July 1, 2019

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506
Via Email: pubcom@finra.org

Dear Ms. Mitchell:

Rockfleet Financial Services, Inc. ("Rockfleet") is a broker/dealer and submitting these comments in response to FINRA Regulatory Notice 19-17 ("RN 19-17").

Rockfleet recognizes FINRA's desire to remove "bad actors" from its ranks, which appears to be the goal of Proposed New Rule 4111 ("Rule 4111"), under the guise of ensuring harmed investors are paid their arbitration settlements. However, Rule 4111 could unfairly impact the broker/dealer, other employees, customers, and counterparties negatively. While there are charts and commentary on the method by which firms would be classified as "Restricted Firms," they do not tie together cohesively and seem to have been backed into to make a case for the firms that FINRA wants to target.

Unfair Impact

As noted by one commentator, the Restricted Firm designation for a small firm can be triggered by one individual with 15 events, or 15 individuals with one event. Putting aside why a firm would register and individual with 15 events, it is grossly unfair to consider the firm itself as the problem, especially if the disclosure events happened at a prior firm.

Anecdotally, we hear that clearing firms are planning to include being designated as a Restricted Firm to be disclosed to them by correspondent firms, and the clearing agreement will be terminated. This is grossly unfair to the other individuals employed by the firm who can no longer open an account or process a trade for their customers, who will also be severely impacted.

Firms utilizing tri-party clearing agreements could be impacted through no fault of their own. Take, for example, Firm B, recently classified as a Restricted Firm, Its clearing firm, Firm A, terminates its clearing agreement. Firm C, who has a tri-party clearing agreement with Firm B now also no longer has a clearing firm, through no fault of its own.

RN 19-17 states that the restricted account held at a bank or clearing firm would be in the broker/dealer's name, but subject to numerous restrictions, including requiring FINRA approval for asset distribution. It seems unlikely that banks and clearing firms are going to create new policies and procedures, account documents, processes, etc. to open up what FINRA estimates to be fewer than 100 accounts.

Broker/dealer owners looking to retire and sell their portion of the business, for example, and have nothing to do with the "bad actors" could be negatively impacted by a malicious, meritless arbitration.

Net capital computations require a reserve for the award in some instances, and the restricted account appears not to qualify as good capital as the assets are not readily convertible to cash. This doubles the net capital impact.

Some broker/dealers may have much of their net capital tied up in their clearing deposit – potentially more than their regulatory net capital requirement. Even the 25% of excess net capital threshold could plunge a firm into a net capital violation, effectively shutting it down. Even without a violation, the funds held at the clearing firm cannot be released; firms may have limited cash with which to pay their bills and make payroll, impacting potentially numerous employees who have nothing to do with the arbitration award, and with no due process. FINRA's confiscation of the broker/dealer's property could result in a devastating economic impact on a broker/dealer, its employees, customers, vendors, and other counterparities.

<u>The Math</u>

Some of the examples cited do not tie-in. In the Background & Discussion section, FINRA notes "five large firms (i.e., firms with 500 or more registered person) with 750 or more disclosure events over the prior five years" as seemingly part of the problem. Yet, the chart in Appendix D-2 lists zero large firms in 2017 and 2018.

RN 19-17 states, "The median number of events per firm, for the firms that would have met the Preliminary Criteria for Identification, ranged from approximately 10-17 events, compared to 0 events amongst the other firms." With there being no large firms on the list, it would appear that large firms have no events, as they are "the other firms." This appears to be blatantly inaccurate and misleading.

RN 19-17 makes reference in numerous places to "peer firms" and specifically asks in its Request for Comments if the seven firm-size categories in Rule 4111(i)(11) are grouped appropriately. There is no indication of how many firms fall into each category, so there is no way to determine if there is an even distribution. Likewise, there is no way to determine from the information provided if the metric associated with each Firm Size Category is appropriate.

Targeted Firms

Several references in RN 19-17 indicated that FINRA pre-selected the firms it wants to target with Rule 4111, then backed into the methodology that would ensure their selection:

"Based on staff analysis of all firms registered with FINRA between 2013 and 2018, firms that would have met the Preliminary Criteria for Identification had on average 4-8 times more Registered Person and Member Firm Events than peer firms at the time of identification. Specifically, the number of events per firm, for firms that would have met the Preliminary Criteria for Identification, ranged, on average, from 26-42 events during the Evaluation Period, compared to 5-7 events per firm for the other firms." It would seem that objective criteria should first be established, i.e., we are going to look at firms with 25 times more events and then identify the firms. Conversely, FINRA apparently identified the firms they want to target first, then calculated the statistics.

"FINRA has conducted a thorough analysis of the proposed criteria and thresholds to ensure that the proposed Preliminary Criteria for Identification primarily identify the member firms that are motivating this rule proposal." This blatantly states that they are targeting specific firms and developed the thresholds to match the list.

Bypassing Safeguards

Section 3(a)(39) of the Securities Exchange Act of 1934. One of the highlighted means of avoiding having a firm's assets confiscated and placed into a restricted account is suggested several times in RN 19-17: fire the identified registered representatives causing the firm to be classified as a "Restricted Firm." It appears FINRA's efforts to remove "bad actors" is frustrated by the inability to ban registered representatives who do not meet any of the disqualifying events according to Section 3(a)(39) of the Securities Exchange Act of 1934 ("Exchange Act").

Temporary Cease and Desist Orders. FINRA's efforts are additionally frustrated by its acknowledged limitations as they "are available only in narrowly defined circumstances."

When these narrowly defined circumstances were granted, there must have been much discussion on the topic. Rule 4111 seeks to circumvent the safeguards in place to protect broker/dealers from overzealous enforcement officers.

Due Process. RN 19-17 notes that, "the firm can further prolong the disciplinary action by litigating….," i.e., by exercising its legal rights. Rule 4111 would seek to circumvent this. The account must be funded immediately, or a portion of it if there is an appeal, regardless of if the customer's complaint has any merit. Pending, as well as final awards are included in the calculation, assuming a 100% loss rate by the broker/dealer, for the full amount claimed in the complaint.

Too Much Discretion. RN 19-17 states that, "Nothing in the examples is intended to suggest that the Department will follow specific formulas in determining a maximum Restricted Deposit Requirement or the weigh that any circumstances carry."

Counterintuitive Principles

One of the overriding goals of Rule 4111 is to seize control of a portion of a firm's assets so that if the firm goes out of business or otherwise does not pay a customer arbitration award, FINRA can direct those funds. However, RN 19-17 notes that "the member's failure to comply with the Rule 4111 Requirements, within seven days of service of the notice, will result in a suspension or cancellation of membership." RN 19-17 previously notes its frustration in compelling former broker/dealers to pay arbitration awards, as when "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." It appears it is in FINRA's best interest to NOT cancel a firm's membership, or it loses whatever control it formerly had over the firm.

Exaggeration of the Issue

In the Background & Discussions section, FINRA states that "Enforcement actions in turn can only be brought after a rule has been violated – and any resulting customer harm has already occurred." While the first phrase is correct, the requirement for customer harm for enforcement action is not. FINRA regularly takes enforcement action on rule violations that do not harm customers. That same paragraph continues on lamenting that broker/dealers exercise their rights to appeals, hearings, and other relief – processes put in place exactly to prevent the type of overreach that Rule 4111 seeks to implement.

Existing Examination Process. RN 19-17 notes that certain firms have "a poor supervisory structure and compliance culture." FINRA scrutinizes a broker/dealer's supervisory system before it becomes a member and conducts regular, periodic examinations. It also has the ability for ad hoc Information Requests. There is no reason for any firm with a poor supervisory structure and compliance culture to be continuing in that manner.

Alternatives to Rule 4111

Errors and Omissions ("E&O") Insurance. As noted by several commenters, many firms have E&O Insurance that covers these awards. Similar to the rule requiring a fidelity bond, FINRA could require E&O insurance for all broker/dealers.

Summary

A letter to the Senate Banking Committee on unpaid arbitrations cites that of all customer cases closed between 2012 and 2016, only 2% resulted in an unpaid award, representing $14 million in 2016. Of that $14 million, $8.96 million are against broker/dealers who are no longer in business, leaving only $5.04 million where FINRA would gain any leverage from Rule 4111.

While certainly of profound importance to the customers seeking their awards, it is not a widespread industry issue and the serious harm it would inflict in its implementation is unwarranted. Rule 4111 is overkill for a $5 million/year problem that can be best addressed by other means, as suggested above, i.e., simply mandating E&O insurance.

As a final thought, it is likely that if a firm were found to be subject to Rule 4111 and funding the restricted account would essentially shut it down, the firm would simply not fund the account and terminate its membership agreement, leaving FINRA in exactly the position it is seeking to avoid.

Sincerely,

Catherine M Corrigan

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Chair, President & CEO