

VIA ELECTRONIC MAIL

July 1, 2019

Submitted electronically to pubcom@finra.org

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

Re: FINRA Regulatory Notice 19-17
Protecting Investors from Misconduct: FINRA Requests Comment on Proposed New Rule 4111 (Restricted Firm Obligations) Imposing Additional Obligations on Firms with a Significant History of Misconduct

Dear Ms. Mitchell:

On May 2, 2019, the Financial Industry Regulatory Authority, Inc. (“FINRA”) issued Regulatory Notice 19-17, *Protecting Investors from Misconduct*, (the “Notice”).¹ The Notice solicits comment on proposed new Rule 4111 (the “Proposed Rule”), as well as a proposed new rule and proposed amendments to existing rules to allow firms to request a prompt review of FINRA’s determinations under the Proposed Rule and create an expedited proceeding that would allow for a prompt review of determinations under the Proposed Rule.

The Notice summarizes FINRA’s review of its existing programs to address the heightened risks that can be posed to investors and the broader market by some FINRA member firms and individuals with histories of misconduct. Despite examination and enforcement efforts, FINRA notes that persistent compliance issues continue to arise in a small number of FINRA member firms. To remedy these issues, FINRA launched an initiative to enhance its controls over the risks posed by individuals, including clarifying heightened supervision requirements, revising the FINRA Sanction Guidelines, raising fees for statutory disqualification applications, and revising examination waiver guidelines to consider an individual’s past misconduct. FINRA Regulatory Notice 19-17 would: (i) require materiality consultations for FINRA member firms that employ brokers with a history of misconduct; (ii) authorize Hearing Panels and Hearing Officers to impose conditions and restrictions on individuals during an appeal of a disciplinary decision; and (iii) require an interim plan of heightened supervision with any firm’s application to continue associating with a statutorily disqualified person.

¹ The Notice is posted at https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-19-17.pdf.

Background on FSI Members

The Financial Services Institute² (FSI) appreciates the opportunity to comment on this proposal. The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the U.S., there are approximately 167,000 independent financial advisors, which account for approximately 64.5% percent of all producing registered representatives.³ These financial advisors are self-employed independent contractors, rather than employees of Independent Broker-Dealers (IBD).

FSI member firms provide business support to financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners who typically have strong ties to their communities and know their clients personally. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations and retirement plans with financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their investment goals.

Overview of the Proposed Rule

Despite recent regulatory enhancements to deal with member firms with a concentration of brokers with past misconduct issues and without adequate supervision, FINRA indicates that challenges remain. To remedy these issues, the Proposed Rule seeks to impose tailored obligations on firms that have significantly higher levels of risk-related disclosures than their similarly sized peers (a “Restricted Firm”). The Proposed Rule would create a multi-step process to guide FINRA’s determination of whether to impose additional obligations.

A firm’s review process begins by calculating the sum of certain disclosure events and registered persons associated with previously expelled firms (“Preliminary Identification Metrics”). A firm’s Preliminary Identification Metrics are then standardized and compared with numeric thresholds, which represent outliers with respect to peers for the type of events in the category (“Preliminary Identification Metrics Thresholds”). By comparing a firm’s Preliminary Identification Metrics to the established Preliminary Identification Metrics Thresholds, the Proposed Rule seeks to identify firms that present significantly higher risk than a large percentage of FINRA members. By providing different categories based on a firm’s size, the Preliminary Identification Metrics Thresholds seek to ensure that each firm is compared only to its similarly sized peers. A firm meets the Preliminary Criteria for Identification as a Restricted Firm if: (1) two or more of a firm’s

² The **Financial Services Institute (FSI)** is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has successfully promoted a more responsible regulatory environment for more than 100 independent financial services firm members and their 160,000+ affiliated financial advisors – which comprise over 60% of all producing registered representatives. We effect change through involvement in FINRA governance as well as constructive engagement in the regulatory and legislative processes, working to create a healthier regulatory environment for our members so they can provide affordable, objective advice to hard-working Main Street Americans. For more information, please click [here](#).

³ The use of the term “financial advisor” or “advisor” in this letter is a reference to an individual who is a dually registered representative of a broker-dealer and an investment adviser representative of a registered investment adviser firm. The use of the term “investment adviser” or “adviser” in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

Preliminary Identification Metrics are equal to or more than the corresponding threshold for the firm's size; (2) at least one of those Preliminary Identification Metrics is the Registered Person Adjudicated Event Metric, the Member Firm Adjudicated Event Metric, or the Expelled Firm Association Metric; and (3) the member firm has two or more Registered Person or Member Firm Events.

Once a firm is deemed to meet the Preliminary Criteria for Identification, the Proposed Rule would require FINRA to conduct an initial evaluation to "determine whether it is aware of information that would show that the member—despite having met the Preliminary Criteria for Identification—does not pose a high degree of risk."⁴ FINRA notes that this is intended to guard against the risk of misidentification of firms that could result from using the process outlined above.

FINRA would also permit some firms who meet the Preliminary Criteria for Identification to reduce staffing levels to no longer meet the criteria. However, this option is only available if it is the firm's first time meeting the criteria. The Proposed Rule permits FINRA to continue the review if FINRA determines that a firm still meets the Preliminary Criteria for Identification following any reduction in staffing levels, or if a firm is not eligible for or opts out of reducing staffing levels.

The next step in the review process grants FINRA the discretion to determine the maximum amount of any deposit that a member could be required to maintain, in cash or qualified securities, in a segregated account at a bank or clearing firm ("Restricted Deposit Requirement"). In addition to discouraging misconduct, FINRA notes that the financial requirement aims to preserve firm funds for payment of arbitration awards.

As another line of defense intended to guard against the risk of misidentification, the Proposed Rule requires a member firm consultation with FINRA during which the firm could explain why it should not be designated as a Restricted Firm and why it should not be subject to a Restricted Deposit Requirement. While the Proposed Rule outlines how a firm may overcome the presumption that it should be designated as a Restricted Firm and subject to a Restricted Deposit Requirement, it grants FINRA discretion to make the final determination as to whether a firm has overcome the presumption. Upon finding that a firm should be designated as a Restricted Firm, the Proposed Rule would grant FINRA discretion to impose any additional obligations, including financial requirements or other conditions or restrictions.

Discussion

FSI appreciates the opportunity to submit comments in response to the Notice. FSI is generally supportive of FINRA's efforts to protect investors from firms with histories of repeated misconduct. However, FSI believes that the Proposed Rule would benefit from clear parameters around the discretion that will be exercised by FINRA and clarification on the impact to net capital requirements and small firms. We provide further analysis below.

⁴ The Notice, at p. 11.

I. FINRA's Broad Use of Discretion

A. Preliminary Identification Metrics Thresholds

The Proposed Rule grants FINRA broad discretion to determine how a firm will be identified for review. The Notice states that the Preliminary Criteria for Identification, Preliminary Identification Metrics and Preliminary Identification Metrics Thresholds are intended to identify firms who are outliers among their similarly sized peers.⁵ The Notice states that this is merely a preliminary identification of firms that present significantly higher risk than a large percentage of FINRA member firms.⁶ However, FINRA acknowledges that the numeric, threshold-based criteria runs the risk of being over-inclusive and could lead to the misidentification of firms. Still, FINRA states that it believes that the proposed counting criteria strikes a balance between misidentification and the alternative criteria that it examined.⁷

FSI is concerned that the Proposed Rule does not provide adequate safeguards to protect firms against misidentification. The preliminary criteria, thresholds and safeguards are subjective and centered on FINRA's use of discretion to determine whether a firm should be subject to review, as discussed in more detail below. FSI requests that FINRA adopt more conservative counting criteria for the Preliminary Criteria for Identification as to not subject misidentified firms to an unnecessary and burdensome review process.

B. Initial Internal Review and Member Consultation

The Proposed Rule grants FINRA broad discretion to make a determination as to whether a firm is a Restricted Firm and should be subject to financial requirements and specified conditions or restrictions. During the initial internal review, FINRA has complete discretion to determine whether a firm that has been preliminarily identified should continue in the review process. During the member consultation, the firm is required to overcome FINRA's presumption that it is a Restricted Firm and that it should be subject to a Restricted Deposit Requirement. The Proposed Rule also grants FINRA the authority to request information and documents from a firm, as it deems necessary or appropriate for making its final determination.⁸

FSI agrees with FINRA that the numeric, threshold-based criteria create risks of misidentification and over-inclusiveness.⁹ For this reason, FSI does not believe that a firm should shoulder the risk of misidentification and the burden of overcoming a presumption that is based on FINRA's use of discretion. Instead, FSI believes that the initial internal review should instead require FINRA to objectively demonstrate its reasons for continuing the review process for a firm that has been preliminarily identified as high risk. FSI also believes that a member consultation presents an opportunity for FINRA to work collaboratively with a firm that has been correctly identified to remedy any issues that pose high risks to retail investors.

C. Maximum Restricted Deposit Requirement

The Proposed Rule grants FINRA broad discretion to make a determination of a firm's maximum Restricted Deposit Requirement. Under the Proposed Rule, FINRA would be required to

⁵ The Notice, at p. 9.

⁶ The Notice, at p. 9.

⁷ The Notice, at pp. 32-33.

⁸ Proposed FINRA Rule 4111(d)(3)(B), (D)-(E).

⁹ See, e.g., The Notice, at p. 25.

consider “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’ or unpaid arbitration awards or unpaid settlements related to arbitrations, and concerns raised during FINRA exams” when determining a firm’s maximum Restricted Deposit Requirement.”¹⁰ The Notice states 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.”¹¹ Further, the Notice invites comments on “alternative ways of calculating the Restricted Deposit Requirement that would be more predictable while remaining impactful.”¹²

As currently drafted, FINRA would have broad discretion to determine the amount of a firm’s maximum Restricted Deposit Requirement, so long as it *considers* the many factors required by the Proposed Rule. FSI agrees that some subjectivity is necessary to be able to tailor Restricted Deposit Requirements to each Restricted Firm. However, FSI believes that this can be achieved by use of published guidelines that would serve to provide transparency to FINRA’s discretion with respect to this determination. FSI urges FINRA to consider also providing firms with a written notice explaining its determination of a firm’s maximum Restricted Deposit Requirement, which would promote transparency, accountability, predictability and consistent application of the Proposed Rule.

D. Department Decisions

The Proposed Rule grants FINRA broad discretion to determine whether a firm will be deemed a Restricted Firm, and whether a financial requirement would be imposed on a Restricted Firm. In addition, the Proposed Rule would grant FINRA discretion to determine the amount of any financial requirement and any specified conditions or restrictions that may be imposed.

FSI understands the need to encourage compliance and protect investors from harm. However, the Notice does not acknowledge the fact that the SEC and FINRA already provide deterrents for violating their rules in the form of robust sanctions. The imposition of additional obligations based on a mix of criteria that includes events that have already been adjudicated would result in further penalizing firms for matters that were already decided. The Notice also does not address the fact that the SEC and FINRA have transparent enforcement guidelines. FSI believes that the Proposed Rule would benefit from transparency around the calculation of Restricted Deposit Requirements, and the types of conditions and restrictions that it intends to impose on Restricted Firms. Similar to the request above, FSI urges FINRA to consider providing firms with a written notice explaining its determination of a firm’s Restricted Deposit Requirement, specified conditions and restrictions. This would promote transparency, accountability, predictability and consistent application of the Proposed Rule.

II. Net Capital Requirements

The Proposed Rule would require that the Restricted Deposit Requirement be maintained in an account subject to a number of restrictions on withdrawals. The Notice indicates that the account restrictions would impact how a Restricted Firm calculates its net capital levels. Specifically, a deposit in the account would be an asset of the firm that could not readily be

¹⁰ Proposed FINRA Rule 4111(i)(15)(A).

¹¹ The Notice, at p. 12.

¹² The Notice, at p. 12.

converted into cash, due to the restrictions on accessing it. Therefore, the firm would be required to deduct deposits in the account when determining its net capital under Exchange Act Rule 15c3-1 and FINRA Rule 4110.

It appears that FINRA presumes that any amount in a Restricted Deposit Account should be deducted from a firm's net capital based on the requirement to deduct "fixed assets and assets which cannot be readily converted into cash" from a firm's net worth.¹³ The SEC provides a non-exhaustive list of items that may be considered "fixed assets" or "assets which cannot be readily converted into cash," including real estate, furniture, unsecured advances and loans, interest receivable, certain insurance claims, all other unsecured receivables, certain securities borrowed, and certain receivables from an affiliate of the firm. FSI believes that FINRA should seek SEC staff guidance which would serve to confirm that a Restricted Deposit Account fits into the category of assets which cannot be readily converted into cash.

III. Impact on Small Firms

FSI is concerned about the impact that the Proposed Rule would have on small firms, which are those firms with 150 or fewer registered representatives.¹⁴ The Notice states that FINRA expects that between 60-98 firms would meet the Preliminary Criteria for Identification under the Proposed Rule. However, approximately 90% of the firms that meet the preliminary criteria would be small firms.

FSI agrees with FINRA that "[s]mall firms represent a critical portion of FINRA's membership and often face regulatory challenges that are unique from their large firm counterparts."¹⁵ In particular, small firms are more likely to settle complaints with customers and agree to a FINRA Letter of Acceptance, Waiver and Consent for enforcement actions involving FINRA. In other words, the number and type of disclosure events involving small firms may not necessarily be indicative of the level of misconduct occurring at small firms. This is due in part because small firms have limited financial resources for litigation expenses and related costs. This results in many small firms having disclosure events that they would not otherwise have if they were able to fully litigate the complaint or action. As a result of this limitation, large firms do not incur the same types and number of disclosure events as small firms. FSI is concerned that that the Proposed Rule could create a patently unfair outcome for small firms, and may only serve to exacerbate the challenges experienced by smaller firms.

IV. Transparency and Retrospective Review

FSI appreciates FINRA's willingness to be transparent with firms regarding the specific calculation of the firm's Preliminary Criteria for Identification. This transparency will assist firms in understanding FINRA's determination and allow them to make necessary changes that could alter the determination and preserve investor protection. Additionally, the numeric thresholds provide firms with the information necessary to determine where they stand in comparison to their similarly sized peers. While this information is helpful to an individual firm, FSI believes that there are collateral consequences that could result from any determinations, information or documents

¹³ Exchange Act Rule 15c3-1(c)(2)(iv).

¹⁴ 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.

¹⁵ See FINRA, The Small Firm Report (July 23, 2018), <https://www.finra.org/industry/small-firm-report>.

related to the review process being made publicly available or being used in FINRA arbitration. By FINRA's admission, the Preliminary Criteria for Identification is not without flaw, and runs the risk of misidentifying firms even when multiple safeguards are in place.¹⁶ Publicly identifying firms based on criteria that is less than precise may result in reputational risk that many firms would consider to be irreparable. For this reason, we caution FINRA to treat the following information as strictly confidential information: (i) whether, in any given year, a firm meets the Preliminary Criteria for Identification; (ii) information or documents provided during FINRA's consultation with the firm; (iii) a firm's status as a Restricted Firm and any written notice of such determination; and (iv) if applicable, the existence of a Restricted Deposit Account or any other specified conditions or restrictions resulting from the review.

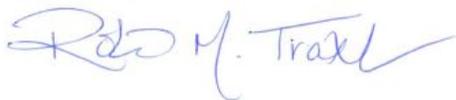
FSI also appreciates that FINRA will periodically conduct a review of the Preliminary Identification Metrics Thresholds.¹⁷ We encourage FINRA to also consider a retrospective review of Rule 4111 at a future point in time, preferably after the rule has been in place for at least three years. The review should examine whether Rule 4111 is accomplishing its intended goal and whether the investor protection benefits of the rule continue to outweigh the resource output by both firms and FINRA to comply with and enforce the rule. Depending on the outcome of the review, FINRA should then seek to make any necessary changes or adjustments to the Rule and its application.

Conclusion

In conclusion, FSI believes that the Proposed Rule would benefit from clear parameters around the discretion that will be exercised by FINRA and clarification on the impact to net capital requirements and small firms.

Thank you in advance for considering these comments. If you have questions about anything in this letter, or if we can be of any further assistance in connection with this rulemaking, please feel free to contact me at robin.traxler@financialservices.org or (202) 393-0022.

Respectfully submitted,



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Senior Vice President, Policy & Deputy General Counsel

¹⁶ See The Notice, at p. 35 (noting that the proposed rule “includes several processes, including qualitative reviews and consultations, to *minimize* potential sources of misidentifications.”) (emphasis added).

¹⁷ The Notice, at p. 18.