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Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006-1506
Attn: Jennifer Piorko Mitchell

Re: Comment on Proposed Rule 4111

Dear Ms. Mitchell:

My law firm and I have represented many FINRA, NYSE, and AMEX member firms and associated persons for nearly thirty (30) years. This letter is sent with respect to Proposed FINRA Rule 4111 which we view as an ill-advised attempt by FINRA to legislate out of existence small broker dealers and registered representatives that FINRA, through the use of flawed criteria, classifies as bad actors. The proposed rule should not be adopted. Broker dealers, large and small, are already subject to strict regulatory examinations and scrutiny that include regular FINRA cycle exams and audits designed to detect potential and actual regulatory issues for remediation or, in instances where regulatory issues are perceived to be egregious, result in disciplinary actions. Small firms are already under siege in attempts to keep up with FINRA examinations and the often burdensome and repetitive requests for documents and information. It is often a full time job trying to keep ahead of FINRA with respect to 8210 requests and many reputable small broker dealers have closed shop as a result of the burdens that already exist relating to regulatory exams. Proposed FINRA Rule 4111 will add another layer of administrative red tape that small firms will not be able to comply with and that will force them out of business – perhaps that is the goal of the proposed rule.

Despite paying lip service in the proposed rule to a process for administrative review there is a "Presumption that the firm will be designated as an RF" – a Restricted Firm. Small firms already exist in an environment of perceived hostility. FINRA is codifying this apparent animus with a "presumption" that a firm is a bad actor and imposes on the firm the burden to rebut FINRA's pre-conceived conclusion. This presumption of guilt is contrary to one of the core tenets upon which this country was founded.

FINRA proposes to designate as "Restricted Firms" those that "have a history of misconduct" and "persistently employ brokers who engage in misconduct." Unfortunately, nearly all firms, large and small, have been the subject of civil customer claims and disciplinary actions and investigations that conclude with outcomes that, though unfavorable, are not any evidence of misconduct. In the proposed rule FINRA considers, generally, two categories that fall within its definition of misconduct: customer initiated civil litigation in the form of customer arbitrations and court actions, and disciplinary investigations and actions by SROs and federal and state regulators. This includes proceedings that are "pending" – that is, the matters that have not been adjudicated and have not resulted in adverse determinations. Brokers that FINRA regards as recidivist are often the subject of customer arbitrations and regulatory actions that are of questionable merit. The matters are often settled to avoid the uncertainties of litigation and to avoid the significant FINRA fees and attorney's fees associated with participating in, and defending, such actions. Small firms are often the place of last resort for such brokers who should be permitted to ply their trade but who will be rendered unemployable as a result of the proposed rule.

The proposed rule defines "Registered Person Adjudicated Events" at 4111(i)(4)(A) as:

> (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;
>
> (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

Arbitration settlements and awards are one of the criteria referenced in the proposed rule. Any reliance on arbitration settlements and awards is misplaced. FINRA has permitted the arbitration process to run amok such that Non-Attorney Representatives (NARs) often relying on stolen customer records engage in customer cold calling to drum up frivolous customer arbitration claims. The actions of NARs has been so egregious that FINRA has enacted a proposed rule to ban NARs from representing customers in FINRA arbitrations. The claims filed by NARs are often inflated and for exorbitant sums that compel brokers (and firms) to settle for more than the $15,000 threshold broker reporting amount – since attorney's fees and FINRA fees alone would result in tens of thousands of dollars in costs. This does not give rise to the presumption of a meritorious claim and should not form a basis for any determination that a broker engaged in "misconduct". In addition, one of the NARs, Stock Loss Recovery Group, LLC, filed what turned out to be bogus arbitration and mediation claims through the FINRA DR Portal. After receiving claims filed by Stock Loss Recovery Group, LLC, FINRA sent repeated and stern emails to member firms such that if they did not promptly respond to mediation demands filed through FINRA the matters would result in arbitration proceedings. The "complaints" resulted in disclosures on broker U-4s. The Stock Loss Recovery Group, LLC arbitration and mediation claims, and settlements, were fraudulent and done in certain instances without the customers' knowledge. FINRA allowed this NAR to utilize the FINRA platform to perpetuate this fraud. When one member firm requested that FINRA reimburse the member firm as a result of FINRA's negligence in permitting its platform to be used for a fraudulent purpose, the request met with silence. One of the principals of Stock Loss Recovery Group, LLC was criminally charged and is currently incarcerated.

Many customer claimant law firms have systems that alert them to arbitration filings against brokers – which arbitration filings also identify the broker dealers with which the brokers are affiliated. The law firms promptly issue releases, blog and web postings asking if any customers have accounts with the broker or broker dealer in attempts to solicit claimants for the purpose of filing customer claims. This results in additional frivolous customer arbitrations, corresponding CRD disclosures and, in many instances, settlements beyond the threshold amount. In certain instances such claims result in actual arbitration awards against brokerage firms and brokers. However, the "market place" resolves such matters, and such awards should not form the basis for an attempt by FINRA to designate a firm or a broker as a bad actor. The bottom line is that customer arbitrations, customer settlements, and arbitration awards are not indicative of wrongdoing – they are evidence of a civil dispute between a customer and his or her broker and broker dealer. Customer arbitrations and settlements are not valid evidence of broker misconduct and should not form a basis for a determination of "misconduct".

Reliance on "a final regulatory action that resulted in a finding, sanction or order" as a basis to determine that a broker engaged in "misconduct" is also misplaced. For the purposes of CRD disclosure, and now proposed Rule 4111, a <u>settlement</u> with a regulatory agency constitutes a "finding" or "order". Defending regulatory actions is expensive and there are significant dire consequences in the event a party is the subject of an adverse ruling, including potential statutory disqualification. The prevailing wisdom among the securities defense bar is that a respondent stands little chance before a state regulatory tribunal, regardless of the merit or lack of merit of a state claim. The chances of a respondent prevailing in FINRA OHO and Market Regulation actions are also regarded as dim.[1] Respondent brokers (and brokerage firms) have no choice but to settle typically "without admitting or denying the claims and allegations". Oftentimes, regulatory actions and corresponding settlements are not indicative of broker "misconduct" and should not result in a black mark to the broker or the broker dealer hiring such brokers.

Reliance on "Pending Events" including "a pending investigation by a regulatory authority" is also misplaced. "Registered Person Pending Events," defined in proposed Rule 4111(i)(4)(B), 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 pending investment-related civil judicial matter; (ii) a pending investigation by a regulatory authority; (iii) a pending regulatory action that was brought by the SEC or CFTC, other federal regulatory agency, a state regulatory agency . . ." Regulatory actions that have not even been adjudicated and investigations will be considered by FINRA in determining if a firm will be designated a "Restricted Firm" for hiring brokers subject to such matters. The inclusion of "Pending Events" for consideration in labeling a firm a "Restricted Firm", in and of itself, demonstrates the improper and ill-advised nature of the proposed rule.

The above discussion applies equally to "Member Firm Adjudicated Events"[2] and "Member Firm Pending Events".

FINRA is disproportionately and unfairly targeting small broker dealers. A review of the FINRA Broker Check Report for Merrill Lynch shows 1340 reported disclosures; Citigroup Global Markets Inc. (formerly Smith Barney) has 1175 reported disclosures; Goldman Sachs has 342 disclosures; Wells Fargo Clearing Services has 453 disclosures and Wells Fargo Securities has 142 disclosures. The dollar amounts of arbitration awards and disciplinary assessments against large firms far exceeds those of what FINRA will label "Restricted Firms". Other than fining large firms amounts that are a mere drop in the bucket, and that will have no material

[1] The FINRA Office of Hearing Officers adjudicates Department of Enforcement actions against member firms. A review of the biographies of the "impartial" Hearing Officers employed by the FINRA Office of Hearing Officers reveals that nearly all of them were previously employed by FINRA to prosecute cases against brokers and brokerage firms on behalf of the FINRA Department of Enforcement, FINRA Market Regulation Department, the FINRA National Adjudicatory Council or by the SEC enforcement divisions.

[2] "Member Firm Adjudicated Events," defined in proposed Rule 4111(i)(4)(D), means any of the following events that are reportable on the member firm's Uniform Registration Forms, or are based on customer arbitrations filed with FINRA's dispute resolution forum: (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 SEC or CFTC, other federal regulatory agency, a state regulatory agency, a foreign financial regulatory authority, or a self-regulatory organization; or (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.

impact on firm operations, FINRA is certainly not taking any action to rein in alleged misconduct by shutting down large firms.

Once FINRA identifies a Scarlet Letter firm it will then impose a "Maximum Restricted Deposit Requirement" as the cudgel to finally put the firm out of business. "Once the Department determines that the member has failed to rebut the presumption set forth in paragraphs (d)(1)(A) and (d)(1)(B) that it should be designated as a Restricted Firm that must maintain the maximum Restricted Deposit Requirement . . ." The term "Restricted Deposit Requirement" means the deposit to be maintained by the member as follows:

> (A) the specific maximum Restricted Deposit Requirement for a member, determined by the Department taking into consideration the nature of the firm'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," ["the claim amount includes claimed compensatory loss amounts"] unpaid arbitration awards or unpaid settlements related to arbitrations, <u>and concerns raised during FINRA exams</u>." (Emphasis added.)

FINRA will now require small firms to maintain in deposit accounts amounts sufficient to cover any or every arbitration <u>claim</u>, regardless of the merits of the claims. Many small firms have errors and omissions insurance policies that cover arbitration clams and the deductibles associated with such policies are set aside by firms over the course of proceedings out of recurring revenues. FINRA will presumably require such firms to make up-front deposits of deductible amounts, or entire claim amounts subject to carrier reservations of rights, that will significantly and negatively impact net capital. Firms that do not have E&O insurance often set aside amounts during the course of arbitration proceedings sufficient to fund potential settlements or awards. As with E&O deductibles and carrier disputed claims, requiring up front financing of uninsured claims, many of which are specious, would have negative net capital implications. Broker dealers have no interest in going out of business by failing to settle meritorious arbitration claims or failing to pay arbitration awards. The FINRA "Statistics on Unpaid Customer Awards in FINRA Arbitrations" show that of the 2,512 FINRA arbitration claims closed in 2017, 1,650 or 66% were settled. Of the 151 monetary awards issued in 2017 just 15 awards against active broker dealers and brokers were unpaid – which is .006% of all 2017 closed arbitrations. The vast majority of unpaid monetary awards, 70%, were against firms and brokers that were already inactive as of the date the statements of claim were filed and most of those arbitrations were uncontested. There was no breakdown of the number of unpaid awards against active broker dealers versus individual brokers. However it is reasonable to conclude that unpaid awards against active broker dealers was significantly less than 15 in 2017. Any assertion that unpaid arbitration awards against broker dealers is rampant and justifies a requirement that firms set aside up-front money to ensure payment of arbitration awards is false.

Requiring deposits relating to non-adjudicated arbitration claims is patently improper and smacks of the imposition of an unwarranted financial burden on small broker dealers.

In addition to required deposits relating to non-adjudicated (and often meritless) claims, another criterion for considering the amount of the Restricted Deposit Requirement is "concerns raised during FINRA exams". This is particularly problematic and should not be a factor for consideration. Though the broker dealer community has a great deal of respect for the examination process and the FINRA examiners it is often the case that novice examiners who have no experience in the securities industry and have very little regulatory experience conduct the front-line examinations and inspections. In addition, firms have experienced examiners who have expressed hostility and have threatened firms and individual brokers with regulatory actions and expulsion. Moreover, "concerns raised during FINRA exams" should be designed to call to the attention of broker dealers matters that require review, attention, and remediation if necessary. FINRA exams should be a tool for improvement of broker dealer operations and regulatory compliance. "Concerns" is an ill-defined catch all that is, frankly, alarming. Many of the "concerns" that are raised in FINRA exams are typically the subject of exit letters, responses and interviews that often result in the resolution of issues in the ordinary course without resort to enforcement proceedings. Reliance on "concerns" raised during FINRA exams to essentially punish a firm by requiring it to maintain a restricted deposit account goes against the fundamental purpose of the exam process.

There are fundamental defects with respect to Proposed Rule 4111, a very few of which have been outlined in this letter. The broker dealer community understands that one of the fundamental purposes of FINRA is to ensure adherence to securities laws, rules and regulations. However, Proposed Rule 4111 does nothing to advance this goal and appears to be an attempt to legislate out of existence small broker dealers that fall into certain categories based on flawed metrics – including "pending" matters that have not resulted in adverse determinations. Further, the administrative imperatives and processes associated with the proposed rule will include another layer of FINRA procedures that small broker dealers will have difficulty complying with and will sap resources that would be better spent complying with regulatory mandates and the necessary oversight associated with customer protection.

FINRA should not adopt Proposed Rule 4111.

Very truly yours,

Michael P. Gilmore

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