Source: https://www.finra.org/sites/default/files/notice_comment_file_ref/18-16_Netw1_Comment.pdf

[208] As of this writing, FINRA has communicated that in December 2018, the Board of Governors has approved The Board approved two rule proposals to be published by FINRA for comment or filed with the SEC, one of which is the proposal to prohibit compensated Non-Attorney Representatives (NARs) in arbitration and mediation: " The Board approved filing with the SEC proposed amendments to the Codes of Arbitration and Mediation Procedure relating to prohibiting compensated non-attorney representatives from practicing in the FINRA arbitration and mediation forum." Source: http://www.finra.org/newsroom/2018/report-from-finra-board-of-governors-meeting-december-2018. That said, as of the date of composition of the instant Comment Letter, this rule proposal appears not to have been submitted to the SEC for review.



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Accordingly, Network 1 respectfully requests that FINRA take into account this disproportionate percentage of arbitration cases as being bona fide "nuisance value" in nature.

On a related note, proposed new Rule 4111 would allow law firms, acting on a contingency fee basis when engaging in "barratry",[209] knowing the impact on the firm's net capital, to effectively hold smaller firms hostage to the repercussions of "Restricted Firm" status, by threatening arbitration in "nuisance value" cases in hope for "quick and quiet resolution".

Once again, proposed new Rule 4111(i)(14) operates as a self-fulfilling prophecy. By identifying a member firm as a "Restricted Firm", proposed new Rule 4111(i)(14) puts a target on the backs of these member firms, drawing these firms to the attention of law firms engaged in "barratry", encouraging even more "nuisance value" arbitrations to be brought against such member firms, resulting in a downward spiral that never ends.

Accordingly, Network 1 respectfully requests that FINRA take into account the unethical practice bringing "nuisance value" lawsuits and exclude – not include - *pending* arbitration claims when considering the amount that FINRA requires to be set aside for either the minimum or maximum Restricted Deposit Requirement in proposed new Rule 4111(i)(15).

## 11. Conclusion

No one can reasonably dispute that a workable solution to the problem of dealing with "bad brokers" in the securities industry is needed.

At the same time, everyone who is reasonable can appreciate the frustration that FINRA is experiencing, and has experienced for years, in attempting to deal with "bad brokers" on a day-to-day basis while at the same time coming up with an enduring solution that (1) protects the investing public from "bad actors"; (2) curbs bad behavior of repeat offenders who cannot be so easily terminated; (3) preventing "bad actors" from the jumping from one firm to another, if not outright remove them from the securities industry; and (4) does so in a practical way that is in consonance with fundamental principles of justice and in compliance with constitutional prohibitions that limit the extent to which power can be exercised consistent with liberty in the marketplace. Economic freedom working in

[209] *See* footnote 164, Network 1 Financial Securities Comment Letter (26 June 2018).



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tandem with virtue[210] or virtuous behavior has been the hallmark of what, traditionally, made America uniquely what it is and the envy of all other nations. Keeping virtue in the market place – the goal of

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[210] This question – What is Virtue? – is so fundamental, to both the analysis and coming up with an ultimate solution to the real or perceived problem of bad behavior especially in the market place, that it deserves serious dedication of time and effort. Philosophy does have consequences. In this footnote we will present some background to how the philosophy of law has looked at virtue as pertains to the market place. But let's start with a practical 21st century scenario and potential ethical problem. A financial advisor sells a variable annuity to an 80 year old senior citizen. Or a stock broker engages in active trading for a customer of no particularly relevant age. Today, we conduct the analysis through the prism of suitability or very recently through the prism of "best interests" of the customer. Today's regulatory analysis – suitability / best interest – is actually the logical conclusion to the long search for justice in the market place whose problem was created by the shift in, or more accurately, towards contract law that began in Reformation Europe in the 1500s. Prior to that time, the law of the market place was governed by Roman law and natural law principles. In the days when Roman and natural law principles prevailed, an agreement between parties needed to have a *causa* in order to become a contract enforceable by the strong arm of the law. As the Roman jurist Ulpian explained: "If there is no additional ground [*causa*], in that case it is certain that no obligation can be created on the mere agreement; so that a bare agreement does not produce an obligation." Natural Law jurists built on this fundamental principle of *causa*, concluding that a "morally binding promise should also be legally binding if it is part of an agreement (a *pactum*, or consensual obligation) that is itself morally justified. The object or purpose (*causa*) of the contract had to be reasonable and equitable." This led to two significant restraints on the freedom of contracts that went beyond Roman law: the prohibition against enforcing usurious contracts and the requirements that contracts must be made at a just price. The Natural Law jurists' reliance on an objective standard of justice determined which agreements created an obligation as determined by civil law. Things changed in post-Reformation Europe created by the new theology that emphasized *individual* and *subjective* determination (in contrast to the former emphasis being on the common good). The Roman Law concept of *causa*, supplemented by the Natural Law requirement that the *causa* be both reasonable and equitable, was supplanted in Reformation England by the concept of *consideration*. Every first year law student learns that, in the absence of *consideration*, there is no binding contract at law *Consideration* is the "bargained for exchange". Whereas in pre-Reformation Europe only contractual promises supported by a *causa* were legally enforceable and enforced, in post-Reformation England the courts developed the practice of only enforcing *bargains* – that is, contractual promises supported by *consideration* – again, an exchange of bargained-for promises. In Natural Law jurisdictions, parties were always free to contract, but only *just* contracts – that is, contracts supported by *causa* – were enforceable by the law; in other words, obligation of the parties to fulfill their promise rested on the cause or *justness of the transaction*. Post-Reformation English courts rejected this Natural Law understanding of law in favor of *strict liability*. One of the oldest English court decisions, *Paradine v. Jane*, 82 E.R.519 (Kings Bench, 1647), set the trend for this shift away from contracts supported by *causa* replaced by contracts supported by *consideration*, creating *strict liability* for freely made covenants, leaving each party to bear the risk of unforeseen circumstances. Although modern English and American courts have, over the years, attempted to temper the purity of strict liability by introducing concepts like "mistake", "frustration of purpose", etc., the starting point in every judicial review of a transaction is (1) inviolability of the bargain and (2) strict liability for each party to bear the risk of unforeseen circumstances (e.g., volatility in the markets). Now let us apply these Roman Law/Natural Law and Post-Reformation Contract Law principles to the two scenarios postulated at the beginning of this footnote. Under Roman/Natural Law principles, the transaction (selling a variable annuity to an 80 year old senior citizen) lacks a *causa* because the transaction objectively lacks, not just reason, but equity. At Roman Law, and in Natural Law jurisdictions, it is the right of the state or government to step in between the parties in order to protect the common good from the immorality of the transaction – it does not matter whether the 80 year customer wants, needs, or thinks he needs a variable annuity; the individual's wants and needs are subordinate to the best interests of the common good. In Natural Law jurisdictions, this transaction would not be legally enforceable contract because the transaction lacks *causa*. A law-giver and the courts in a Natural Law jurisdiction would be free to declare this transaction and similar transaction as against the common good. A different conclusion is reached under contract law principles that started in post-Reformation Europe. These principles are the foundation of American capitalism and are the principles that are at play in the securities industry, today. In our scenario, even though the customer may be 80 years old, the "bargain" (i.e, the purchase of the variable annuity) is *inviolable*; and because the bargain is inviolable, each party – here especially the 80 year old customer – *bears his own risk* of unforeseen circumstances: *consideration* has replaced *causa* (with its concern for reasonableness and equity and morality). And because the contract is enforceable, there can be no imputation of wrongdoing to the financial advisor, at least under principles of American capitalism. The same respective conclusions would apply for the customer engaged in active trading of his account. Under Roman and Natural Law principles, *causa* (with its concern for reasonableness and equity and morality) is lacking because of the state's concern for the practical effect that gambling and other considerations ultimately have on the common good. But under post-Reformation contract of law principles, *causa* (with its concern for reasonableness and equity) is no longer legally relevant; concern for the common good is replaced by the new theology's emphasis on *individual* and *subjective* determination of what is good for himself – and in this scenario for *this* particular customer. The customer is free to engage in any covenant he wants without any interference by government (or its administrative agencies or their delegates) and the quid pro quo for this freedom of contract is that the customer bears, on his own, the risk of loss caused by the market place. Under



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FINRA Rule 2010's requirement that members firms and their brokers "observe high standards of commercial honor and just and equitable principles of trade" – is the ultimate objective, we believe, of FINRA's efforts in Regulatory Notice 19-17.

Unfortunately, proposed new Rule 4111 "goes too far", to use Justice Holmes' phrase.[211]

Arguably, proposed new Rule 4111 is, as a result of powers directly delegated by Congress to FINRA and indirectly by the SEC, the product of Rule-Making that has the "force of law"[212] and is therefore Legislation as this term is meant in the context of the definition of a Bill of Attainder.[213]

Proposed new Rule 4111 is a Bill of Attainder precisely because, prior to rolling out this rule proposal for comment by the membership and review and approval by the SEC, FINRA has already identified a subset of FINRA membership - sixty-one or so member firms - that FINRA has targeted to be identified as "high risk firms" so that FINRA can employ the criteria crafted into Rule 4111 with these firms in mind, in order to formally adjudge (through a non-judicial process) these same firms to be "Restricted Firms", thereby triggering limitations on how these firms can utilize their assets for net capital calculation – with the ultimate objective of pressing these firms to voluntarily "close their doors" – some sooner, others later – without needing to undertake termination of membership through the normal course of enforcement proceedings.

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Roman and Natural Law principles, the contract, though not legally enforceable, is also not morally justifiable; therefore, the broker, having encouraged the customer to engage in immoral conduct (i.e, active trading), could be deemed a "bad broker". The opposite is true under American capitalist principles founded in post-Reformation contract law: the same broker is not a "bad broker" because: (1) the broker is nothing more than one of the parties to the bargain (the customer, the other party, wants to actively trade and the broker, because of his FINRA registrations, has the power to execute his customer's trading orders); (2) the bargain is supported by consideration (e.g., commissions in exchange for services to the customer); and (3) because the transaction (active trading) is *morally neutral* (i.e., *causa* in its concern for reason and equity is replaced by *consideration*); thus, the broker cannot be deemed a "bad broker". Things like cost-to-equity, or profit-and-loss, and commission-to-equity ratios are, in principle, legally meaningless in fundamental post-Reformation/American capitalism. As we said at the outset, Philosophy has consequences. This is why it is, and will continue to be, so very difficult to reasonably arrive at defining who is, and who is not, a "bad broker". So long as a broker conducts securities business *consonant with the principles of American contract law*, whose principles derive ultimately from the English courts of the post-Reformation, any criteria attempting to define a broker as a "bad broker" will ultimately struggle to survive scrutiny under the weight of objective reasoning whenever "bad broker" criteria contradicts the fundamental principles of contract law that leaves no room for *causa* (with its focus on reason, equity – and, under the operation of natural law – morality) because, in the final analysis, declaring a broker to be a "bad broker", under any criteria, is a moral judgment. – jcc

[211] Justice Holmes, writing for the majority in Pennsylvania Coal Co. v. Mahon, stated that "[t]he general rule at least is that while property may be regulated to a certain extent, *if regulation goes too far it will be recognized as a taking.*"

[212] Pursuant to the Supreme Court's *Chevron-Mead* analysis, rules of such administrative agencies as the Internal Revenue Service and the Treasury Department and the Federal Trade Commission have been deemed by the Court to have the "force of law".

[213] Section 5 of this Comment Letter (relating to Rule-Making as Legislation); Section 6 of this Comment Letter (relating to FINRA and Congressional Delegation).



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In other words, through proposed new Rule 4111, FINRA hopes to accomplish indirectly that which it has been struggling, if not failing (according to FINRA's implied admissions), to accomplish directly through enforcement proceedings – the accepted course that at least has some modicum of due process.

And because proposed new Rule 4111 "goes too far", FINRA has triggered another constitutional prohibition, namely, the prohibition against "regulatory taking" of private property:

- In Regulatory Notice 18-16, FINRA triggered regulatory taking because it aimed at controlling a member's property right to *hire* whom it so chooses;

- In Regulatory Notice 19-17, FINRA triggers regulatory taking because it aims at controlling a member's property right, as an employer, to *fire* employees.

Because of these principles of law, arguably (from our perspective, but not FINRA's perspective), FINRA is a "state actor". Because FINRA is a "state actor", prohibitions against "attaint of persons" and "taking of property", as set forth in the U.S. Constitution, apply.

Proposed new Rule 4111 is a Bill of Attainder that violates the constitutional prohibition against "regulatory taking" of property by "government action", whether at the hands of agencies or deputies of government agencies.[214]

That said, it is worthy of consideration that proposed new Rule 4111 may not even be necessary, based on statistics provided by FINRA.[215]

Proposed new Rule 4111 is premised on the need to "creat[e] appropriate incentives to members that pose higher risks to change their behavior."

[214] As Network 1 has argued, and we believe amply demonstrated in its June 26th 2018 Comment Letter to Regulatory Notice 18-16, FINRA is in the many functions that it performs a "deputy" of the SEC, and for this reason triggers "state action", making FINRA a "state actor". https://www.finra.org/sites/default/files/notice_comment_file_ref/18-16_Netw1_Comment.pdf, at pp. 15, 16, 28, 30, 37-38, 40, 41, 46.

[215] *See* the FINRA Exhibit D-2 attachment to Regulatory Notice 19-17.



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But the percentage of *decline in the number of Bad Brokers*, from 2013 to 2018, *has decreased by* **20.50%.** Based on these statistics, arguably, FINRA is already accomplishing its objective without the need for proposed new Rule 4111.

| Year | Percentage of 'Preliminarily' Identified Bad Firms | Number of "Bad Firms" divided by Total Number of Firms |
|---|---|---|
| | | |
| 2013 | 2.14% | 89 / 4,140 |
| 2014 | 2.40% | 98 / 4,068 |
| 2015 | 2.18% | 86 / 3,941 |
| 2016 | 1.70% | 67 / 3,835 |
| 2017 | 1.60% | 60 / 3,721 |
| 2018 | 1.70% | 61 / 3,582 |
| | | |

- The percentage of "Bad Firms" declined from 2.14% in 2013 to 1.7% in 2018.
- The difference (2.14% minus 1.7%) is a decline of 0.44% over a period of six (6) years (i.e., 2013 through 2108).
- The percentage of decline from 2013 to 2018 is 20.50% (0.44% / 2.14%).
- Data is taken from FINRA's Attachment D-2 to Regulatory Notice 19-17.

It is also worthy of consideration that proposed new Rule 4111 may not even be necessary because of the performance of FINRA's Enforcement Program:

Regulatory Actions 2014 – 2018: [216]

| Regulatory Actions | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| **Investor Complaints Received** | 3,136 | 3,002 | 3,070 | 3,250 | 2,802 |
| **New Disciplinary Actions Filed** | 921 | 1,369 | 1,434 | 1,512 | 1,397 |
| **Fines** (in millions) | \$61.0 | \$64.9 | \$173.8 | \$93.8 | \$132.6 |
| **Restitution** (in millions) | \$25.5 | \$66.8 | \$27.9 | \$96.6 | \$32.3 |
| **Firms Expelled** | 16 | 20 | 24 | 31 | 18 |
| **Firms Suspended** | 23 | 29 | 26 | 25 | 5 |

[216] https://www.finra.org/newsroom/statistics



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| | | | | | |
|---|---|---|---|---|---|
| **Individuals Barred** | 386 | 492 | 517 | 496 | 481 |
| **Individuals Suspended** | 472 | 733 | 727 | 736 | 705 |

FINRA's angst notwithstanding,[217] FINRA is blessed with a coterie of skilled trial attorneys who have served, and continue to serve, FINRA and investors well.[218] The above statistics speaks for itself.

The delay caused by the enforcement process is the natural consequence of due process considerations guaranteed by our Constitution, and therefore should not be taken lightly or even disregard in order to justify an end that, ultimately, is illusory.

We use the word "illusory" because the intended "end" – namely, ridding the securities industry of every "bad broker" and every "high risk" firm – is wished for in an environment (namely, the securities market place) where customer and broker each in their turn willingly bargain for the opportunity for profit in arena where "high risk of unforeseen consequences" is an *essential* component of making a profit, and of course its opposite, incurring a loss. This is extensively discussed in footnote 210.

Some brokers truly are or will be "bad" brokers. At the same time some customers are experienced investors who play "dumb like a fox" when the market goes against them because they know there will be lawyers who engage in "barratry" and will take "nuisance value" claim against a broker on a contingent-fee basis, costing the investor nothing unless the investor wins at arbitration.

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[217] FINRA writes: "Enforcement actions in turn can only be brought after a rule has been violated—and any resulting customer harm has already occurred. In addition, these proceedings can take significant time to develop, prosecute and conclude, during which time the individual or firm is able to continue misconduct, perpetuating significant risks of additional harm to customers and investors. Parties with serious compliance issues often will litigate enforcement actions brought by FINRA, which potentially involves a hearing and multiple rounds of appeals, thereby effectively forestalling the imposition of disciplinary sanctions for an extended period. For example, an enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the National Adjudicatory Council (NAC), and a further appeal to the SEC. Moreover, even when a FINRA Hearing Panel imposes a significant sanction, the firm can forestall its effectiveness through the appeals process, because sanctions are stayed during appeals to the NAC and potentially the SEC. And when all appeals are exhausted, the firm may have withdrawn its FINRA membership, limiting FINRA's jurisdiction and eliminating the leverage that FINRA has to incent the firm to comply with the sanction, including making restitution to customers. Temporary cease and desist proceedings do not always provide an effective remedy for potential ongoing harm to investors during the enforcement process. Temporary cease and desist proceedings are available only in narrowly defined circumstances. Moreover, initiation by FINRA of a temporary cease and desist action does not necessarily enable more rapid intervention, because FINRA must be prepared to file the underlying disciplinary complaint at the same time." *See* Regulatory Notice 19-17 at 4.

[218] On a personal note: As a former trial lawyer myself, I hold in high regard the attorneys at NASD and FINRA Enforcement with whom I have dealt over the last 20 years since I crossed over from private practice to securities regulation and broker/dealer compliance practice both at various law firms and as in-house counsel. I regard the attorneys with whom I have dealt as worthy adversaries, which is the highest compliment that a trial lawyer can give to a colleague. - jcc



The Galleria ▪ Suite 241 ▪ Building 2
2 Bridge Avenue ▪ Red Bank, NJ 07701-1106
Phone: 732-758-9001 ▪ Toll Free: 800-886-7007 ▪ Fax: 732-758-6671

In the final analysis, Who is a "bad broker"?, is in no way easily capable of being determined.

Our Country's history of constitutional law teaches us the important lesson that making a judgment about who is or is not a "bad" person is better left to adjudicators (who apply facts-of-record to principles of law and vice versa), rather than to rule-makers (who make judgments, in advance, as to who is a "bad" person and who should effectively be exited from the industry without the benefit of a forum offering traditional protections Star Chamber verdicts).

Proposed new Rule 4111 would shift this judgment process, first and foremost to the rule-maker and its executors (i.e. the Department of Supervision Management). The employment of a Hearing Officer in the expedited hearing protocol is of no constitutional consequence because of the significant material conflicts of interest that exist (as we have already amply demonstrated). Moreover, there is no hint that due process would exist in a meaningful way in this expedited hearing process, under Proposed new Rule 4111. The "formula" for judging which member firm is, at least preliminarily and eventually permanently, determined to be a "Restricted Firm" is so fluid and so obscure as to evoke images of the notorious Star Chamber.

Proposed new Rule 4111 is constitutionally defective. It is a Bill of Attainder. It does trigger Regulatory Taking that is in violation of Amendment V of the Constitution. FINRA may continue to argue that it is not a "state actor" and therefore constitutional considerations do not apply to FINRA. Aside from the fact that both Regulatory Notice 18-16 and now Regulatory Notice 19-17 have inched FINRA ever so convincing close to "state action" enticing several courts to be willing to take up this question "of first instance", FINRA should be concerned about the court of public opinion that grows ever more suspicious of a governing body that has so much power – more power than the SEC – and yet is so privileged that every protection that Americans are accustomed to having on his and her side, simply does not apply to it (namely, FINRA).

Again, FINRA already has a practical solution to the problem of "bad brokers". It is FINRA's excellent Enforcement Program. It may not be as "efficient" as FINRA may desire (that is, the right of appeal delays the final outcome of cases). But, the FINRA Enforcement Program certainly is effective – in 2018, through the efforts of the FINRA enforcement attorneys 386 individual brokers were barred and 472 brokers were suspended. The trade-off for "efficiency" is constitutional protections. We are therefore encouraging FINRA to give as much, if not greater, weight to constitutional protections as it desires to give a first place to "efficiency".

Again, the intended "end" – namely, ridding the securities industry of every "bad broker" and every "high risk" firm in the securities market place – is "illusory" because "risk" and the "opportunity for



The Galleria ▪ Suite 241 ▪ Building 2
2 Bridge Avenue ▪ Red Bank, NJ 07701-1106
Phone: 732-758-9001 ▪ Toll Free: 800-886-7007 ▪ Fax: 732-758-6671

profit" is the essence of the securities market place. It is the nature of the beast. There will always be "bad" brokers just as there will always be "bad" customers. Accordingly, pursuing this "end" at the expense of constitutional protections is dangerous to our Country's founding principles.

An important lesson can be taken James Madison, who, in Federalist 10, writes the prophecy:

> "There are two methods of curing the mischiefs of faction [read: investors vs. brokers vs FINRA]: the one, by removing its causes; the other, by controlling its effects.
>
> "There are again two methods of removing the causes of faction: the one, by destroying the liberty which is essential to its existence; the other, by giving to every citizen the same opinions, the same passions, and the same interests.
>
> "It could never be more truly said than of the first remedy, that it was worse than the disease. Liberty is to faction what air is to fire, an aliment without which it instantly expires. But it could not be less folly to abolish liberty, which is essential to political life, because it nourishes faction, than it would be to wish the annihilation of air, which is essential to animal life, because it imparts to fire its destructive agency.
>
> "The second expedient is as impracticable as the first would be unwise. As long as the reason of man continues fallible, and he is at liberty to exercise it, different opinions will be formed. As long as the connection subsists between his reason and his self-love, his opinions and his passions will have a reciprocal influence on each other; and the former will be objects to which the latter will attach themselves."

A regulator can remove the "cause" of investor harm: Search out and remove all "bad brokers" without a bona fide adjudicatory process. But in doing so, the consequence will be "destroying liberty of the market place".

If James Madison were writing today, he would say that the first remedy - searching out and removing all "bad brokers" without a bona fide adjudicatory process – is worse than the disease that FINRA is attempt to heal within the market place.
James Madison would also very likely write that the second solution – making everyone fall in, "lock, stock, and barrel", with FINRA's determination as to who is and who is not a "bad broker" – would be impracticable because, as Madison writes, the reason of man continues fallible, and [because] he is at liberty to exercise it, different opinions will be formed".

We need only point to the example of the Compliance Analyst with a lily-white history who leaves his employment with an expelled firm and hired by a smaller firm or a larger firm: Is he or is he not to be counted as a "bad broker" towards FINRA's "preliminary" determination of "Restricted Firm" status? Similarly, we need only point to the likelihood of a member firm being transformed into a "Restricted Firm" simply because it hired a broker who was (apparently) lily-white at the time of hire but whose skeletons came out of the closet years later when the statute of limitations come close to expiration.

Setting aside interpreting the technical applications and limitless scenarios of the various provisions in proposed new Rule 4111, reasonable minds will invariably differ on the question whether a member firm, determined by FINRA to be a "Restricted Firm", really is a "bad firm", morally speaking. For, as James Madison explains, "the reason of man continues fallible, and [because] he is at liberty to exercise it, different opinions will be formed".

It is doubtful that James Madison would agree that a regulator – whether we agree that it is a "state actor" or not – should have the final say on this question.

As James Madison writes, in concluding the point being made above:

> "The diversity in the faculties of men, from which the rights of property originate, is not less an insuperable obstacle to a uniformity of interests. The protection of these faculties is the first object of government. From the protection of different and unequal faculties of acquiring property, the possession of different degrees and kinds of property immediately results; and from the influence of these on the sentiments and views of the respective proprietors, ensues a division of the society into different interests and parties."

To paraphrase James Madison: The securities market place is the premier forum for acquiring property through man's fallible, different and unequal faculties. This applies to customer and broker alike. There are already plenty of rules on the record books that adhere to and safeguard constitutional protections; and, there already exists a well-functioning enforcement process that has demonstrated effectiveness, even if not satisfactory to FINRA in regards to the "significant time" – delay, in other words – invariably involved in the enforcement process.

Far better, James Madison would argue, that the determination who is and who is not a "bad broker" or a "bad firm" should be left to an enforcement process that is not tainted by Bills of Attainder, Regulatory Taking, and supported by at least some semblance of due process, than to be left into the hands of the Rule-Maker's and those who (i.e the Department of Member Supervision and its cooperating Hearing Officer) would execute the provisions of proposed new Rule 4111.

For all these reasons, we respectfully request that proposed new Rule 4111 and the other amendments to the Rule 9500 Series not be submitted to the SEC for consideration.



The Galleria • Suite 241 • Building 2
2 Bridge Avenue • Red Bank, NJ 07701-1106
Phone: 732-758-9001 • Toll Free: 800-886-7007 • Fax: 732-758-6671

NETWORK 1 FINANCIAL
SECURITIES, INC.

Respectfully submitted,

**NETWORK 1 FINANCIAL SECURITIES, Inc.**

BY: ______________________
Damon D. Testaverde
Chairman

BY: ______________________
William R. Hunt, Jr.
President

BY: ______________________
Joseph C. Cascarelli, Esq.
Corporate Counsel

cc: Michael Molinaro,
Chief Compliance Officer