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July 1, 2019

VIA ELECTRONIC SUBMISSION

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

Re: Regulatory Notice 19-17, Protecting Investors from Misconduct

Dear Ms. Mitchell:

The Investor Rights Clinic at Pace Law School, operating through John Jay Legal Services, Inc. (PIRC),[1] welcomes the opportunity to comment on FINRA's proposed new Rule 4111 (Restricted Firm Obligations), which imposes additional obligations on firms with a significant history of misconduct. The proposed rule seeks to promote investor protection and market integrity by giving FINRA a tool to incentivize member firms to comply with regulatory requirements and to pay arbitration awards. To accomplish these goals, the proposed rule authorizes FINRA to identify firms that present a heightened risk of harm to investors through a multi-step process involving numeric-based threshold calculations. It then requires these firms to make deposits of cash or qualified securities that could not be withdrawn without FINRA's prior written consent and to adhere to other conditions or restrictions on the member's operations that FINRA deems necessary or appropriate to protect investors.

PIRC supports FINRA's efforts to protect investors from firms with a significant history of misconduct and views the rule as a positive step in this direction. However, we believe the rule should be refined, and we recommend broader measures to accomplish the goals set out in the Regulatory Notice. While the proposed numeric thresholds should identify many high-risk firms, we are concerned that some firms could try to mislead and underreport disclosures to stay below the numeric thresholds. Moreover, while the proposed financial obligations on Restricted Firms should help deter misconduct, we recommend that FINRA clarify the process for

[1] PIRC, which opened in 1997, is the nation's first law school clinic in which law students, for academic credit and under close faculty supervision, provide pro bono representation to individual investors of modest means in arbitrable securities disputes. *See* Barbara Black, *Establishing A Securities Arbitration Clinic: The Experience at Pace*, 50 J. LEGAL EDUC. 35 (2000); *see also* Press Release 97-101, Securities Exchange Commission, *SEC Announces Pilot Securities Arbitration Clinic To Help Small Investors – Levitt Response To Concerns Voiced At Town Meetings* (Nov. 12 1997), *available at* http://www.sec.gov/news/press/pressarchive/1997/97-101.txt.

determining and using the restricted funds and more fully detail the other potential conditions or restrictions. Finally, PIRC supports the creation of an industry-funded national investor recovery pool to address the larger issue of unpaid awards and recommends investor education to deter serial misconduct by requiring member firms and registered representatives to provide BrokerCheck reports to customers.

Identifying Restricted Firms Using Numeric-Based Thresholds

To identify the firms that expose investors to high risk because of their history of significant misconduct, FINRA proposes using a multi-step, "funnel" process which begins with an annual calculation, based on six categories of broker and firms disclosures,[2] to preliminarily identify firms that present a significantly higher risk to investors than a large percentage of the membership. FINRA proposes using numeric thresholds for seven different firm sizes to ensure that each member firm is compared to similarly sized peers. The identification process then involves an initial evaluation by FINRA to determine whether, despite preliminary identification, the member does not impose a sufficiently high level of risk to warrant further review. If further review is warranted, FINRA would provide a one-time option to reduce staffing levels to below the thresholds. FINRA also offers a consultation with the member firm to determine whether it should be considered Restricted, as well as the opportunity to appeal. Only after this thorough process would FINRA consider a member a Restricted Firm.

As detailed in the Regulatory Notice, it appears that FINRA is cognizant of the most problematic and consistent offenders in the industry. The proposed rule uses numeric thresholds based on individual and firm disclosure events to identify these firms, while giving firms sufficient opportunity to avoid being mistakenly or wrongly identified as Restricted. Additionally, the one-time option to reduce risky staff has the added bonus of lowering the number of representatives who have repeatedly harmed investors.

While PIRC supports the numeric-based threshold approach as a positive step towards identifying high-risk firms, we are concerned that firms may attempt to mislead and underreport required disclosures in an attempt to stay below the numeric thresholds. FINRA notes that the IIROC "terms and conditions" approach would capture member firms with substantial compliance failures that might not otherwise be captured by the threshold approach but declined to propose that approach at this time. We support any supplemental or alternative methods, such as the "terms and conditions" approach, that would identify high-risk firms that have evaded the numeric threshold approach.

We are also concerned that the firms identified by the numeric-based threshold approach may underrepresent the number of firms and individuals with numerous disclosure events that have been expunged. It has been well established that, despite FINRA's position that expungement of customer dispute information is an extraordinary measure, expungement is granted in the majority of cases in which it is requested. Thus, the numeric-based threshold criteria may not capture all of the firms or individuals with a significant and disproportionate

[2] These six categories are: Registered Person Adjudicated Events, Registered Person Pending Events, Registered Person Termination and Internal Review Events, Member Firm Adjudicated Events, Member Firm Pending Events, and Registered Person Associated with Previously Expelled Firms.

history of misconduct. Moreover, we echo PIABA's concern that the numeric-based threshold approach could encourage unwarranted requests for expungement in an attempt to avoid the Restricted Firm designation.

Industry objections that the proposed rule would disproportionately affect small firms are unwarranted, as the rule accounts for different firm sizes in its threshold calculations and should only identify firms that persistently hire individuals who pose a high risk to investors.

Restricted Firm Financial Obligations

Proposed Rule 4111 would give FINRA the authority to impose financial obligations on designated Restricted Firms by requiring them to make deposits of cash or qualified securities into a Restricted Deposit Account and maintain a minimum balance called the Restricted Deposit Requirement. FINRA will tailor the Restricted Deposit Requirement based on, among other factors, the nature of the firm's operations and activities, annual revenue, net capital requirements, the number of offices and registered persons, the nature of the disclosure events captured by the numeric thresholds, and the amount of any covered pending arbitration claims or unpaid arbitration awards. Once funds are deposited in the restricted account, Restricted Firms could not withdraw them without FINRA's prior consent. In addition to the Deposit Requirement, the proposed rule anticipates additional potential "conditions or restrictions."

PIRC generally supports the Restricted Firm financial obligations aspect of the proposed rule and believes it should help deter misconduct. However, the additional potential "conditions and restrictions" seem ambiguous, and it is unclear if and how FINRA will adjust a member's Restricted Deposit Requirement if a member actually uses these funds to pay unpaid awards.

The proposed financial obligations should help FINRA rein in Restricted Firms that shut down and reconstitute themselves in an attempt to avoid paying settlements and awards because members would need FINRA's consent to withdraw funds from their Restricted Accounts. A member that becomes a former member would still have funds tied up in the previous firm's Restricted Account and thus have less capital to work with upon attempted reconstitution. Although this aspect of the proposal should have a positive deterrent effect, we echo the concern raised by PIABA President Christine Lazaro that it could encourage gamesmanship among member firms to keep operating capital low.[3]

Unpaid Arbitration Awards

The Restricted Deposit Requirement should help address the issue of unpaid arbitration awards. However, while the proposed rule suggests that the funds subject to the Restricted Deposit Requirement *should be used* by member firms to pay unpaid arbitration awards, it does not state that they *must be used* for this purpose. We recommend making this a requirement.

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[3] Christine Lazaro, *FINRA Proposal to Restrict Recidivist Behavior a Good Start – But More Needs to be Done*, INVESTMENTNEWS: OUTSIDE-IN (May 14, 2019), https://www.investmentnews.com/article/20190514/BLOG09/190519967/finra-proposal-to-restrict-recidivist-behavior-a-good-start-x2014.

Additionally, because the funds generated by the Restricted Deposit Requirement likely will not be sufficient to cover all unpaid arbitration awards, PIRC supports the creation of a national investor recovery pool as a complementary method to address this issue. The pool should be maintained and administered by FINRA through the collection of fines on rule-breaking members, from its profits, or through a modest assessment on members. In addition to ensuring that all awards are paid to customers, such a pool should incentivize the industry to police itself and minimize the misconduct that has led to the need for such a pool.

Mandatory Disclosure of BrokerCheck Reports

To ensure that customers are aware of reported misconduct before choosing a broker, PIRC recommends an additional condition on Restricted Firms – requiring mandatory disclosure of BrokerCheck reports by these firms and their registered representatives. Specifically, we recommend that FINRA require members to provide both firm and individual BrokerCheck reports to new customers as part of the account opening process, as well as at periodic intervals (perhaps with year-end account statements). This type of simple investor education would empower investors to avoid working with, or to ask clarifying questions of, brokers with a history of significant misconduct, while deterring such misconduct in the first place. Despite FINRA's efforts to promote BrokerCheck, in our experience, customers who are victims of brokers with a significant history of misconduct are unaware of this tool until it is too late. FINRA should consider requiring this disclosure of all members and registered representatives, which would provide all investors with the ability to make informed decisions when choosing a broker.

Conclusion

While proposed Rule 4111 enhances the protection of investors from firms with a history of significant misconduct, the rule should be refined to avoid underreporting and gamesmanship, as well as explicitly to require the payment of unpaid arbitration awards. Finally, we encourage FINRA to address the larger problem of unpaid arbitration awards through a national investor recovery pool and to enhance investor education by requiring brokers to share BrokerCheck reports with customers.

Respectfully submitted,

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