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June 28, 2019

Via Email: pubcom@finra.org
Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, D.C. 20006-1506

Re: Proposed New Rule 4111

Dear Ms. Mitchell:

This law firm represents numerous FINRA Members and has done so for more than twenty years. We take this opportunity to provide our comments and concerns with respect to FINRA's Proposed New Rule 4111 (the "Proposed Rule").[1] It is plain that the purpose of the Proposed Rule is to have certain Member Firms set-aside funds under FINRA's sole control to satisfy potential customer arbitration awards in light of former Members who have failed to pay arbitration awards (the "Unpaid Awards"). While the Proposed Rule is a potential means to reduce the amount of Unpaid Awards, it is a subjective rule that lacks clarity in a number of areas and the same result – the reduction or elimination of Unpaid Awards – is better achieved through less subjective and onerous means.

We take this occasion to address our concerns with the Proposed Rule and to offer suggestions to improve the Proposed Rule and to achieve its end-goal through better means. For example, the Proposed Rule should: i) employ a more objective approach to determining a Member Firm's Restricted Deposit Requirement (the "Deposit Requirement"); ii) account for a Member Firm's insurance coverage in calculating the Deposit Requirement; iii) improve the Initial Department Evaluation process by adding additional objective criteria in the evaluation process; iv) provide for a more diligent analysis of the Registered Person Event Metric; and v) use a narrower criteria when calculating the Expelled Firm Association metric. Finally, we will address an alternative proposal to ensure that there are no Unpaid Awards in the future – a proposal previously advocated by the Public Investors Arbitration Bar Association ("PIABA") and a form of the proposal that has recently been enacted by the State of Vermont.

[1] Non-defined Capitalized Terms are adopted from the definitions set forth in the Proposed Rule and in FINRA Regulatory Notice 19-17 (the "Notice").

The Proposed Rule Needs a More Objective Approach
To Determining a Member Firm's Restricted Deposit Requirement

Presently, Member Firms, as brokers or dealers, are required to satisfy net capital requirements set forth in SEA Rule 15c3-1, which sets forth objective requirements for the calculation of a broker or dealer minimum net capital. The Proposed Rule, through the Deposit Requirement, would, in essence, impose a greater net capital requirement upon a Member Firm by requiring it to deposit an amount – determined solely by FINRA – into a segregated account under FINRA's control. The calculation of the Deposit Requirement, however, is subject to arbitrary metrics determined by FINRA, and it fails to account for the nature of the claims and actual compensatory losses at issue when determining Covered Pending Arbitration Claims.

Under the Proposed Rule, FINRA, at its discretion, could impose an obligation upon a Member Firm to set aside the amount for each Covered Pending Arbitration Claim regardless of the merits of such claims. Because FINRA eliminated dispositive motions on the merits prior to the close of a claimant's case-in-chief, *see* FINRA Rule 12504(a)(6)(b), a Member Firm does not have an expedient means to have a meritless claim dismissed and removed from FINRA's Deposit Requirement calculations. An empirical analysis published by the American Bar Association reveals that the percent of compensatory damages awarded to a claimant versus the amount sought in the claim decreases as the amount of the claim increases.[2] For example, according to the analysis, claimants who asserted claims for compensatory damages in excess of $250,000 were awarded an average of less than 40% of the requested amount. The Proposed Rule fails to account for such data, which results in a larger and unnecessary financial burden on a Member Firm.

The Deposit Requirement also fails to account for the vagaries of claims filed by claimants represented by counsel and non-attorney representatives. Presently, the Proposed Rule defines a Covered Pending Arbitration Claim as an investment-related, consumer-oriented claim filed against a Member or its Associated Person 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. For purposes of this definition, the claim amount includes claimed compensatory loss amounts only . . . ." Proposed Rule, (i)(2) (emphasis added). It is not uncommon for a Statement of Claim to set forth a claimant's claim for compensatory damages in a range, such as

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[2] Howard B. Prossnitz, *Who Wins FINRA Cases and Why? An Empirical Analysis (Part 2)*, A.B.A. GPSolo eReport (July 2013), https://www.americanbar.org/groups/gpsolo/publications/gpsolo_ereport/2013/july_2013/who_wins_finra_cases_and_why_empirical_analysis_part_2/ (last accessed June 20, 2019).

$100,000 to $500,000, without regard to the actual losses incurred by the claimant.[3] As a result, the Proposed Rule should require FINRA to calculate, and utilize, the actual compensatory loss amount incurred by a claimant when calculating the Deposit Requirement.

The Proposed Rule Should Account for a Member Firm's Insurance Coverage when Calculating the Restricted Deposit Requirement

The Proposed Rule does not adjust the Deposit Requirement for a Member Firm's insurance coverage of a Covered Pending Arbitration Claim. There are Member Firms who have purchased Errors and Omissions Insurance to cover potential customer claims. The SEC's net capital rule expressly accounts for a broker or dealer's insurance coverage of a valid and covered claim when calculating whether a broker or dealer is in compliance with the net capital rule. *See* SEA Rule 15c3-1; specifically, within section (c)(1)/14 – "Adverse Award in an Arbitration Proceeding" and in section (c)(2)(iv)(D) – "Insurance Claims." Therefore, the Proposed Rule should include a similar provision in the calculation of the Deposit Requirement, which would reduce the maximum Deposit Requirement for a Member Firm based on its insurance coverage. Indeed, the Proposed Rule should explicitly provide that, if a Member Firm has adequate insurance coverage, it should be ***excluded*** from the Restricted Deposit Requirement.

The Proposed Rule Should Add Additional Objective Criteria in the Initial Department Evaluation Process

The Proposed Rule provides that, during the Initial Department Evaluation (the "Evaluation"), FINRA will review Member Firms that have met the Preliminary Criteria for Identification for any disclosure events "that should not have been included [in the Preliminary Identification Metrics]." *See* Notice, p. 11. While the Notice offers some examples of what FINRA may review during the Evaluation, it does not set forth specific parameters of the Evaluation and objective criteria to be utilized by FINRA. As currently constructed, this section of the Proposed Rule allows for too much discretion on the part of FINRA.

At a minimum, the Proposed Rule should include objective and quantifiable criteria to be applied by the Staff to provide transparency to Member Firms and to ensure uniformity across the Districts. Further, when considering objective criteria, FINRA should eliminate disclosure events that are filed by a compensated non-attorney representative ("NARs") on behalf of a claimant. As FINRA has recognized, NARs may "pursue frivolous or stale claims to attempt to

[3] The ranges usually mirror the amounts set forth in the Filing Fee Claim Schedule. *See* FINRA Rule 12900(a)(1).

elicit settlements." *See* FINRA Regulatory Notice 17-34, p. 3.[4] The Proposed Rule should also eliminate disclosure events in which the Registered Person was no longer registered with the settling Member Firm when the claim was brought, later settled, and the Registered Person was not a party to the claim and did not contribute any monies to the settlement. Finally, the Proposed Rule should eliminate disclosure events wherein an Arbitration Panel has made one of the requisite findings required by FINRA Rule 2080(b)(1), but a court of competent jurisdiction has not yet entered the order confirming an arbitration award containing expungement relief. Finally, the Proposed Rule should also consider excluding disclosure events in which the Registered Person has sought expungement in a Covered Pending Arbitration Claim.

The Proposed Rule Should Provide for a More
Diligent Analysis of Registered Person (Adjudicated and Pending) Events

The purpose of the Proposed Rule is to protect investors from the actions of Restricted Firms, which employ recidivist Registered Persons with a high number of adjudicated or pending events. The Proposed Rule, however, does not distinguish between a Registered Person, who has 15 disclosure events, and 15 Registered Persons, who each have one disclosure event. Both would count as 15 disclosure events. The Proposed Rule should distinguish between a recidivist Registered Person and a group of Registered Persons, who may each have had a single disclosure event resulting from a large market correction or a problem with a specific investment product.

The Proposed Rule Should Provide for
Limitations on the Expelled Firm Association Metric

The Proposed Rule's Preliminary Identification Metric includes Registered Persons associated with previously expelled firms at any time during his/her career and marks such a person with a Scarlet Letter regardless of how long ago he/she worked at such a firm and regardless if his/her record is otherwise unblemished. The Proposed Rule does not provide for any objective criteria to evaluate a Registered Person's tenure at an expelled firm, such as the length of time between the Registered Person's departure from the firm and the firm's expulsion; the amount of disclosure events the expelled firm had during the time period of the Registered Person's employment; and the amount of time that the Registered Person was associated with the

[4] On December 21, 2018, FINRA issued a New Release announcing that FINRA's Board of Governors had approved a rule proposal to prohibit NARs from practicing in the arbitration and mediation forums. *See* http://www.finra.org/newsroom/2018/report-from-finra-board-of-governors-meeting-december-2018 (last accessed June 20, 2019).

expelled firm. Finally, the Proposed Rule should impose a time limitation, such as ten years, when considering a Registered Person's affiliation with a subsequently expelled firm.[5]

Rather than Proceed with the Proposed Rule, FINRA Should Establish a Fund to Satisfy Unpaid Awards and Fund it from Fines Received Resulting from Actual Violations

The Proposed Rule, as highlighted, has numerous issues and will impose an undue financial burden on Member Firms. Rather than pursue the Proposed Rule, FINRA should establish a restitution fund (the "Restitution Fund") to satisfy Unpaid Awards, and fund the Restitution Fund from monetary fines that FINRA imposes, and collects, from Members resulting from actual violations. For 2017, FINRA Reported that the total amount of unpaid arbitration awards that year was $21 million.[6] That same year, FINRA imposed fines, in addition to ordering restitution, in the amount of $64.9 million for actual violations by Member Firms.[7] Therefore, if FINRA earmarked one-third of the fines that it collected, it would eliminate any Unpaid Awards going forward, which is the purpose of the Proposed Rule.

The concept of establishing a Restitution Fund is not new or novel. PIABA previously advocated for FINRA to establish a similar fund.[8] Within the past week, the State of Vermont created a similar restitution fund for victims of investment fraud within that state.[9] Rather than pursue the burdensome and unwieldly Proposed Rule, FINRA should establish a Restitution Fund. By establishing such a fund, FINRA will ensure that Unpaid Awards are satisfied by Members who have committed actual violations and not impose an undue financial burden on

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[5] Ten years is more than a sufficient amount of time to consider having passed between a Registered Person's prior affiliation with a subsequently expelled firm. Under Article III, Section 3 of FINRA's By-Laws, a person is subject to statutory disqualification as that term is defined in Section 3(a)(39) of the Securities Exchange Act of 1934. Section 39(a)(39)(F) provides for a ten-year look back for certain misdemeanor and all felony criminal convictions from the date of conviction.

[6] https://www.finra.org/arbitration-and-mediation/statistics-unpaid-customer-awards-finra-arbitration (last accessed June 20, 2019).

[7] https://www.finra.org/newsroom/statistics (last accessed June 20, 2019).

[8] https://piaba.org/piaba-newsroom/unpaid-awards (last accessed June 20, 2019).

[9] https://dfr.vermont.gov/press-release/vermont-creates-restitution-fund-victims-securities-fraud (accessed June 20, 2019).

Member Firms that have not been found to have violated any rules or caused any harm to customers.

For these reasons, we request that FINRA reconsider the Proposed Rule in its present form, and we implore FINRA to drop the Proposed Rule in favor of creating a Restitution Fund to satisfy Unpaid Awards.

Respectfully submitted,

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Richard J. Babnick Jr.