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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No.* SR - 2020 - * 011
Amendment No. (req. for Amendments *)

Filing by Financial Industry Regulatory Authority

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial * ☑ Amendment * ☐ Withdrawal ☐

Section 19(b)(2) * ☑ Section 19(b)(3)(A) * ☐ Section 19(b)(3)(B) * ☐

Rule

☐ 19b-4(f)(1) ☐ 19b-4(f)(4)
☐ 19b-4(f)(2) ☐ 19b-4(f)(5)
☐ 19b-4(f)(3) ☐ 19b-4(f)(6)

Pilot ☐

Extension of Time Period for Commission Action * ☐

Date Expires *

Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010

Section 806(e)(1) * ☐ Section 806(e)(2) * ☐

Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934

Section 3C(b)(2) * ☐

Exhibit 2 Sent As Paper Document ☐

Exhibit 3 Sent As Paper Document ☐

Description

Provide a brief description of the action (limit 250 characters, required when Initial is checked *).

Proposed Rule Change to Address Brokers with a Significant History of Misconduct

Contact Information

Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.

First Name * Michael Last Name * Garawski
Title * Associate General Counsel
E-mail * michael.garawski@finra.org
Telephone * (202) 728-8835 Fax (202) 728-8264

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

(Title *)

Date 04/03/2020

By Patrice Gliniecki

(Name *)

Senior Vice President and Deputy General Counsel

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Patrice Gliniecki,

Required fields are shown with yellow backgrounds and asterisks.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information * Add Remove View	The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.
Exhibit 1 - Notice of Proposed Rule Change * Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO] -xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies * Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO] -xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications Add Remove View Exhibit Sent As Paper Document ☐	Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.
Exhibit 3 - Form, Report, or Questionnaire Add Remove View Exhibit Sent As Paper Document ☐	Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.
Exhibit 4 - Marked Copies Add Remove View	The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.
Exhibit 5 - Proposed Rule Text Add Remove View	The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.
Partial Amendment Add Remove View	If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of the Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act"),[1] Financial Industry Regulatory Authority, Inc. ("FINRA") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to: (1) amend the FINRA Rule 9200 Series (Disciplinary Proceedings) and the 9300 Series (Review of Disciplinary Proceeding by National Adjudicatory Council and FINRA Board; Application for SEC Review) to allow a Hearing Officer to impose conditions or restrictions on the activities of a respondent member firm or respondent broker, and require a respondent broker's member firm to adopt heightened supervisory procedures for such broker, when a disciplinary matter is appealed to the National Adjudicatory Council ("NAC") or called for NAC review; (2) amend the FINRA Rule 9520 Series (Eligibility Proceedings) to require member firms to adopt heightened supervisory procedures for statutorily disqualified brokers during the period a statutory disqualification eligibility request is under review by FINRA; (3) amend FINRA Rule 8312 (FINRA BrokerCheck Disclosure) to allow the disclosure through FINRA BrokerCheck of the status of a member firm as a "taping firm" under FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms); and (4) amend the FINRA Rule 1000 Series (Member Application and Associated Person Registration) to require a member firm to submit a written request to FINRA's Department of Member Regulation ("Member Regulation"), through the Membership Application Group ("MAP Group"), seeking a materiality consultation and approval of a continuing membership application, if required, when a natural person that has, in the

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[1] 15 U.S.C. 78s(b)(1).

prior five years, one or more “final criminal matters” or two or more “specified risk events”[2] seeks to become an owner, control person, principal or registered person of the member firm.

The text of the proposed rule change is attached as Exhibit 5.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The FINRA Board of Governors authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.

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2 As explained more below, the proposed definitions of “final criminal matter” and “specified risk event” generally include final, adjudicated disclosure events disclosed on a person’s or firm’s Uniform Registration Forms. For purposes of the proposed rule change, Uniform Registration Forms for firms and brokers refer to, and would be defined as, the Uniform Application for Broker-Dealer Registration (Form BD), the Uniform Application for Securities Industry Registration or Transfer (Form U4), the Uniform Termination Notice for Securities Industry Registration (Form U5) and the Uniform Disciplinary Action Reporting Form (Form U6), as such may be amended or any successor(s) thereto.

3. **<u>Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change</u>**

(a) Purpose

<u>Overview</u>

FINRA uses a combination of tools to reduce the risk of harm to investors from member firms and the brokers they hire that have a history of misconduct. These tools include assessments of applications filed by member firms to retain or employ an individual subject to a statutory disqualification, reviews of membership and continuing membership applications ("CMAs"), disclosure of brokers' regulatory backgrounds, supervision requirements, focused examinations, risk monitoring and disciplinary actions. These tools, among others, have been useful in identifying and addressing a range of misconduct and serve to further the Exchange Act goals, reflected in FINRA's mission, of investor protection and market integrity.

In addition, FINRA Rule 3110 (Supervision) requires member firms to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and FINRA rules. The rule also requires member firms to establish, maintain and enforce written procedures to supervise the types of business in which they engage and the activities of their associated persons that are reasonably designed to achieve compliance with applicable securities laws and FINRA rules.[3]

Despite these requirements and FINRA's ongoing efforts to strengthen protections for investors and the markets through its oversight of member firms and the

[3] <u>See</u> Rule 3110(a) and (b).

brokers they employ, persistent compliance issues continue to arise in some member firms. Recent studies, for example, find that some firms persistently employ brokers who engage in misconduct, which results in higher levels of misconduct by these firms. These studies also provide evidence that past disciplinary and other regulatory events associated with a member firm or individual can be predictive of similar future events, such as repeated disciplinary actions, arbitrations and complaints.[4] This risk cannot always be adequately addressed by FINRA's existing rules and programs.

Brokers and member firms with a history of misconduct can pose a particular challenge for FINRA's existing examination and enforcement programs. For example, FINRA examinations of member firms can identify compliance failures—or imminent failures—and prescribe remedies to be taken, but examiners are not empowered to require a firm to change or limit its business operations in a particular manner. While these constraints on the examination process protect firms from potentially arbitrary or overly onerous examination findings, a firm or individual with a history of misconduct can take advantage of these limits to continue ongoing activities that harm or pose risk of harm to investors until they result in an enforcement action.

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4 For example, in 2015 FINRA's Office of the Chief Economist (OCE) published a study that examined the predictability of disciplinary and other disclosure events associated with investor harm based on past similar events. The OCE study showed that past disclosure events, including regulatory actions, customer arbitrations and litigations of brokers, have significant power to predict future investor harm. See Hammad Qureshi & Jonathan Sokobin, Do Investors Have Valuable Information About Brokers? (FINRA Office of the Chief Economist Working Paper, Aug. 2015). A subsequent academic research paper presented evidence that suggests a higher rate of new disciplinary and other disclosure events is highly correlated with past disciplinary and other disclosure events, as far back as nine years prior. See Mark Egan, Gregor Matvos, & Amit Seru, The Market for Financial Adviser Misconduct, J. Pol. Econ. 127, no. 1 (Feb. 2019): 233-295.

FINRA disciplinary actions, in turn, can be brought only after a violation—and any resulting customer harm—may have already occurred. In addition, disciplinary proceedings can take significant time to develop, prosecute and conclude, during which time the respondent in a disciplinary proceeding is able to continue misconduct, perpetuating significant risks of additional harm to customers and investors. Litigated enforcement actions brought by FINRA involve a hearing and often multiple rounds of appeals, thereby effectively forestalling the imposition of disciplinary sanctions—and their potential deterrent effect—for an extended period. For example, a FINRA enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the NAC, and further appeals to the SEC and federal courts of appeals. Moreover, even when a FINRA Hearing Panel or Hearing Officer imposes a significant sanction, the sanction is stayed during appeal to the NAC, many sanctions are automatically stayed on appeal to the SEC, and they potentially can be stayed during appeal to the courts. When all appeals are exhausted, the respondent's FINRA registration may have terminated, limiting FINRA's jurisdiction and eliminating the leverage that FINRA has to incent the respondent to comply with the sanction, including making restitution to customers.

Similarly, FINRA's eligibility proceedings are sometimes not available or sufficient to address the risks posed by brokers with a significant history of past misconduct. Federal law and regulations define the types of misconduct that presumptively disqualify a broker from associating with a member firm and also govern the standards and procedures FINRA must follow when a firm seeks to associate or continue associating with a broker subject to a statutory disqualification. These laws and regulations limit who FINRA may subject to an eligibility proceeding and affect how FINRA may exercise its authority in those proceedings.

FINRA's membership proceedings also do not always protect against the risks posed when a firm hires brokers with a significant history of misconduct. For firms eligible for the safe harbor for business expansions in IM-1011-1 (Safe Harbor for Business Expansions), there are a defined set of expansions (including, among other things, increases in the number of associated persons involved in sales) that are presumed not to be a material change in business operations and therefore do not require the firm to file a CMA.

Thus, notwithstanding the existing protections afforded by the federal securities laws and FINRA rules, the risk of potential customer harm may persist where a firm or broker has a significant history of past misconduct.

FINRA is taking steps to strengthen its tools to respond to brokers with a significant history of misconduct and the firms that employ them, several of which are described below. In addition, the proposed rule change, as explained further below, would create several additional protections to address this risk.

Additional Steps Undertaken by FINRA

As part of this initiative, FINRA has undertaken the following:

- Published Regulatory Notice 18-15 (Heightened Supervision), which reiterates the existing obligation of member firms to implement for such individuals tailored heightened supervisory procedures under Rule 3110;
- Published Regulatory Notice 18-17 (FINRA Revises the Sanction Guidelines), which announced revisions to the FINRA Sanction Guidelines;

- Raised fees for statutory disqualification applications;[5] and
- Revised the qualification examination waiver guidelines to permit FINRA to more broadly consider past misconduct when considering examination waiver requests.

In addition, to further address issues created by member firms that have a significant history of misconduct, FINRA has issued a Regulatory Notice seeking comment on proposed new Rule 4111 (Restricted Firm Obligations).[6]

Proposed Amendments to the FINRA Rule 9200 Series and FINRA Rule 9300 Series to Enhance Investor Protection During the Pendency of an Appeal or Call-for-Review Proceeding

FINRA is proposing amendments to the Rule 9200 Series (Disciplinary Proceedings) and Rule 9300 Series (Review of Disciplinary Proceeding by National Adjudicatory Council and FINRA Board; Application for SEC Review) to bolster investor protection during the pendency of an appeal from, or a NAC review of, a Hearing Panel or Hearing Officer disciplinary decision, by empowering Hearing Officers to impose conditions or restrictions on disciplined respondents and requiring firms to adopt heightened supervision plans concerning disciplined individual respondents. The proposed rule also would establish a process for an expedited review by the Review Subcommittee of the NAC of any conditions or restrictions imposed.

Currently, the Rule 9200 and Rule 9300 Series permit FINRA to bring disciplinary actions against member firms, associated persons of member firms or

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5 See Securities Exchange Act Release No. 83181 (May 7, 2018), 83 FR 22107 (May 11, 2018) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2018-018).

6 See Regulatory Notice 19-17 (May 2019).

persons within FINRA's jurisdiction for alleged violations of FINRA rules, SEC regulations or federal securities laws. Following the filing of a complaint, FINRA's Chief Hearing Officer will assign a Hearing Officer to preside over the disciplinary proceeding and appoint a Hearing Panel, or an Extended Hearing Panel if applicable,[7] to conduct a hearing and issue a written decision. For each case, the Hearing Panel or, in the case of default decisions, the Hearing Officer will issue a written decision that makes findings and, if violations occurred, imposes sanctions. Sanctions can include, among other things, fines, suspensions, bars and orders to pay restitution.

Under FINRA's disciplinary procedures, any party can appeal a Hearing Panel or Hearing Officer decision to the NAC. In addition, any member of the NAC or the NAC's Review Subcommittee, or the General Counsel in the case of default decisions, may on their own initiate a review of a decision. On appeal or review, the NAC will determine if a Hearing Panel's or a Hearing Officer's findings were factually supported and legally correct. The NAC also reviews any sanctions imposed and considers the FINRA Sanction Guidelines when doing so. The NAC prepares a proposed written decision. If the FINRA Board of Governors does not call the case for review, the NAC's decision becomes final and constitutes the final disciplinary action of FINRA, unless the NAC remands the proceeding to the Hearing Officer or Hearing Panel. If the FINRA Board of Governors calls the case for review, the FINRA Board of Governors' decision constitutes

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[7] References to "Hearing Panel" will refer to both a Hearing Panel and an Extended Hearing Panel collectively, unless otherwise noted. A Hearing Panel consists of a FINRA Hearing Officer and two panelists, drawn primarily from a pool of current and former securities industry members of FINRA's District and Regional Committees, as well as its Market Regulation Committee, former members of FINRA's NAC and former FINRA Directors or Governors.

the final disciplinary action of FINRA, unless the Board of Governors remands the proceeding to the NAC. A respondent in a FINRA disciplinary proceeding may appeal a final FINRA disciplinary action to the SEC, and further to a United States federal court of appeals.

When a Hearing Panel or Hearing Officer decision is on appeal or review before the NAC, any sanctions imposed by the Hearing Panel or Hearing Officer decision, including bars and expulsions, are automatically stayed and not enforced against the respondent during the pendency of the appeal or review proceeding.[8] In turn, the filing of an application for SEC review stays the effectiveness of any sanction, other than a bar or an expulsion, imposed in a decision constituting a final FINRA disciplinary action.[9]

Proposed FINRA Rule 9285 (Interim Orders and Mandatory Heightened Supervision While on Appeal or Discretionary Review) would establish additional investor protections when a Hearing Panel or Hearing Officer decision that makes findings that a respondent violated a statute or rule provision is appealed to the NAC or called for NAC review.

Proposed Rule 9285(a) would provide that the Hearing Officer that participated in the underlying disciplinary proceeding may impose any conditions or restrictions on the activities of a respondent during the appeal as the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm. In light of comments received in response to Regulatory Notice 18-16, FINRA has modified the proposal to make the

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8 See FINRA Rules 9311(b), 9312(b). In contrast, an appeal to the NAC or a call for NAC review does not stay a decision, or that part of a decision, that imposes a permanent cease and desist order. See FINRA Rules 9311(b), 9312(b).

9 See FINRA Rule 9370(a).

imposition of possible conditions and restrictions a separate, second step after a finding of a violation by a Hearing Panel or Hearing Officer, and to provide greater clarity on how the process would operate.

Unless otherwise ordered by a Hearing Officer, proposed Rule 9285(a)(1) would allow FINRA's Department of Enforcement ("Enforcement"), within ten days after service of a notice of appeal from, or the notice of a call for NAC review of, a disciplinary decision of a Hearing Officer or Hearing Panel, to file a motion for the imposition of conditions or restrictions on the activities of a respondent that are reasonably necessary for the purpose of preventing customer harm.[10] Proposed Rule 9285(a)(1) also would provide expressly that the Hearing Officer that participated in the underlying disciplinary proceeding would have jurisdiction to rule on a motion seeking conditions or restrictions, notwithstanding the appeal or call for NAC review. FINRA believes that the Hearing Officer's knowledge about the factual background and the violations, gained through presiding over the disciplinary proceeding, would make the Hearing Officer well qualified to evaluate the potential for customer harm and craft, in the first instance and in an expeditious manner, tailored conditions and restrictions to minimize that potential harm. In a change from the proposal in Regulatory Notice 18-16, the proposed rule would give the Hearing Officer who participated in the underlying proceeding (instead of the Hearing Panel) the authority to impose conditions or restrictions that are reasonably necessary for the purpose of preventing customer harm, a

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10 See Rule 9311(a) (generally allowing a party to file a notice of appeal within 25 days after service of a decision issued pursuant to Rule 9268 or Rule 9269) and Rule 9312 (generally allowing a call for review within 45 days after the date of service of a decision issued pursuant to Rule 9268 and within 25 days after the date of service of a default decision issued pursuant to Rule 9269).

change that FINRA believes will enable orders imposing conditions or restrictions to be imposed more expeditiously.

Proposed Rule 9285(a)(2) through (a)(5), along with proposed Rule 9285(c), would establish the briefing, timing and other procedural requirements relating to the imposition of conditions or restrictions. The proposed rule would permit Enforcement to file a motion seeking the imposition of conditions or restrictions that are reasonably necessary for the purpose of preventing customer harm, and the motion must specify the conditions and restrictions that are sought to be imposed and explain why they are necessary. A respondent would have the right to file an opposition or other response to the motion within ten days after service of the motion, unless otherwise ordered by the Hearing Officer, and must explain why no conditions or restrictions should be imposed or specify alternative conditions and restrictions that are sought to be imposed and explain why they are reasonably necessary for the purpose of preventing customer harm. Enforcement would have no automatic right to file a reply. The Hearing Officer would decide the motion on the papers and without oral argument, unless an oral argument is specifically ordered. In addition, the Hearing Officer would be required to issue a written order ruling upon the motion in an expeditious manner and no later than 20 days after any opposition or permitted reply is filed. In an enhancement from the proposal in Regulatory Notice 18-16, proposed Rule 9285(a)(5) also would require that the Office of Hearing Officers provide a copy of the order to each FINRA member with which the respondent is associated.

If the Hearing Officer grants a motion for conditions or restrictions, its order should describe the activities that the respondent shall refrain from taking and any conditions imposed. The Hearing Officer would be guided by the limiting principle—set forth in proposed Rule 9285(a)(5)—that the Hearing Officer shall have the authority to impose any conditions or restrictions that the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm. As FINRA explained in Regulatory Notice 18-16, the conditions and restrictions imposed should target the misconduct demonstrated in the disciplinary proceeding and be tailored to the specific risks posed by the member firm or broker. Conditions or restrictions could include, for example, prohibiting a member firm or broker from offering private placements in cases of misrepresentations and omissions made to customers, or prohibiting penny stock liquidations in cases involving violations of the penny stock rules. A condition could also include posting a bond to cover harm to customers before the sanction imposed becomes final or precluding a broker from acting in a specified capacity. FINRA believes authorizing Hearing Officers to impose conditions or restrictions during the period an appeal or review proceeding is pending would allow FINRA to target the demonstrated bad conduct of a respondent during the pendency of the appeal or review and add an interim layer of investor protection while the disciplinary proceeding remains pending.[11]

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[11] The examples of conditions and restrictions set forth above are intended to provide guidance concerning the kinds of conditions and restrictions that could be imposed. FINRA expects that requiring Enforcement to file a motion specifying the conditions or restrictions sought also will help focus adjudicators on options that are available, and allow for the flexibility needed to address the risk posed by different factual scenarios. If helpful to adjudicators and parties, FINRA also would publish additional guidance on the kinds of restrictions or conditions that could be imposed.

Proposed Rule 9285(b), along with proposed Rule 9285(c), would establish an expedited process for the review of a Hearing Officer's order imposing conditions or restrictions. Specifically, proposed Rule 9285(b)(1) would permit a respondent that is subject to a Hearing Officer order imposing conditions or restrictions to file, within ten days after service of that order, a motion with the Review Subcommittee to modify or remove any or all of the conditions or restrictions. Proposed Rule 9285(b)(2) would provide, among other things, that the respondent has the burden to show that the conditions or restrictions are not reasonably necessary for the purpose of preventing customer harm.[12]

Proposed Rule 9285(b)(3) would give Enforcement five days from service of the respondent's motion to file an opposition or other response, unless otherwise ordered by the Review Subcommittee. Proposed Rule 9285(b)(4) would provide that the respondent may not file a reply. Proposed Rule 9285(b)(5) would provide that the NAC's Review Subcommittee would decide the motion based on the papers and without oral argument, unless an oral argument is specifically ordered by the Review Subcommittee, and make

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12 In Regulatory Notice 18-16, FINRA originally proposed that the respondent would also be required to demonstrate that Hearing Officer "committed an error by ordering the conditions or restrictions imposed." FINRA believes that it is more appropriate for the burden in proposed Rule 9285(b)(2) to mirror what Enforcement must show when seeking conditions or restrictions and the Hearing Officer's authority to impose conditions and restrictions.

Notwithstanding that FINRA no longer proposes including the "committed an error" standard in the proposed rule, FINRA intends that the Review Subcommittee would essentially conduct a de novo review when considering a respondent's motion to modify or remove conditions or restrictions. An exception would be for a Hearing Officer's credibility determinations, which are entitled to considerable weight and deference, and can be overturned only where the record contains substantial evidence for doing so.

that decision in an expeditious manner and no later than 30 days after the filing of the opposition. The rule would provide that the Review Subcommittee could approve, modify or remove any and all of the conditions or restrictions. It also would require that FINRA's Office of General Counsel provide a copy of the Review Subcommittee's order to each FINRA member with which the respondent is associated. Proposed Rule 9285(b)(6) would provide that the filing of a motion pursuant to Rule 9285(b) would stay the effectiveness of the conditions and restrictions ordered by the Hearing Officer until the Review Subcommittee rules on the motion.

Proposed Rule 9285(d) would provide that conditions or restrictions imposed by a Hearing Officer that are not subject to a stay or imposed by the Review Subcommittee shall remain in effect until FINRA's final decision takes effect. Thus, the conditions or restrictions would remain in effect until there is a final FINRA disciplinary action and all appeals are exhausted.

The remainder of proposed Rule 9285 sets requirements for member firms, during an appeal or NAC review proceeding, to establish mandatory heightened supervision plans for disciplined respondents. Specifically, when a Hearing Panel or Hearing Officer disciplinary decision finding that a respondent violated a statute or rule provision is appealed or called for NAC review, proposed Rule 9285(e) would require any member with which the respondent is associated to adopt a written plan of heightened supervision of the respondent. The plan of heightened supervision would be required to comply with FINRA Rule 3110,[13] be reasonably designed and tailored to include specific supervisory

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13 Rule 3110 requires member firms to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and FINRA rules. See also Regulatory

policies and procedures that address the violations found by the Hearing Panel or Hearing Officer, and be reasonably designed to prevent or detect a reoccurrence of those violations. The plan of heightened supervision would be required to, at a minimum, designate an appropriately registered principal responsible for carrying out the plan of heightened supervision. Proposed Rule 9285(d) also would require that the plan of heightened supervision be signed by the designated principal and include an acknowledgement that the principal is responsible for implementing and maintaining the plan. The plan of heightened supervision would be required to remain in place until FINRA's final decision takes effect. Thus, the plan of heightened supervision would be required to remain in place until there is a final FINRA disciplinary action and all appeals are exhausted.[14]

Proposed Rule 9285(d) would require the member to file the written plan of heightened supervision with FINRA's Office of General Counsel and serve a copy on Enforcement and the respondent, within ten days of any party filing an appeal from the Hearing Panel's or Hearing Officer's decision or of the case being called for NAC review. Similarly, if the respondent becomes associated with another member firm while the Hearing Panel's or Hearing Officer's decision is on appeal to, or review before, the NAC, that firm would be required, within ten days of the respondent becoming associated

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Notice 18-15 (Guidance on Implementing Effective Heightened Supervisory Procedures for Associated Persons with a History of Misconduct), at p.2 & n.2 (April 2018).

14 Although proposed Rule 9285(d) would not require heightened supervision plans after FINRA's final decision takes effect, the supervisory obligations of member firms regarding associated persons with a history of past misconduct would continue to apply. See Regulatory Notice 18-15 (April 2018).

with it, to file a copy of a plan of heightened supervision with FINRA's Office of General Counsel and serve a copy on Enforcement and the respondent.

In a change from Regulatory Notice 18-16, FINRA has modified the heightened supervision plan requirements to account for the possibility that a firm could be required pursuant to proposed Rule 9285(e) to adopt a mandatory heightened supervision plan before any conditions or restrictions imposed pursuant to proposed Rule 9285 take effect. Proposed Rule 9285(e)(1) would require that a member that has adopted a written plan of heightened supervision for a respondent would be required to file and serve an amended plan that takes into account any conditions or restrictions imposed pursuant to proposed Rule 9285, within ten days of the conditions or restrictions becoming effective.

Proposed Rule 9285 would apply to disciplinary proceedings initiated on or after the effective date of the proposed rule.

Along with proposed Rule 9285, FINRA is proposing corresponding amendments to five existing rules: FINRA Rules 9235 (Hearing Officer Authority), 9311 (Appeal by Any Party; Cross-Appeal), 9312 (Review Proceeding Initiated by Adjudicatory Council), 9321 (Transmission of Record), and 9556 (Failure to Comply with Temporary and Permanent Cease and Desist Orders).

The proposed amendments to Rule 9235 would provide that the Hearing Officer has the authority to rule on a motion pursuant to Rule 9285 for conditions or restrictions.

The proposed amendments to Rules 9311 and 9312 would ensure that the stay provisions in those rules do not affect a motion for conditions or restrictions.[15] Currently,

[15] The proposed amendments to Rule 9312 discussed in this paragraph reflect an enhancement to the proposal in Regulatory Notice 18-16 (April 2018).

Rule 9311(b) provides, in pertinent part, that an appeal to the NAC from a decision issued pursuant to Rule 9268 or Rule 9269 shall operate as a stay of that decision until the NAC issues a decision pursuant to Rule 9349 or, in cases called for discretionary review by the FINRA Board, until a decision is issued pursuant to Rule 9351. Rule 9312(b) contains similar stay provisions for decisions that are called for review. Rules 9311(b) and 9312(b) would be amended to expressly state that, notwithstanding the stay of sanctions under Rules 9311 and 9312, the Hearing Officer may impose such conditions and restrictions on the activities of a respondent as the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm, in accordance in proposed Rule 9285(a), and that the Review Subcommittee shall consider any motion filed pursuant to Rule 9285(b) to modify or remove any or all of the conditions or restrictions.

Other proposed amendments to Rule 9311 and 9312 would ensure that a member firm is notified of events that would require it to adopt a written plan of heightened supervision pursuant to proposed Rule 9285.[16] Proposed Rule 9311(g) would require the Office of Hearing Officers, when an appeal is filed from a decision finding that a Respondent violated a statute or rule provision, to promptly notify each FINRA member with which the Respondent is associated that an appeal has been filed. Similarly, proposed Rule 9312(c)(3) would require the Office of General Counsel, when a decision finding that a Respondent violated a statute or rule provision is called for review, to

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[16] The proposed amendments to Rules 9311 and 9312 discussed in this paragraph are an enhancement from the proposal in Regulatory Notice 18-16 (April 2018).

promptly notify each FINRA member with which the Respondent is associated of the call for review.

The proposed amendments to Rule 9321 would govern the record related to a motion for conditions or restrictions.[17] Rule 9321 currently governs the process for the Office of Hearing Officers to transmit the record of a disciplinary proceeding to the NAC. The proposed amendments to Rule 9321 would set forth provisions for how the Office of Hearing Officers would transmit to the NAC the supplemental record of a proceeding concerning a motion to impose conditions or restrictions.

Rule 9556 currently governs expedited proceedings for failures to comply with temporary and permanent cease and desist orders. The proposed amendments to Rule 9556 would grant FINRA staff the authority to bring an expedited proceeding against a respondent that fails to comply with conditions and restrictions imposed pursuant to proposed Rule 9285 and create the process for the expedited proceeding. Specifically, proposed Rule 9556(a)(2) would permit FINRA staff to issue a notice to a respondent stating that the failure to comply with the conditions or restrictions imposed under Rule 9285 within seven days of service of the notice will result in a suspension or cancellation of membership or a suspension or bar from associating with any member. Proposed Rule 9556(c)(2) would govern the contents of the notice. It would require that the notice explicitly identify the conditions or restrictions that are alleged to have been violated and contain a statement of facts specifying the alleged violation. It also would require that the notice state or explain—just as the rule currently requires for a notice of a failure to

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[17] The proposed amendments to Rule 9321 reflect an enhancement to the proposal in Regulatory Notice 18-16 (April 2018).

comply with temporary and permanent cease and desist orders—when the FINRA action will take effect, what the respondent must do to avoid such action, that the respondent may file a written request for a hearing with the Office of Hearing Officers pursuant to Rule 9559, the deadline for requesting a hearing and the Hearing Officer's or Hearing Panel's authority.

Proposed Amendments to the FINRA Rule 9520 Series to Require Interim Plans of Heightened Supervision of a Disqualified Person During the Period When FINRA is Reviewing an Eligibility Application

FINRA is proposing to amend FINRA Rule 9522 (Initiation of Eligibility Proceeding; Member Regulation Consideration) in the FINRA Rule 9520 Series (Eligibility Proceedings) to require a member firm that files an application to continue associating with a disqualified person under Rule 9522(a)(3) or 9522(b)(1)(B) to also include an interim plan of heightened supervision that would be in effect throughout the entirety of the application review process.[18] The proposed amendments would delineate the circumstances under which a statutorily disqualified individual may remain associated with a FINRA member while FINRA is reviewing the application.

As background, brokers who have engaged in the types of misconduct specified in the Exchange Act's statutory disqualification provisions must undergo special review by FINRA before they are permitted to re-enter or continue working in the securities industry. In conducting its review, FINRA seeks to exclude brokers who pose a risk of

18 In Regulatory Notice 18-16 (April 2018), FINRA originally proposed the amendments discussed in this section as amendments to FINRA Rule 9523.

recidivism from re-entering or continuing in the securities business, subject to the limits developed in SEC case law.

As a general framework, the Exchange Act sets out the types of misconduct that presumptively exclude brokers from engaging in the securities business, identified as statutory disqualifications.[19] These statutory disqualifications are the result of actions against a broker taken by a regulator or court based on a finding of serious misconduct that calls into question the integrity of the broker, and include, among other things, any felony and certain misdemeanors for a period of ten years from the date of conviction; expulsions or bars (and current suspensions) from membership or participation in a self-regulatory organization; bars (and current suspensions) ordered by the SEC, Commodity Futures Trading Commission or other appropriate regulatory agency or authority; willful violations of the federal securities and commodities laws or MSRB rules; permanent or temporary injunctions from acting in certain capacities; and certain final orders of a state securities commission.

The Exchange Act and SEC rules thereunder establish a framework within which FINRA evaluates whether to allow an individual who is subject to a statutory disqualification to associate with a member firm.[20] A member firm that seeks to employ

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[19] Section 3(a)(39) of the Exchange Act defines the circumstances when a person is subject to a "statutory disqualification."

[20] See 15 U.S.C. 78o-3(g)(2) ("A registered securities association may, and in cases in which the Commission, by order, directs as necessary or appropriate in the public interest or for the protection of investors shall, deny membership to any registered broker or dealer, and bar from becoming associated with a member any person, who is subject to a statutory disqualification."); see also 17 CFR 240.19h-1.

or continue the employment of a disqualified individual must file an application seeking approval from FINRA ("SD Application").[21] The Rule 9520 Series sets forth rules governing eligibility proceedings, in which FINRA evaluates whether to allow a member, person associated with a member, potential member or potential associated person subject to a statutory disqualification to enter or remain in the securities industry. A member firm's SD Application to associate with, or continue associating with, a disqualified person is subject to careful scrutiny by FINRA to review whether the individual's association with the member firm is in the public interest and does not create an unreasonable risk or harm to the market or investors. To determine whether the SD Application will be approved or denied, FINRA takes into account factors that include the nature and gravity of the disqualifying event; the length of time that has elapsed since the disqualifying event and any intervening misconduct occurring since; the regulatory history of the disqualified individual, the firm and individuals who will act as supervisors; the potential for future regulatory problems; the precise nature of the securities-related activities proposed in the SD Application; and any proposed plan of heightened supervision.[22]

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21 See General Information on FINRA's Eligibility Requirements, http://www.finra.org/industry/general-information-finras-eligibility-requirements.

22 FINRA's review of many SD Applications also is governed by the standards set forth in Paul Edward Van Dusen, 47 S.E.C. 668 (1981), and Arthur H. Ross, 50 S.E.C. 1082 (1992). These standards provide that in situations where an individual's misconduct has already been addressed by the SEC or FINRA, and certain sanctions have been imposed for such misconduct, FINRA should not consider the individual's underlying misconduct when it evaluates an SD Application. In Van Dusen, the SEC stated that when the period of time specified in the sanction has passed, in the absence of "new information reflecting adversely on [the applicant's] ability to function in his proposed employment in a manner consonant with the public interest," it is inconsistent with the remedial

If FINRA recommends approval of the SD Application, the recommendation is submitted either directly to the SEC for its review or to the NAC and ultimately to the SEC for their reviews and approvals, as applicable. If FINRA recommends denial of the SD Application, the member firm has the right to a hearing before a panel of the Statutory Disqualification Committee and the opportunity to demonstrate why the SD Application should be approved.[23] If the NAC denies the SD Application, the member firm can appeal the decision to the SEC and, thereafter, a federal court of appeals.[24]

Currently, as part of an SD Application, a member firm will propose a written plan of heightened supervision of the statutorily disqualified person that would become

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purposes of the Exchange Act and unfair to deny an application for re-entry. 47 S.E.C. at 671. The SEC also noted in Van Dusen, however, that an applicant's re-entry is not "to be granted automatically" after the expiration of a given time period. Id. Instead, the SEC instructed FINRA to consider other factors, such as: (1) "other misconduct in which the applicant may have engaged"; (2) "the nature and disciplinary history of a prospective employer"; and (3) "the supervision to be accorded the applicant." Id. Further, in Ross, the SEC established a narrow exception to the rule that FINRA confine its analysis to "new information." 50 S.E.C. at 1085. The SEC stated that FINRA could consider the conduct underlying a disqualifying order if an applicant's later misconduct was so similar that it formed a "significant pattern." Id. at 1085 n.10.

23 The hearing panel considers evidence and other matters in the record and makes a written recommendation on the SD Application to the Statutory Disqualification Committee. See Rule 9524(a)(10). The Statutory Disqualification Committee, in turn, recommends a decision to the NAC, which issues a written decision to the member firm that filed the SD Application. See Rules 9524(a)(10), 9524(b).

24 Approximately 73.5 percent of the SD Applications filed during 2013-2018 were either denied by FINRA, withdrawn because the applicant expected FINRA would recommend denial of its application, or closed because the SD Application was not required by operation of law. Approximately 12.5 percent were approved. FINRA approval sometimes resulted from legal principles, including those embodied in the Exchange Act and in case law, as noted above, which limits FINRA's discretion to deny an application. The remaining 14 percent of the SD Applications are pending.

effective upon approval by FINRA of the SD Application to associate with the statutorily disqualified person.[25] A heightened supervisory plan must be acceptable to FINRA, and FINRA will reject any plan that is not specifically tailored to address the individual's prior misconduct and mitigate the risk of future misconduct. In this regard, FINRA's primary consideration is a heightened supervisory plan carefully constructed to best ensure investor protection.

Despite the fact that FINRA will generally not approve an SD Application that lacks an acceptable plan of heightened supervision, there is currently no requirement under FINRA rules that firms place statutorily disqualified individuals whom they employ on interim heightened supervision while an SD Application is pending. However, the proposed amendments to Rule 9522 would establish this requirement, consistent with existing FINRA guidance.[26]

Specifically, proposed Rule 9522(f) would require that an application to continue associating with a statutorily disqualified person must include an interim plan of heightened supervision and a written representation from the member firm that the

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[25] See General Information on FINRA's Eligibility Requirements, http://www.finra.org/industry/general-information-finras-eligibility-requirements (explaining that "in virtually every application that the NAC approves, it will do so subject to the applicant member's agreement to implement a special supervisory plan").

[26] FINRA has reminded member firms of their obligation to tailor the firm's supervisory systems to account for brokers with a history of industry or regulatory-related incidents, including disciplinary actions. And specifically as to disqualified persons, FINRA has stated that a firm's continuing to associate with a person who becomes disqualified while associated with the firm raises significant investor protection concerns, and that such a firm should evaluate the facts and circumstances to make a determination of whether adopting and implementing an interim plan of heightened supervision during the pendency of an SD Application would be appropriate. See Regulatory Notice 18-15 (April 2018).

statutorily disqualified person is currently subject to that plan. The proposed rule would require that the interim plan of heightened supervision comply with Rule 3110 and be reasonably designed and tailored to include specific supervisory policies and procedures that address any regulatory concerns related to the nature of the disqualification, the nature of the firm's business, and the disqualified person's current and proposed activities during the review process. The proposed rule also would require that the SD Application identify an appropriately registered principal responsible for carrying out the interim plan of heightened supervision, and that the responsible principal sign the plan and acknowledge his or her responsibility for implementing and maintaining it. The interim plan of heightened supervision would be in effect throughout the entirety of the SD Application review process, which would conclude only upon the final resolution of the eligibility proceeding.

Proposed Rule 9522(g) would authorize Member Regulation to reject an SD Application filed pursuant to Rule 9522(a)(3) or Rule 9522(b)(1)(B) that seeks the continued association of a disqualified person if it determines that the application is substantially incomplete—either because it does not include a reasonably designed interim plan of heightened supervision or because it does not include a written representation that the disqualified person is currently subject to that plan. The sponsoring firm would have ten days after service of the notice of delinquency, or such other time as prescribed by Member Regulation, to remedy the SD Application.

Under proposed Rule 9522(h), if an applicant firm fails to remedy an SD Application that is substantially incomplete, Member Regulation would provide written notice of its determination to reject the SD Application and its reasons for so doing, and

FINRA would refund the application fee, less $1,000, which FINRA would retain as a processing fee. Upon such rejection of the SD Application, the applicant firm would be required to promptly terminate association with the disqualified person.[27]

The proposed amendments to Rule 9522 would apply to SD Applications that are filed on or after the effective date of the proposed rule amendments.

Proposed Amendments to FINRA Rule 8312

Rule 8312 (FINRA BrokerCheck Disclosure) governs the information FINRA releases to the public through its BrokerCheck system.[28] BrokerCheck helps investors make informed choices about the brokers and member firms with which they conduct business by providing extensive registration and disciplinary history to investors at no charge. FINRA requires member firms to inform their customers of the availability of BrokerCheck.[29]

Rule 8312(b) currently requires that FINRA release information about, among other things, whether a particular member firm is subject to the provisions of FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms) (the “Taping Rule”),

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27 As part of its examination program, FINRA would generally examine for compliance with interim plans of heightened supervision established pursuant to proposed Rule 9522(f).

28 The BrokerCheck website address is brokercheck.finra.org.

29 See FINRA Rule 2210(d)(8) (requiring that each of a member’s websites include a readily apparent reference and hyperlink to BrokerCheck on the initial webpage that the member intends to be viewed by retail investors and any other webpage that includes a professional profile of one or more registered persons who conduct business with retail investors); FINRA Rule 2267 (requiring members to provide to customers the FINRA BrokerCheck Hotline Number and a statement as to the availability to the customer of an investor brochure that includes information describing BrokerCheck).

but only in response to telephonic inquiries via the BrokerCheck toll-free telephone listing. The Taping Rule is designed to ensure that a member firm with a significant number of registered persons that previously were employed by "disciplined firms"[30] has specific supervisory procedures in place to prevent fraudulent and improper sales practices or other customer harm.[31] Under the Taping Rule, a member with a specified percentage of registered persons who have been associated with disciplined firms in a registered capacity in the last three years is designated as a "taping firm."[32]

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30 Rule 3170(a)(2) defines a "disciplined firm" to mean:

> (A) a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the SEC revoking its registration as a broker-dealer;
>
> (B) a futures commission merchant or introducing broker that has been formally charged by either the Commodity Futures Trading Commission or a registered futures association with deceptive telemarketing practices or promotional material relating to security futures, those charges have been resolved, and the futures commission merchant or introducing broker has been closed down and permanently barred from the futures industry as a result of those charges; or
>
> (C) a futures commission merchant or introducing broker that, in connection with sales practices involving the offer, purchase, or sale of security futures is subject to an order of the SEC revoking its registration as a broker or dealer.

31 To assist member firms in complying with Rule 3170, FINRA publishes on its website a list of Disciplined Firms Under FINRA Taping Rule, which identifies firms that meet the definition of "disciplined firm" and that were disciplined within the last three years. As of March 31, 2020, that list identified seven firms as "disciplined firms." See https://www.finra.org/rules-guidance/oversight-enforcement/disciplinary-actions/disciplined-firms-under-taping-rule.

32 Rule 3170(a)(5)(A) defines a "taping firm" to mean:

> (i) A member with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been associated with

A member firm that either is notified by FINRA or otherwise has actual knowledge that it is a taping firm must establish, maintain and enforce special written procedures for supervising the telemarketing activities of all its registered persons. Those procedures must include procedures for recording all telephone conversations between the taping firm's registered persons and both existing and potential customers, and for reviewing the recordings to ensure compliance with applicable securities laws and regulations and applicable FINRA rules. The Taping Rule also requires taping firms to retain all the recordings for a period of not less than three years and file quarterly reports with FINRA.[33]

To provide enhanced disclosure to the public of information as to whether a member firm is subject to the Taping Rule, FINRA is proposing to delete the requirement in Rule 8312(b) that FINRA provide that information only in response to telephonic inquiries via the BrokerCheck toll-free telephone listing. As a result, proposed Rule

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> one or more disciplined firms in a registered capacity within the last three years;
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> (ii) A member with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years;
>
> (iii) A member with at least twenty registered persons where 20% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years.

As of March 31, 2020, there is one firm that is designated as a taping firm.

[33] Rule 3170 provides member firms that trigger application of the taping requirement a one-time opportunity to adjust their staffing levels to fall below the prescribed threshold levels and thus avoid application of the Taping Rule. See Rule 3170(c).

8312(b) would permit FINRA to release through BrokerCheck information as to whether a particular member firm is subject to the Taping Rule.[34] FINRA believes that broadening the disclosure through BrokerCheck of the status of a member firm as a taping firm will help inform more investors of the heightened procedures required of the firm, which may incent the investors to research more carefully the background of a broker associated with the taping firm.

Proposed Amendments to the FINRA Rule 1000 Series to Impose Additional Obligations on Member Firms that Associate with Persons with a Significant History of Past Misconduct[35]

➢ Current MAP Process

FINRA is proposing amendments to the FINRA Rule 1000 Series (Member Application and Associated Person Registration)—specifically the rules that govern membership proceedings ("MAP Rules")—to impose additional obligations on member firms when a natural person that has, in the prior five years, either one or more "final criminal matters" or two or more "specified risk events" seeks to become an owner, control person, principal or registered person of the member.

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34 See Rule 8312(a) (requiring that "[i]n response to a written inquiry, electronic inquiry, or telephonic inquiry via a toll-free telephonic listing," FINRA shall release through BrokerCheck information regarding, in pertinent part, a current or former FINRA member).

35 The text of FINRA Rules 1011, 1017 and CAB Rule 111 incorporates the changes approved by the SEC in Securities Exchange Act Release No. 88482 (March 26, 2020), 85 FR 18299 (April 1, 2020) (Order Approving File No. SR-FINRA-2019-030) ("MAP Rules Amendment Release").

Reviewing CMAs is one of the ways FINRA seeks to address the risks posed by brokers with a significant history of misconduct. Rule 1017 specifies the changes in a member's ownership, control or business operations that require a CMA and FINRA's approval.[36] Among the events that require a CMA are a "material change in business operations," which is defined to include: (1) removing or modifying a membership agreement restriction; (2) market making, underwriting or acting as a dealer for the first time; and (3) adding business activities that require a higher minimum net capital under SEA Rule 15c3-1.[37] In addition, a CMA is required for business expansions to increase

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36 See Rule 1017(a). The events that require a member to file a CMA for approval before effecting the proposed event are:

> (1) a merger of the member with another member, unless both members are members of the New York Stock Exchange, Inc. ("NYSE") or the surviving entity will continue to be a member of the NYSE;
>
> (2) a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the NYSE;
>
> (3) direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members of the NYSE;
>
> (4) a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or
>
> (5) a material change in business operations as defined in Rule 1011.

In addition, Rule 1017(a)(6) mandates a member firm to seek a materiality consultation in two situations in which specified pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements are involved. See MAP Rules Amendment Release.

37 See Rules 1011(l), 1017(a)(5). Rule 1011(l) sets forth a non-exhaustive list of events that are material changes in business operations. FINRA also has provided guidance on additional criteria member firms should take into consideration when

the number of "associated persons involved in sales," offices, or markets made that are a material change in business operations.[38] However, IM-1011-1 (Safe Harbor for Business Expansions) creates a safe harbor for incremental increases in these three categories of business expansions. Under this safe harbor provision, a member, subject to specified conditions and thresholds, may undergo such business expansions without filing a CMA.[39] One such expansion is an increase, within the parameters set forth in IM-1011-1, in the number of "associated persons involved in sales."[40]

In determining whether to approve a CMA, Member Regulation, through the MAP Group (collectively, "the Department"), evaluates whether the applicant and its associated persons meet each of the standards for admission in FINRA Rule 1014(a) and

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assessing the materiality of a proposed change. See Notice to Members 00-73 (October 2000). A member may file an application for approval of a material change in business operations at any time, but the member may not effect such change until the conclusion of the proceeding, unless Member Regulation and the member otherwise agree. See Rule 1017(c)(3).

38 See Rule 1017(b)(2)(C) ("If the application requests approval of an increase in Associated Persons involved in sales, offices, or markets made, the application shall set forth the increases in such areas during the preceding 12 months.").

39 The safe harbor is unavailable to a member that has a membership agreement that contains a specific restriction as to one or more of the three areas of expansion or to a member that has a "disciplinary history" as defined in IM-1011-1. The safe harbor also is not available to any member that is seeking to add one or more "associated persons involved in sales" and one or more of those associated persons has a "covered pending arbitration claim," an unpaid arbitration award or unpaid settlement related to an arbitration. See MAP Rules Amendment Release.

40 For eligible firms, IM-1011-1 permits a firm that has one to ten "associated persons involved in sales" to increase that number by ten persons within a one-year period, and a firm that has 11 or more "associated persons involved in sales" to increase that number by ten persons or 30 percent, whichever is greater, within a one-year period. See IM-1011-1.

whether the applicant would continue to meet those standards upon approval of the CMA.[41] The Department evaluates an applicant's financial, operational, supervisory and compliance systems to ensure that each applicant meets these standards for admission.

One of the standards, Rule 1014(a)(3), requires an applicant to demonstrate that it and its associated persons are capable of complying with the federal securities laws and FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade. When the Department evaluates the Rule 1014(a)(3) standard, it takes into consideration, among other things, whether persons associated with an applicant are the subject of disciplinary actions taken against them by industry authorities, criminal actions, civil actions, arbitrations, customer complaints, remedial actions or other industry-related matters that could pose a threat to public investors.[42] Some of these matters are considered whether they are adjudicated, settled or pending.[43] Some of these events are so material that, when they exist, a presumption exists that the CMA should be denied.[44]

Although firms with a "disciplinary history" as defined by IM-1011-1 are not eligible to use the safe harbor, none of the safe harbor's parameters relates to the history of a member firm's associated persons. Given the recent studies that provide evidence of

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[41] See Rule 1017(h)(1) and (h)(1)(A).

[42] See Rule 1014(a)(3).

[43] See Rule 1014(a)(3).

[44] See Rule 1017(h) ("Where the Department determines that the Applicant or its Associated Person are the subject of any of the events set forth in Rule 1014(a)(3)(A) and (C) through (E), a presumption exists that the application should be denied.").

the predictability of future regulatory-related events for brokers with a history of past regulatory-related events, FINRA is concerned about instances where a member on-boards associated persons with a significant history of misconduct and does so within the safe-harbor parameters, thus avoiding prior consultation or review by FINRA. FINRA believes there are instances in which a member firm's hiring of an associated person with a significant history of misconduct—and other associations with such persons—would reflect a material change in business operations.

- Proposed Rule 1017(a)(7) to Require Materiality Consultations

The proposed amendments to the MAP Rules would seek to address this concern. Proposed Rule 1017(a)(7) would require that a member firm, notwithstanding Rule 1017(a)(3),[45] (a)(4),[46] (a)(5)[47] and (a)(6)[48] and IM-1011-1,[49] file a CMA when a natural

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[45] Rule 1017(a)(3) requires a member to file a CMA for approval of direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members of the New York Stock Exchange, Inc. The reference to Rule 1017(a)(3) in proposed Rule 1017(a)(7) reflects a change from the proposal in Regulatory Notice 18-16.

[46] Rule 1017(a)(4) requires a member to file a CMA for approval of a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital.

[47] Rule 1017(a)(5) requires a member to file a CMA for approval of a "material change in business operations."

[48] See MAP Rules Amendment Release.

[49] The reference to IM-1011-1 in proposed Rule 1017(a)(7) reflects a change from the proposal in Regulatory Notice 18-16.

person seeking to become an owner, control person, principal or registered person of a member has, in the prior five years, one or more "final criminal matters" or two or more "specified risk events"—as further explained below—unless the member has submitted a written request to the Department seeking a materiality consultation for the contemplated activity. Rule 1017(a)(7) would further provide, however, that Rule 1017(a)(7) would not apply when the member is required to file an SD Application or written request for relief pursuant to Rule 9522 for approval of the same contemplated association.[50] Proposed Rule 1017(a)(7) also would contain requirements for the request seeking a materiality consultation and the Department's review and determination, including a description of the possible outcomes of FINRA's determination on a materiality consultation.

Proposed Rule 1017(a)(7) also would establish that the safe harbor for business expansions in IM-1011-1 would not be available to the member firm when a materiality consultation is required under proposed Rule 1017(a)(7). In a corresponding change, proposed IM-1011-3 (Business Expansions and Persons with Specified Risk Events) would provide that the safe harbor for business expansions in IM-1011-1 would not be available to any member that is seeking to add a natural person who has, in the prior five years, one or more "final criminal matters" or two or more "specified risk events" and seeks to become an owner, control person, principal or registered person of the member.

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50 In that event, the member firm would be required to obtain FINRA's approval to associate or continue associating with the disqualified person pursuant to the FINRA Rule 9520 Series, but it would not also be required to request a materiality consultation or file a CMA pursuant to proposed Rule 1017(a)(7). The Member Regulation staff that considers the SD Application may consult with the MAP Group, as appropriate.

Proposed IM-1011-3 would further provide, in those circumstances, that if the member is not otherwise required to file a CMA, the member must comply with the requirements of proposed Rule 1017(a)(7).[51] Proposed Rule 1017(a)(7) and proposed IM-1011-3 would not apply when a person is already a principal at a member firm and seeks to add an additional principal registration at that same firm. In that instance, the proposed rule amendments would not require a materiality consultation.

Currently, FINRA has a voluntary materiality consultation process.[52] As explained above, a member is required to file a CMA when it plans to undergo an event specified under Rule 1017 (e.g., acquisition or transfer of the member's assets, a business expansion). Before taking this step, a member has the option of seeking guidance, or a materiality consultation, from FINRA on whether or not such proposed event would require a CMA.[53] The materiality consultation process is voluntary, and FINRA has

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51 FINRA has modified the language in proposed Rule 1017(a)(7) and IM-1011-3 from the versions that were proposed in Regulatory Notice 18-16. FINRA has done so for clarity and to align the structure of these proposed rules to the changes to the MAP Rules approved in the MAP Rules Amendment Release.

52 See The Materiality Consultation Process for Continuing Membership Applications, https://www.finra.org/rules-guidance/guidance/materiality-consultation-process; see also Regulatory Notice 18-23 (July 2018).

53 See IM-1011-1 (stating, "[f]or any expansion beyond these [safe harbor] limits, a member should contact its district office prior to implementing the change to determine whether the proposed expansion requires an application under Rule 1017"); see also Notice to Members 00-73 (October 2000) (stating that "[a] member may, but is not required to, contact the District Office to obtain guidance on" whether a change and expansion that falls outside of the safe harbor provisions is material).

published guidelines about this process on FINRA.org.[54] A request for a materiality consultation, for which there is no fee, is a written request from a member for FINRA's determination on whether a contemplated change in business operations or activities is material and would therefore require a CMA. The characterization of a proposed change as material depends on an assessment of all the relevant facts and circumstances. Through this consultation, FINRA may communicate with the member to obtain further documents and information regarding the contemplated change and its anticipated impact on the member. Where FINRA determines that a contemplated change is material, FINRA will instruct the member to file a CMA if it intends to proceed with such change. Ultimately, the member is responsible for compliance with Rule 1017. If FINRA determines during the materiality consultation that the contemplated business change is material, then the member potentially could be subject to disciplinary action for failure to file a CMA under Rule 1017.[55]

The proposed rule change would establish an additional category of mandatory materiality consultations.[56] The materiality consultations required by proposed Rule

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[54] See The Materiality Consultation Process for Continuing Membership Applications, https://www.finra.org/rules-guidance/guidance/materiality-consultation-process.

[55] See Notice to Members 00-73 (October 2000).

[56] FINRA Rule 1017(a)(6) will mandate materiality consultations if a member is contemplating: (i) to add one or more "associated persons involved in sales" and one or more of those associated persons has a "covered pending arbitration claim," an unpaid arbitration award or an unpaid settlement related to an arbitration; or (ii) any direct or indirect acquisition or transfer of a member's assets or any asset, business or line of operation where the transferring member or an associated person of the transferring member has a covered pending arbitration claim, an unpaid arbitration award or an unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA. See MAP

1017(a)(7) would focus on, and the submitting member firm would need to provide information relating to, the conduct underlying the individual's "final criminal matters" and "specified risk events," as well as other matters relating to the subject person, such as disciplinary actions taken by FINRA or other industry authorities, adverse examination findings, customer complaints, pending or unadjudicated matters, terminations for cause or other incidents that could indicate a threat to public investors. The Department's assessment in the materiality consultation would consider, among other things, whether the events are customer-related; whether the events represent discrete actions or are based on the same underlying conduct; the anticipated activities of the person; the disciplinary history, experience and background of the proposed supervisor, if applicable; the disciplinary history, supervisory practices, standards, systems and internal controls of the member firm and whether they are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules; whether the member firm employs or intends to employ in any capacity multiple persons with one or more "final criminal matters" or two or more "specified risk events" in the prior five years; and any other investor protection concern raised by seeking to make the person an owner, control person, principal or registered person of the member firm.

- Proposed Definitions of "Final Criminal Matter" and "Specified Risk Event"

Rules Amendment Release. In a separate proposal, FINRA is proposing to mandate materiality consultations under other circumstances. See Regulatory Notice 18-23 (July 2018) (seeking comment on a proposal to the MAP rules that would, among other things, codify the materiality consultation process and mandate a consultation under specified circumstances such as where an applicant seeks to engage in, for the first time, retail foreign currency exchange activities, variable life settlement sales to retail customers, options activities or municipal securities activities).

The terms "final criminal matter" and "specified risk event" would be defined in proposed amendments to Rule 1011 (Definitions). Proposed Rule 1011(h) would define the term "final criminal matter" to mean a final criminal matter that resulted in a conviction of, or guilty plea or nolo contendere (no contest) by, a person that is disclosed, or was required to be disclosed, on the applicable Uniform Registration Forms.[57] Proposed Rule 1011(p) would define "specified risk event" to mean any one of the following events that are disclosed, or are or were required to be disclosed, on the applicable Uniform Registration Forms: (1) a final investment-related,[58] consumer-initiated customer arbitration award or civil judgment against the person for a dollar amount at or above $15,000 in which the person was a named party; (2) a final investment-related, consumer-initiated customer arbitration settlement or civil litigation settlement for a dollar amount at or above $15,000 in which the person was a named party; (3) a final investment-related civil action where (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000, or (B) the sanction against the person was a bar, expulsion, revocation, or suspension; and

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57 Proposed Rule 1011(r) would define "Uniform Registration Forms" to mean the Uniform Application for Broker-Dealer Registration (Form BD), the Uniform Application for Securities Industry Registration or Transfer (Form U4), the Uniform Termination Notice for Securities Industry Registration (Form U5) and the Uniform Disciplinary Action Reporting Form (Form U6), as such may be amended or any successor(s) thereto.

58 The Form U4 Explanation of Terms defines the term "investment-related" as pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association).

(4) a final regulatory action where (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000, or (B) the sanction against the person was a bar (permanently or temporarily), expulsion, rescission, revocation or suspension from associating with a member.

The proposed definitions and criteria would provide transparency regarding how the proposed rules would be applied, as they are based on disclosure events required to be reported on the Uniform Registration Forms. Firms, in general, would be able to identify the specific set of disclosure events that would count towards the proposed criteria and, using available data, determine independently whether a proposed association with an individual would require a materiality consultation.[59]

In addition, as explained more below in the Economic Impact Assessment, FINRA developed the proposed criteria and definitions with significant attention to the economic trade-off between including individuals who are less likely to subsequently pose risk of harm to customers, and not including individuals who are more likely to subsequently pose risk of harm to customers.

FINRA believes the proposed amendments to the Rule 1000 Series would further promote investor protection by applying stronger standards for continuing membership with FINRA and for changes to a current member firm’s ownership, control or business operations.

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59 The exceptions are that the Uniform Registration Forms do not provide information about customer awards or judgments against, or customer settlements with, control affiliates who have not filed a Form U4. For those events, firms would have to gather that information directly from the person.

As noted in Item 2 of this filing, if the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.[60]

(b) Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[61] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed rule change is designed to protect investors and the public interest by strengthening the tools available to FINRA to address the risks posed by brokers with a significant history of misconduct and the firms that employ them. Allowing Hearing Officers to impose tailored conditions and restrictions on respondents after the finding of a violation, and requiring firms to place disciplined respondent brokers with whom they associate under mandatory heightened supervision during the pendency of an appeal or a review proceeding, would create strong measures of deterrence while an appeal or review

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[60] FINRA notes that the proposed rule change would impact all members, including members that are funding portals or have elected to be treated as capital acquisition brokers ("CABs"), given that the funding portal rule set incorporates the Rule 9200 Series and Rule 9300 Series and Rule 9556 by reference, and the CAB rule set incorporates Rules 1011, 1017 and 8312 and the Rule 9200 Series, Rule 9300 Series and Rule 9500 Series by reference. In addition, FINRA is proposing corresponding amendments to CAB Rule 111, to reflect that a CAB would be subject to IM-1011-3, and amendments to Funding Portal Rule 900(b) to require heightened supervision during the time an eligibility request is pending.

[61] 15 U.S.C. 78o-3(b)(6).

proceeding is pending and while the sanctions imposed have not yet taken effect. Likewise, requiring firms to place disqualified persons on interim plan of heightened supervision while an SD Application is pending would require that a fundamental investor protection measure—almost always required at firms that FINRA, as part of the eligibility proceedings process, permits to associate with disqualified persons—be established at an earlier point in time and thereby limit the potential for harm to the public. Broadening the disclosure through BrokerCheck of the status of a member firm as a taping firm, beyond only telephonic BrokerCheck inquiries, will inform more investors of the heightened procedures required of the taping firm, and thereby incent investors to research carefully the background of a broker associated with the taping firm. Finally, requiring member firms to seek materiality consultations when a person seeking to become an owner, control person, principal or registered person has a significant history of misconduct will give FINRA an opportunity to assess whether the proposed association is material and warrants closer regulatory scrutiny and, further, may create incentives for changes in behavior by both brokers and the firms that employ them. In situations where the proposed association of a person with a significant history of misconduct would require a CMA, FINRA would then be able to assess, if the firm still seeks to proceed, whether the member firm would continue to meet all the Rule 1014 membership standards if the proposed association were approved and prevent the proposed association if it would not continue to meet those standards.[62]

As such, the proposed rule change will help address concerns regarding brokers with a significant history of misconduct in situations where risks for potential further

[62] See Rule 1014(a) (Standards for Admission).

harm to investors may exist, particularly when such individuals concentrate at a firm or are able to move readily from firm to firm. The proposed additional obligations on such brokers and the increased scrutiny by the firms that employ them, should create incentives for brokers and firms to change activities and behaviors to mitigate FINRA's concerns.

4. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rulemaking, its potential economic impacts, including anticipated benefits and costs, and the alternatives FINRA considered in assessing how to best meet its regulatory objectives.

A. Regulatory Need

FINRA uses a number of measures to deter and discipline misconduct by brokers and the firms that employ them. These measures span across several FINRA programs, including statutory disqualification processes, review of membership applications, disclosure of brokers' regulatory backgrounds, supervision requirements, focused examinations, risk monitoring and disciplinary actions.

Nonetheless, some brokers, while relatively small in number, may continue to present heightened risk of harm to investors and act in ways that could harm their customers—sometimes substantially. Any misconduct by these brokers may also undermine confidence in the securities markets as a whole. For example, recent studies provide evidence on predictability of future regulatory-related events for brokers with a history of past regulatory-related events such as repeated disciplinary actions, arbitrations and customer complaints.[63]

Brokers with a history of misconduct can pose a particular challenge to FINRA's existing programs, such as FINRA examination and enforcement programs. For example, while the FINRA examination program can identify compliance failures and prescribe remedies to be taken, examiners are not empowered to require individuals to make changes to or limit their activities in a particular manner. While these constraints on the examination process protect against potentially arbitrary or overly onerous examination findings, an individual with a history of misconduct can take advantage of these limitations to continue ongoing activities that harm or pose risk of harm to investors until they result in an enforcement action. Likewise, enforcement actions can take significant time to develop, prosecute and conclude, during which time the individual is able to continue misconduct.

Furthermore, although FINRA has adopted rules that impose supervisory obligations on firms to ensure they are appropriately supervising their brokers' activities, some firms do not effectively carry out these supervisory obligations to ensure compliance. This is consistent with some recent academic studies, which find that some firms persistently employ brokers who engage in misconduct, and that misconduct can be

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[63] See supra note 4.

concentrated at these firms, suggesting that some firms may not be acting appropriately as a first line of defense to prevent customer harm.[64]

Therefore, without additional protections, the risk of potential customer harm may continue to exist at firms that employ brokers that have a significant number of regulatory-related events and that fail to effectively carry out their supervisory obligations. The proposals are designed to further promote investor protection by mitigating these concerns while preserving principles of fairness.

B. Economic Baseline

The following provides the economic baseline for each of the current proposals. These baselines serve as the primary points of comparison for assessing economic impacts, including incremental benefits and costs of the proposed rule amendments. For this proposal, FINRA reviewed and analyzed relevant data over the 2013-2018 period (review period).

1. Proposed Amendments to the FINRA Rule 9200 Series and FINRA Rule 9300 Series

The economic baseline used to evaluate the economic impacts of the proposed rule changes to the Rule 9200 Series and Rule 9300 Series is the current regulatory framework under these rules.[65] FINRA analyzed disciplinary matters that were appealed to the NAC over the review period that reached a final decision by the NAC.[66] During

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64 For example, see Mark Egan, Gregor Matvos, & Amit Seru, The Market for Financial Adviser Misconduct, J. Pol. Econ. 127, no. 1 (Feb. 2019): 233-295.

65 The proposal also includes corresponding amendments to Rule 9556.

66 This analysis included all NAC appeals (including calls for NAC review) filed during the review period that reached a final decision by May 1, 2019. The

the review period, there were approximately 20 such appeals filed each year, of which approximately 80 percent were filed by brokers, five percent were filed by firms, and the remaining 15 percent were filed jointly by brokers and firms.[67] FINRA determined that, on average, these disciplinary decisions were on appeal to the NAC for approximately 15 months.[68]

2. Proposed Amendments to the FINRA Rule 9520 Series

The economic baseline used to evaluate the economic impacts of the proposed rule changes to the Rule 9520 Series is the current regulatory framework under these rules. FINRA analyzed SD Applications filed during the review period and determined that there were 80 SD Applications filed by 71 firms for 79 individuals, or approximately 13 applications that were filed by 12 firms each year.[69] Approximately 65 percent of these applications were filed by small firms, 12 percent were filed by mid-size firms, and 23 percent were filed by large firms.[70] FINRA also examined the resolution of these

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analysis includes all NAC decisions, including affirmations, modifications or reversals of the findings in the disciplinary matters. The analysis excludes appeals that were withdrawn prior to the resolution of the appeal process.

67 FINRA further estimates that approximately 94 percent of the appeals filed by brokers involved one broker, and the remaining six percent involved two brokers. All the appeals filed by firms were associated with one firm.

68 The median processing time was approximately 14 months, while the 25th and the 75th percentiles were approximately 11 months and 19 months, respectively.

69 One of these 79 individuals was associated with multiple SD Applications over the review period. Of the 71 firms that filed SD Applications, approximately 90 percent filed one application during the review period, and the remaining 10 percent filed two or more applications.

70 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

applications and determined that approximately 12.5 percent of the SD Applications were approved, 11 percent were denied, 14 percent were pending during the review period, and the remaining applications (62.5 percent) did not require a resolution because the statutorily disqualified individual's registration with the filing firm was terminated or the SD Application was subsequently withdrawn.[71] FINRA determined that, on average, the processing time for an SD Application that reached a final resolution (i.e., an approval or a denial) was approximately 15 months.[72]

3. Proposed Amendments to FINRA Rule 8312

The economic baseline used to evaluate the economic impacts of the proposed rule changes to Rule 8312 (FINRA BrokerCheck Disclosure) is the current regulatory framework under Rules 8312 and 3170. During the review period, FINRA determined that 17 firms hired or retained enough registered persons from previously disciplined firms to be designated as a "taping firm" under Rule 3170 and were notified about their status during this period. All of these firms were small firms with an average size of approximately 40 registered persons. Of these 17 firms, 12 firms did not become subject to the rule's recording requirements because they either took advantage of the one-time staff-reduction opportunity in Rule 3170(c) or terminated their FINRA membership, and

than 499 registered persons, and a large firm as a member with 500 or more registered persons. See FINRA By-Laws, Article I.

[71] In approximately 21 percent of the SD Applications, the application was withdrawn because the decision leading to the disqualifying event was overturned, thus the individual was no longer subject to a statutory disqualification, or because the sanctions were no longer in effect.

[72] The median processing time was approximately 14 months, and the 25th and the 75th percentiles were approximately 10 months and 19 months, respectively.

one firm was granted an exemption pursuant to Rule 3170(d). As a result, only four of the firms designated as "taping firms" became subject to the recording requirements of Rule 3170.

4. Proposed Amendments to the FINRA Rule 1000 Series

The economic baseline used to evaluate the economic impacts of the proposed rule changes to the MAP Rules is the current regulatory framework under these rules. The proposed rule change would directly impact individuals with one or more final criminal matters or two or more specified risk events within the prior five years, who seek to become owners, control persons, principals or registered persons of a member firm. The criteria used for identifying individuals under this proposal and the number of individuals meeting the proposed criteria are discussed below.

C. Economic Impacts

The following provides the economic impacts, including the anticipated benefits and costs for each of the current proposals.

1. Proposed Amendments to the FINRA Rule 9200 Series and FINRA Rule 9300 Series

The proposed rule amendments would directly impact firms and brokers whose disciplinary matters are on appeal to, or review by, the NAC. These impacts would vary across appeals and depend on, among other factors, the nature and severity of the conditions or restrictions imposed on the activities of respondents. As discussed above, the scope of these conditions or restrictions would depend on what the Hearing Officer determines to be reasonably necessary for the purpose of preventing customer harm. Further, the conditions and restrictions would be tailored to the specific risks posed by the brokers or firms during the appeal period. Accordingly, the conditions and restrictions are not intended to rise to the level of the underlying sanctions and would likely not be economically equivalent to imposing the sanctions during the appeal. In addition, respondents will be able to seek expedited reviews of orders imposing conditions or restrictions.

Anticipated Benefits

The primary benefit of this proposal accrues from limiting the potential risk of continued harm to customers by respondents during the appeal period by imposing conditions or restrictions on their activities, and requiring them to be subject to heightened supervision plans, while their disciplinary matter is on appeal. In order to evaluate these benefits and assess the potential risk posed by brokers during the appeal period, FINRA examined cases that were appealed to the NAC during 2013-2016 and determined whether the brokers associated with an appeal to the NAC had a new disclosure event—for this analysis, a final criminal matter or a specified risk event, as defined above—at any time from the filing of the appeal through the year-end after the year in which the appeal reached a decision.[73] Based on this analysis, FINRA estimates that 21 of the 75 brokers who appealed to the NAC during the 2013-2016 period were associated with a total of 28 disclosure events that occurred during the interstitial period

[73] In making these calculations, FINRA based its analysis on the occurrence of disclosure events as used in proposed IM-1011-3 and Rule 1017(a)(7). The analysis includes events that occurred and reached a resolution between the NAC appeal year and a year after the NAC decision year to allow sufficient time for events that occurred during the pendency of NAC to reach a resolution. Accordingly, the sample period for this analysis is based on appeals filed during the 2013-2016 period, instead of the full review period (2013-2018).

after the filing of their appeal to the NAC.[74] FINRA anticipates that the proposed heightened supervision requirement and the conditions or restrictions placed on the activities of these brokers would lead to greater oversight of their activities by their firm during the appeal period, thereby reducing the potential risk of future customer harm during this period.[75]

Anticipated Costs

The costs of this proposal would primarily fall upon brokers or firms whose activities during the appeal period would be subject to the specific conditions or restrictions imposed by the Hearing Officer.[76] In addition, firms would incur costs associated with implementing heightened supervision for brokers while their disciplinary matters are under appeal. These costs would likely vary significantly across firms and could increase if the broker acts in a principal capacity. For example, firms employing disciplined respondents who serve as principals, executive managers or owners, or who operate in other senior capacities, would likely assume higher costs in developing and

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74 These estimates are based on appeals filed by brokers, or jointly filed by brokers and firms, and excludes appeals that were filed only by firms. These estimates likely underrepresent the overall risk of customer harm posed by these brokers, because they are based on a specific set of events and outcomes used for classifying brokers for the proposed amendments to the MAP Rules. In addition, these brokers had other disclosure events after their appeal was filed, and some of these other events may also be associated with risk of customer harm.

75 FINRA also anticipates that the proposed changes to Rule 9556, which will establish an expedited proceeding for failures to comply with conditions or restrictions, will help ensure that the firms will comply with the conditions and restrictions imposed.

76 Brokers and firms that choose to defend against motions for conditions and restrictions and that pursue expedited reviews of orders imposing conditions or restrictions would incur additional costs associated with these reviews.

implementing tailored supervisory plans. Such plans may entail re-assignments of responsibilities, restructuring within senior management and leadership, and more complex oversight and governance approaches. These potential costs, in turn, may result in some brokers voluntarily leaving the industry rather than waiting for the resolution of the appeal process.[77]

The costs associated with this proposal would apply to brokers and their employing member firms while the brokers are employed during the pendency of the NAC appeals (the average processing time of which is 15 months) and any subsequent appeals.[78] Many broker-appellants, however, are not employed with any member firms when their NAC appeal is filed or leave shortly after the appeal is filed. FINRA examined the employment history, including employment start and end dates, of the 131 brokers[79] associated with NAC appeals during the review period, and estimates that 54 of them (or 41 percent) were not employed by any member firm during the appeal process, 33 of them (or 25 percent) were employed by a member firm only for part of the appeal process, and 44 of them (or 34 percent) were employed by a member firm throughout the appeal process.

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[77] The proposal may also impose costs on issuers in limited instances where a firm is enjoined from participating in a private placement and the issuer is especially reliant on that firm. The private issuer may incur search costs to find a replacement firm or individual and incur other direct and indirect costs associated with the offering.

[78] FINRA has no estimate for the time associated with subsequent appeals.

[79] These 131 brokers correspond to those associated with a NAC appeal during the review period (2013-2018). The 75 brokers discussed in the Anticipated Benefits section above are a subgroup of brokers associated with a NAC appeal during the 2013-2016 period. See supra note 73.

FINRA notes that consistent with existing FINRA guidance, some firms may have already established heightened supervision of individuals while their disciplinary matters are on appeal.[80] The existing heightened supervision plans may address all, some or none of the conditions or restrictions imposed by the Hearing Panel Officer. Accordingly, for these firms the anticipated costs of this proposal may be lower.

Other Economic Impacts

In developing the proposal, FINRA considered the possibility that, in some cases, this proposal may limit activities of brokers and firms, while their disciplinary matter is under appeal, in instances where the restricted activities do not pose a risk to customers. In such cases, these brokers and firms may lose economic opportunities, and their customers may lose the benefits associated with the provision of these services. FINRA believes that the proposed rule changes mitigate such risks by requiring the conditions or restrictions imposed to be reasonably necessary for the purpose of preventing customer harm and by providing a respondent with the right to seek expedited review of a motion to modify or remove any or all of the conditions and restrictions. Further, as discussed above, approximately 66 percent of the broker-appellants during the review period either were not employed by a member firm during the appeal process or were employed by a member firm only for part of the appeal process. Accordingly, these brokers would not be impacted by this proposal or would be subject to the proposed limitations only for a limited period of time.

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80 See Regulatory Notice 18-15 (April 2018).

2. Proposed Amendments to the FINRA Rule 9520 Series

The proposed rule amendments would impact statutorily disqualified individuals and their employing firms while the SD Application is being processed. These individuals would be subject to heightened supervision during the pendency of their SD Applications.

Anticipated Benefits

The primary benefit of this proposed rule change would arise from greater oversight by employing firms of the activities of statutorily disqualified individuals during the pendency of their SD Applications, thereby reducing the potential risk of customer harm during this period. In order to assess the potential risk posed by these individuals during the pendency of their SD Applications, FINRA examined whether individuals associated with an SD Application filed during the 2013-2016 period had a disclosure event[81] at any time from the filing of the SD Application through two years after filing.[82] Based on this analysis, FINRA estimates that 26 (or 51 percent) of the 51 individuals associated with SD Applications during the 2013-2016 period had a total of

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81 For purposes of this analysis, "disclosure event" included final criminal matters and specified risk events, as defined in proposed Rule 1011(h) and (p).

82 This analysis includes events that occurred and reached a resolution from the SD Application filing year until the end of two years later to allow sufficient time for events that occurred during the eligibility proceeding to reach a resolution. Accordingly, the sample period for this analysis is based on SD Applications filed during the 2013-2016 period, instead of the full review period (2013-2018).

41 disclosure events during the interstitial period after the filing of their SD Application.[83]

Anticipated Costs

The costs associated with this proposal would fall primarily on firms that incur direct and indirect costs associated with establishing and implementing the tailored heightened supervision plan while an SD Application is under review. As discussed above, the costs would likely vary significantly across firms and could increase if the statutorily disqualified individuals also serve as principals, executive managers, or owners or operate in other senior capacities. Moreover, the heightened supervision requirement may deter some firms from retaining these individuals and, as a result, these individuals may find it more difficult to remain in the industry.

3. Proposed Amendments to the BrokerCheck Rule

The proposed amendments would impact taping firms and their registered persons. Taping firms have a proportionately significant number of registered persons who were associated with firms that were expelled by a self-regulatory organization or had their registration revoked by the SEC for sales practice violations, and as a result, may pose greater risk to their customers.

Anticipated Benefits

The primary benefit of this proposed rule change would arise from the investor protection benefits associated with disclosing a firm's status as a "taping firm" through BrokerCheck to the investors. This would allow investors to make more informed

83 This likely underrepresents the overall risk of customer harm, because the disclosure events in this analysis included only final criminal matters and specified risk events.

choices about the brokers and firms with which they conduct business. The anticipated benefits would increase with the likelihood that a potential or actual customer to a taping firm seeks information through BrokerCheck.

Anticipated Costs

The proposal would not impose any direct costs on brokers or firms. Nonetheless it may impact their businesses, as investors may rely on information about a firm's status as a taping firm in determining whom to engage for financial services and brokerage activities. Disclosing the status of a firm as a "taping firm" through BrokerCheck may also further deter firms from hiring or retaining brokers who were employed previously by disciplined firms in order to avoid the "taping firm" thresholds and resulting disclosure on BrokerCheck.[84]

4. Proposed Amendments to MAP Rules

The proposed rule change would directly impact individuals with one or more final criminal matters or two or more specified risk events within the prior five years, who seek to become owners, control persons, principals or registered persons of a member firm. To estimate the number of brokers who would meet the proposed criteria, FINRA analyzed the categories of events and conditions associated with the proposed criteria for all brokers during the review period. For each year, FINRA determined the approximate number of brokers who met the proposed criteria and became owners, control persons, principals or registered persons of a member firm. As discussed in more

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84 As discussed above, only four firms during the review period became subject to the taping requirements of Rule 3170. As a result, FINRA does not anticipate that this proposal would be associated with significant economic impacts, including the anticipated benefits or costs.

detail below, this analysis showed that there were 110-215 such individuals, per year, who would have met the proposed criteria had it been in place during the review period.

The proposal is intended to apply to brokers who may pose greater risks to their customers than other brokers. A framework for evaluating the effectiveness of the criteria is to observe the rate at which brokers identified collectively by the criteria are substantially more likely to have regulatory-related events, including specified risk events and final criminal matters, than their peers. Based on FINRA's analysis of all individuals who sought to become owners, control persons, principals or registered persons of a member firm during the review period, individuals who would have met the proposed criteria had on average 1.4-1.6 final criminal matters and specified risk events (per broker), while other brokers had on average 0.002-0.004 such events (per broker).[85] These estimates suggest that individuals who would have been affected by this proposal (had it been in place during the review period) had on average over 450-900 times more final criminal matters and specified risk events than other brokers during the same review period.

Anticipated Benefits

The primary benefit of the proposed amendments would be to reduce the potential risk of future customer harm by individuals who meet the proposed criteria and seek to become an owner, control person, principal, or registered person of a member firm. FINRA believes the proposed rule change would further promote investor protection by

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85 As discussed above, the proposed criteria includes individuals with one or more "final criminal matters" or two or more "specified risk events" in the prior five years. The individuals who would have met the proposed criteria as a result of two or more "specified risk events" in the prior five years had on average 2.3-2.9 such events during the review period.

applying stronger standards for continuing membership with FINRA and for changes to a current member firm's ownership, control or business operations. These benefits would primarily arise from changes in broker and firm behavior and increased scrutiny by FINRA of brokers who meet the proposed criteria during the review of a materiality consultation and, where appropriate, a CMA.

To scope these potential benefits and assess the potential risk posed by brokers who would meet the proposed criteria, FINRA evaluated the extent to which brokers who would have met the criteria during 2013-2016 (had the criteria existed) and sought the proposed roles were associated with "new" final criminal matters or specified risk events after having met the proposed criteria. These "new" events correspond to events that were identified or occurred after the broker's meeting the proposed criteria, and do not include events that were pending at the time of meeting the criteria and subsequently resolved in the years afterwards. As shown in Exhibit 3e, FINRA estimates that, in 2013, 215 brokers would have met the proposed criteria and sought the proposed roles. These brokers were associated with 35 "new" final criminal matters or specified risk events that occurred after their meeting the proposed criteria, between 2014 and 2018. Exhibit 3e similarly shows the number of events associated with brokers who would have met the proposed criteria and sought the proposed roles in 2014, 2015 and 2016. Across 2013-2016, there were 635 unique brokers who would have met the proposed criteria and sought the proposed roles, and these brokers were associated with a total of 93 events that occurred in the years after they met the proposed criteria.

Exhibit 3e also shows, for the 2013-2016 period, a factor representing a multiple for the average number of events for brokers who would have met the proposed criteria and sought the proposed roles relative to other brokers who sought the proposed roles. For example, the factor of 16x for 2013 indicates that brokers meeting the proposed criteria and seeking the proposed roles in 2013 had on average 16 times more new events (per broker) in the subsequent years (2014-2018) than other brokers who sought those roles in 2013.[86] Overall, this analysis demonstrates that brokers who would have met the proposed criteria and sought the proposed roles during the 2013-2016 period had on average approximately 16-49 times more new criminal matters and specified risk events after meeting the criteria than other brokers who sought the proposed roles.

Anticipated Costs

The cost of this proposal would fall on the firms that seek to add owners, control persons, principals or registered persons who meet the proposed criteria. These firms would be directly impacted by the proposals through the requirements to seek a materiality consultation with FINRA and, potentially, to file a CMA. While there is no FINRA fee for seeking a materiality consultation, firms may incur internal costs or costs associated with engaging external experts in conjunction with the filing of a CMA. In addition, the proposal could result in delays to a firm's ability to add owners, control persons, principals or registered persons who meet the proposed criteria, during the time the mandatory materiality consultation and any required CMA is being processed. FINRA examined the time to process materiality consultations and determined that, on average, these consultations are completed within eight to ten days, although this time period could be longer depending on the complexity of the contemplated expansion or

86 Brokers meeting the proposed criteria and seeking the proposed roles in 2013 had on average 0.16 new events (per broker) in the subsequent years (2014-2018) compared to 0.01 events (per broker) for other brokers seeking the proposed roles.

transaction and the aggregate number of consultations under review. These anticipated costs may deter some firms from hiring individuals meeting the proposed criteria, who as a result may find it difficult to remain in the industry or bear other labor market related costs.

Other Economic Impacts

To provide transparency and clarity regarding the application of this proposal, the proposed criteria is based on disclosure events required to be reported on the Uniform Registration Forms. Information about disclosure events reported on the Uniform Registration Forms is generally available to firms and FINRA. Accordingly, firms would be able to identify the specific set of disclosure events that would count towards the proposed criteria and replicate the proposed thresholds using available data, with a few exceptions.[87] In determining the proposed numeric threshold, FINRA considered three key factors: (1) the different types of reported disclosure events; (2) the counting criteria (i.e., the number of reported events required to trigger the obligations); and (3) the time period over which the events are counted. In evaluating the proposed numeric threshold versus alternative criteria, significant attention was given to the impact of possible misidentification of individuals; specifically, the economic trade-off between including individuals who are less likely to subsequently pose risk of harm to customers, and not including individuals who are more likely to subsequently pose risk of harm to

[87] Firms have access to disclosure events reported on Form U4, U5, and U6 filings for individuals who were previously registered with the same firms or with other firms. Firms do not have access, however, to information regarding individuals that is disclosed on another firm's Form BD. Firms may not have access to information about disclosure events for individuals, including control affiliates, who were not previously registered.

customers. There are costs associated with both types of misidentifications. For example, subjecting individuals who are less likely to pose a risk to customers to mandatory materiality consultations, and potentially CMAs, would impose additional costs on these individuals, their affiliated firms and customers. The proposed numeric threshold aims to appropriately balance these costs in the context of economic impacts associated with the proposed amendments to the MAP Rules.

The proposal may create incentives for changes in behavior to avoid meeting the proposed threshold. Under the proposal standing alone, brokers and firms may be more likely to try to settle customer complaints or arbitrations below $15,000 so that their settlements do not count towards the proposed threshold. To the extent, if any, that customers also would be willing to settle for less, this change may reduce the compensation provided to customers.[88] Alternatively, it could increase the time, effort and costs for customers associated with negotiating a settlement, even if the settled amount would not change. Brokers and firms also may consider underreporting the disclosure events to avoid being subject to the proposed rule. However, this potential impact is mitigated by the facts that many of the events are reported by FINRA or other regulators, incorrect or missing reports can trigger regulatory action by FINRA, and FINRA rules require firms to take appropriate steps to verify the accuracy and completeness of the information contained in the Uniform Registration Forms before they are filed. FINRA also has the ability to check for unreported events, particularly those

88 The proposed $15,000 threshold for customer settlements corresponds to the reporting threshold for the Uniform Registration Forms and for the settlement information to be displayed through BrokerCheck. Accordingly, the change in incentives to brokers and firms associated with the proposed rule should be considered in the presence of the incentives already in place.

that third parties report in separate public notices, such as the outcomes of some civil proceedings.

FINRA recognizes that in some instances, firms may not be able to identify certain individuals with disclosure events who may seek to become owners, control persons, principals or registered persons of the firm. Similarly, firms may have less incentive to conduct appropriate due diligence on those individuals for whom firms may not have readily available disclosure history.[89] Firms still would be required, however, to seek information on relevant disclosure events from individuals who seek to become principals or registered persons, as part of the registration process, and take reasonable steps (e.g., by conducting background checks) to verify the accuracy and completeness of the information provided by the individuals. Nonetheless, FINRA recognizes that in some cases, even after conducting reasonable due diligence, firms may not have the required information to identify certain individuals who meet the proposed criteria, and these individuals may continue to pose risk of future investor harm. FINRA believes that these risks are mitigated by its own examination risk programs that monitor and examine individuals for whom there are concerns of ongoing misconduct or imminent risk of harm to investors. These programs identify high-risk individuals based on the analysis of data available to the firms as well as additional regulatory data available to FINRA.[90]

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89 For example, as discussed above, firms do not have access to disclosure events for non-registered control affiliates at other firms. FINRA uses disclosure events reported on Form BD across all firms to identify disclosure records of non-registered control affiliates.

90 See supra note 87.

In developing this proposal, FINRA analyzed disclosure events reported on the Uniform Registration Forms for all individuals during the review period. For each year, FINRA evaluated the data and determined the approximate number of individuals who would have met the proposed numeric threshold of one or more final criminal matters or two or more specified risk events in the prior five years. Exhibit 3a shows the disclosure categories that FINRA considered and the subcategories that were used for identifying final criminal matters and specified risk events. The exhibit also shows the mapping of these disclosure categories to the underlying questions in Form U4.[91] Exhibit 3b shows the corresponding mapping of these disclosure categories to the questions in Form BD.[92] Exhibit 3c provides a breakdown of the disclosure categories for all individuals registered with FINRA in 2018.[93] The exhibit illustrates the impacts of refining subcategories of reported disclosure events and using different numeric thresholds on the number of disclosure events and the number of registered persons associated with these events.[94]

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91 Forms U5 and U6 have questions similar to Form U4 that can also be mapped to the disclosure categories in Exhibit 3a.

92 Form BD includes information on disclosure events for individual control affiliates, including non-registered control affiliates that may not have Form U4, U5 or U6 filings. Form BD is the primary source of information on disclosure events for these unregistered control affiliates. Form BD includes information on final criminal matters and certain specified risk events associated with regulatory actions and civil judicial actions, but does not include information on customer awards or settlements.

93 Exhibit 3c does not include information on individuals who were not registered with FINRA in 2018. These non-registered individuals may include non-registered associated persons, including non-registered control affiliates.

94 Exhibit 3c shows the number of criminal disclosures and "disclosures considered in developing specified risk events" (regulatory action disclosures, civil judicial disclosures, and customer complaint, arbitration and civil litigation disclosures)—including final and pending disclosures—for brokers who were registered with

This analysis has led FINRA to initially propose the numeric threshold set forth in the current proposal.

The additional proposed obligations would only apply to individuals with one or more final criminal matters or two or more specified risk events within the prior five years who seek to become owners, control persons, principals or registered persons of a firm. Accordingly, FINRA examined registration information in order to identify all individuals who would have met the proposed criteria and sought the proposed roles during the review period. Those identified serve as a reasonable estimate for the number of individuals who would have been directly impacted by this proposal had it been in place at the time. This analysis indicates that there were 110-215 such individuals per year, as shown in Exhibit 3d. These individuals represent 0.09-0.16 percent of individuals who became owners, control persons, principals, or registered persons with a new member in any year during the review period.[95]

FINRA in 2018, over such brokers' entire reporting history; the number of brokers associated with these disclosure events; and the impact of refining the disclosure categories and the periods over which these events are counted. For example, the exhibit shows that brokers who were registered with FINRA in 2018 had, over their entire reporting history, 19,655 criminal disclosures and 134,928 "disclosures considered in developing specified risk events." It also shows that 41,915 individuals had, over their entire reporting history, one or more criminal disclosures or two or more "disclosures considered in developing specified risk events." When narrowing the disclosure categories to include only the "final criminal matters" and "specified risk events" as defined in this proposal (including the five-year lookback period), the results narrow to 174 final criminal matters and 2,616 specified risk events, and to 414 brokers who met the proposed numeric threshold of one or more final criminal matters or two or more specified risk events in the prior five years.

95 These percentages are calculated by dividing FINRA's estimate of the number of individuals who met the proposed criteria each year during the review period and sought the proposed roles (110-215 individuals per year) by the number of individuals who became owners, control persons, principals, or registered persons

FINRA also analyzed firms that employed individuals who would be directly impacted by this proposal. The analysis shows that in each year over the review period, there were between 74-155 firms employing individuals who would have met the proposed criteria. Approximately 41 percent of these firms were small, 12 percent were mid-size, and the remaining 47 percent were large.[96] FINRA estimates that approximately 31 percent of the individuals meeting the proposed criteria and who sought the proposed roles were employed by small firms, ten percent by mid-size firms and 59 percent by large firms.

D. <u>Alternatives Considered</u>

FINRA recognizes that the design and implementation of the rule proposals may impose direct and indirect costs on a variety of stakeholders, including member firms, associated persons, regulators, investors and the public. Accordingly, in developing its rule proposals, FINRA sought to identify alternative ways to enhance the efficiency and effectiveness of the proposals while maintaining their regulatory objectives. The following provides a discussion of the alternatives FINRA considered for the current proposals.

1. <u>Proposed Amendments to the FINRA Rule 9200 Series and FINRA Rule 9300 Series</u>

As an alternative to the proposal to authorize Hearing Officers to impose conditions or restrictions, FINRA considered whether to require sanctions imposed by the

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with a new member each year during the review period (122,003-131,156 individuals per year).

96 <u>See</u> <u>supra</u> note 70.

FINRA Hearing Panel or Hearing Officer in disciplinary decisions to be effective during the pendency of the NAC appeals and subsequent appeals. FINRA believes that such an approach could be too restrictive in disciplinary matters with significant sanctions and where the risk of harm may be specific to particular activities. Accordingly, FINRA believes that conditions and restrictions that are tailored specifically to the risk posed by the individuals during the pendency of the appeals, and are reasonably necessary for the purpose of preventing customer harm, would provide a better balance between protecting investors and preventing undue costs on individuals and firms while their appeals are pending.

2. Proposed Amendments to the FINRA Rule 9520 Series

This proposal would subject statutorily disqualified individuals employed with member firms to heightened supervision during the pendency of their SD Applications. Considering that the problem addressed by the proposed amendments to the FINRA Rule 9520 Series is very specific, FINRA did not consider any significant alternatives to this targeted proposal.

3. Proposed Amendments to FINRA Rule 8312

Considering that this proposal would likely not be associated with material economic impacts, FINRA did not consider any significant alternatives to this proposal.[97]

4. Proposed Amendments to the FINRA Rule 1000 Series

FINRA considered several alternatives to the numeric and categorical thresholds for identifying individuals who would be subject to the proposed amendments to the

[97] As discussed above, there were only four firms that became subject to the taping requirements of Rule 3170 during the review period.

MAP Rules. In determining the proposed threshold, FINRA focused significant attention on the economic trade-off between incorrect identification of individuals who may not subsequently pose risk of harm to their customers, and not including individuals who may subsequently pose risk of harm to customers. FINRA also considered three key factors: (1) the different types of reported disclosure events, (2) the counting criteria (i.e., the number of reported events), and (3) the time period over which the events are counted. FINRA considered several alternatives for each of these three factors.

a. Alternatives Associated with the Types of Disclosure Events

In determining the different types of disclosure events, FINRA considered all categories of disclosure events reported on the Uniform Registration Forms, including the financial disclosures and the termination disclosures. FINRA decided to exclude financial disclosures, which include personal bankruptcies, civil bonds, or judgments and liens. While these events may be of interest to investors in evaluating whether or not to engage a broker, these types of events are not by themselves direct evidence of customer harm. FINRA also considered whether termination disclosures should be included as specified risk events. Termination disclosures include job separations after allegations against the brokers.[98] Certain termination disclosures reflect conflicts of interest between the firm and the broker and, as a result, may not necessarily be indicative of misconduct. Further, the underlying allegations in the termination disclosures may be associated with other disclosure events, such as those associated with customer settlements or awards, regulatory actions or civil judicial actions, which are already included in the proposed

98 Termination disclosures involve situations where the individual voluntarily resigned, was discharged, or was permitted to resign after allegations.

criteria. Where so, the underlying conduct posing potential future customer harm would be captured in the proposed criteria. As a result, FINRA did not include termination disclosures as specified risk events. Accordingly, FINRA considered the remaining five categories of disclosure events listed in Exhibit 3a.

Within each disclosure category included in the proposed criteria, FINRA considered whether pending matters should be included or if the criteria should be restricted to final matters that have reached a resolution not in favor of the broker. Pending matters may be associated with an emerging pattern of customer harm and capture timely information of potential ongoing or recent misconduct. However, pending matters may also include disclosure events that remain unresolved or subsequently get dismissed because they lack merit or suitable evidence. FINRA excluded pending matters in the current proposal because the potential adverse impacts on the individuals who may be identified because of pending matters would likely outweigh the benefit of including pending matters.[99]

Exhibit 3a shows the five categories of disclosure events that were considered and the subcategories that were included in the proposed criteria. For criminal matters, FINRA considered whether criminal charges that do not result in a conviction or a plea of guilty or nolo contendere (no contest) should be included in the proposed criteria. These events correspond to criminal matters in which the associated charges were subsequently dismissed or withdrawn and, as a result, are not necessarily evidence of misconduct.

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[99] For example, individuals who may be identified on a fixed numeric threshold based upon pending matters could find it difficult to become owners, control persons, principals, or registered persons of a member firm while these matters are pending, even if such matters are subsequently dismissed. See also Exhibit 3c.

Accordingly, FINRA only included criminal convictions, including pleas of guilty or nolo contendere (no contest), in the proposed criteria.

For customer settlements and awards, FINRA considered whether settlements and awards in which the broker was not "named" should be considered as a specified risk event. These "subject of" customer settlements and awards correspond to events where the customer initiates a claim against the firm and does not specifically name the broker, but the firm identifies the broker as required by the Uniform Registration Forms.[100] In these cases, the broker is not party to the proceedings or settlement. There may be conflicts of interest between the firm and the broker such that the claim may be attributed to the broker without the ability of that broker to directly participate in the resolution. Accordingly, FINRA excluded "subject of" customer settlements and awards from the proposed criteria. FINRA recognizes that excluding these events may also undercount instances where the broker may have been responsible for the alleged customer harm.

For civil judicial actions and regulatory actions, FINRA considered whether all sanctions associated with final matters should be included in the proposed criteria or whether certain less severe sanctions should be excluded. Final regulatory action or civil judicial action disclosures may be associated with a wide variety of activities, ranging from material customer harm to more technical rule violations, such as a failure to make

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[100] For example, the Instructions to Form U4 provide that the answer to Questions 14I(4) or 14I(5) should be "yes" if the broker was not named as a respondent/defendant but (1) the Statement of Claim or Complaint specifically mentions the individual by name and alleges the broker was involved in one or more sales practice violations or (2) the Statement of Claim or Complaint does not mention the broker by name, but the firm has made a good faith determination that the sales practice violation(s) alleged involves one or more particular brokers.

timely filings or other events not directly related to customer harm. However, due to the way in which such information is currently reported, it is not straightforward to distinguish regulatory or civil judicial actions associated with customer harm from other such actions.[101] In the absence of a reliable way to identify regulatory and civil judicial actions associated with customer harm, FINRA considered using a proxy of severity of the underlying sanctions as a way to exclude events that are likely not associated with material customer harm. Therefore, FINRA is proposing to include regulatory actions or civil judicial actions that are associated with more severe sanctions, such as bars, suspensions or monetary sanctions above a de minimis dollar threshold of $15,000. FINRA notes that relying strictly on a proxy for severity would likely exclude certain regulatory actions or civil judicial actions that are associated with customer harm, and may include certain regulatory actions or civil judicial actions that are not associated with customer harm.

FINRA also considered several alternative de minimis dollar thresholds for disclosure events included in the proposed criteria. For example, FINRA considered higher dollar thresholds of $25,000, $50,000 and $100,000 for customer settlements, customer awards, and monetary sanctions associated with regulatory actions and civil judicial actions. A dollar threshold may capture a dimension of severity of the alleged customer harm. The Uniform Registration Forms establish a de minimis dollar reporting threshold of $10,000 for complaints filed prior to 2009 and $15,000 afterwards. The

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[101] For example, the Uniform Registration Forms contain information in disclosure reporting pages that could be useful in identifying regulatory actions or civil judicial actions associated with customer harm, but it is stored as "free-text" and, therefore, cannot be reliably compared across disclosures.

reporting threshold may, however, be low and possibly include instances where the payment was made to end the complaint and minimize litigation costs. However, the dollar threshold does not account for the value of the customers' accounts, and there are likely cases where even low dollar amounts represent remuneration of a significant portion of customer investments. Accordingly, a dollar threshold may be both under-inclusive and over-inclusive, and as a result FINRA considered a range of alternative thresholds. Increasing the dollar threshold from $15,000 to $25,000, $50,000 and $100,000 would decrease the number of individuals impacted by this proposal from 110-215 individuals each year over the review period (as explained above) to 108-207 individuals, 103-197 individuals and 97-180 individuals each year, respectively. Finally, FINRA notes that establishing a de minimis dollar threshold that is different than the current reporting requirements could increase confusion among investors and registered persons and would likely create additional incentives for brokers and firms to keep future settlements below the dollar level that would trigger the restrictions, to the detriment of customers.

b. Alternatives Associated with the Counting Criteria

FINRA considered a range of alternative criteria for counting criminal matters or specified risk events. For example, FINRA considered whether the counting criteria for final criminal matters should be two or more final criminal matters or one final criminal matter and another specified risk event. This alternative would effectively count final criminal matters the same way as other specified risk events. FINRA believes that final criminal matters are generally more directly tied to serious misconduct than some of the other specified risk events. Accordingly, FINRA believes that one final criminal matter, as defined by this proposal, should be sufficient to trigger the proposed criteria.[102]

FINRA also considered alternative criteria for counting specified risk events. For example, FINRA considered decreasing the proposed threshold from two specified risk events to one. This alternative would change the proposed criteria to one or more final criminal matters or one (instead of two) or more specified risk events during the prior five-year period. This approach would increase the number of individuals impacted by this proposal from 110-215 individuals to 341-675 individuals each year, over the review period. FINRA also considered increasing the proposed threshold from two specified risk events to three, thereby changing the proposed criteria to one or more final criminal matter or three (instead of two) or more specified risk events during the prior five-year period. This approach would decrease the number of individuals impacted by this proposal from 110-215 individuals to 86-161 individuals each year, over the review period. For the reasons explained above, FINRA considered alternative criteria for counting specified risk events, but chose the specification in the current proposal.

c. Alternatives Associated with the Time Period over which the Disclosure Events Are Counted

FINRA also considered alternative criteria for the time period over which final criminal matters and specified risk events are counted. For example, FINRA considered whether final criminal matters or specified risk events should be counted over the individual's entire reporting period or counted only over a more recent period. Based on

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102 FINRA recognizes that final criminal matters include felony convictions that may not be investment related (e.g., a conviction associated with multiple DUIs).

its experience, FINRA believes that events that are more than ten years old do not necessarily pose the same level of possible future risk to customers as more recent events. Further, counting final criminal matters or specified risk events over an individual's entire reporting period would imply that individuals with such events would be subject to the criteria for their entire career, even if they subsequently worked without being associated with any future events. Accordingly, FINRA decided to include final criminal matters or specified risk events occurring only in a more recent period.

FINRA also considered a threshold based on a five-year lookback period for final criminal matters, but a five-to-ten year lookback period for specified risk events. Specifically, FINRA considered a threshold that would be met if the individual had one specified risk event having resolved during the previous ten years, and a second specified risk event resolved during the previous five years, or if the individual had one or more final criminal matters resolved in the prior five-year period. This approach would increase the number of individuals impacted by this proposal from 110-215 individuals to 127-236 individuals each year, over the review period. For the reasons explained above, FINRA considered alternative criteria for the lookback period for specified risk events, but chose the specification in the current proposal.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 18-16 (April 2018). Thirteen comments were received in response to the Regulatory Notice.[103] A copy of the Regulatory Notice is attached as Exhibit 2a. A list of commenters is

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103 All references to commenters are to the comment letters as listed in Exhibit 2b.

attached as Exhibit 2b. Copies of the comment letters received in response to the Regulatory Notice are attached as Exhibit 2c. Of the 13 comment letters received, eight were generally in favor of the proposed rule change, two were generally opposed, and one stated that the proposal was an improvement over the status quo but that significantly more action would be needed to protect investors.

FINRA has considered the comments received. In light of some of those comments, FINRA has made some modifications to the proposal. The comments and FINRA's responses are set forth in detail below.

General Support for and Opposition to the Proposal

Five commenters expressed general support for the proposed rule changes in Regulatory Notice 18-16, but all had suggestions on how aspects of the proposal should be modified.[104] Two commenters expressed support for the proposed amendments, subject to certain modifications.[105] One commenter expressed general support for the proposed amendments except the proposed amendments to the Rule 1000 Series.[106] Two commenters suggested different approaches that FINRA could take.[107] One commenter expressed opposition to specific aspects of the proposal.[108] One commenter opined that

[104] MML, NASAA, PIABA, SIFMA, Wulff Hansen.

[105] Cambridge, FSI.

[106] Janney.

[107] Better Markets, IBN.

[108] Luxor.

the proposal has numerous deficiencies and offered remedies.[109] All of these commenters' suggestions are discussed in more detail below.

Proposed Amendments to the FINRA Rules 9200 and 9300 Series to Enhance Investor Protection During the Pendency of an Appeal or Call-for-Review Proceeding

- Conditions or Restrictions

The proposed amendments to the Rule 9200 and 9300 Series would allow a Hearing Officer to impose conditions or restrictions on the activities of a respondent during the pendency of an appeal to the NAC from, or call for NAC review of, a disciplinary decision.

Some commenters expressed support for these specific proposals. FSI commented that permitting Hearing Officers to impose conditions and restrictions strikes the appropriate balance between the member's rights and investor protection concerns. NASAA supported imposing temporary remedies on parties that lose at the hearing level, writing that it would align FINRA's procedures with federal and state law. PIABA wrote that a disciplinary respondent should not be permitted to conduct business as usual during a disciplinary appeal.

Several commenters requested that a disciplined respondent and firms that associate with a disciplined respondent have an opportunity to propose to the Hearing Officers the conditions and restrictions that should be imposed.[110] Cambridge stated that this opportunity would help ensure that conditions and restrictions are not overly broad

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[109] Network 1.

[110] Cambridge, FSI, SIFMA.

and account for a firm's size, resources and ability to supervise, and that it would alleviate concerns about potential lost income, lost opportunities and lost clients that could result from the conditions or restrictions. SIFMA wrote that this opportunity would help ensure that any conditions and restrictions imposed are reasonably necessary for the nature and scale of the misconduct at issue and tailored to a firm's business model, and that it would reduce the number of motions to modify or remove conditions or restrictions.

While FINRA appreciates the comments, FINRA notes that the proposal allows an individual respondent to make arguments concerning the potential conditions and restrictions to the Hearing Officer. In this regard, nothing in the proposed rule change prevents a respondent in a disciplinary proceeding from proposing, in opposition or response to a motion for conditions or restrictions, the conditions and restrictions that could or should be imposed. Likewise, nothing prevents an individual respondent, during the underlying disciplinary proceeding itself, from introducing relevant evidence. Moreover, FINRA rules only give named parties the right to participate in a FINRA disciplinary proceeding, and the complaint issued against an individual respondent will not always name that person's employing firm as a respondent. However, in light of these comments, FINRA is proposing to modify the proposed rule as set forth in Regulatory Notice 18-16 to clarify that a respondent's opposition or other response to a motion for conditions or restrictions must explain why no conditions or restrictions should be imposed or specify alternate conditions or restrictions that are sought to be imposed and explain why the conditions or restrictions are reasonably necessary for the purpose of preventing customer harm.

Cambridge stated that the proposal does not address the recourse available for damages that could result from any conditions or restrictions imposed, in the event the underlying disciplinary decision is reversed on appeal. FINRA believes the proposal mitigates such risks. The standard for imposing conditions or restrictions—those that the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm—and the ability to request an expedited proceeding before the Review Subcommittee for prompt review of any conditions or restrictions imposed would act to ensure the conditions and restrictions imposed are reasonably tailored to address the potential concerns. The Hearing Officer that imposes conditions or restrictions in the first instance would be knowledgeable about the case and, therefore, well-suited to craft restrictions or conditions that are tailored to addressing the potential customer harm. And if a respondent believes that the conditions or restrictions imposed are too burdensome, the respondent would be permitted to request an expedited review and stay the conditions or restrictions.

Better Markets suggested that Hearing Officers should be required, not just permitted, to impose conditions or restrictions that are necessary to protect investors pending an appeal to the NAC. FINRA believes, however, that it is more appropriate to give Hearing Officers discretion. There may be situations when conditions or restrictions may be deemed not necessary, such as when a respondent firm or a respondent individual's employing firm has already undertaken substantial subsequent remedial measures or when the violations at issue do not involve the risk of customer harm.

FSI and Luxor opposed the standard in proposed FINRA Rule 9285(a) that the Hearing Officer may impose conditions or restrictions that it considers "reasonably necessary for the purpose of preventing customer harm." FSI opined that that standard could lead to conditions or restrictions that are unduly burdensome or unrelated to the misconduct, and it suggested that the standard also require that the conditions and restrictions be "reasonably designed to prevent further violations of the rule or rules the Hearing Panel or Hearing Officer [in the underlying disciplinary proceeding] has found to have been violated." FSI further suggested that, when imposing conditions or restrictions, Hearing Officers be required to consider the firm's size, resources and overall ability to supervise the registered representative's compliance with the conditions or restrictions. Luxor wrote that the proposed standard would have a chilling effect on a respondent's right to appeal because, depending on the conditions and restrictions imposed, the respondent may be unable to afford legal representation or may suffer irreversible damage to a book of business.

FINRA's proposed standard, however, is consistent with the rules of other self-regulatory organizations.[111] Moreover, FINRA believes that the proposed standard—

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[111] See BOX Rule 12110 ("Pending effectiveness of a decision imposing a sanction on the Respondent, the person, committee or panel issuing the decision (the 'adjudicator') may impose such conditions and restrictions on the activities of the Respondent as it considers reasonably necessary for the protection of investors and the Exchange."); CBOE Rule 13.11(b) ("Pending effectiveness of a decision imposing a sanction on the Respondent, the Hearing Panel or the CRO, as applicable, may impose such conditions and restrictions on the activities of the Respondent as the Hearing Panel or the CRO, as applicable, considers reasonably necessary for the protection of investors and the Exchange"); CBOE BZX Rule 8.11 ("Pending effectiveness of a decision imposing a penalty on the Respondent, the CRO, Hearing Panel or committee of the Board, as applicable, may impose such conditions and restrictions on the activities of the Respondent as he, she or it considers reasonably necessary for the protection of investors, creditors and the Exchange."); MIAX Options Rule 1011(b) ("Pending effectiveness of a decision imposing a sanction on the Respondent, the person, committee or panel issuing the decision (the 'adjudicator') may impose such conditions and restrictions on

both its use of the term “reasonably necessary” and its emphasis on “for the purpose of preventing customer harm”—provides sufficient and appropriate limiting parameters. FINRA also believes that requiring that conditions or restrictions be reasonably designed to prevent further violations of the rule or rules found to have been violated in the underlying disciplinary decision, as FSI suggests, may not allow the Hearing Officer to adequately address the investor protection concerns that have been raised by the activities of the respondent. As FINRA explained above (and in Regulatory Notice 18-16), the conditions and restrictions imposed should target the misconduct demonstrated in the disciplinary proceeding and be tailored to the specific risks posed by the member firm or broker. With regard to FSI’s suggestions to amend the standard to require consideration of numerous additional factors, FINRA believes that, for investor protection purposes, the primary driver of the conditions or restrictions should be what is reasonably necessary to prevent customer harm, not the size of the respondent’s employing firm or its claims about its resources. FINRA believes that the proposed standard—coupled with the parties’ ability to participate in the process, the knowledge of the Hearing Officers, and the availability of an expedited review—are appropriate to yield conditions or restrictions that are targeted at the specific, identifiable risks presented to customers and that are not overly burdensome. FINRA further proposes, that in light of this and other comments, to clarify the process for imposing conditions and restrictions during the pendency of an appeal. Specifically, FINRA is proposing to modify the proposed rule as set forth in Regulatory Notice 18-16 to clarify when and how parties can seek to impose reasonably

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the activities of the Respondent as it considers reasonably necessary for the protection of investors and the Exchange.”).

necessary conditions and restrictions following a disciplinary decision by a Hearing Panel or Hearing Officer, the process for a respondent to request an appeal through an expedited proceeding of such conditions and restrictions, and to further clarify that such conditions and restrictions would be stayed during such expedited proceeding.

Several commenters requested that a different burden be applied in proposed Rule 9285(b)(2) for seeking the modification or removal of conditions or restrictions.[112] PIABA suggested that, to modify or remove conditions or restrictions, the respondent should be required to provide clear and convincing evidence of a manifest error by the trier of fact and show the likelihood of success of the underlying appeal. Cambridge and FSI suggested that the respondent should have to show that the Hearing Officer committed an error, that the conditions or restrictions are overly broad, or that they are not narrowly tailored to prevent future occurrences of the underlying violations.

FINRA declines these comments. As explained above, the burden in proposed Rule 9285(b)(2) is that the respondent would have to demonstrate that the conditions or restrictions imposed are not reasonably necessary for the purpose of preventing customer harm. This burden is consistent with the standard set forth in proposed Rule 9285(a) for establishing conditions and restrictions in the first place. Furthermore, FINRA believes that, for fairness reasons, a respondent’s ability to seek the modification or removal of conditions or restrictions should not be constrained by the underlying merits of the respondent’s disciplinary appeal. Because there would be a separate, specific standard for the imposition of conditions or restrictions—i.e., those that the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm—any

[112] Cambridge, FSI, PIABA.

conditions or restrictions imposed could be erroneous for a reason that is entirely unrelated to whether a respondent's underlying appeal has a likelihood of success. Likewise, FINRA does not support establishing a burden of proof that would be more difficult to meet, such as a "clear and convincing evidence of a manifest error by the trier of fact" standard. Thus, FINRA has retained that aspect of the standard proposed in Regulatory Notice 18-16 that would require a respondent to demonstrate, when moving to modify or remove conditions or restrictions, that the conditions or restrictions imposed are not reasonably necessary for the purpose of preventing customer harm.

PIABA and Better Markets wrote about the provisions in proposed Rule 9285(b) that would allow a respondent to seek expedited review of an order imposing conditions or restrictions. PIABA supported the proposed expedited review process. Better Markets, on the other hand, wrote that expedited reviews would add burdens to the NAC and cause delays in processing underlying disciplinary appeals. FINRA has retained the proposed expedited review process. FINRA has added the expedited review process to make the overall process more fair for the respondents involved. It also will further investor protection: because the filing of a motion to modify or remove conditions or restrictions would stay the effectiveness of the conditions or restrictions, an expedited review would allow properly imposed conditions and restrictions to become effective sooner. Moreover, because proposed Rule 9285(b) would assign the NAC's Review Subcommittee—and not the NAC itself—to decide motions to modify or remove conditions or restrictions and establish a 30-day deadline for doing so, FINRA expects that the expedited review process will not result in materially longer times for the NAC to process underlying disciplinary appeals.

Several commenters disagreed with how, pursuant to proposed Rule 9285(b), a motion to modify or remove conditions or restrictions would effect a stay of the conditions or restrictions. Better Markets and NASAA suggested that, for investor protection reasons, there should be no stays. NASAA further commented that permitting stays would be inconsistent with how proposed Rule 9285(b) would require firms to establish heightened supervision over individuals who appeal disciplinary decisions. Luxor, on the other hand, essentially sought to expand stays, writing that no conditions and restrictions should be imposed during a disciplinary appeal except upon a showing by FINRA of clear and convincing evidence of imminent harm to the public.

In light of the conflicting comments and FINRA's belief that the stay provision strikes the right balance, FINRA is proposing to retain the proposed stay provision. It appropriately balances the investor-protection benefits of imposing reasonably necessary conditions and restrictions with the Exchange Act requirement that FINRA provide a fair procedure in disciplinary proceedings. A stay of appropriately issued conditions or restrictions would be in place only during the relatively short duration of an expedited proceeding. Moreover, FINRA does not agree that having a temporary stay of conditions or restrictions during the expedited proceeding process and requiring firms to establish heightened supervision plans during the pendency of appeals are inconsistent. Proposed Rule 9285(e) would require a disciplined respondent's member firm to establish a reasonably designed heightened supervision plan regardless of whether a Hearing Officer imposes conditions and restrictions.[113] Thus, there is no reason for a respondent's firm to

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[113] See also Regulatory Notice 18-15 (April 2018) (Guidance on Implementing Effective Heightened Supervisory Procedures for Associated Persons with a History of Past Misconduct).

delay adopting a heightened supervision plan while any conditions or restrictions are stayed pending an expedited review. Moreover, proposed Rule 9285(e) contemplates that a respondent's firm would need to create an amended plan of heightened supervision that takes into account any conditions or restrictions imposed after the initial plan is adopted.

PIABA wrote that the proposal should require that an individual respondent's employing firm be notified immediately of any conditions or restrictions imposed. FINRA generally agrees with this comment and, as explained above, has modified the proposal to require that the Office of Hearing Officers or the Office of General Counsel, as appropriate, provide a copy of the order imposing conditions and restrictions to each FINRA member with which the respondent is associated. This would be similar to how FINRA rules currently require that copies of disciplinary decisions be provided to each FINRA member with which a respondent is associated.[114]

- <u>Heightened Supervision of Disciplined Respondents</u>

FINRA also received comments concerning the proposed amendments to require, in the event of an appeal or call for review, that an individual respondent's member firm adopt heightened supervisory procedures for that individual respondent.

Better Markets and PIABA expressed support for requiring firms to adopt written plans of heightened supervision while a disciplinary appeal is pending.

FSI and SIFMA stated that requiring firms to adopt written plans of heightened supervision within ten days of any appeal or call for review is an insufficiently short amount of time, and that firms should have 30 days. FINRA believes, however, that the ten-day period is appropriate under the circumstances. The longer the time period

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[114] <u>See</u> Rule 9268(d).

without a plan of heightened supervision in place, the greater the risk to investors. Retaining the shorter, ten-day deadline will allow the investor-protection benefits of the heightened supervision plans to be in place sooner. FINRA also believes that the ten-day period is sufficient because a firm should be aware of the potential need to adopt a heightened supervision plan well in advance of when it would be required to do so. In this regard, Form U4 requires that registered persons report when they are the subject of a regulatory complaint that could result in an affirmative answer to other Form U4 disclosure questions that ask about self-regulatory organization findings and disciplinary actions, and FINRA rules require that the Office of Hearing Officers promptly provide a copy of a disciplinary decision to each member with which a respondent is associated. Furthermore, the ten-day deadline for adopting a heightened supervision plan would begin only when the respondent appeals the decision to the NAC or when the matter is called for review. FINRA Rules 9311 and 9312 provide 25 days to file an appeal and 25 to 45 days to call a case for review.

PIABA suggested that a firm required to adopt a plan of heightened supervision pursuant to proposed Rule 9285 also should be required to document its enforcement of that plan. FINRA has previously indicated that documenting the enforcement of a heightened supervision plan could be a useful element of such a plan.[115] Instead of singling out additional provisions like these in the rule text, however, FINRA believes that its published notices provide a thorough source of guidance on heightened

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115 See Notice to Members 97-19 (April 1997) (advising that firms could require supervisors of registered representatives subject to special supervisory arrangements to provide a sign-off on daily activity or to periodically attest in writing that they have carried out the terms of the special supervision).

supervision plans, including what provisions should be included at a minimum, and what other provisions can be part of an effective plan.[116] As needed or appropriate, FINRA would be able to update its published guidance to account for the heightened supervision plans required by the proposed rule change.

Luxor suggested that heightened supervision plans would not be necessary where a Hearing Officer imposes conditions or restrictions. FINRA believes that even when conditions and restrictions are imposed, the respondent's member firm would still need to address, in a heightened supervision plan, how it would implement and execute those conditions and restrictions. Furthermore, heightened supervision plans would be needed to address activities that are not subject to any imposed conditions or restrictions.

Proposed Amendments to the FINRA Rule 9520 Series to Require Automatic Interim Plans of Heightened Supervision of a Disqualified Person During the Period When FINRA is Reviewing an Eligibility Application

Several commenters specifically approved of the proposed amendments to Rule 9522, which would require a member firm to adopt interim heightened supervisory procedures for a disqualified person during the pendency of the firm's SD Application to continue associating with that disqualified person. NASAA commented that this regulatory gap should be closed. PIABA commented that there is an obvious benefit to the proposal.

Better Markets suggested that firms should be required to adopt a plan of heightened supervision immediately when an associated person is found to have

116 See Notice to Members 97-17 (April 1997); Regulatory Notice 18-15 (April 2018).

committed acts that are grounds for becoming disqualified, even pending the associated person's appeal of the underlying disqualifying event. While FINRA agrees that there may be benefits to requiring firms to place a disqualified associated person on a heightened supervision plan immediately and before the filing of an application to continue associating with that person, FINRA believes the timing requirement of the proposed rule—to require such a plan once a firm has made a determination to seek approval for continued association with the disqualified associated person—strikes the appropriate balance.

Network 1 wrote that requiring firms to expend resources on developing heightened supervision plans for disqualified persons while an SD Application is pending is a disincentive to hiring the person at all. While FINRA recognizes that the requirement to develop and implement an interim heightened supervision plan in these circumstances may deter some firms from retaining or hiring a disqualified person, FINRA believes that if a firm elects to sponsor a disqualified person it needs to provide greater oversight of the activities of such person during the pendency of the SD Application, thereby reducing the potential risk of customer harm during this period. Moreover, if the SD Application is approved by FINRA, the firm would in almost all cases be required to prepare a plan of heightened supervision.

Aderant noted that although proposed Rule 9522(g) sets a ten-day deadline to remedy a substantially incomplete application that seeks the continued associated of a disqualified person, the version proposed in Regulatory Notice 18-16 did not identify the specific event that triggers the ten-day deadline. FINRA agrees that a modification is appropriate and has revised proposed Rule 9522(g) to establish that the event triggering the ten-day deadline is service of the notice of delinquency.

Proposed Amendments to FINRA Rule 8312

The proposed amendments to FINRA Rule 8312 would remove the requirement that the only means through which persons can request information as to whether a particular member is subject to the provisions of the Taping Rule is a telephonic inquiry via the BrokerCheck toll-free telephone listing. The proposed amended rule would permit FINRA to release this information through BrokerCheck regardless of how it is requested.

NASAA agreed with this proposal, stating that it would advance investor protection.

Other commenters opposed it. Luxor wrote that the proposal is punitive, will disproportionately cause reputational damage to small firms, and will create a perception that a taping firm and its representatives are to be viewed negatively simply by association with behavior that occurred at other firms and other persons. Network 1 commented that there is little likelihood the public will understand the difference between a taping firm and a disciplined firm. FINRA notes that Rule 8312 already provides, however, that FINRA will release whether a particular member firm is subject to the Taping Rule in response to telephonic inquiries via the BrokerCheck toll-free telephone listing. The proposed amendments—which will only remove the telephonic inquiry limitation—will simply make it easier for investors to obtain this same information by expanding the means through which investors can access it. Moreover, the comment that the proposed amendments would have a disproportionate effect on small firms has no basis; there is currently only one firm subject to the Taping Rule.

Several comments raised concerns regarding the content of the proposed BrokerCheck disclosure relating to taping firms. Better Markets and PIABA requested that the disclosure be explained in BrokerCheck and include a specific narrative description of why the disclosure is being made. NASAA suggested that the proposed BrokerCheck disclosure appear only on the BrokerCheck reports of the few firms that are subject to the Taping Rule. NASAA further commented that the disclosure should identify the firm as subject to the Taping Rule and explain in plain English what that means. Network 1 and Better Markets raised concerns as to how the proposed amendments would impact the information disclosed through BrokerCheck concerning individuals. Network 1 requested that FINRA amend the proposal to ensure that the information disclosed on BrokerCheck not communicate any “guilt by association” for persons who are employees of taping firms and who have “clean records.” Better Markets, on the other hand, suggested that the BrokerCheck profiles of individual brokers should denote when they are associated with taping firms.

FINRA appreciates the concerns expressed and agrees that the BrokerCheck disclosure of a firm as being subject to the Taping Rule should include a clear explanation of what that means, to help investors understand why the taping firm is subject to heightened procedures and incent them to research the background of a broker associated with the taping firm.

Proposed Amendments to the FINRA Rule 1000 Series to Impose Additional Obligations on Member Firms that Associate with Persons with a Significant History of Past Misconduct

➢ General Comments

The proposed amendments to the FINRA Rule 1010 Series would require a member firm to submit a letter to Member Regulation seeking a materiality consultation when a natural person that has, in the prior five years, one or more "final criminal matters" or two or more "specified risk events" seeks to become an owner, control person, principal or registered person.

Several commenters expressed general support for the proposed amendments to the Rule 1000 Series.[117] Better Markets characterized requiring materiality consultations before hiring as an important regulatory innovation. NASAA described the proposal as a reasonable means of getting Member Regulation more involved in members' decisions to associate with individuals who have significant disciplinary histories. PIABA wrote that the proposed amendments would promote investor protection, adequately apply stronger standards for continuing membership, and remind firms of the need to keep new representatives with significant disciplinary histories under a well-defined, well-enforced supervisory plan.

Janney and SIFMA commented that the proposed rule requiring materiality consultations is contrary to the spirit of FINRA's current guidance about materiality consultations, which they assert focuses on changes to a firm's business model and not the activity or employability of individuals. FINRA disagrees with this assertion and

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[117] Better Markets, Cambridge, NASAA, PIABA.

believes the proposed rule is consistent with FINRA rules governing the membership application process, which considers, among other things, firms' hiring decisions and individuals' past activities. For example, the safe harbor in IM-1011-1 is premised on the notion that hiring a certain number of associated persons involved in sales can be a material change in business operations that requires the filing of a CMA, and the safe harbor is not available to a member firm or a principal of a firm that has a specified disciplinary history. Likewise, FINRA rules require Member Regulation to consider, in new membership applications and CMAs, a variety of criminal, civil, regulatory, and arbitration events when assessing whether an applicant and its associated persons are capable of complying with federal securities laws, the rules and regulations thereunder, and FINRA rules.[118]

Several commenters expressed concern about the possible negative impact of the proposed rule on a firm's hiring practices and the ability of individuals with such events to be hired. Luxor commented that the proposed rule changes are unnecessary, because FINRA can contact a firm when it has hired "high-risk brokers." Luxor also commented that if a person has a license to operate and has not been barred or otherwise precluded from operating, no additional consultation should be required when a firm wishes to hire that person. Janney stated that the investing public and the markets would be better protected by FINRA taking contemporaneous action, instead of disrupting the hiring practices of an unrelated firm as many as five years after the underlying disclosure events in proposed Rule 1017(a)(7) and IM-1011-3 have occurred. Janney also expressed the view that it appears that FINRA would like to review transitions specifically in the

[118] See Rule 1014(a)(3).

context of an affiliation change, and the proposed rule would create the ability to prevent transition of a registered representative without taking enforcement action.

FINRA believes the proposed rule is necessary to ensure that FINRA has a more meaningful regulatory touchpoint at the time an individual with a significant history of misconduct seeks to become an owner, control person, principal or registered person of a member firm. The proposal would apply in the limited circumstance where such individual meets the required thresholds for disclosure events. FINRA believes requiring firms to ask FINRA for a materiality consultation, for example, when it is planning to hire a particular individual that meets the required thresholds, would allow FINRA the opportunity to meaningfully assess the underlying disciplinary events and review the firm's supervisory practices and internal controls. The ability of FINRA to conduct this review contemporaneously furthers investor protection. Moreover, nothing in the proposed rule precludes FINRA from taking enforcement action when necessary or appropriate.

- Definitions and Criteria that Would Require a Materiality Consultation

FINRA received numerous comments concerning the definitions in proposed Rule 1011 of "final criminal matter" and "specified risk event" and the criteria in proposed Rule 1017(a)(7) that would trigger the need to request a materiality consultation. Some commenters expressly supported the proposed definitions and criteria.[119] FSI wrote that the numeric parameters and proposed criteria are sound and reasonable, and it supported how the "specified risk events" are final and investment- or regulatory-related. NASAA wrote that the proposed definition of "final criminal matter" appropriately captures the

[119] FSI, NASAA, PIABA.

scope of disclosable criminal events on the Uniform Registration Forms. PIABA wrote that the criteria and definitions are appropriate and clear enough to avoid confusion, and that the minor compliance costs will be far outweighed by the increased investor protections.

Other commenters suggested alternatives to the proposed definitions and criteria. For example:

- Some commenters proposed that the definition of "final criminal matter" include only investment- or fraud-related criminal matters[120] or matters that would generate a risk of customer harm.[121]

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120 Luxor, Wulff Hansen.

121 MML. This commenter also requested guidance concerning whether "final criminal matter" would include situations where a person receives a deferred sentence and can clear a conviction through compliance with a court-ordered program. Per the proposed definition, whether a "final criminal matter" would count for purposes of proposed Rule 1017(a)(7) and IM-1011-3 would depend on whether the matter "is disclosed, or was required to be disclosed, on the applicable Uniform Registration Forms." The setting aside of a conviction does not necessarily mean that it need not be reported on, or that the matter should be expunged from, the Uniform Registration Forms. See, e.g., Form U4 and U5 Interpretive Questions and Answers, http://www.finra.org/sites/default/files/Interpretive-Guidance-final-03.05.15.pdf (Questions 14A and 14B, Interpretive Question and Answer 2, stating that "[e]ach order setting aside a conviction will be reviewed by RAD staff to determine if the conviction must be reported").

- Several commenters proposed that the definition of "specified risk event" use a dollar threshold that is either higher[122] or lower[123] than $15,000.
- Some commenters proposed that the final awards and settlements that are counted as "specified risk events" be broadened[124] or narrowed.[125]
- Several commenters proposed changes to how "specified risk events" would be counted.[126]
- Some commenters suggested that lookback periods for events that would trigger a materiality consultation be either shortened[127] or increased.[128]
- Luxor wrote that additional factors should be included in the criteria for whether a materiality consultation is required, including the length of time the individual has been in the industry, the number of events during that period, and the circumstances of those events.

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122 Cambridge, IBN, Janney, MML. Cambridge asserted that some unfair high-risk characterizations resulting from a $15,000 threshold would involve control persons, principals and registered persons who are required to disclose events due to a managerial role but are "likely not directly involved in" the underlying violations in those disclosed events. FINRA notes that the proposed definition of "specified risk event" does not include final awards or settlements where the person was not named but is only the "subject of."

123 Better Markets.

124 NASAA.

125 Luxor, Network 1.

126 Luxor, MML, Wulff Hansen.

127 Luxor.

128 NASAA.

- Several commenters suggested narrowing the kinds of business expansions that would require materiality consultations.[129]

After considering all the commenters' suggested alternative definitions and criteria, FINRA has decided to retain the definitions of "final criminal matter" and "specified risk events" and the criteria that would trigger a materiality consultation that it proposed in Regulatory Notice 18-16. Many of the comments concern issues that FINRA already considered and addressed in the economic assessment in Regulatory Notice 18-16, and the comments have not persuaded FINRA that any changes to the definitions or criteria would be more efficient or effective at addressing the potential for future customer harm presented. As FINRA explained in Regulatory Notice 18-16, the primary benefit of the proposed rule change would be to reduce the potential risk of future customer harm by individuals who meet the proposed criteria and seek to become an owner, control person, principal or registered person of a member firm. The proposed rule change would further promote investor protection by applying stronger standards for changes to a current member firm's ownership, control or business operations, including the potential that such changes would require the filing and approval of a CMA. In developing this proposal, one of the guiding principles was to provide transparency regarding the proposal's application, so that firms could largely identify with available data the specific set of disclosure events that would count towards the proposed criteria and whether a proposed business change would trigger the need for a materiality consultation. This is why FINRA's proposal is based mostly on events disclosed on the Uniform Registration Forms, which are generally available to firms and FINRA.

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[129] Janney, Luxor, MML, SIFMA, Wulff Hansen.

While FINRA generally agrees with the comments that the proposed materiality consultation process should account for situations where numerous "specified risk events" are related,[130] it does not believe that modifying the rule-based criteria is the best way to do so. Rather, FINRA believes the materiality consultation process should allow it to assess an individual's particular events. Moreover, based on experience gained through the materiality consultations, FINRA may be able to develop guidance for the Department concerning situations involving the "specified risk events" that could affect whether a proposed business expansion is or is not material.

Wulff Hansen suggested that a materiality consultation should be required when a person having two or more "specified risk events" is already associated with a member and seeks to become an owner or control person. FINRA notes that the proposed rule already would require materiality consultations for internal moves. As explained above, however, the proposed rule would not apply when a person who meets the proposed criteria in proposed Rule 1017(a)(7) is already a principal at a member firm and seeks to add an additional principal registration at that same firm. In that instance, the proposed rule amendments would not require a materiality consultation.

- Materiality Consultation Procedures

FSI and Janney requested that FINRA develop additional procedures for the materiality consultation process. For example, these commenters wrote that FINRA should establish time frames for FINRA staff to issue a decision in a materiality consultation, with one commenter explaining that time deadlines would allow firms to minimize litigation risks when making hiring decisions. FSI asked that FINRA consider

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130 MML, Wulff Hansen.

establishing rule-based remedies for firms that disagree with FINRA staff's materiality consultation decisions, and a rule-based requirement that FINRA explain in writing a decision that requires a firm to file a CMA.[131] MML suggested that the proposed rule should outline the issues that would be central to the Department's materiality determination and clarify the proposed requirement that a member submit a written letter to the Department in a "manner prescribed by FINRA."

In general, FINRA believes that additional rule-based procedures for the materiality consultation process would undermine its informality, flexibility and expedited nature. By analogy, FINRA's existing materiality consultation process has no written-decision requirement and no appeal process. Nevertheless, FINRA believes it would be helpful to provide guidance about the materiality consultation process that would be required by the proposed rule, to supplement the already published guidance about FINRA's existing materiality consultation process.[132] For that reason, FINRA has explained in detail—both in Regulatory Notice 18-16 and above—the kinds of

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131 FSI also wrote that additional procedures would be appropriate because the materiality consultations would be a rule-based requirement, not voluntary.

132 See The Materiality Consultation Process for CMAs, https://www.finra.org/rules-guidance/guidance/materiality-consultation-process. FINRA's existing guidance provides that a materiality consultation submission should include, but is not limited to, the following: (i) a description of the proposed change in business sufficient for staff to understand the scope of the business and how it will be conducted; (ii) why the firm believes that the proposed new business or product is similar in scope or nature to their existing business; (iii) the anticipated impact the change will have to the firm's supervisory structure; (iv) any impact the proposed change will have to the firm's capital or liquidity; (v) the nature and scope of updates required to written supervisory procedures, systems and firm operations; (vi) any recent disciplinary matters that relate to the proposed activities as well as how the firm's overall regulatory history may impact the ability of the firm to effectively conduct the activity; and (vii) any relevant documentation to support the proposal.

information that the firm should provide when seeking a materiality consultation required by proposed Rule 1017(a)(7) and what information would be relevant to the Department's materiality decision. FINRA also will provide more guidance as necessary as to what firms should provide when seeking the materiality consultation required by the proposed rule amendments.

Miscellaneous Comments

SIFMA requested that FINRA provide a notification to firms of registered persons who have "specified risk events," similar to how FINRA provides information gathered in its public records searches for information relating to bankruptcies, judgments and liens, asserting that individuals may not identify and disclose "specified risk events" to firms in a timely manner. FINRA appreciates this suggestion, but notes that the events included in the definition are derived from the Uniform Registration Forms and, therefore, firms should generally be able to conduct appropriate due diligence to identify such individuals. Indeed, FINRA Rule 3110(e) already requires firms to establish and implement written procedures reasonably designed to verify the accuracy and completeness of the information contain in an applicant's initial or transfer Form U4, which would include verifying the accuracy and completeness of answers and disclosures concerning "final criminal matters" and the events covered by the definition of "specified risk events."

Cambridge commented that persons should have the opportunity to confidentially submit an application seeking a materiality consultation to "pre-qualify" a transition from one firm to another and gain confidence that they are free to make such a transfer. FINRA does not believe, however, that prequalification of a person with a significant history of misconduct would be appropriate, or even possible, in the absence of additional information about, among other things, the specific context in which the person would be associated with a new firm and the activities and history of such proposed new firm.

Better Markets opined that the proposed rule change would reflect an improvement over the status quo but is still insufficient, and that FINRA should do more to reduce the number of brokers with a significant history of misconduct and the prevalence of recidivism. Specifically, Better Markets wrote that FINRA should ban brokers with two criminal convictions or three "specified risk events" at a $5,000 level (instead of the proposed $15,000 level) and immediately and permanently expel a firm where more than 20% of its brokers have three or more "specified risk events." Better Markets also suggested that FINRA engage in more investor education on the topic of recidivist brokers, design a user-friendly disclosure system that clearly identifies brokers with a demonstrable pattern of violations, and repeal the part of FINRA Rule 9311 that stays a Hearing Panel or Hearing Officer decision pending an appeal to the NAC.

FINRA's efforts to address the risks posed by brokers with a significant history of misconduct are ongoing, and FINRA appreciates comments on additional steps that FINRA might take. Some of Better Markets' suggestions, however, amount to a request that FINRA create new categories of "statutory disqualification." Federal law defines the types of misconduct that presumptively disqualify a broker from associating with a firm, and amending what qualifies as a statutory disqualification is beyond FINRA's jurisdiction. In addition, FINRA does not agree that repealing the provision in Rule 9311(b) that stays the effect of a Hearing Panel or Hearing Officer decision would be appropriate at this time. FINRA's rule that stays the effect of a Hearing Panel or Hearing

Officer decision is consistent with rules of other self-regulatory organizations and the SEC.[133] Moreover, the proposed rule change would protect investors during a disciplinary appeal by empowering Hearing Officers to impose conditions and restrictions that they consider reasonably necessary for the purpose of preventing customer harm.

Miscellaneous Comments Outside the Scope of the Proposal

Some comments raised concerns regarding broader issues, such as arbitration proceedings and public disclosure of arbitration settlements,[134] the composition of Hearing Panels in FINRA's disciplinary proceedings,[135] questions about whether firms

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133 See, e.g., 17 CFR 201.360(d) (providing that an SEC ALJ's initial decision shall not become final as to a party or person who timely files a petition for review); CBOE Rule 13.11(b) (providing that sanctions shall not become effective until the Exchange review process is completed or the decision otherwise becomes final); NASDAQ PHLX Rule 9311(b) (providing that an appeal to the Exchange Review Council from a disciplinary decision shall operate as a stay until the Exchange Review Council issues a decision); NYSE CHX Article 12, Rule 6 (providing that the enforcement of any orders or penalties shall be stayed upon the filing of a notice of appeal pending the outcome of final review by a Judiciary Committee or the Board of Directors).

134 IBN suggested that FINRA should have local arbitration hearings, with panels composed of local representatives and local firms, and that FINRA should eliminate mandatory arbitration or require arbitrators to be lawyers and follow the rule of law. Network 1 commented that FINRA should consider the "prejudicial effect" on brokers of the six-year limitations period for filing an arbitration claim and of nuisance-value arbitration actions brought by non-attorney representatives; that references to arbitration claims brought by a non-attorney representative that are settled or that result in an award in favor of the broker should be removed from the broker's public record; and that an arbitration claim brought by a non-attorney representative that results in a settlement should not be made available to the public at all.

135 Network 1 commented that FINRA adjudicatory panels should include one attorney with a demonstrated history of representing brokers or member firms, securities industry experience, and knowledge of securities laws, regulations and rules and industry practices in the investment banking and securities businesses.

are permitted to pay disqualified persons consistent with FINRA Rule 8311,[136] various Constitutional protections that FINRA should adopt in investigations and disciplinary proceedings,[137] and how FINRA might improve the Taping Rule to prevent non-compliance with that rule.[138] FINRA believes, however, that these comments are all outside the scope of the proposal.

6. <u>Extension of Time Period for Commission Action</u>

FINRA does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.[139]

7. <u>Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)</u>

Not applicable.

8. <u>Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission</u>

Not applicable.

9. <u>Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act</u>

Not applicable.

10. <u>Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act</u>

Not applicable.

It also commented that FINRA should establish a process for soliciting “bona fide neutrals” to sit on adjudicatory panels.

136 Network 1.

137 Network 1.

138 NASAA.

139 15 U.S.C. 78s(b)(2).

11. Exhibits

Exhibit 1. Completed notice of proposed rule change for publication in the Federal Register.

Exhibit 2a. Regulatory Notice 18-16 (April 2018)

Exhibit 2b. List of comment letters received in response to Regulatory Notice 18-16 (April 2018).

Exhibit 2c. Copies of the comment letters received in response to Regulatory Notice 18-16 (April 2018).

Exhibit 3a. Disclosure Categories Considered for Criminal Matters and Specified Risk Events (Mapped to Form U4).

Exhibit 3b. Disclosure Categories Considered for Criminal Matters and Specified Risk Events (Mapped to Form BD).

Exhibit 3c. Breakdown of Final Criminal Matters and Specified Risk Events.

Exhibit 3d. Individuals and Firms Impacted by the Proposed Amendments to the MAP Rules.

Exhibit 3e. "New" Final Criminal Matters and Specified Risk Events (after identification) Associated with Individuals Meeting the Proposed Criteria in Proposed IM-1011-3 and Proposed Rule 1017(a)(7).

Exhibit 5. Text of the proposed rule change.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-   ; File No. SR-FINRA-2020-011)

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Address Brokers with a Significant History of Misconduct

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on   , Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to (1) amend the FINRA Rule 9200 Series (Disciplinary Proceedings) and the 9300 Series (Review of Disciplinary Proceeding by National Adjudicatory Council and FINRA Board; Application for SEC Review) to allow a Hearing Officer to impose conditions or restrictions on the activities of a respondent member firm or respondent broker, and require a respondent broker's member firm to adopt heightened supervisory procedures for such broker, when a disciplinary matter is appealed to the National Adjudicatory Council ("NAC") or called for NAC review;

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[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b-4.

(2) amend the FINRA Rule 9520 Series (Eligibility Proceedings) to require member firms to adopt heightened supervisory procedures for statutorily disqualified brokers during the period a statutory disqualification eligibility request is under review by FINRA;
(3) amend FINRA Rule 8312 (FINRA BrokerCheck Disclosure) to allow the disclosure through FINRA BrokerCheck of the status of a member firm as a “taping firm” under FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms); and
(4) amend the FINRA Rule 1000 Series (Member Application and Associated Person Registration) to require a member firm to submit a written request to FINRA’s Department of Member Regulation (“Member Regulation”), through the Membership Application Group (“MAP Group”), seeking a materiality consultation and approval of a continuing membership application, if required, when a natural person that has, in the prior five years, one or more “final criminal matters” or two or more “specified risk events”[3] seeks to become an owner, control person, principal or registered person of the member firm.

The text of the proposed rule change is available on FINRA’s website at http://www.finra.org, at the principal office of FINRA and at the Commission’s Public Reference Room.

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[3] As explained more below, the proposed definitions of “final criminal matter” and “specified risk event” generally include final, adjudicated disclosure events disclosed on a person’s or firm’s Uniform Registration Forms. For purposes of the proposed rule change, Uniform Registration Forms for firms and brokers refer to, and would be defined as, the Uniform Application for Broker-Dealer Registration (Form BD), the Uniform Application for Securities Industry Registration or Transfer (Form U4), the Uniform Termination Notice for Securities Industry Registration (Form U5) and the Uniform Disciplinary Action Reporting Form (Form U6), as such may be amended or any successor(s) thereto.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Overview

FINRA uses a combination of tools to reduce the risk of harm to investors from member firms and the brokers they hire that have a history of misconduct. These tools include assessments of applications filed by member firms to retain or employ an individual subject to a statutory disqualification, reviews of membership and continuing membership applications ("CMAs"), disclosure of brokers' regulatory backgrounds, supervision requirements, focused examinations, risk monitoring and disciplinary actions. These tools, among others, have been useful in identifying and addressing a range of misconduct and serve to further the Exchange Act goals, reflected in FINRA's mission, of investor protection and market integrity.

In addition, FINRA Rule 3110 (Supervision) requires member firms to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and FINRA rules. The rule also requires member firms to establish, maintain and enforce written procedures to supervise the types of business in which they engage and the activities of their associated persons that are reasonably designed to achieve compliance with applicable securities laws and FINRA rules.[4]

Despite these requirements and FINRA's ongoing efforts to strengthen protections for investors and the markets through its oversight of member firms and the brokers they employ, persistent compliance issues continue to arise in some member firms. Recent studies, for example, find that some firms persistently employ brokers who engage in misconduct, which results in higher levels of misconduct by these firms. These studies also provide evidence that past disciplinary and other regulatory events associated with a member firm or individual can be predictive of similar future events, such as repeated disciplinary actions, arbitrations and complaints.[5] This risk cannot always be adequately addressed by FINRA's existing rules and programs.

Brokers and member firms with a history of misconduct can pose a particular challenge for FINRA's existing examination and enforcement programs. For example, FINRA examinations of member firms can identify compliance failures—or imminent

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4 See Rule 3110(a) and (b).

5 For example, in 2015 FINRA's Office of the Chief Economist (OCE) published a study that examined the predictability of disciplinary and other disclosure events associated with investor harm based on past similar events. The OCE study showed that past disclosure events, including regulatory actions, customer arbitrations and litigations of brokers, have significant power to predict future investor harm. See Hammad Qureshi & Jonathan Sokobin, Do Investors Have Valuable Information About Brokers? (FINRA Office of the Chief Economist Working Paper, Aug. 2015). A subsequent academic research paper presented evidence that suggests a higher rate of new disciplinary and other disclosure events is highly correlated with past disciplinary and other disclosure events, as far back as nine years prior. See Mark Egan, Gregor Matvos, & Amit Seru, The Market for Financial Adviser Misconduct, J. Pol. Econ. 127, no. 1 (Feb. 2019): 233-295.

failures—and prescribe remedies to be taken, but examiners are not empowered to require a firm to change or limit its business operations in a particular manner. While these constraints on the examination process protect firms from potentially arbitrary or overly onerous examination findings, a firm or individual with a history of misconduct can take advantage of these limits to continue ongoing activities that harm or pose risk of harm to investors until they result in an enforcement action.

FINRA disciplinary actions, in turn, can be brought only after a violation—and any resulting customer harm—may have already occurred. In addition, disciplinary proceedings can take significant time to develop, prosecute and conclude, during which time the respondent in a disciplinary proceeding is able to continue misconduct, perpetuating significant risks of additional harm to customers and investors. Litigated enforcement actions brought by FINRA involve a hearing and often multiple rounds of appeals, thereby effectively forestalling the imposition of disciplinary sanctions—and their potential deterrent effect—for an extended period. For example, a FINRA enforcement proceeding could involve a hearing before a Hearing Panel, numerous motions, an appeal to the NAC, and further appeals to the SEC and federal courts of appeals. Moreover, even when a FINRA Hearing Panel or Hearing Officer imposes a significant sanction, the sanction is stayed during appeal to the NAC, many sanctions are automatically stayed on appeal to the SEC, and they potentially can be stayed during appeal to the courts. When all appeals are exhausted, the respondent’s FINRA registration may have terminated, limiting FINRA’s jurisdiction and eliminating the leverage that FINRA has to incent the respondent to comply with the sanction, including making restitution to customers.

Similarly, FINRA's eligibility proceedings are sometimes not available or sufficient to address the risks posed by brokers with a significant history of past misconduct. Federal law and regulations define the types of misconduct that presumptively disqualify a broker from associating with a member firm and also govern the standards and procedures FINRA must follow when a firm seeks to associate or continue associating with a broker subject to a statutory disqualification. These laws and regulations limit who FINRA may subject to an eligibility proceeding and affect how FINRA may exercise its authority in those proceedings.

FINRA's membership proceedings also do not always protect against the risks posed when a firm hires brokers with a significant history of misconduct. For firms eligible for the safe harbor for business expansions in IM-1011-1 (Safe Harbor for Business Expansions), there are a defined set of expansions (including, among other things, increases in the number of associated persons involved in sales) that are presumed not to be a material change in business operations and therefore do not require the firm to file a CMA.

Thus, notwithstanding the existing protections afforded by the federal securities laws and FINRA rules, the risk of potential customer harm may persist where a firm or broker has a significant history of past misconduct.

FINRA is taking steps to strengthen its tools to respond to brokers with a significant history of misconduct and the firms that employ them, several of which are described below. In addition, the proposed rule change, as explained further below, would create several additional protections to address this risk.

Additional Steps Undertaken by FINRA

As part of this initiative, FINRA has undertaken the following:

- Published Regulatory Notice 18-15 (Heightened Supervision), which reiterates the existing obligation of member firms to implement for such individuals tailored heightened supervisory procedures under Rule 3110;
- Published Regulatory Notice 18-17 (FINRA Revises the Sanction Guidelines), which announced revisions to the FINRA Sanction Guidelines;
- Raised fees for statutory disqualification applications;[6] and
- Revised the qualification examination waiver guidelines to permit FINRA to more broadly consider past misconduct when considering examination waiver requests.

In addition, to further address issues created by member firms that have a significant history of misconduct, FINRA has issued a Regulatory Notice seeking comment on proposed new Rule 4111 (Restricted Firm Obligations).[7]

Proposed Amendments to the FINRA Rule 9200 Series and FINRA Rule 9300 Series to Enhance Investor Protection During the Pendency of an Appeal or Call-for-Review Proceeding

FINRA is proposing amendments to the Rule 9200 Series (Disciplinary Proceedings) and Rule 9300 Series (Review of Disciplinary Proceeding by National Adjudicatory Council and FINRA Board; Application for SEC Review) to bolster investor protection during the pendency of an appeal from, or a NAC review of, a

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6 See Securities Exchange Act Release No. 83181 (May 7, 2018), 83 FR 22107 (May 11, 2018) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2018-018).

7 See Regulatory Notice 19-17 (May 2019).

Hearing Panel or Hearing Officer disciplinary decision, by empowering Hearing Officers to impose conditions or restrictions on disciplined respondents and requiring firms to adopt heightened supervision plans concerning disciplined individual respondents. The proposed rule also would establish a process for an expedited review by the Review Subcommittee of the NAC of any conditions or restrictions imposed.

Currently, the Rule 9200 and Rule 9300 Series permit FINRA to bring disciplinary actions against member firms, associated persons of member firms or persons within FINRA's jurisdiction for alleged violations of FINRA rules, SEC regulations or federal securities laws. Following the filing of a complaint, FINRA's Chief Hearing Officer will assign a Hearing Officer to preside over the disciplinary proceeding and appoint a Hearing Panel, or an Extended Hearing Panel if applicable,[8] to conduct a hearing and issue a written decision. For each case, the Hearing Panel or, in the case of default decisions, the Hearing Officer will issue a written decision that makes findings and, if violations occurred, imposes sanctions. Sanctions can include, among other things, fines, suspensions, bars and orders to pay restitution.

Under FINRA's disciplinary procedures, any party can appeal a Hearing Panel or Hearing Officer decision to the NAC. In addition, any member of the NAC or the NAC's Review Subcommittee, or the General Counsel in the case of default decisions, may on their own initiate a review of a decision. On appeal or review, the NAC will determine if

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[8] References to "Hearing Panel" will refer to both a Hearing Panel and an Extended Hearing Panel collectively, unless otherwise noted. A Hearing Panel consists of a FINRA Hearing Officer and two panelists, drawn primarily from a pool of current and former securities industry members of FINRA's District and Regional Committees, as well as its Market Regulation Committee, former members of FINRA's NAC and former FINRA Directors or Governors.

a Hearing Panel's or a Hearing Officer's findings were factually supported and legally correct. The NAC also reviews any sanctions imposed and considers the FINRA Sanction Guidelines when doing so. The NAC prepares a proposed written decision. If the FINRA Board of Governors does not call the case for review, the NAC's decision becomes final and constitutes the final disciplinary action of FINRA, unless the NAC remands the proceeding to the Hearing Officer or Hearing Panel. If the FINRA Board of Governors calls the case for review, the FINRA Board of Governors' decision constitutes the final disciplinary action of FINRA, unless the Board of Governors remands the proceeding to the NAC. A respondent in a FINRA disciplinary proceeding may appeal a final FINRA disciplinary action to the SEC, and further to a United States federal court of appeals.

When a Hearing Panel or Hearing Officer decision is on appeal or review before the NAC, any sanctions imposed by the Hearing Panel or Hearing Officer decision, including bars and expulsions, are automatically stayed and not enforced against the respondent during the pendency of the appeal or review proceeding.[9] In turn, the filing of an application for SEC review stays the effectiveness of any sanction, other than a bar or an expulsion, imposed in a decision constituting a final FINRA disciplinary action.[10]

Proposed FINRA Rule 9285 (Interim Orders and Mandatory Heightened Supervision While on Appeal or Discretionary Review) would establish additional investor protections when a Hearing Panel or Hearing Officer decision that makes

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[9] See FINRA Rules 9311(b), 9312(b). In contrast, an appeal to the NAC or a call for NAC review does not stay a decision, or that part of a decision, that imposes a permanent cease and desist order. See FINRA Rules 9311(b), 9312(b).

[10] See FINRA Rule 9370(a).

findings that a respondent violated a statute or rule provision is appealed to the NAC or called for NAC review.

Proposed Rule 9285(a) would provide that the Hearing Officer that participated in the underlying disciplinary proceeding may impose any conditions or restrictions on the activities of a respondent during the appeal as the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm. In light of comments received in response to Regulatory Notice 18-16, FINRA has modified the proposal to make the imposition of possible conditions and restrictions a separate, second step after a finding of a violation by a Hearing Panel or Hearing Officer, and to provide greater clarity on how the process would operate.

Unless otherwise ordered by a Hearing Officer, proposed Rule 9285(a)(1) would allow FINRA's Department of Enforcement ("Enforcement"), within ten days after service of a notice of appeal from, or the notice of a call for NAC review of, a disciplinary decision of a Hearing Officer or Hearing Panel, to file a motion for the imposition of conditions or restrictions on the activities of a respondent that are reasonably necessary for the purpose of preventing customer harm.[11] Proposed Rule 9285(a)(1) also would provide expressly that the Hearing Officer that participated in the underlying disciplinary proceeding would have jurisdiction to rule on a motion seeking conditions or restrictions, notwithstanding the appeal or call for NAC review. FINRA believes that the Hearing Officer's knowledge about the factual background and the

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[11] See Rule 9311(a) (generally allowing a party to file a notice of appeal within 25 days after service of a decision issued pursuant to Rule 9268 or Rule 9269) and Rule 9312 (generally allowing a call for review within 45 days after the date of service of a decision issued pursuant to Rule 9268 and within 25 days after the date of service of a default decision issued pursuant to Rule 9269).

violations, gained through presiding over the disciplinary proceeding, would make the Hearing Officer well qualified to evaluate the potential for customer harm and craft, in the first instance and in an expeditious manner, tailored conditions and restrictions to minimize that potential harm. In a change from the proposal in Regulatory Notice 18-16, the proposed rule would give the Hearing Officer who participated in the underlying proceeding (instead of the Hearing Panel) the authority to impose conditions or restrictions that are reasonably necessary for the purpose of preventing customer harm, a change that FINRA believes will enable orders imposing conditions or restrictions to be imposed more expeditiously.

Proposed Rule 9285(a)(2) through (a)(5), along with proposed Rule 9285(c), would establish the briefing, timing and other procedural requirements relating to the imposition of conditions or restrictions. The proposed rule would permit Enforcement to file a motion seeking the imposition of conditions or restrictions that are reasonably necessary for the purpose of preventing customer harm, and the motion must specify the conditions and restrictions that are sought to be imposed and explain why they are necessary. A respondent would have the right to file an opposition or other response to the motion within ten days after service of the motion, unless otherwise ordered by the Hearing Officer, and must explain why no conditions or restrictions should be imposed or specify alternative conditions and restrictions that are sought to be imposed and explain why they are reasonably necessary for the purpose of preventing customer harm. Enforcement would have no automatic right to file a reply. The Hearing Officer would decide the motion on the papers and without oral argument, unless an oral argument is specifically ordered. In addition, the Hearing Officer would be required to issue a written order ruling upon the motion in an expeditious manner and no later than 20 days after any opposition or permitted reply is filed. In an enhancement from the proposal in Regulatory Notice 18-16, proposed Rule 9285(a)(5) also would require that the Office of Hearing Officers provide a copy of the order to each FINRA member with which the respondent is associated.

If the Hearing Officer grants a motion for conditions or restrictions, its order should describe the activities that the respondent shall refrain from taking and any conditions imposed. The Hearing Officer would be guided by the limiting principle—set forth in proposed Rule 9285(a)(5)—that the Hearing Officer shall have the authority to impose any conditions or restrictions that the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm. As FINRA explained in Regulatory Notice 18-16, the conditions and restrictions imposed should target the misconduct demonstrated in the disciplinary proceeding and be tailored to the specific risks posed by the member firm or broker. Conditions or restrictions could include, for example, prohibiting a member firm or broker from offering private placements in cases of misrepresentations and omissions made to customers, or prohibiting penny stock liquidations in cases involving violations of the penny stock rules. A condition could also include posting a bond to cover harm to customers before the sanction imposed becomes final or precluding a broker from acting in a specified capacity. FINRA believes authorizing Hearing Officers to impose conditions or restrictions during the period an appeal or review proceeding is pending would allow FINRA to target the demonstrated bad conduct of a respondent during the pendency of the appeal or review and add an interim layer of investor protection while the disciplinary proceeding remains pending.[12]

Proposed Rule 9285(b), along with proposed Rule 9285(c), would establish an expedited process for the review of a Hearing Officer's order imposing conditions or restrictions. Specifically, proposed Rule 9285(b)(1) would permit a respondent that is subject to a Hearing Officer order imposing conditions or restrictions to file, within ten days after service of that order, a motion with the Review Subcommittee to modify or remove any or all of the conditions or restrictions. Proposed Rule 9285(b)(2) would provide, among other things, that the respondent has the burden to show that the conditions or restrictions are not reasonably necessary for the purpose of preventing customer harm.[13]

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[12] The examples of conditions and restrictions set forth above are intended to provide guidance concerning the kinds of conditions and restrictions that could be imposed. FINRA expects that requiring Enforcement to file a motion specifying the conditions or restrictions sought also will help focus adjudicators on options that are available, and allow for the flexibility needed to address the risk posed by different factual scenarios. If helpful to adjudicators and parties, FINRA also would publish additional guidance on the kinds of restrictions or conditions that could be imposed.

[13] In Regulatory Notice 18-16, FINRA originally proposed that the respondent would also be required to demonstrate that Hearing Officer "committed an error by ordering the conditions or restrictions imposed." FINRA believes that it is more appropriate for the burden in proposed Rule 9285(b)(2) to mirror what Enforcement must show when seeking conditions or restrictions and the Hearing Officer's authority to impose conditions and restrictions.

Notwithstanding that FINRA no longer proposes including the "committed an error" standard in the proposed rule, FINRA intends that the Review Subcommittee would essentially conduct a de novo review when considering a respondent's motion to modify or remove conditions or restrictions. An exception would be for a Hearing Officer's credibility determinations, which are entitled to considerable weight and deference, and can be overturned only where the record contains substantial evidence for doing so.

Proposed Rule 9285(b)(3) would give Enforcement five days from service of the respondent's motion to file an opposition or other response, unless otherwise ordered by the Review Subcommittee. Proposed Rule 9285(b)(4) would provide that the respondent may not file a reply. Proposed Rule 9285(b)(5) would provide that the NAC's Review Subcommittee would decide the motion based on the papers and without oral argument, unless an oral argument is specifically ordered by the Review Subcommittee, and make that decision in an expeditious manner and no later than 30 days after the filing of the opposition. The rule would provide that the Review Subcommittee could approve, modify or remove any and all of the conditions or restrictions. It also would require that FINRA's Office of General Counsel provide a copy of the Review Subcommittee's order to each FINRA member with which the respondent is associated. Proposed Rule 9285(b)(6) would provide that the filing of a motion pursuant to Rule 9285(b) would stay the effectiveness of the conditions and restrictions ordered by the Hearing Officer until the Review Subcommittee rules on the motion.

Proposed Rule 9285(d) would provide that conditions or restrictions imposed by a Hearing Officer that are not subject to a stay or imposed by the Review Subcommittee shall remain in effect until FINRA's final decision takes effect. Thus, the conditions or restrictions would remain in effect until there is a final FINRA disciplinary action and all appeals are exhausted.

The remainder of proposed Rule 9285 sets requirements for member firms, during an appeal or NAC review proceeding, to establish mandatory heightened supervision plans for disciplined respondents. Specifically, when a Hearing Panel or Hearing Officer disciplinary decision finding that a respondent violated a statute or rule provision is appealed or called for NAC review, proposed Rule 9285(e) would require any member with which the respondent is associated to adopt a written plan of heightened supervision of the respondent. The plan of heightened supervision would be required to comply with FINRA Rule 3110,[14] be reasonably designed and tailored to include specific supervisory policies and procedures that address the violations found by the Hearing Panel or Hearing Officer, and be reasonably designed to prevent or detect a reoccurrence of those violations. The plan of heightened supervision would be required to, at a minimum, designate an appropriately registered principal responsible for carrying out the plan of heightened supervision. Proposed Rule 9285(d) also would require that the plan of heightened supervision be signed by the designated principal and include an acknowledgement that the principal is responsible for implementing and maintaining the plan. The plan of heightened supervision would be required to remain in place until FINRA's final decision takes effect. Thus, the plan of heightened supervision would be required to remain in place until there is a final FINRA disciplinary action and all appeals are exhausted.[15]

Proposed Rule 9285(d) would require the member to file the written plan of heightened supervision with FINRA's Office of General Counsel and serve a copy on

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[14] Rule 3110 requires member firms to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and FINRA rules. See also Regulatory Notice 18-15 (Guidance on Implementing Effective Heightened Supervisory Procedures for Associated Persons with a History of Misconduct), at p.2 & n.2 (April 2018).

[15] Although proposed Rule 9285(d) would not require heightened supervision plans after FINRA's final decision takes effect, the supervisory obligations of member firms regarding associated persons with a history of past misconduct would continue to apply. See Regulatory Notice 18-15 (April 2018).

Enforcement and the respondent, within ten days of any party filing an appeal from the Hearing Panel's or Hearing Officer's decision or of the case being called for NAC review. Similarly, if the respondent becomes associated with another member firm while the Hearing Panel's or Hearing Officer's decision is on appeal to, or review before, the NAC, that firm would be required, within ten days of the respondent becoming associated with it, to file a copy of a plan of heightened supervision with FINRA's Office of General Counsel and serve a copy on Enforcement and the respondent.

In a change from Regulatory Notice 18-16, FINRA has modified the heightened supervision plan requirements to account for the possibility that a firm could be required pursuant to proposed Rule 9285(e) to adopt a mandatory heightened supervision plan before any conditions or restrictions imposed pursuant to proposed Rule 9285 take effect. Proposed Rule 9285(e)(1) would require that a member that has adopted a written plan of heightened supervision for a respondent would be required to file and serve an amended plan that takes into account any conditions or restrictions imposed pursuant to proposed Rule 9285, within ten days of the conditions or restrictions becoming effective.

Proposed Rule 9285 would apply to disciplinary proceedings initiated on or after the effective date of the proposed rule.

Along with proposed Rule 9285, FINRA is proposing corresponding amendments to five existing rules: FINRA Rules 9235 (Hearing Officer Authority), 9311 (Appeal by Any Party; Cross-Appeal), 9312 (Review Proceeding Initiated by Adjudicatory Council), 9321 (Transmission of Record), and 9556 (Failure to Comply with Temporary and Permanent Cease and Desist Orders).

The proposed amendments to Rule 9235 would provide that the Hearing Officer has the authority to rule on a motion pursuant to Rule 9285 for conditions or restrictions.

The proposed amendments to Rules 9311 and 9312 would ensure that the stay provisions in those rules do not affect a motion for conditions or restrictions.[16] Currently, Rule 9311(b) provides, in pertinent part, that an appeal to the NAC from a decision issued pursuant to Rule 9268 or Rule 9269 shall operate as a stay of that decision until the NAC issues a decision pursuant to Rule 9349 or, in cases called for discretionary review by the FINRA Board, until a decision is issued pursuant to Rule 9351. Rule 9312(b) contains similar stay provisions for decisions that are called for review. Rules 9311(b) and 9312(b) would be amended to expressly state that, notwithstanding the stay of sanctions under Rules 9311 and 9312, the Hearing Officer may impose such conditions and restrictions on the activities of a respondent as the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm, in accordance in proposed Rule 9285(a), and that the Review Subcommittee shall consider any motion filed pursuant to Rule 9285(b) to modify or remove any or all of the conditions or restrictions.

Other proposed amendments to Rule 9311 and 9312 would ensure that a member firm is notified of events that would require it to adopt a written plan of heightened supervision pursuant to proposed Rule 9285.[17] Proposed Rule 9311(g) would require the Office of Hearing Officers, when an appeal is filed from a decision finding that a

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[16] The proposed amendments to Rule 9312 discussed in this paragraph reflect an enhancement to the proposal in Regulatory Notice 18-16 (April 2018).

[17] The proposed amendments to Rules 9311 and 9312 discussed in this paragraph are an enhancement from the proposal in Regulatory Notice 18-16 (April 2018).

Respondent violated a statute or rule provision, to promptly notify each FINRA member with which the Respondent is associated that an appeal has been filed. Similarly, proposed Rule 9312(c)(3) would require the Office of General Counsel, when a decision finding that a Respondent violated a statute or rule provision is called for review, to promptly notify each FINRA member with which the Respondent is associated of the call for review.

The proposed amendments to Rule 9321 would govern the record related to a motion for conditions or restrictions.[18] Rule 9321 currently governs the process for the Office of Hearing Officers to transmit the record of a disciplinary proceeding to the NAC. The proposed amendments to Rule 9321 would set forth provisions for how the Office of Hearing Officers would transmit to the NAC the supplemental record of a proceeding concerning a motion to impose conditions or restrictions.

Rule 9556 currently governs expedited proceedings for failures to comply with temporary and permanent cease and desist orders. The proposed amendments to Rule 9556 would grant FINRA staff the authority to bring an expedited proceeding against a respondent that fails to comply with conditions and restrictions imposed pursuant to proposed Rule 9285 and create the process for the expedited proceeding. Specifically, proposed Rule 9556(a)(2) would permit FINRA staff to issue a notice to a respondent stating that the failure to comply with the conditions or restrictions imposed under Rule 9285 within seven days of service of the notice will result in a suspension or cancellation of membership or a suspension or bar from associating with any member. Proposed Rule

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[18] The proposed amendments to Rule 9321 reflect an enhancement to the proposal in Regulatory Notice 18-16 (April 2018).

9556(c)(2) would govern the contents of the notice. It would require that the notice explicitly identify the conditions or restrictions that are alleged to have been violated and contain a statement of facts specifying the alleged violation. It also would require that the notice state or explain—just as the rule currently requires for a notice of a failure to comply with temporary and permanent cease and desist orders—when the FINRA action will take effect, what the respondent must do to avoid such action, that the respondent may file a written request for a hearing with the Office of Hearing Officers pursuant to Rule 9559, the deadline for requesting a hearing and the Hearing Officer's or Hearing Panel's authority.

Proposed Amendments to the FINRA Rule 9520 Series to Require Interim Plans of Heightened Supervision of a Disqualified Person During the Period When FINRA is Reviewing an Eligibility Application

FINRA is proposing to amend FINRA Rule 9522 (Initiation of Eligibility Proceeding; Member Regulation Consideration) in the FINRA Rule 9520 Series (Eligibility Proceedings) to require a member firm that files an application to continue associating with a disqualified person under Rule 9522(a)(3) or 9522(b)(1)(B) to also include an interim plan of heightened supervision that would be in effect throughout the entirety of the application review process.[19] The proposed amendments would delineate the circumstances under which a statutorily disqualified individual may remain associated with a FINRA member while FINRA is reviewing the application.

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[19] In Regulatory Notice 18-16 (April 2018), FINRA originally proposed the amendments discussed in this section as amendments to FINRA Rule 9523.

As background, brokers who have engaged in the types of misconduct specified in the Exchange Act's statutory disqualification provisions must undergo special review by FINRA before they are permitted to re-enter or continue working in the securities industry. In conducting its review, FINRA seeks to exclude brokers who pose a risk of recidivism from re-entering or continuing in the securities business, subject to the limits developed in SEC case law.

As a general framework, the Exchange Act sets out the types of misconduct that presumptively exclude brokers from engaging in the securities business, identified as statutory disqualifications.[20] These statutory disqualifications are the result of actions against a broker taken by a regulator or court based on a finding of serious misconduct that calls into question the integrity of the broker, and include, among other things, any felony and certain misdemeanors for a period of ten years from the date of conviction; expulsions or bars (and current suspensions) from membership or participation in a self-regulatory organization; bars (and current suspensions) ordered by the SEC, Commodity Futures Trading Commission or other appropriate regulatory agency or authority; willful violations of the federal securities and commodities laws or MSRB rules; permanent or temporary injunctions from acting in certain capacities; and certain final orders of a state securities commission.

The Exchange Act and SEC rules thereunder establish a framework within which FINRA evaluates whether to allow an individual who is subject to a statutory

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[20] Section 3(a)(39) of the Exchange Act defines the circumstances when a person is subject to a "statutory disqualification."

disqualification to associate with a member firm.[21] A member firm that seeks to employ or continue the employment of a disqualified individual must file an application seeking approval from FINRA ("SD Application").[22] The Rule 9520 Series sets forth rules governing eligibility proceedings, in which FINRA evaluates whether to allow a member, person associated with a member, potential member or potential associated person subject to a statutory disqualification to enter or remain in the securities industry. A member firm's SD Application to associate with, or continue associating with, a disqualified person is subject to careful scrutiny by FINRA to review whether the individual's association with the member firm is in the public interest and does not create an unreasonable risk or harm to the market or investors. To determine whether the SD Application will be approved or denied, FINRA takes into account factors that include the nature and gravity of the disqualifying event; the length of time that has elapsed since the disqualifying event and any intervening misconduct occurring since; the regulatory history of the disqualified individual, the firm and individuals who will act as supervisors; the potential for future regulatory problems; the precise nature of the securities-related activities proposed in the SD Application; and any proposed plan of heightened supervision.[23]

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21 See 15 U.S.C. 78o-3(g)(2) ("A registered securities association may, and in cases in which the Commission, by order, directs as necessary or appropriate in the public interest or for the protection of investors shall, deny membership to any registered broker or dealer, and bar from becoming associated with a member any person, who is subject to a statutory disqualification."); see also 17 CFR 240.19h-1.

22 See General Information on FINRA's Eligibility Requirements, http://www.finra.org/industry/general-information-finras-eligibility-requirements.

23 FINRA's review of many SD Applications also is governed by the standards set forth in Paul Edward Van Dusen, 47 S.E.C. 668 (1981), and Arthur H. Ross, 50

If FINRA recommends approval of the SD Application, the recommendation is submitted either directly to the SEC for its review or to the NAC and ultimately to the SEC for their reviews and approvals, as applicable. If FINRA recommends denial of the SD Application, the member firm has the right to a hearing before a panel of the Statutory Disqualification Committee and the opportunity to demonstrate why the SD Application should be approved.[24] If the NAC denies the SD Application, the member firm can appeal the decision to the SEC and, thereafter, a federal court of appeals.[25]

S.E.C. 1082 (1992). These standards provide that in situations where an individual's misconduct has already been addressed by the SEC or FINRA, and certain sanctions have been imposed for such misconduct, FINRA should not consider the individual's underlying misconduct when it evaluates an SD Application. In Van Dusen, the SEC stated that when the period of time specified in the sanction has passed, in the absence of "new information reflecting adversely on [the applicant's] ability to function in his proposed employment in a manner consonant with the public interest," it is inconsistent with the remedial purposes of the Exchange Act and unfair to deny an application for re-entry. 47 S.E.C. at 671. The SEC also noted in Van Dusen, however, that an applicant's re-entry is not "to be granted automatically" after the expiration of a given time period. Id. Instead, the SEC instructed FINRA to consider other factors, such as: (1) "other misconduct in which the applicant may have engaged"; (2) "the nature and disciplinary history of a prospective employer"; and (3) "the supervision to be accorded the applicant." Id. Further, in Ross, the SEC established a narrow exception to the rule that FINRA confine its analysis to "new information." 50 S.E.C. at 1085. The SEC stated that FINRA could consider the conduct underlying a disqualifying order if an applicant's later misconduct was so similar that it formed a "significant pattern." Id. at 1085 n.10.

24 The hearing panel considers evidence and other matters in the record and makes a written recommendation on the SD Application to the Statutory Disqualification Committee. See Rule 9524(a)(10). The Statutory Disqualification Committee, in turn, recommends a decision to the NAC, which issues a written decision to the member firm that filed the SD Application. See Rules 9524(a)(10), 9524(b).

25 Approximately 73.5 percent of the SD Applications filed during 2013-2018 were either denied by FINRA, withdrawn because the applicant expected FINRA would recommend denial of its application, or closed because the SD Application was not required by operation of law. Approximately 12.5 percent were approved. FINRA approval sometimes resulted from legal principles, including those embodied in the Exchange Act and in case law, as noted above, which limits

Currently, as part of an SD Application, a member firm will propose a written plan of heightened supervision of the statutorily disqualified person that would become effective upon approval by FINRA of the SD Application to associate with the statutorily disqualified person.[26] A heightened supervisory plan must be acceptable to FINRA, and FINRA will reject any plan that is not specifically tailored to address the individual's prior misconduct and mitigate the risk of future misconduct. In this regard, FINRA's primary consideration is a heightened supervisory plan carefully constructed to best ensure investor protection.

Despite the fact that FINRA will generally not approve an SD Application that lacks an acceptable plan of heightened supervision, there is currently no requirement under FINRA rules that firms place statutorily disqualified individuals whom they employ on interim heightened supervision while an SD Application is pending. However, the proposed amendments to Rule 9522 would establish this requirement, consistent with existing FINRA guidance.[27]

FINRA's discretion to deny an application. The remaining 14 percent of the SD Applications are pending.

[26] See General Information on FINRA's Eligibility Requirements, http://www.finra.org/industry/general-information-finras-eligibility-requirements (explaining that "in virtually every application that the NAC approves, it will do so subject to the applicant member's agreement to implement a special supervisory plan").

[27] FINRA has reminded member firms of their obligation to tailor the firm's supervisory systems to account for brokers with a history of industry or regulatory-related incidents, including disciplinary actions. And specifically as to disqualified persons, FINRA has stated that a firm's continuing to associate with a person who becomes disqualified while associated with the firm raises significant investor protection concerns, and that such a firm should evaluate the facts and circumstances to make a determination of whether adopting and implementing an

Specifically, proposed Rule 9522(f) would require that an application to continue associating with a statutorily disqualified person must include an interim plan of heightened supervision and a written representation from the member firm that the statutorily disqualified person is currently subject to that plan. The proposed rule would require that the interim plan of heightened supervision comply with Rule 3110 and be reasonably designed and tailored to include specific supervisory policies and procedures that address any regulatory concerns related to the nature of the disqualification, the nature of the firm's business, and the disqualified person's current and proposed activities during the review process. The proposed rule also would require that the SD Application identify an appropriately registered principal responsible for carrying out the interim plan of heightened supervision, and that the responsible principal sign the plan and acknowledge his or her responsibility for implementing and maintaining it. The interim plan of heightened supervision would be in effect throughout the entirety of the SD Application review process, which would conclude only upon the final resolution of the eligibility proceeding.

Proposed Rule 9522(g) would authorize Member Regulation to reject an SD Application filed pursuant to Rule 9522(a)(3) or Rule 9522(b)(1)(B) that seeks the continued association of a disqualified person if it determines that the application is substantially incomplete—either because it does not include a reasonably designed interim plan of heightened supervision or because it does not include a written representation that the disqualified person is currently subject to that plan. The

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interim plan of heightened supervision during the pendency of an SD Application would be appropriate. See Regulatory Notice 18-15 (April 2018).

sponsoring firm would have ten days after service of the notice of delinquency, or such other time as prescribed by Member Regulation, to remedy the SD Application.

Under proposed Rule 9522(h), if an applicant firm fails to remedy an SD Application that is substantially incomplete, Member Regulation would provide written notice of its determination to reject the SD Application and its reasons for so doing, and FINRA would refund the application fee, less $1,000, which FINRA would retain as a processing fee. Upon such rejection of the SD Application, the applicant firm would be required to promptly terminate association with the disqualified person.[28]

The proposed amendments to Rule 9522 would apply to SD Applications that are filed on or after the effective date of the proposed rule amendments.

Proposed Amendments to FINRA Rule 8312

Rule 8312 (FINRA BrokerCheck Disclosure) governs the information FINRA releases to the public through its BrokerCheck system.[29] BrokerCheck helps investors make informed choices about the brokers and member firms with which they conduct business by providing extensive registration and disciplinary history to investors at no charge. FINRA requires member firms to inform their customers of the availability of BrokerCheck.[30]

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[28] As part of its examination program, FINRA would generally examine for compliance with interim plans of heightened supervision established pursuant to proposed Rule 9522(f).

[29] The BrokerCheck website address is brokercheck.finra.org.

[30] See FINRA Rule 2210(d)(8) (requiring that each of a member's websites include a readily apparent reference and hyperlink to BrokerCheck on the initial webpage that the member intends to be viewed by retail investors and any other webpage that includes a professional profile of one or more registered persons who conduct business with retail investors); FINRA Rule 2267 (requiring members to provide to customers the FINRA BrokerCheck Hotline Number and a statement as to the

Rule 8312(b) currently requires that FINRA release information about, among other things, whether a particular member firm is subject to the provisions of FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms) (the "Taping Rule"), but only in response to telephonic inquiries via the BrokerCheck toll-free telephone listing. The Taping Rule is designed to ensure that a member firm with a significant number of registered persons that previously were employed by "disciplined firms"[31] has specific supervisory procedures in place to prevent fraudulent and improper sales practices or other customer harm.[32] Under the Taping Rule, a member with a specified

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availability to the customer of an investor brochure that includes information describing BrokerCheck).

[31] Rule 3170(a)(2) defines a "disciplined firm" to mean:

> (A) a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the SEC revoking its registration as a broker-dealer;
>
> (B) a futures commission merchant or introducing broker that has been formally charged by either the Commodity Futures Trading Commission or a registered futures association with deceptive telemarketing practices or promotional material relating to security futures, those charges have been resolved, and the futures commission merchant or introducing broker has been closed down and permanently barred from the futures industry as a result of those charges; or
>
> (C) a futures commission merchant or introducing broker that, in connection with sales practices involving the offer, purchase, or sale of security futures is subject to an order of the SEC revoking its registration as a broker or dealer.

[32] To assist member firms in complying with Rule 3170, FINRA publishes on its website a list of Disciplined Firms Under FINRA Taping Rule, which identifies firms that meet the definition of "disciplined firm" and that were disciplined within the last three years. As of March 31, 2020, that list identified seven firms as "disciplined firms." See https://www.finra.org/rules-guidance/oversight-enforcement/disciplinary-actions/disciplined-firms-under-taping-rule.

percentage of registered persons who have been associated with disciplined firms in a registered capacity in the last three years is designated as a "taping firm."[33]

A member firm that either is notified by FINRA or otherwise has actual knowledge that it is a taping firm must establish, maintain and enforce special written procedures for supervising the telemarketing activities of all its registered persons. Those procedures must include procedures for recording all telephone conversations between the taping firm's registered persons and both existing and potential customers, and for reviewing the recordings to ensure compliance with applicable securities laws and regulations and applicable FINRA rules. The Taping Rule also requires taping firms to retain all the recordings for a period of not less than three years and file quarterly reports with FINRA.[34]

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33 Rule 3170(a)(5)(A) defines a "taping firm" to mean:

> (i) A member with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years;
>
> (ii) A member with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years;
>
> (iii) A member with at least twenty registered persons where 20% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years.

As of March 31, 2020, there is one firm that is designated as a taping firm.

34 Rule 3170 provides member firms that trigger application of the taping requirement a one-time opportunity to adjust their staffing levels to fall below the prescribed threshold levels and thus avoid application of the Taping Rule. See Rule 3170(c).

To provide enhanced disclosure to the public of information as to whether a member firm is subject to the Taping Rule, FINRA is proposing to delete the requirement in Rule 8312(b) that FINRA provide that information only in response to telephonic inquiries via the BrokerCheck toll-free telephone listing. As a result, proposed Rule 8312(b) would permit FINRA to release through BrokerCheck information as to whether a particular member firm is subject to the Taping Rule.[35] FINRA believes that broadening the disclosure through BrokerCheck of the status of a member firm as a taping firm will help inform more investors of the heightened procedures required of the firm, which may incent the investors to research more carefully the background of a broker associated with the taping firm.

Proposed Amendments to the FINRA Rule 1000 Series to Impose Additional Obligations on Member Firms that Associate with Persons with a Significant History of Past Misconduct[36]

➢ Current MAP Process

FINRA is proposing amendments to the FINRA Rule 1000 Series (Member Application and Associated Person Registration)—specifically the rules that govern membership proceedings ("MAP Rules")—to impose additional obligations on member firms when a natural person that has, in the prior five years, either one or more "final

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35 See Rule 8312(a) (requiring that "[i]n response to a written inquiry, electronic inquiry, or telephonic inquiry via a toll-free telephonic listing," FINRA shall release through BrokerCheck information regarding, in pertinent part, a current or former FINRA member).

36 The text of FINRA Rules 1011, 1017 and CAB Rule 111 incorporates the changes approved by the SEC in Securities Exchange Act Release No. 88482 (March 26, 2020), 85 FR 18299 (April 1, 2020) (Order Approving File No. SR-FINRA-2019-030) ("MAP Rules Amendment Release").

criminal matters" or two or more "specified risk events" seeks to become an owner, control person, principal or registered person of the member.

Reviewing CMAs is one of the ways FINRA seeks to address the risks posed by brokers with a significant history of misconduct. Rule 1017 specifies the changes in a member's ownership, control or business operations that require a CMA and FINRA's approval.[37] Among the events that require a CMA are a "material change in business operations," which is defined to include: (1) removing or modifying a membership agreement restriction; (2) market making, underwriting or acting as a dealer for the first time; and (3) adding business activities that require a higher minimum net capital under

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37 See Rule 1017(a). The events that require a member to file a CMA for approval before effecting the proposed event are:

> (1) a merger of the member with another member, unless both members are members of the New York Stock Exchange, Inc. ("NYSE") or the surviving entity will continue to be a member of the NYSE;
>
> (2) a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the NYSE;
>
> (3) direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members of the NYSE;
>
> (4) a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or
>
> (5) a material change in business operations as defined in Rule 1011.

In addition, Rule 1017(a)(6) mandates a member firm to seek a materiality consultation in two situations in which specified pending arbitration claims, unpaid arbitration awards, or unpaid arbitration settlements are involved. See MAP Rules Amendment Release.

SEA Rule 15c3-1.[38] In addition, a CMA is required for business expansions to increase the number of "associated persons involved in sales," offices, or markets made that are a material change in business operations.[39] However, IM-1011-1 (Safe Harbor for Business Expansions) creates a safe harbor for incremental increases in these three categories of business expansions. Under this safe harbor provision, a member, subject to specified conditions and thresholds, may undergo such business expansions without filing a CMA.[40] One such expansion is an increase, within the parameters set forth in IM-1011-1, in the number of "associated persons involved in sales."[41]

[38] See Rules 1011(l), 1017(a)(5). Rule 1011(l) sets forth a non-exhaustive list of events that are material changes in business operations. FINRA also has provided guidance on additional criteria member firms should take into consideration when assessing the materiality of a proposed change. See Notice to Members 00-73 (October 2000). A member may file an application for approval of a material change in business operations at any time, but the member may not effect such change until the conclusion of the proceeding, unless Member Regulation and the member otherwise agree. See Rule 1017(c)(3).

[39] See Rule 1017(b)(2)(C) ("If the application requests approval of an increase in Associated Persons involved in sales, offices, or markets made, the application shall set forth the increases in such areas during the preceding 12 months.").

[40] The safe harbor is unavailable to a member that has a membership agreement that contains a specific restriction as to one or more of the three areas of expansion or to a member that has a "disciplinary history" as defined in IM-1011-1. The safe harbor also is not available to any member that is seeking to add one or more "associated persons involved in sales" and one or more of those associated persons has a "covered pending arbitration claim," an unpaid arbitration award or unpaid settlement related to an arbitration. See MAP Rules Amendment Release.

[41] For eligible firms, IM-1011-1 permits a firm that has one to ten "associated persons involved in sales" to increase that number by ten persons within a one-year period, and a firm that has 11 or more "associated persons involved in sales" to increase that number by ten persons or 30 percent, whichever is greater, within a one-year period. See IM-1011-1.

In determining whether to approve a CMA, Member Regulation, through the MAP Group (collectively, "the Department"), evaluates whether the applicant and its associated persons meet each of the standards for admission in FINRA Rule 1014(a) and whether the applicant would continue to meet those standards upon approval of the CMA.[42] The Department evaluates an applicant's financial, operational, supervisory and compliance systems to ensure that each applicant meets these standards for admission.

One of the standards, Rule 1014(a)(3), requires an applicant to demonstrate that it and its associated persons are capable of complying with the federal securities laws and FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade. When the Department evaluates the Rule 1014(a)(3) standard, it takes into consideration, among other things, whether persons associated with an applicant are the subject of disciplinary actions taken against them by industry authorities, criminal actions, civil actions, arbitrations, customer complaints, remedial actions or other industry-related matters that could pose a threat to public investors.[43] Some of these matters are considered whether they are adjudicated, settled or pending.[44] Some of these events are so material that, when they exist, a presumption exists that the CMA should be denied.[45]

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[42] See Rule 1017(h)(1) and (h)(1)(A).

[43] See Rule 1014(a)(3).

[44] See Rule 1014(a)(3).

[45] See Rule 1017(h) ("Where the Department determines that the Applicant or its Associated Person are the subject of any of the events set forth in Rule 1014(a)(3)(A) and (C) through (E), a presumption exists that the application should be denied.").

Although firms with a "disciplinary history" as defined by IM-1011-1 are not eligible to use the safe harbor, none of the safe harbor's parameters relates to the history of a member firm's associated persons. Given the recent studies that provide evidence of the predictability of future regulatory-related events for brokers with a history of past regulatory-related events, FINRA is concerned about instances where a member on-boards associated persons with a significant history of misconduct and does so within the safe-harbor parameters, thus avoiding prior consultation or review by FINRA. FINRA believes there are instances in which a member firm's hiring of an associated person with a significant history of misconduct—and other associations with such persons—would reflect a material change in business operations.

- Proposed Rule 1017(a)(7) to Require Materiality Consultations

The proposed amendments to the MAP Rules would seek to address this concern. Proposed Rule 1017(a)(7) would require that a member firm, notwithstanding Rule

1017(a)(3),[46] (a)(4),[47] (a)(5)[48] and (a)(6)[49] and IM-1011-1,[50] file a CMA when a natural person seeking to become an owner, control person, principal or registered person of a member has, in the prior five years, one or more "final criminal matters" or two or more "specified risk events"—as further explained below—unless the member has submitted a written request to the Department seeking a materiality consultation for the contemplated activity. Rule 1017(a)(7) would further provide, however, that Rule 1017(a)(7) would not apply when the member is required to file an SD Application or written request for relief pursuant to Rule 9522 for approval of the same contemplated association.[51]

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46 Rule 1017(a)(3) requires a member to file a CMA for approval of direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members of the New York Stock Exchange, Inc. The reference to Rule 1017(a)(3) in proposed Rule 1017(a)(7) reflects a change from the proposal in Regulatory Notice 18-16.

47 Rule 1017(a)(4) requires a member to file a CMA for approval of a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital.

48 Rule 1017(a)(5) requires a member to file a CMA for approval of a "material change in business operations."

49 See MAP Rules Amendment Release.

50 The reference to IM-1011-1 in proposed Rule 1017(a)(7) reflects a change from the proposal in Regulatory Notice 18-16.

51 In that event, the member firm would be required to obtain FINRA's approval to associate or continue associating with the disqualified person pursuant to the FINRA Rule 9520 Series, but it would not also be required to request a materiality consultation or file a CMA pursuant to proposed Rule 1017(a)(7). The Member Regulation staff that considers the SD Application may consult with the MAP Group, as appropriate.

Proposed Rule 1017(a)(7) also would contain requirements for the request seeking a materiality consultation and the Department's review and determination, including a description of the possible outcomes of FINRA's determination on a materiality consultation.

Proposed Rule 1017(a)(7) also would establish that the safe harbor for business expansions in IM-1011-1 would not be available to the member firm when a materiality consultation is required under proposed Rule 1017(a)(7). In a corresponding change, proposed IM-1011-3 (Business Expansions and Persons with Specified Risk Events) would provide that the safe harbor for business expansions in IM-1011-1 would not be available to any member that is seeking to add a natural person who has, in the prior five years, one or more "final criminal matters" or two or more "specified risk events" and seeks to become an owner, control person, principal or registered person of the member. Proposed IM-1011-3 would further provide, in those circumstances, that if the member is not otherwise required to file a CMA, the member must comply with the requirements of proposed Rule 1017(a)(7).[52] Proposed Rule 1017(a)(7) and proposed IM-1011-3 would not apply when a person is already a principal at a member firm and seeks to add an additional principal registration at that same firm. In that instance, the proposed rule amendments would not require a materiality consultation.

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52 FINRA has modified the language in proposed Rule 1017(a)(7) and IM-1011-3 from the versions that were proposed in Regulatory Notice 18-16. FINRA has done so for clarity and to align the structure of these proposed rules to the changes to the MAP Rules approved in the MAP Rules Amendment Release.

Currently, FINRA has a voluntary materiality consultation process.[53] As explained above, a member is required to file a CMA when it plans to undergo an event specified under Rule 1017 (e.g., acquisition or transfer of the member's assets, a business expansion). Before taking this step, a member has the option of seeking guidance, or a materiality consultation, from FINRA on whether or not such proposed event would require a CMA.[54] The materiality consultation process is voluntary, and FINRA has published guidelines about this process on FINRA.org.[55] A request for a materiality consultation, for which there is no fee, is a written request from a member for FINRA's determination on whether a contemplated change in business operations or activities is material and would therefore require a CMA. The characterization of a proposed change as material depends on an assessment of all the relevant facts and circumstances. Through this consultation, FINRA may communicate with the member to obtain further documents and information regarding the contemplated change and its anticipated impact on the member. Where FINRA determines that a contemplated change is material, FINRA will instruct the member to file a CMA if it intends to proceed with such change.

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53 See The Materiality Consultation Process for Continuing Membership Applications, https://www.finra.org/rules-guidance/guidance/materiality-consultation-process; see also Regulatory Notice 18-23 (July 2018).

54 See IM-1011-1 (stating, "[f]or any expansion beyond these [safe harbor] limits, a member should contact its district office prior to implementing the change to determine whether the proposed expansion requires an application under Rule 1017"); see also Notice to Members 00-73 (October 2000) (stating that "[a] member may, but is not required to, contact the District Office to obtain guidance on" whether a change and expansion that falls outside of the safe harbor provisions is material).

55 See The Materiality Consultation Process for Continuing Membership Applications, https://www.finra.org/rules-guidance/guidance/materiality-consultation-process.

Ultimately, the member is responsible for compliance with Rule 1017. If FINRA determines during the materiality consultation that the contemplated business change is material, then the member potentially could be subject to disciplinary action for failure to file a CMA under Rule 1017.[56]

The proposed rule change would establish an additional category of mandatory materiality consultations.[57] The materiality consultations required by proposed Rule 1017(a)(7) would focus on, and the submitting member firm would need to provide information relating to, the conduct underlying the individual's "final criminal matters" and "specified risk events," as well as other matters relating to the subject person, such as disciplinary actions taken by FINRA or other industry authorities, adverse examination findings, customer complaints, pending or unadjudicated matters, terminations for cause or other incidents that could indicate a threat to public investors. The Department's assessment in the materiality consultation would consider, among other things, whether

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56 See Notice to Members 00-73 (October 2000).

57 FINRA Rule 1017(a)(6) will mandate materiality consultations if a member is contemplating: (i) to add one or more "associated persons involved in sales" and one or more of those associated persons has a "covered pending arbitration claim," an unpaid arbitration award or an unpaid settlement related to an arbitration; or (ii) any direct or indirect acquisition or transfer of a member's assets or any asset, business or line of operation where the transferring member or an associated person of the transferring member has a covered pending arbitration claim, an unpaid arbitration award or an unpaid settlement related to an arbitration, and the member is not otherwise required to file a CMA. See MAP Rules Amendment Release. In a separate proposal, FINRA is proposing to mandate materiality consultations under other circumstances. See Regulatory Notice 18-23 (July 2018) (seeking comment on a proposal to the MAP rules that would, among other things, codify the materiality consultation process and mandate a consultation under specified circumstances such as where an applicant seeks to engage in, for the first time, retail foreign currency exchange activities, variable life settlement sales to retail customers, options activities or municipal securities activities).

the events are customer-related; whether the events represent discrete actions or are based on the same underlying conduct; the anticipated activities of the person; the disciplinary history, experience and background of the proposed supervisor, if applicable; the disciplinary history, supervisory practices, standards, systems and internal controls of the member firm and whether they are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules; whether the member firm employs or intends to employ in any capacity multiple persons with one or more "final criminal matters" or two or more "specified risk events" in the prior five years; and any other investor protection concern raised by seeking to make the person an owner, control person, principal or registered person of the member firm.

➢ Proposed Definitions of "Final Criminal Matter" and "Specified Risk Event"

The terms "final criminal matter" and "specified risk event" would be defined in proposed amendments to Rule 1011 (Definitions). Proposed Rule 1011(h) would define the term "final criminal matter" to mean a final criminal matter that resulted in a conviction of, or guilty plea or nolo contendere (no contest) by, a person that is disclosed, or was required to be disclosed, on the applicable Uniform Registration Forms.[58] Proposed Rule 1011(p) would define "specified risk event" to mean any one of the following events that are disclosed, or are or were required to be disclosed, on the

58 Proposed Rule 1011(r) would define "Uniform Registration Forms" to mean the Uniform Application for Broker-Dealer Registration (Form BD), the Uniform Application for Securities Industry Registration or Transfer (Form U4), the Uniform Termination Notice for Securities Industry Registration (Form U5) and the Uniform Disciplinary Action Reporting Form (Form U6), as such may be amended or any successor(s) thereto.

applicable Uniform Registration Forms: (1) a final investment-related,[59] consumer-initiated customer arbitration award or civil judgment against the person for a dollar amount at or above $15,000 in which the person was a named party; (2) a final investment-related, consumer-initiated customer arbitration settlement or civil litigation settlement for a dollar amount at or above $15,000 in which the person was a named party; (3) a final investment-related civil action where (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000, or (B) the sanction against the person was a bar, expulsion, revocation, or suspension; and (4) a final regulatory action where (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000, or (B) the sanction against the person was a bar (permanently or temporarily), expulsion, rescission, revocation or suspension from associating with a member.

The proposed definitions and criteria would provide transparency regarding how the proposed rules would be applied, as they are based on disclosure events required to be reported on the Uniform Registration Forms. Firms, in general, would be able to identify the specific set of disclosure events that would count towards the proposed criteria and,

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[59] The Form U4 Explanation of Terms defines the term "investment-related" as pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association).

using available data, determine independently whether a proposed association with an individual would require a materiality consultation.[60]

In addition, as explained more below in the Economic Impact Assessment, FINRA developed the proposed criteria and definitions with significant attention to the economic trade-off between including individuals who are less likely to subsequently pose risk of harm to customers, and not including individuals who are more likely to subsequently pose risk of harm to customers.

FINRA believes the proposed amendments to the Rule 1000 Series would further promote investor protection by applying stronger standards for continuing membership with FINRA and for changes to a current member firm's ownership, control or business operations.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The effective date will be no later than 180 days following publication of the Regulatory Notice announcing Commission approval.[61]

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60 The exceptions are that the Uniform Registration Forms do not provide information about customer awards or judgments against, or customer settlements with, control affiliates who have not filed a Form U4. For those events, firms would have to gather that information directly from the person.

61 FINRA notes that the proposed rule change would impact all members, including members that are funding portals or have elected to be treated as capital acquisition brokers ("CABs"), given that the funding portal rule set incorporates the Rule 9200 Series and Rule 9300 Series and Rule 9556 by reference, and the CAB rule set incorporates Rules 1011, 1017 and 8312 and the Rule 9200 Series, Rule 9300 Series and Rule 9500 Series by reference. In addition, FINRA is proposing corresponding amendments to CAB Rule 111, to reflect that a CAB

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[62] which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The proposed rule change is designed to protect investors and the public interest by strengthening the tools available to FINRA to address the risks posed by brokers with a significant history of misconduct and the firms that employ them. Allowing Hearing Officers to impose tailored conditions and restrictions on respondents after the finding of a violation, and requiring firms to place disciplined respondent brokers with whom they associate under mandatory heightened supervision during the pendency of an appeal or a review proceeding, would create strong measures of deterrence while an appeal or review proceeding is pending and while the sanctions imposed have not yet taken effect. Likewise, requiring firms to place disqualified persons on interim plan of heightened supervision while an SD Application is pending would require that a fundamental investor protection measure—almost always required at firms that FINRA, as part of the eligibility proceedings process, permits to associate with disqualified persons—be established at an earlier point in time and thereby limit the potential for harm to the public. Broadening the disclosure through BrokerCheck of the status of a member firm as a taping firm, beyond only telephonic BrokerCheck inquiries, will inform more

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would be subject to IM-1011-3, and amendments to Funding Portal Rule 900(b) to require heightened supervision during the time an eligibility request is pending.

[62] 15 U.S.C. 78o-3(b)(6).

investors of the heightened procedures required of the taping firm, and thereby incent investors to research carefully the background of a broker associated with the taping firm. Finally, requiring member firms to seek materiality consultations when a person seeking to become an owner, control person, principal or registered person has a significant history of misconduct will give FINRA an opportunity to assess whether the proposed association is material and warrants closer regulatory scrutiny and, further, may create incentives for changes in behavior by both brokers and the firms that employ them. In situations where the proposed association of a person with a significant history of misconduct would require a CMA, FINRA would then be able to assess, if the firm still seeks to proceed, whether the member firm would continue to meet all the Rule 1014 membership standards if the proposed association were approved and prevent the proposed association if it would not continue to meet those standards.[63]

As such, the proposed rule change will help address concerns regarding brokers with a significant history of misconduct in situations where risks for potential further harm to investors may exist, particularly when such individuals concentrate at a firm or are able to move readily from firm to firm. The proposed additional obligations on such brokers and the increased scrutiny by the firms that employ them, should create incentives for brokers and firms to change activities and behaviors to mitigate FINRA's concerns.

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[63] See Rule 1014(a) (Standards for Admission).

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to analyze the regulatory need for the proposed rulemaking, its potential economic impacts, including anticipated benefits and costs, and the alternatives FINRA considered in assessing how to best meet its regulatory objectives.

(a) Regulatory Need

FINRA uses a number of measures to deter and discipline misconduct by brokers and the firms that employ them. These measures span across several FINRA programs, including statutory disqualification processes, review of membership applications, disclosure of brokers' regulatory backgrounds, supervision requirements, focused examinations, risk monitoring and disciplinary actions.

Nonetheless, some brokers, while relatively small in number, may continue to present heightened risk of harm to investors and act in ways that could harm their customers—sometimes substantially. Any misconduct by these brokers may also undermine confidence in the securities markets as a whole. For example, recent studies provide evidence on predictability of future regulatory-related events for brokers with a history of past regulatory-related events such as repeated disciplinary actions, arbitrations and customer complaints.[64]

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[64] See supra note 5.

Brokers with a history of misconduct can pose a particular challenge to FINRA's existing programs, such as FINRA examination and enforcement programs. For example, while the FINRA examination program can identify compliance failures and prescribe remedies to be taken, examiners are not empowered to require individuals to make changes to or limit their activities in a particular manner. While these constraints on the examination process protect against potentially arbitrary or overly onerous examination findings, an individual with a history of misconduct can take advantage of these limitations to continue ongoing activities that harm or pose risk of harm to investors until they result in an enforcement action. Likewise, enforcement actions can take significant time to develop, prosecute and conclude, during which time the individual is able to continue misconduct.

Furthermore, although FINRA has adopted rules that impose supervisory obligations on firms to ensure they are appropriately supervising their brokers' activities, some firms do not effectively carry out these supervisory obligations to ensure compliance. This is consistent with some recent academic studies, which find that some firms persistently employ brokers who engage in misconduct, and that misconduct can be concentrated at these firms, suggesting that some firms may not be acting appropriately as a first line of defense to prevent customer harm.[65]

Therefore, without additional protections, the risk of potential customer harm may continue to exist at firms that employ brokers that have a significant number of regulatory-related events and that fail to effectively carry out their supervisory

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[65] For example, see Mark Egan, Gregor Matvos, & Amit Seru, The Market for Financial Adviser Misconduct, J. Pol. Econ. 127, no. 1 (Feb. 2019): 233-295.

obligations. The proposals are designed to further promote investor protection by mitigating these concerns while preserving principles of fairness.

(b) Economic Baseline

The following provides the economic baseline for each of the current proposals. These baselines serve as the primary points of comparison for assessing economic impacts, including incremental benefits and costs of the proposed rule amendments. For this proposal, FINRA reviewed and analyzed relevant data over the 2013-2018 period (review period).

1. Proposed Amendments to the FINRA Rule 9200 Series and FINRA Rule 9300 Series

The economic baseline used to evaluate the economic impacts of the proposed rule changes to the Rule 9200 Series and Rule 9300 Series is the current regulatory framework under these rules.[66] FINRA analyzed disciplinary matters that were appealed to the NAC over the review period that reached a final decision by the NAC.[67] During the review period, there were approximately 20 such appeals filed each year, of which approximately 80 percent were filed by brokers, five percent were filed by firms, and the remaining 15 percent were filed jointly by brokers and firms.[68] FINRA determined that,

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[66] The proposal also includes corresponding amendments to Rule 9556.

[67] This analysis included all NAC appeals (including calls for NAC review) filed during the review period that reached a final decision by May 1, 2019. The analysis includes all NAC decisions, including affirmations, modifications or reversals of the findings in the disciplinary matters. The analysis excludes appeals that were withdrawn prior to the resolution of the appeal process.

[68] FINRA further estimates that approximately 94 percent of the appeals filed by brokers involved one broker, and the remaining six percent involved two brokers. All the appeals filed by firms were associated with one firm.

on average, these disciplinary decisions were on appeal to the NAC for approximately 15 months.[69]

2. Proposed Amendments to the FINRA Rule 9520 Series

The economic baseline used to evaluate the economic impacts of the proposed rule changes to the Rule 9520 Series is the current regulatory framework under these rules. FINRA analyzed SD Applications filed during the review period and determined that there were 80 SD Applications filed by 71 firms for 79 individuals, or approximately 13 applications that were filed by 12 firms each year.[70] Approximately 65 percent of these applications were filed by small firms, 12 percent were filed by mid-size firms, and 23 percent were filed by large firms.[71] FINRA also examined the resolution of these applications and determined that approximately 12.5 percent of the SD Applications were approved, 11 percent were denied, 14 percent were pending during the review period, and the remaining applications (62.5 percent) did not require a resolution because the statutorily disqualified individual's registration with the filing firm was terminated or the SD Application was subsequently withdrawn.[72] FINRA determined that, on average, the

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69 The median processing time was approximately 14 months, while the 25th and the 75th percentiles were approximately 11 months and 19 months, respectively.

70 One of these 79 individuals was associated with multiple SD Applications over the review period. Of the 71 firms that filed SD Applications, approximately 90 percent filed one application during the review period, and the remaining 10 percent filed two or more applications.

71 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.

72 In approximately 21 percent of the SD Applications, the application was withdrawn because the decision leading to the disqualifying event was

processing time for an SD Application that reached a final resolution (i.e., an approval or a denial) was approximately 15 months.[73]

3. Proposed Amendments to FINRA Rule 8312

The economic baseline used to evaluate the economic impacts of the proposed rule changes to Rule 8312 (FINRA BrokerCheck Disclosure) is the current regulatory framework under Rules 8312 and 3170. During the review period, FINRA determined that 17 firms hired or retained enough registered persons from previously disciplined firms to be designated as a "taping firm" under Rule 3170 and were notified about their status during this period. All of these firms were small firms with an average size of approximately 40 registered persons. Of these 17 firms, 12 firms did not become subject to the rule's recording requirements because they either took advantage of the one-time staff-reduction opportunity in Rule 3170(c) or terminated their FINRA membership, and one firm was granted an exemption pursuant to Rule 3170(d). As a result, only four of the firms designated as "taping firms" became subject to the recording requirements of Rule 3170.

4. Proposed Amendments to the FINRA Rule 1000 Series

The economic baseline used to evaluate the economic impacts of the proposed rule changes to the MAP Rules is the current regulatory framework under these rules. The proposed rule change would directly impact individuals with one or more final criminal matters or two or more specified risk events within the prior five years, who

overturned, thus the individual was no longer subject to a statutory disqualification, or because the sanctions were no longer in effect.

[73] The median processing time was approximately 14 months, and the 25th and the 75th percentiles were approximately 10 months and 19 months, respectively.

seek to become owners, control persons, principals or registered persons of a member firm. The criteria used for identifying individuals under this proposal and the number of individuals meeting the proposed criteria are discussed below.

(c) Economic Impacts

The following provides the economic impacts, including the anticipated benefits and costs for each of the current proposals.

1. Proposed Amendments to the FINRA Rule 9200 Series and FINRA Rule 9300 Series

The proposed rule amendments would directly impact firms and brokers whose disciplinary matters are on appeal to, or review by, the NAC. These impacts would vary across appeals and depend on, among other factors, the nature and severity of the conditions or restrictions imposed on the activities of respondents. As discussed above, the scope of these conditions or restrictions would depend on what the Hearing Officer determines to be reasonably necessary for the purpose of preventing customer harm. Further, the conditions and restrictions would be tailored to the specific risks posed by the brokers or firms during the appeal period. Accordingly, the conditions and restrictions are not intended to rise to the level of the underlying sanctions and would likely not be economically equivalent to imposing the sanctions during the appeal. In addition, respondents will be able to seek expedited reviews of orders imposing conditions or restrictions.

Anticipated Benefits

The primary benefit of this proposal accrues from limiting the potential risk of continued harm to customers by respondents during the appeal period by imposing conditions or restrictions on their activities, and requiring them to be subject to heightened supervision plans, while their disciplinary matter is on appeal. In order to evaluate these benefits and assess the potential risk posed by brokers during the appeal period, FINRA examined cases that were appealed to the NAC during 2013-2016 and determined whether the brokers associated with an appeal to the NAC had a new disclosure event—for this analysis, a final criminal matter or a specified risk event, as defined above—at any time from the filing of the appeal through the year-end after the year in which the appeal reached a decision.[74] Based on this analysis, FINRA estimates that 21 of the 75 brokers who appealed to the NAC during the 2013-2016 period were associated with a total of 28 disclosure events that occurred during the interstitial period after the filing of their appeal to the NAC.[75] FINRA anticipates that the proposed heightened supervision requirement and the conditions or restrictions placed on the activities of these brokers would lead to greater oversight of their activities by their firm

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[74] In making these calculations, FINRA based its analysis on the occurrence of disclosure events as used in proposed IM-1011-3 and Rule 1017(a)(7). The analysis includes events that occurred and reached a resolution between the NAC appeal year and a year after the NAC decision year to allow sufficient time for events that occurred during the pendency of NAC to reach a resolution. Accordingly, the sample period for this analysis is based on appeals filed during the 2013-2016 period, instead of the full review period (2013-2018).

[75] These estimates are based on appeals filed by brokers, or jointly filed by brokers and firms, and excludes appeals that were filed only by firms. These estimates likely underrepresent the overall risk of customer harm posed by these brokers, because they are based on a specific set of events and outcomes used for classifying brokers for the proposed amendments to the MAP Rules. In addition, these brokers had other disclosure events after their appeal was filed, and some of these other events may also be associated with risk of customer harm.

during the appeal period, thereby reducing the potential risk of future customer harm during this period.[76]

Anticipated Costs

The costs of this proposal would primarily fall upon brokers or firms whose activities during the appeal period would be subject to the specific conditions or restrictions imposed by the Hearing Officer.[77] In addition, firms would incur costs associated with implementing heightened supervision for brokers while their disciplinary matters are under appeal. These costs would likely vary significantly across firms and could increase if the broker acts in a principal capacity. For example, firms employing disciplined respondents who serve as principals, executive managers or owners, or who operate in other senior capacities, would likely assume higher costs in developing and implementing tailored supervisory plans. Such plans may entail re-assignments of responsibilities, restructuring within senior management and leadership, and more complex oversight and governance approaches. These potential costs, in turn, may result in some brokers voluntarily leaving the industry rather than waiting for the resolution of the appeal process.[78]

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[76] FINRA also anticipates that the proposed changes to Rule 9556, which will establish an expedited proceeding for failures to comply with conditions or restrictions, will help ensure that the firms will comply with the conditions and restrictions imposed.

[77] Brokers and firms that choose to defend against motions for conditions and restrictions and that pursue expedited reviews of orders imposing conditions or restrictions would incur additional costs associated with these reviews.

[78] The proposal may also impose costs on issuers in limited instances where a firm is enjoined from participating in a private placement and the issuer is especially reliant on that firm. The private issuer may incur search costs to find a

The costs associated with this proposal would apply to brokers and their employing member firms while the brokers are employed during the pendency of the NAC appeals (the average processing time of which is 15 months) and any subsequent appeals.[79] Many broker-appellants, however, are not employed with any member firms when their NAC appeal is filed or leave shortly after the appeal is filed. FINRA examined the employment history, including employment start and end dates, of the 131 brokers[80] associated with NAC appeals during the review period, and estimates that 54 of them (or 41 percent) were not employed by any member firm during the appeal process, 33 of them (or 25 percent) were employed by a member firm only for part of the appeal process, and 44 of them (or 34 percent) were employed by a member firm throughout the appeal process.

FINRA notes that consistent with existing FINRA guidance, some firms may have already established heightened supervision of individuals while their disciplinary matters are on appeal.[81] The existing heightened supervision plans may address all, some or none of the conditions or restrictions imposed by the Hearing Panel Officer. Accordingly, for these firms the anticipated costs of this proposal may be lower.

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replacement firm or individual and incur other direct and indirect costs associated with the offering.

79 FINRA has no estimate for the time associated with subsequent appeals.

80 These 131 brokers correspond to those associated with a NAC appeal during the review period (2013-2018). The 75 brokers discussed in the Anticipated Benefits section above are a subgroup of brokers associated with a NAC appeal during the 2013-2016 period. <u>See</u> <u>supra</u> note 74.

81 <u>See</u> <u>Regulatory Notice</u> 18-15 (April 2018).

Other Economic Impacts

In developing the proposal, FINRA considered the possibility that, in some cases, this proposal may limit activities of brokers and firms, while their disciplinary matter is under appeal, in instances where the restricted activities do not pose a risk to customers. In such cases, these brokers and firms may lose economic opportunities, and their customers may lose the benefits associated with the provision of these services. FINRA believes that the proposed rule changes mitigate such risks by requiring the conditions or restrictions imposed to be reasonably necessary for the purpose of preventing customer harm and by providing a respondent with the right to seek expedited review of a motion to modify or remove any or all of the conditions and restrictions. Further, as discussed above, approximately 66 percent of the broker-appellants during the review period either were not employed by a member firm during the appeal process or were employed by a member firm only for part of the appeal process. Accordingly, these brokers would not be impacted by this proposal or would be subject to the proposed limitations only for a limited period of time.

2. Proposed Amendments to the FINRA Rule 9520 Series

The proposed rule amendments would impact statutorily disqualified individuals and their employing firms while the SD Application is being processed. These individuals would be subject to heightened supervision during the pendency of their SD Applications.

Anticipated Benefits

The primary benefit of this proposed rule change would arise from greater oversight by employing firms of the activities of statutorily disqualified individuals during the pendency of their SD Applications, thereby reducing the potential risk of customer harm during this period. In order to assess the potential risk posed by these individuals during the pendency of their SD Applications, FINRA examined whether individuals associated with an SD Application filed during the 2013-2016 period had a disclosure event[82] at any time from the filing of the SD Application through two years after filing.[83] Based on this analysis, FINRA estimates that 26 (or 51 percent) of the 51 individuals associated with SD Applications during the 2013-2016 period had a total of 41 disclosure events during the interstitial period after the filing of their SD Application.[84]

Anticipated Costs

The costs associated with this proposal would fall primarily on firms that incur direct and indirect costs associated with establishing and implementing the tailored heightened supervision plan while an SD Application is under review. As discussed above, the costs would likely vary significantly across firms and could increase if the statutorily disqualified individuals also serve as principals, executive managers, or owners or operate in other senior capacities. Moreover, the heightened supervision

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82 For purposes of this analysis, "disclosure event" included final criminal matters and specified risk events, as defined in proposed Rule 1011(h) and (p).

83 This analysis includes events that occurred and reached a resolution from the SD Application filing year until the end of two years later to allow sufficient time for events that occurred during the eligibility proceeding to reach a resolution. Accordingly, the sample period for this analysis is based on SD Applications filed during the 2013-2016 period, instead of the full review period (2013-2018).

84 This likely underrepresents the overall risk of customer harm, because the disclosure events in this analysis included only final criminal matters and specified risk events.

requirement may deter some firms from retaining these individuals and, as a result, these individuals may find it more difficult to remain in the industry.

3. Proposed Amendments to the BrokerCheck Rule

The proposed amendments would impact taping firms and their registered persons. Taping firms have a proportionately significant number of registered persons who were associated with firms that were expelled by a self-regulatory organization or had their registration revoked by the SEC for sales practice violations, and as a result, may pose greater risk to their customers.

Anticipated Benefits

The primary benefit of this proposed rule change would arise from the investor protection benefits associated with disclosing a firm's status as a "taping firm" through BrokerCheck to the investors. This would allow investors to make more informed choices about the brokers and firms with which they conduct business. The anticipated benefits would increase with the likelihood that a potential or actual customer to a taping firm seeks information through BrokerCheck.

Anticipated Costs

The proposal would not impose any direct costs on brokers or firms. Nonetheless it may impact their businesses, as investors may rely on information about a firm's status as a taping firm in determining whom to engage for financial services and brokerage activities. Disclosing the status of a firm as a "taping firm" through BrokerCheck may also further deter firms from hiring or retaining brokers who were employed previously by disciplined firms in order to avoid the "taping firm" thresholds and resulting disclosure on BrokerCheck.[85]

4. Proposed Amendments to MAP Rules

The proposed rule change would directly impact individuals with one or more final criminal matters or two or more specified risk events within the prior five years, who seek to become owners, control persons, principals or registered persons of a member firm. To estimate the number of brokers who would meet the proposed criteria, FINRA analyzed the categories of events and conditions associated with the proposed criteria for all brokers during the review period. For each year, FINRA determined the approximate number of brokers who met the proposed criteria and became owners, control persons, principals or registered persons of a member firm. As discussed in more detail below, this analysis showed that there were 110-215 such individuals, per year, who would have met the proposed criteria had it been in place during the review period.

The proposal is intended to apply to brokers who may pose greater risks to their customers than other brokers. A framework for evaluating the effectiveness of the criteria is to observe the rate at which brokers identified collectively by the criteria are substantially more likely to have regulatory-related events, including specified risk events and final criminal matters, than their peers. Based on FINRA's analysis of all individuals who sought to become owners, control persons, principals or registered persons of a member firm during the review period, individuals who would have met the proposed

85 As discussed above, only four firms during the review period became subject to the taping requirements of Rule 3170. As a result, FINRA does not anticipate that this proposal would be associated with significant economic impacts, including the anticipated benefits or costs.

criteria had on average 1.4-1.6 final criminal matters and specified risk events (per broker), while other brokers had on average 0.002-0.004 such events (per broker).[86] These estimates suggest that individuals who would have been affected by this proposal (had it been in place during the review period) had on average over 450-900 times more final criminal matters and specified risk events than other brokers during the same review period.

Anticipated Benefits

The primary benefit of the proposed amendments would be to reduce the potential risk of future customer harm by individuals who meet the proposed criteria and seek to become an owner, control person, principal, or registered person of a member firm. FINRA believes the proposed rule change would further promote investor protection by applying stronger standards for continuing membership with FINRA and for changes to a current member firm's ownership, control or business operations. These benefits would primarily arise from changes in broker and firm behavior and increased scrutiny by FINRA of brokers who meet the proposed criteria during the review of a materiality consultation and, where appropriate, a CMA.

To scope these potential benefits and assess the potential risk posed by brokers who would meet the proposed criteria, FINRA evaluated the extent to which brokers who would have met the criteria during 2013-2016 (had the criteria existed) and sought the proposed roles were associated with "new" final criminal matters or specified risk events

[86] As discussed above, the proposed criteria includes individuals with one or more "final criminal matters" or two or more "specified risk events" in the prior five years. The individuals who would have met the proposed criteria as a result of two or more "specified risk events" in the prior five years had on average 2.3-2.9 such events during the review period.

after having met the proposed criteria. These "new" events correspond to events that were identified or occurred after the broker's meeting the proposed criteria, and do not include events that were pending at the time of meeting the criteria and subsequently resolved in the years afterwards. As shown in Exhibit 3e, FINRA estimates that, in 2013, 215 brokers would have met the proposed criteria and sought the proposed roles. These brokers were associated with 35 "new" final criminal matters or specified risk events that occurred after their meeting the proposed criteria, between 2014 and 2018. Exhibit 3e similarly shows the number of events associated with brokers who would have met the proposed criteria and sought the proposed roles in 2014, 2015 and 2016. Across 2013-2016, there were 635 unique brokers who would have met the proposed criteria and sought the proposed roles, and these brokers were associated with a total of 93 events that occurred in the years after they met the proposed criteria.

Exhibit 3e also shows, for the 2013-2016 period, a factor representing a multiple for the average number of events for brokers who would have met the proposed criteria and sought the proposed roles relative to other brokers who sought the proposed roles. For example, the factor of 16x for 2013 indicates that brokers meeting the proposed criteria and seeking the proposed roles in 2013 had on average 16 times more new events (per broker) in the subsequent years (2014-2018) than other brokers who sought those roles in 2013.[87] Overall, this analysis demonstrates that brokers who would have met the proposed criteria and sought the proposed roles during the 2013-2016 period had on average approximately 16-49 times more new criminal matters and specified risk events

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87 Brokers meeting the proposed criteria and seeking the proposed roles in 2013 had on average 0.16 new events (per broker) in the subsequent years (2014-2018) compared to 0.01 events (per broker) for other brokers seeking the proposed roles.

after meeting the criteria than other brokers who sought the proposed roles.

Anticipated Costs

The cost of this proposal would fall on the firms that seek to add owners, control persons, principals or registered persons who meet the proposed criteria. These firms would be directly impacted by the proposals through the requirements to seek a materiality consultation with FINRA and, potentially, to file a CMA. While there is no FINRA fee for seeking a materiality consultation, firms may incur internal costs or costs associated with engaging external experts in conjunction with the filing of a CMA. In addition, the proposal could result in delays to a firm's ability to add owners, control persons, principals or registered persons who meet the proposed criteria, during the time the mandatory materiality consultation and any required CMA is being processed. FINRA examined the time to process materiality consultations and determined that, on average, these consultations are completed within eight to ten days, although this time period could be longer depending on the complexity of the contemplated expansion or transaction and the aggregate number of consultations under review. These anticipated costs may deter some firms from hiring individuals meeting the proposed criteria, who as a result may find it difficult to remain in the industry or bear other labor market related costs.

Other Economic Impacts

To provide transparency and clarity regarding the application of this proposal, the proposed criteria is based on disclosure events required to be reported on the Uniform Registration Forms. Information about disclosure events reported on the Uniform Registration Forms is generally available to firms and FINRA. Accordingly, firms would be able to identify the specific set of disclosure events that would count towards the proposed criteria and replicate the proposed thresholds using available data, with a few exceptions.[88] In determining the proposed numeric threshold, FINRA considered three key factors: (1) the different types of reported disclosure events; (2) the counting criteria (i.e., the number of reported events required to trigger the obligations); and (3) the time period over which the events are counted. In evaluating the proposed numeric threshold versus alternative criteria, significant attention was given to the impact of possible misidentification of individuals; specifically, the economic trade-off between including individuals who are less likely to subsequently pose risk of harm to customers, and not including individuals who are more likely to subsequently pose risk of harm to customers. There are costs associated with both types of misidentifications. For example, subjecting individuals who are less likely to pose a risk to customers to mandatory materiality consultations, and potentially CMAs, would impose additional costs on these individuals, their affiliated firms and customers. The proposed numeric threshold aims to appropriately balance these costs in the context of economic impacts associated with the proposed amendments to the MAP Rules.

The proposal may create incentives for changes in behavior to avoid meeting the proposed threshold. Under the proposal standing alone, brokers and firms may be more likely to try to settle customer complaints or arbitrations below $15,000 so that their

[88] Firms have access to disclosure events reported on Form U4, U5, and U6 filings for individuals who were previously registered with the same firms or with other firms. Firms do not have access, however, to information regarding individuals that is disclosed on another firm's Form BD. Firms may not have access to information about disclosure events for individuals, including control affiliates, who were not previously registered.

settlements do not count towards the proposed threshold. To the extent, if any, that customers also would be willing to settle for less, this change may reduce the compensation provided to customers.[89] Alternatively, it could increase the time, effort and costs for customers associated with negotiating a settlement, even if the settled amount would not change. Brokers and firms also may consider underreporting the disclosure events to avoid being subject to the proposed rule. However, this potential impact is mitigated by the facts that many of the events are reported by FINRA or other regulators, incorrect or missing reports can trigger regulatory action by FINRA, and FINRA rules require firms to take appropriate steps to verify the accuracy and completeness of the information contained in the Uniform Registration Forms before they are filed. FINRA also has the ability to check for unreported events, particularly those that third parties report in separate public notices, such as the outcomes of some civil proceedings.

FINRA recognizes that in some instances, firms may not be able to identify certain individuals with disclosure events who may seek to become owners, control persons, principals or registered persons of the firm. Similarly, firms may have less incentive to conduct appropriate due diligence on those individuals for whom firms may not have readily available disclosure history.[90] Firms still would be required, however, to

89 The proposed $15,000 threshold for customer settlements corresponds to the reporting threshold for the Uniform Registration Forms and for the settlement information to be displayed through BrokerCheck. Accordingly, the change in incentives to brokers and firms associated with the proposed rule should be considered in the presence of the incentives already in place.

90 For example, as discussed above, firms do not have access to disclosure events for non-registered control affiliates at other firms. FINRA uses disclosure events

seek information on relevant disclosure events from individuals who seek to become principals or registered persons, as part of the registration process, and take reasonable steps (e.g., by conducting background checks) to verify the accuracy and completeness of the information provided by the individuals. Nonetheless, FINRA recognizes that in some cases, even after conducting reasonable due diligence, firms may not have the required information to identify certain individuals who meet the proposed criteria, and these individuals may continue to pose risk of future investor harm. FINRA believes that these risks are mitigated by its own examination risk programs that monitor and examine individuals for whom there are concerns of ongoing misconduct or imminent risk of harm to investors. These programs identify high-risk individuals based on the analysis of data available to the firms as well as additional regulatory data available to FINRA.[91]

In developing this proposal, FINRA analyzed disclosure events reported on the Uniform Registration Forms for all individuals during the review period. For each year, FINRA evaluated the data and determined the approximate number of individuals who would have met the proposed numeric threshold of one or more final criminal matters or two or more specified risk events in the prior five years. Exhibit 3a shows the disclosure categories that FINRA considered and the subcategories that were used for identifying final criminal matters and specified risk events. The exhibit also shows the mapping of these disclosure categories to the underlying questions in Form U4.[92] Exhibit 3b shows

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reported on Form BD across all firms to identify disclosure records of non-registered control affiliates.

91 See supra note 88.

92 Forms U5 and U6 have questions similar to Form U4 that can also be mapped to the disclosure categories in Exhibit 3a.

the corresponding mapping of these disclosure categories to the questions in Form BD.[93] Exhibit 3c provides a breakdown of the disclosure categories for all individuals registered with FINRA in 2018.[94] The exhibit illustrates the impacts of refining subcategories of reported disclosure events and using different numeric thresholds on the number of disclosure events and the number of registered persons associated with these events.[95] This analysis has led FINRA to initially propose the numeric threshold set forth in the current proposal.

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93 Form BD includes information on disclosure events for individual control affiliates, including non-registered control affiliates that may not have Form U4, U5 or U6 filings. Form BD is the primary source of information on disclosure events for these unregistered control affiliates. Form BD includes information on final criminal matters and certain specified risk events associated with regulatory actions and civil judicial actions, but does not include information on customer awards or settlements.

94 Exhibit 3c does not include information on individuals who were not registered with FINRA in 2018. These non-registered individuals may include non-registered associated persons, including non-registered control affiliates.

95 Exhibit 3c shows the number of criminal disclosures and “disclosures considered in developing specified risk events” (regulatory action disclosures, civil judicial disclosures, and customer complaint, arbitration and civil litigation disclosures)—including final and pending disclosures—for brokers who were registered with FINRA in 2018, over such brokers’ entire reporting history; the number of brokers associated with these disclosure events; and the impact of refining the disclosure categories and the periods over which these events are counted. For example, the exhibit shows that brokers who were registered with FINRA in 2018 had, over their entire reporting history, 19,655 criminal disclosures and 134,928 “disclosures considered in developing specified risk events.” It also shows that 41,915 individuals had, over their entire reporting history, one or more criminal disclosures or two or more “disclosures considered in developing specified risk events.” When narrowing the disclosure categories to include only the “final criminal matters” and “specified risk events” as defined in this proposal (including the five-year lookback period), the results narrow to 174 final criminal matters and 2,616 specified risk events, and to 414 brokers who met the proposed numeric threshold of one or more final criminal matters or two or more specified risk events in the prior five years.

The additional proposed obligations would only apply to individuals with one or more final criminal matters or two or more specified risk events within the prior five years who seek to become owners, control persons, principals or registered persons of a firm. Accordingly, FINRA examined registration information in order to identify all individuals who would have met the proposed criteria and sought the proposed roles during the review period. Those identified serve as a reasonable estimate for the number of individuals who would have been directly impacted by this proposal had it been in place at the time. This analysis indicates that there were 110-215 such individuals per year, as shown in Exhibit 3d. These individuals represent 0.09-0.16 percent of individuals who became owners, control persons, principals, or registered persons with a new member in any year during the review period.[96]

FINRA also analyzed firms that employed individuals who would be directly impacted by this proposal. The analysis shows that in each year over the review period, there were between 74-155 firms employing individuals who would have met the proposed criteria. Approximately 41 percent of these firms were small, 12 percent were mid-size, and the remaining 47 percent were large.[97] FINRA estimates that approximately 31 percent of the individuals meeting the proposed criteria and who sought

[96] These percentages are calculated by dividing FINRA's estimate of the number of individuals who met the proposed criteria each year during the review period and sought the proposed roles (110-215 individuals per year) by the number of individuals who became owners, control persons, principals, or registered persons with a new member each year during the review period (122,003-131,156 individuals per year).

[97] <u>See</u> <u>supra</u> note 71.

the proposed roles were employed by small firms, ten percent by mid-size firms and 59 percent by large firms.

(d) Alternatives Considered

FINRA recognizes that the design and implementation of the rule proposals may impose direct and indirect costs on a variety of stakeholders, including member firms, associated persons, regulators, investors and the public. Accordingly, in developing its rule proposals, FINRA sought to identify alternative ways to enhance the efficiency and effectiveness of the proposals while maintaining their regulatory objectives. The following provides a discussion of the alternatives FINRA considered for the current proposals.

1. Proposed Amendments to the FINRA Rule 9200 Series and FINRA Rule 9300 Series

As an alternative to the proposal to authorize Hearing Officers to impose conditions or restrictions, FINRA considered whether to require sanctions imposed by the FINRA Hearing Panel or Hearing Officer in disciplinary decisions to be effective during the pendency of the NAC appeals and subsequent appeals. FINRA believes that such an approach could be too restrictive in disciplinary matters with significant sanctions and where the risk of harm may be specific to particular activities. Accordingly, FINRA believes that conditions and restrictions that are tailored specifically to the risk posed by the individuals during the pendency of the appeals, and are reasonably necessary for the purpose of preventing customer harm, would provide a better balance between protecting investors and preventing undue costs on individuals and firms while their appeals are pending.

2. Proposed Amendments to the FINRA Rule 9520 Series

This proposal would subject statutorily disqualified individuals employed with member firms to heightened supervision during the pendency of their SD Applications. Considering that the problem addressed by the proposed amendments to the FINRA Rule 9520 Series is very specific, FINRA did not consider any significant alternatives to this targeted proposal.

3. Proposed Amendments to FINRA Rule 8312

Considering that this proposal would likely not be associated with material economic impacts, FINRA did not consider any significant alternatives to this proposal.[98]

4. Proposed Amendments to the FINRA Rule 1000 Series

FINRA considered several alternatives to the numeric and categorical thresholds for identifying individuals who would be subject to the proposed amendments to the MAP Rules. In determining the proposed threshold, FINRA focused significant attention on the economic trade-off between incorrect identification of individuals who may not subsequently pose risk of harm to their customers, and not including individuals who may subsequently pose risk of harm to customers. FINRA also considered three key factors: (1) the different types of reported disclosure events, (2) the counting criteria (i.e., the number of reported events), and (3) the time period over which the events are counted. FINRA considered several alternatives for each of these three factors.

98 As discussed above, there were only four firms that became subject to the taping requirements of Rule 3170 during the review period.

a. Alternatives Associated with the Types of Disclosure Events

In determining the different types of disclosure events, FINRA considered all categories of disclosure events reported on the Uniform Registration Forms, including the financial disclosures and the termination disclosures. FINRA decided to exclude financial disclosures, which include personal bankruptcies, civil bonds, or judgments and liens. While these events may be of interest to investors in evaluating whether or not to engage a broker, these types of events are not by themselves direct evidence of customer harm. FINRA also considered whether termination disclosures should be included as specified risk events. Termination disclosures include job separations after allegations against the brokers.[99] Certain termination disclosures reflect conflicts of interest between the firm and the broker and, as a result, may not necessarily be indicative of misconduct. Further, the underlying allegations in the termination disclosures may be associated with other disclosure events, such as those associated with customer settlements or awards, regulatory actions or civil judicial actions, which are already included in the proposed criteria. Where so, the underlying conduct posing potential future customer harm would be captured in the proposed criteria. As a result, FINRA did not include termination disclosures as specified risk events. Accordingly, FINRA considered the remaining five categories of disclosure events listed in Exhibit 3a.

Within each disclosure category included in the proposed criteria, FINRA considered whether pending matters should be included or if the criteria should be restricted to final matters that have reached a resolution not in favor of the broker.

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99 Termination disclosures involve situations where the individual voluntarily resigned, was discharged, or was permitted to resign after allegations.

Pending matters may be associated with an emerging pattern of customer harm and capture timely information of potential ongoing or recent misconduct. However, pending matters may also include disclosure events that remain unresolved or subsequently get dismissed because they lack merit or suitable evidence. FINRA excluded pending matters in the current proposal because the potential adverse impacts on the individuals who may be identified because of pending matters would likely outweigh the benefit of including pending matters.[100]

Exhibit 3a shows the five categories of disclosure events that were considered and the subcategories that were included in the proposed criteria. For criminal matters, FINRA considered whether criminal charges that do not result in a conviction or a plea of guilty or nolo contendere (no contest) should be included in the proposed criteria. These events correspond to criminal matters in which the associated charges were subsequently dismissed or withdrawn and, as a result, are not necessarily evidence of misconduct. Accordingly, FINRA only included criminal convictions, including pleas of guilty or nolo contendere (no contest), in the proposed criteria.

For customer settlements and awards, FINRA considered whether settlements and awards in which the broker was not "named" should be considered as a specified risk event. These "subject of" customer settlements and awards correspond to events where the customer initiates a claim against the firm and does not specifically name the broker,

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[100] For example, individuals who may be identified on a fixed numeric threshold based upon pending matters could find it difficult to become owners, control persons, principals, or registered persons of a member firm while these matters are pending, even if such matters are subsequently dismissed. See also Exhibit 3c.

but the firm identifies the broker as required by the Uniform Registration Forms.[101] In these cases, the broker is not party to the proceedings or settlement. There may be conflicts of interest between the firm and the broker such that the claim may be attributed to the broker without the ability of that broker to directly participate in the resolution. Accordingly, FINRA excluded "subject of" customer settlements and awards from the proposed criteria. FINRA recognizes that excluding these events may also undercount instances where the broker may have been responsible for the alleged customer harm.

For civil judicial actions and regulatory actions, FINRA considered whether all sanctions associated with final matters should be included in the proposed criteria or whether certain less severe sanctions should be excluded. Final regulatory action or civil judicial action disclosures may be associated with a wide variety of activities, ranging from material customer harm to more technical rule violations, such as a failure to make timely filings or other events not directly related to customer harm. However, due to the way in which such information is currently reported, it is not straightforward to distinguish regulatory or civil judicial actions associated with customer harm from other such actions.[102] In the absence of a reliable way to identify regulatory and civil judicial

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101 For example, the Instructions to Form U4 provide that the answer to Questions 14I(4) or 14I(5) should be "yes" if the broker was not named as a respondent/defendant but (1) the Statement of Claim or Complaint specifically mentions the individual by name and alleges the broker was involved in one or more sales practice violations or (2) the Statement of Claim or Complaint does not mention the broker by name, but the firm has made a good faith determination that the sales practice violation(s) alleged involves one or more particular brokers.

102 For example, the Uniform Registration Forms contain information in disclosure reporting pages that could be useful in identifying regulatory actions or civil judicial actions associated with customer harm, but it is stored as "free-text" and, therefore, cannot be reliably compared across disclosures.

actions associated with customer harm, FINRA considered using a proxy of severity of the underlying sanctions as a way to exclude events that are likely not associated with material customer harm. Therefore, FINRA is proposing to include regulatory actions or civil judicial actions that are associated with more severe sanctions, such as bars, suspensions or monetary sanctions above a de minimis dollar threshold of $15,000. FINRA notes that relying strictly on a proxy for severity would likely exclude certain regulatory actions or civil judicial actions that are associated with customer harm, and may include certain regulatory actions or civil judicial actions that are not associated with customer harm.

FINRA also considered several alternative de minimis dollar thresholds for disclosure events included in the proposed criteria. For example, FINRA considered higher dollar thresholds of $25,000, $50,000 and $100,000 for customer settlements, customer awards, and monetary sanctions associated with regulatory actions and civil judicial actions. A dollar threshold may capture a dimension of severity of the alleged customer harm. The Uniform Registration Forms establish a de minimis dollar reporting threshold of $10,000 for complaints filed prior to 2009 and $15,000 afterwards. The reporting threshold may, however, be low and possibly include instances where the payment was made to end the complaint and minimize litigation costs. However, the dollar threshold does not account for the value of the customers' accounts, and there are likely cases where even low dollar amounts represent remuneration of a significant portion of customer investments. Accordingly, a dollar threshold may be both under-inclusive and over-inclusive, and as a result FINRA considered a range of alternative thresholds. Increasing the dollar threshold from $15,000 to $25,000, $50,000 and

$100,000 would decrease the number of individuals impacted by this proposal from 110-215 individuals each year over the review period (as explained above) to 108-207 individuals, 103-197 individuals and 97-180 individuals each year, respectively. Finally, FINRA notes that establishing a de minimis dollar threshold that is different than the current reporting requirements could increase confusion among investors and registered persons and would likely create additional incentives for brokers and firms to keep future settlements below the dollar level that would trigger the restrictions, to the detriment of customers.

b. Alternatives Associated with the Counting Criteria

FINRA considered a range of alternative criteria for counting criminal matters or specified risk events. For example, FINRA considered whether the counting criteria for final criminal matters should be two or more final criminal matters or one final criminal matter and another specified risk event. This alternative would effectively count final criminal matters the same way as other specified risk events. FINRA believes that final criminal matters are generally more directly tied to serious misconduct than some of the other specified risk events. Accordingly, FINRA believes that one final criminal matter, as defined by this proposal, should be sufficient to trigger the proposed criteria.[103]

FINRA also considered alternative criteria for counting specified risk events. For example, FINRA considered decreasing the proposed threshold from two specified risk events to one. This alternative would change the proposed criteria to one or more final criminal matters or one (instead of two) or more specified risk events during the prior

[103] FINRA recognizes that final criminal matters include felony convictions that may not be investment related (e.g., a conviction associated with multiple DUIs).

five-year period. This approach would increase the number of individuals impacted by this proposal from 110-215 individuals to 341-675 individuals each year, over the review period. FINRA also considered increasing the proposed threshold from two specified risk events to three, thereby changing the proposed criteria to one or more final criminal matter or three (instead of two) or more specified risk events during the prior five-year period. This approach would decrease the number of individuals impacted by this proposal from 110-215 individuals to 86-161 individuals each year, over the review period. For the reasons explained above, FINRA considered alternative criteria for counting specified risk events, but chose the specification in the current proposal.

c. Alternatives Associated with the Time Period over which the Disclosure Events Are Counted

FINRA also considered alternative criteria for the time period over which final criminal matters and specified risk events are counted. For example, FINRA considered whether final criminal matters or specified risk events should be counted over the individual's entire reporting period or counted only over a more recent period. Based on its experience, FINRA believes that events that are more than ten years old do not necessarily pose the same level of possible future risk to customers as more recent events. Further, counting final criminal matters or specified risk events over an individual's entire reporting period would imply that individuals with such events would be subject to the criteria for their entire career, even if they subsequently worked without being associated with any future events. Accordingly, FINRA decided to include final criminal matters or specified risk events occurring only in a more recent period.

FINRA also considered a threshold based on a five-year lookback period for final criminal matters, but a five-to-ten year lookback period for specified risk events. Specifically, FINRA considered a threshold that would be met if the individual had one specified risk event having resolved during the previous ten years, and a second specified risk event resolved during the previous five years, or if the individual had one or more final criminal matters resolved in the prior five-year period. This approach would increase the number of individuals impacted by this proposal from 110-215 individuals to 127-236 individuals each year, over the review period. For the reasons explained above, FINRA considered alternative criteria for the lookback period for specified risk events, but chose the specification in the current proposal.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in Regulatory Notice 18-16 (April 2018). Thirteen comments were received in response to the Regulatory Notice.[104] A copy of the Regulatory Notice is attached as Exhibit 2a. A list of commenters is attached as Exhibit 2b. Copies of the comment letters received in response to the Regulatory Notice are attached as Exhibit 2c. Of the 13 comment letters received, eight were generally in favor of the proposed rule change, two were generally opposed, and one stated that the proposal was an improvement over the status quo but that significantly more action would be needed to protect investors.

FINRA has considered the comments received. In light of some of those comments, FINRA has made some modifications to the proposal. The comments and FINRA's responses are set forth in detail below.

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[104] All references to commenters are to the comment letters as listed in Exhibit 2b.

General Support for and Opposition to the Proposal

Five commenters expressed general support for the proposed rule changes in Regulatory Notice 18-16, but all had suggestions on how aspects of the proposal should be modified.[105] Two commenters expressed support for the proposed amendments, subject to certain modifications.[106] One commenter expressed general support for the proposed amendments except the proposed amendments to the Rule 1000 Series.[107] Two commenters suggested different approaches that FINRA could take.[108] One commenter expressed opposition to specific aspects of the proposal.[109] One commenter opined that the proposal has numerous deficiencies and offered remedies.[110] All of these commenters' suggestions are discussed in more detail below.

Proposed Amendments to the FINRA Rules 9200 and 9300 Series to Enhance Investor Protection During the Pendency of an Appeal or Call-for-Review Proceeding

- Conditions or Restrictions

The proposed amendments to the Rule 9200 and 9300 Series would allow a Hearing Officer to impose conditions or restrictions on the activities of a respondent

105 MML, NASAA, PIABA, SIFMA, Wulff Hansen.

106 Cambridge, FSI.

107 Janney.

108 Better Markets, IBN.

109 Luxor.

110 Network 1.

during the pendency of an appeal to the NAC from, or call for NAC review of, a disciplinary decision.

Some commenters expressed support for these specific proposals. FSI commented that permitting Hearing Officers to impose conditions and restrictions strikes the appropriate balance between the member's rights and investor protection concerns. NASAA supported imposing temporary remedies on parties that lose at the hearing level, writing that it would align FINRA's procedures with federal and state law. PIABA wrote that a disciplinary respondent should not be permitted to conduct business as usual during a disciplinary appeal.

Several commenters requested that a disciplined respondent and firms that associate with a disciplined respondent have an opportunity to propose to the Hearing Officers the conditions and restrictions that should be imposed.[111] Cambridge stated that this opportunity would help ensure that conditions and restrictions are not overly broad and account for a firm's size, resources and ability to supervise, and that it would alleviate concerns about potential lost income, lost opportunities and lost clients that could result from the conditions or restrictions. SIFMA wrote that this opportunity would help ensure that any conditions and restrictions imposed are reasonably necessary for the nature and scale of the misconduct at issue and tailored to a firm's business model, and that it would reduce the number of motions to modify or remove conditions or restrictions.

While FINRA appreciates the comments, FINRA notes that the proposal allows an individual respondent to make arguments concerning the potential conditions and

[111] Cambridge, FSI, SIFMA.

restrictions to the Hearing Officer. In this regard, nothing in the proposed rule change prevents a respondent in a disciplinary proceeding from proposing, in opposition or response to a motion for conditions or restrictions, the conditions and restrictions that could or should be imposed. Likewise, nothing prevents an individual respondent, during the underlying disciplinary proceeding itself, from introducing relevant evidence. Moreover, FINRA rules only give named parties the right to participate in a FINRA disciplinary proceeding, and the complaint issued against an individual respondent will not always name that person's employing firm as a respondent. However, in light of these comments, FINRA is proposing to modify the proposed rule as set forth in Regulatory Notice 18-16 to clarify that a respondent's opposition or other response to a motion for conditions or restrictions must explain why no conditions or restrictions should be imposed or specify alternate conditions or restrictions that are sought to be imposed and explain why the conditions or restrictions are reasonably necessary for the purpose of preventing customer harm.

Cambridge stated that the proposal does not address the recourse available for damages that could result from any conditions or restrictions imposed, in the event the underlying disciplinary decision is reversed on appeal. FINRA believes the proposal mitigates such risks. The standard for imposing conditions or restrictions—those that the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm—and the ability to request an expedited proceeding before the Review Subcommittee for prompt review of any conditions or restrictions imposed would act to ensure the conditions and restrictions imposed are reasonably tailored to address the potential concerns. The Hearing Officer that imposes conditions or restrictions in the first instance would be knowledgeable about the case and, therefore, well-suited to craft restrictions or conditions that are tailored to addressing the potential customer harm. And if a respondent believes that the conditions or restrictions imposed are too burdensome, the respondent would be permitted to request an expedited review and stay the conditions or restrictions.

Better Markets suggested that Hearing Officers should be required, not just permitted, to impose conditions or restrictions that are necessary to protect investors pending an appeal to the NAC. FINRA believes, however, that it is more appropriate to give Hearing Officers discretion. There may be situations when conditions or restrictions may be deemed not necessary, such as when a respondent firm or a respondent individual's employing firm has already undertaken substantial subsequent remedial measures or when the violations at issue do not involve the risk of customer harm.

FSI and Luxor opposed the standard in proposed FINRA Rule 9285(a) that the Hearing Officer may impose conditions or restrictions that it considers "reasonably necessary for the purpose of preventing customer harm." FSI opined that that standard could lead to conditions or restrictions that are unduly burdensome or unrelated to the misconduct, and it suggested that the standard also require that the conditions and restrictions be "reasonably designed to prevent further violations of the rule or rules the Hearing Panel or Hearing Officer [in the underlying disciplinary proceeding] has found to have been violated." FSI further suggested that, when imposing conditions or restrictions, Hearing Officers be required to consider the firm's size, resources and overall ability to supervise the registered representative's compliance with the conditions or restrictions. Luxor wrote that the proposed standard would have a chilling effect on a respondent's right to appeal because, depending on the conditions and restrictions imposed, the respondent may be unable to afford legal representation or may suffer irreversible damage to a book of business.

FINRA's proposed standard, however, is consistent with the rules of other self-regulatory organizations.[112] Moreover, FINRA believes that the proposed standard—both its use of the term "reasonably necessary" and its emphasis on "for the purpose of preventing customer harm"—provides sufficient and appropriate limiting parameters. FINRA also believes that requiring that conditions or restrictions be reasonably designed to prevent further violations of the rule or rules found to have been violated in the underlying disciplinary decision, as FSI suggests, may not allow the Hearing Officer to adequately address the investor protection concerns that have been raised by the activities of the respondent. As FINRA explained above (and in Regulatory Notice 18-16), the conditions and restrictions imposed should target the misconduct demonstrated in the

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[112] See BOX Rule 12110 ("Pending effectiveness of a decision imposing a sanction on the Respondent, the person, committee or panel issuing the decision (the 'adjudicator') may impose such conditions and restrictions on the activities of the Respondent as it considers reasonably necessary for the protection of investors and the Exchange."); CBOE Rule 13.11(b) ("Pending effectiveness of a decision imposing a sanction on the Respondent, the Hearing Panel or the CRO, as applicable, may impose such conditions and restrictions on the activities of the Respondent as the Hearing Panel or the CRO, as applicable, considers reasonably necessary for the protection of investors and the Exchange"); CBOE BZX Rule 8.11 ("Pending effectiveness of a decision imposing a penalty on the Respondent, the CRO, Hearing Panel or committee of the Board, as applicable, may impose such conditions and restrictions on the activities of the Respondent as he, she or it considers reasonably necessary for the protection of investors, creditors and the Exchange."); MIAX Options Rule 1011(b) ("Pending effectiveness of a decision imposing a sanction on the Respondent, the person, committee or panel issuing the decision (the 'adjudicator') may impose such conditions and restrictions on the activities of the Respondent as it considers reasonably necessary for the protection of investors and the Exchange.").

disciplinary proceeding and be tailored to the specific risks posed by the member firm or broker. With regard to FSI's suggestions to amend the standard to require consideration of numerous additional factors, FINRA believes that, for investor protection purposes, the primary driver of the conditions or restrictions should be what is reasonably necessary to prevent customer harm, not the size of the respondent's employing firm or its claims about its resources. FINRA believes that the proposed standard—coupled with the parties' ability to participate in the process, the knowledge of the Hearing Officers, and the availability of an expedited review—are appropriate to yield conditions or restrictions that are targeted at the specific, identifiable risks presented to customers and that are not overly burdensome. FINRA further proposes, that in light of this and other comments, to clarify the process for imposing conditions and restrictions during the pendency of an appeal. Specifically, FINRA is proposing to modify the proposed rule as set forth in Regulatory Notice 18-16 to clarify when and how parties can seek to impose reasonably necessary conditions and restrictions following a disciplinary decision by a Hearing Panel or Hearing Officer, the process for a respondent to request an appeal through an expedited proceeding of such conditions and restrictions, and to further clarify that such conditions and restrictions would be stayed during such expedited proceeding.

Several commenters requested that a different burden be applied in proposed Rule 9285(b)(2) for seeking the modification or removal of conditions or restrictions.[113] PIABA suggested that, to modify or remove conditions or restrictions, the respondent should be required to provide clear and convincing evidence of a manifest error by the trier of fact and show the likelihood of success of the underlying appeal. Cambridge and

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113 Cambridge, FSI, PIABA.

FSI suggested that the respondent should have to show that the Hearing Officer committed an error, that the conditions or restrictions are overly broad, or that they are not narrowly tailored to prevent future occurrences of the underlying violations.

FINRA declines these comments. As explained above, the burden in proposed Rule 9285(b)(2) is that the respondent would have to demonstrate that the conditions or restrictions imposed are not reasonably necessary for the purpose of preventing customer harm. This burden is consistent with the standard set forth in proposed Rule 9285(a) for establishing conditions and restrictions in the first place. Furthermore, FINRA believes that, for fairness reasons, a respondent's ability to seek the modification or removal of conditions or restrictions should not be constrained by the underlying merits of the respondent's disciplinary appeal. Because there would be a separate, specific standard for the imposition of conditions or restrictions—i.e., those that the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm—any conditions or restrictions imposed could be erroneous for a reason that is entirely unrelated to whether a respondent's underlying appeal has a likelihood of success. Likewise, FINRA does not support establishing a burden of proof that would be more difficult to meet, such as a "clear and convincing evidence of a manifest error by the trier of fact" standard. Thus, FINRA has retained that aspect of the standard proposed in Regulatory Notice 18-16 that would require a respondent to demonstrate, when moving to modify or remove conditions or restrictions, that the conditions or restrictions imposed are not reasonably necessary for the purpose of preventing customer harm.

PIABA and Better Markets wrote about the provisions in proposed Rule 9285(b) that would allow a respondent to seek expedited review of an order imposing conditions or restrictions. PIABA supported the proposed expedited review process. Better Markets, on the other hand, wrote that expedited reviews would add burdens to the NAC and cause delays in processing underlying disciplinary appeals. FINRA has retained the proposed expedited review process. FINRA has added the expedited review process to make the overall process more fair for the respondents involved. It also will further investor protection: because the filing of a motion to modify or remove conditions or restrictions would stay the effectiveness of the conditions or restrictions, an expedited review would allow properly imposed conditions and restrictions to become effective sooner. Moreover, because proposed Rule 9285(b) would assign the NAC's Review Subcommittee—and not the NAC itself—to decide motions to modify or remove conditions or restrictions and establish a 30-day deadline for doing so, FINRA expects that the expedited review process will not result in materially longer times for the NAC to process underlying disciplinary appeals.

Several commenters disagreed with how, pursuant to proposed Rule 9285(b), a motion to modify or remove conditions or restrictions would effect a stay of the conditions or restrictions. Better Markets and NASAA suggested that, for investor protection reasons, there should be no stays. NASAA further commented that permitting stays would be inconsistent with how proposed Rule 9285(b) would require firms to establish heightened supervision over individuals who appeal disciplinary decisions. Luxor, on the other hand, essentially sought to expand stays, writing that no conditions and restrictions should be imposed during a disciplinary appeal except upon a showing by FINRA of clear and convincing evidence of imminent harm to the public.

In light of the conflicting comments and FINRA's belief that the stay provision strikes the right balance, FINRA is proposing to retain the proposed stay provision. It appropriately balances the investor-protection benefits of imposing reasonably necessary conditions and restrictions with the Exchange Act requirement that FINRA provide a fair procedure in disciplinary proceedings. A stay of appropriately issued conditions or restrictions would be in place only during the relatively short duration of an expedited proceeding. Moreover, FINRA does not agree that having a temporary stay of conditions or restrictions during the expedited proceeding process and requiring firms to establish heightened supervision plans during the pendency of appeals are inconsistent. Proposed Rule 9285(e) would require a disciplined respondent's member firm to establish a reasonably designed heightened supervision plan regardless of whether a Hearing Officer imposes conditions and restrictions.[114] Thus, there is no reason for a respondent's firm to delay adopting a heightened supervision plan while any conditions or restrictions are stayed pending an expedited review. Moreover, proposed Rule 9285(e) contemplates that a respondent's firm would need to create an amended plan of heightened supervision that takes into account any conditions or restrictions imposed after the initial plan is adopted.

PIABA wrote that the proposal should require that an individual respondent's employing firm be notified immediately of any conditions or restrictions imposed. FINRA generally agrees with this comment and, as explained above, has modified the proposal to require that the Office of Hearing Officers or the Office of General Counsel, as appropriate, provide a copy of the order imposing conditions and restrictions to each

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[114] See also Regulatory Notice 18-15 (April 2018) (Guidance on Implementing Effective Heightened Supervisory Procedures for Associated Persons with a History of Past Misconduct).

FINRA member with which the respondent is associated. This would be similar to how FINRA rules currently require that copies of disciplinary decisions be provided to each FINRA member with which a respondent is associated.[115]

➢ Heightened Supervision of Disciplined Respondents

FINRA also received comments concerning the proposed amendments to require, in the event of an appeal or call for review, that an individual respondent's member firm adopt heightened supervisory procedures for that individual respondent.

Better Markets and PIABA expressed support for requiring firms to adopt written plans of heightened supervision while a disciplinary appeal is pending.

FSI and SIFMA stated that requiring firms to adopt written plans of heightened supervision within ten days of any appeal or call for review is an insufficiently short amount of time, and that firms should have 30 days. FINRA believes, however, that the ten-day period is appropriate under the circumstances. The longer the time period without a plan of heightened supervision in place, the greater the risk to investors. Retaining the shorter, ten-day deadline will allow the investor-protection benefits of the heightened supervision plans to be in place sooner. FINRA also believes that the ten-day period is sufficient because a firm should be aware of the potential need to adopt a heightened supervision plan well in advance of when it would be required to do so. In this regard, Form U4 requires that registered persons report when they are the subject of a regulatory complaint that could result in an affirmative answer to other Form U4 disclosure questions that ask about self-regulatory organization findings and disciplinary actions, and FINRA rules require that the Office of Hearing Officers promptly provide a

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[115] See Rule 9268(d).

copy of a disciplinary decision to each member with which a respondent is associated. Furthermore, the ten-day deadline for adopting a heightened supervision plan would begin only when the respondent appeals the decision to the NAC or when the matter is called for review. FINRA Rules 9311 and 9312 provide 25 days to file an appeal and 25 to 45 days to call a case for review.

PIABA suggested that a firm required to adopt a plan of heightened supervision pursuant to proposed Rule 9285 also should be required to document its enforcement of that plan. FINRA has previously indicated that documenting the enforcement of a heightened supervision plan could be a useful element of such a plan.[116] Instead of singling out additional provisions like these in the rule text, however, FINRA believes that its published notices provide a thorough source of guidance on heightened supervision plans, including what provisions should be included at a minimum, and what other provisions can be part of an effective plan.[117] As needed or appropriate, FINRA would be able to update its published guidance to account for the heightened supervision plans required by the proposed rule change.

Luxor suggested that heightened supervision plans would not be necessary where a Hearing Officer imposes conditions or restrictions. FINRA believes that even when conditions and restrictions are imposed, the respondent's member firm would still need to address, in a heightened supervision plan, how it would implement and execute those

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116 See Notice to Members 97-19 (April 1997) (advising that firms could require supervisors of registered representatives subject to special supervisory arrangements to provide a sign-off on daily activity or to periodically attest in writing that they have carried out the terms of the special supervision).

117 See Notice to Members 97-17 (April 1997); Regulatory Notice 18-15 (April 2018).

conditions and restrictions. Furthermore, heightened supervision plans would be needed to address activities that are not subject to any imposed conditions or restrictions.

Proposed Amendments to the FINRA Rule 9520 Series to Require Automatic Interim Plans of Heightened Supervision of a Disqualified Person During the Period When FINRA is Reviewing an Eligibility Application

Several commenters specifically approved of the proposed amendments to Rule 9522, which would require a member firm to adopt interim heightened supervisory procedures for a disqualified person during the pendency of the firm's SD Application to continue associating with that disqualified person. NASAA commented that this regulatory gap should be closed. PIABA commented that there is an obvious benefit to the proposal.

Better Markets suggested that firms should be required to adopt a plan of heightened supervision immediately when an associated person is found to have committed acts that are grounds for becoming disqualified, even pending the associated person's appeal of the underlying disqualifying event. While FINRA agrees that there may be benefits to requiring firms to place a disqualified associated person on a heightened supervision plan immediately and before the filing of an application to continue associating with that person, FINRA believes the timing requirement of the proposed rule—to require such a plan once a firm has made a determination to seek approval for continued association with the disqualified associated person—strikes the appropriate balance.

Network 1 wrote that requiring firms to expend resources on developing heightened supervision plans for disqualified persons while an SD Application is pending is a disincentive to hiring the person at all. While FINRA recognizes that the requirement to develop and implement an interim heightened supervision plan in these circumstances may deter some firms from retaining or hiring a disqualified person, FINRA believes that if a firm elects to sponsor a disqualified person it needs to provide greater oversight of the activities of such person during the pendency of the SD Application, thereby reducing the potential risk of customer harm during this period. Moreover, if the SD Application is approved by FINRA, the firm would in almost all cases be required to prepare a plan of heightened supervision.

Aderant noted that although proposed Rule 9522(g) sets a ten-day deadline to remedy a substantially incomplete application that seeks the continued associated of a disqualified person, the version proposed in Regulatory Notice 18-16 did not identify the specific event that triggers the ten-day deadline. FINRA agrees that a modification is appropriate and has revised proposed Rule 9522(g) to establish that the event triggering the ten-day deadline is service of the notice of delinquency.

Proposed Amendments to FINRA Rule 8312

The proposed amendments to FINRA Rule 8312 would remove the requirement that the only means through which persons can request information as to whether a particular member is subject to the provisions of the Taping Rule is a telephonic inquiry via the BrokerCheck toll-free telephone listing. The proposed amended rule would permit FINRA to release this information through BrokerCheck regardless of how it is requested.

NASAA agreed with this proposal, stating that it would advance investor protection.

Other commenters opposed it. Luxor wrote that the proposal is punitive, will disproportionately cause reputational damage to small firms, and will create a perception that a taping firm and its representatives are to be viewed negatively simply by association with behavior that occurred at other firms and other persons. Network 1 commented that there is little likelihood the public will understand the difference between a taping firm and a disciplined firm. FINRA notes that Rule 8312 already provides, however, that FINRA will release whether a particular member firm is subject to the Taping Rule in response to telephonic inquiries via the BrokerCheck toll-free telephone listing. The proposed amendments—which will only remove the telephonic inquiry limitation—will simply make it easier for investors to obtain this same information by expanding the means through which investors can access it. Moreover, the comment that the proposed amendments would have a disproportionate effect on small firms has no basis; there is currently only one firm subject to the Taping Rule.

Several comments raised concerns regarding the content of the proposed BrokerCheck disclosure relating to taping firms. Better Markets and PIABA requested that the disclosure be explained in BrokerCheck and include a specific narrative description of why the disclosure is being made. NASAA suggested that the proposed BrokerCheck disclosure appear only on the BrokerCheck reports of the few firms that are subject to the Taping Rule. NASAA further commented that the disclosure should identify the firm as subject to the Taping Rule and explain in plain English what that means. Network 1 and Better Markets raised concerns as to how the proposed amendments would impact the information disclosed through BrokerCheck concerning individuals. Network 1 requested that FINRA amend the proposal to ensure that the information disclosed on BrokerCheck not communicate any "guilt by association" for persons who are employees of taping firms and who have "clean records." Better Markets, on the other hand, suggested that the BrokerCheck profiles of individual brokers should denote when they are associated with taping firms.

FINRA appreciates the concerns expressed and agrees that the BrokerCheck disclosure of a firm as being subject to the Taping Rule should include a clear explanation of what that means, to help investors understand why the taping firm is subject to heightened procedures and incent them to research the background of a broker associated with the taping firm.

Proposed Amendments to the FINRA Rule 1000 Series to Impose Additional Obligations on Member Firms that Associate with Persons with a Significant History of Past Misconduct

- General Comments

The proposed amendments to the FINRA Rule 1010 Series would require a member firm to submit a letter to Member Regulation seeking a materiality consultation when a natural person that has, in the prior five years, one or more "final criminal matters" or two or more "specified risk events" seeks to become an owner, control person, principal or registered person.

Several commenters expressed general support for the proposed amendments to the Rule 1000 Series.[118] Better Markets characterized requiring materiality consultations before hiring as an important regulatory innovation. NASAA described the proposal as a reasonable means of getting Member Regulation more involved in members' decisions to

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[118] Better Markets, Cambridge, NASAA, PIABA.

associate with individuals who have significant disciplinary histories. PIABA wrote that the proposed amendments would promote investor protection, adequately apply stronger standards for continuing membership, and remind firms of the need to keep new representatives with significant disciplinary histories under a well-defined, well-enforced supervisory plan.

Janney and SIFMA commented that the proposed rule requiring materiality consultations is contrary to the spirit of FINRA's current guidance about materiality consultations, which they assert focuses on changes to a firm's business model and not the activity or employability of individuals. FINRA disagrees with this assertion and believes the proposed rule is consistent with FINRA rules governing the membership application process, which considers, among other things, firms' hiring decisions and individuals' past activities. For example, the safe harbor in IM-1011-1 is premised on the notion that hiring a certain number of associated persons involved in sales can be a material change in business operations that requires the filing of a CMA, and the safe harbor is not available to a member firm or a principal of a firm that has a specified disciplinary history. Likewise, FINRA rules require Member Regulation to consider, in new membership applications and CMAs, a variety of criminal, civil, regulatory, and arbitration events when assessing whether an applicant and its associated persons are capable of complying with federal securities laws, the rules and regulations thereunder, and FINRA rules.[119]

Several commenters expressed concern about the possible negative impact of the proposed rule on a firm's hiring practices and the ability of individuals with such events

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119 See Rule 1014(a)(3).

to be hired. Luxor commented that the proposed rule changes are unnecessary, because FINRA can contact a firm when it has hired "high-risk brokers." Luxor also commented that if a person has a license to operate and has not been barred or otherwise precluded from operating, no additional consultation should be required when a firm wishes to hire that person. Janney stated that the investing public and the markets would be better protected by FINRA taking contemporaneous action, instead of disrupting the hiring practices of an unrelated firm as many as five years after the underlying disclosure events in proposed Rule 1017(a)(7) and IM-1011-3 have occurred. Janney also expressed the view that it appears that FINRA would like to review transitions specifically in the context of an affiliation change, and the proposed rule would create the ability to prevent transition of a registered representative without taking enforcement action.

FINRA believes the proposed rule is necessary to ensure that FINRA has a more meaningful regulatory touchpoint at the time an individual with a significant history of misconduct seeks to become an owner, control person, principal or registered person of a member firm. The proposal would apply in the limited circumstance where such individual meets the required thresholds for disclosure events. FINRA believes requiring firms to ask FINRA for a materiality consultation, for example, when it is planning to hire a particular individual that meets the required thresholds, would allow FINRA the opportunity to meaningfully assess the underlying disciplinary events and review the firm's supervisory practices and internal controls. The ability of FINRA to conduct this review contemporaneously furthers investor protection. Moreover, nothing in the proposed rule precludes FINRA from taking enforcement action when necessary or appropriate.

➢ Definitions and Criteria that Would Require a Materiality Consultation

FINRA received numerous comments concerning the definitions in proposed Rule 1011 of "final criminal matter" and "specified risk event" and the criteria in proposed Rule 1017(a)(7) that would trigger the need to request a materiality consultation. Some commenters expressly supported the proposed definitions and criteria.[120] FSI wrote that the numeric parameters and proposed criteria are sound and reasonable, and it supported how the "specified risk events" are final and investment- or regulatory-related. NASAA wrote that the proposed definition of "final criminal matter" appropriately captures the scope of disclosable criminal events on the Uniform Registration Forms. PIABA wrote that the criteria and definitions are appropriate and clear enough to avoid confusion, and that the minor compliance costs will be far outweighed by the increased investor protections.

Other commenters suggested alternatives to the proposed definitions and criteria. For example:

- Some commenters proposed that the definition of "final criminal matter" include only investment- or fraud-related criminal matters[121] or matters that would generate a risk of customer harm.[122]

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[120] FSI, NASAA, PIABA.

[121] Luxor, Wulff Hansen.

[122] MML. This commenter also requested guidance concerning whether "final criminal matter" would include situations where a person receives a deferred sentence and can clear a conviction through compliance with a court-ordered program. Per the proposed definition, whether a "final criminal matter" would count for purposes of proposed Rule 1017(a)(7) and IM-1011-3 would depend on whether the matter "is disclosed, or was required to be disclosed, on the applicable Uniform Registration Forms." The setting aside of a conviction does not necessarily mean that it need not be reported on, or that the matter should be

- Several commenters proposed that the definition of "specified risk event" use a dollar threshold that is either higher[123] or lower[124] than $15,000.
- Some commenters proposed that the final awards and settlements that are counted as "specified risk events" be broadened[125] or narrowed.[126]
- Several commenters proposed changes to how "specified risk events" would be counted.[127]
- Some commenters suggested that lookback periods for events that would trigger a materiality consultation be either shortened[128] or increased.[129]

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expunged from, the Uniform Registration Forms. See, e.g., Form U4 and U5 Interpretive Questions and Answers, http://www.finra.org/sites/default/files/Interpretive-Guidance-final-03.05.15.pdf (Questions 14A and 14B, Interpretive Question and Answer 2, stating that "[e]ach order setting aside a conviction will be reviewed by RAD staff to determine if the conviction must be reported").

123 Cambridge, IBN, Janney, MML. Cambridge asserted that some unfair high-risk characterizations resulting from a $15,000 threshold would involve control persons, principals and registered persons who are required to disclose events due to a managerial role but are "likely not directly involved in" the underlying violations in those disclosed events. FINRA notes that the proposed definition of "specified risk event" does not include final awards or settlements where the person was not named but is only the "subject of."

124 Better Markets.

125 NASAA.

126 Luxor, Network 1.

127 Luxor, MML, Wulff Hansen.

128 Luxor.

129 NASAA.

- Luxor wrote that additional factors should be included in the criteria for whether a materiality consultation is required, including the length of time the individual has been in the industry, the number of events during that period, and the circumstances of those events.
- Several commenters suggested narrowing the kinds of business expansions that would require materiality consultations.[130]

After considering all the commenters' suggested alternative definitions and criteria, FINRA has decided to retain the definitions of "final criminal matter" and "specified risk events" and the criteria that would trigger a materiality consultation that it proposed in Regulatory Notice 18-16. Many of the comments concern issues that FINRA already considered and addressed in the economic assessment in Regulatory Notice 18-16, and the comments have not persuaded FINRA that any changes to the definitions or criteria would be more efficient or effective at addressing the potential for future customer harm presented. As FINRA explained in Regulatory Notice 18-16, the primary benefit of the proposed rule change would be to reduce the potential risk of future customer harm by individuals who meet the proposed criteria and seek to become an owner, control person, principal or registered person of a member firm. The proposed rule change would further promote investor protection by applying stronger standards for changes to a current member firm's ownership, control or business operations, including the potential that such changes would require the filing and approval of a CMA. In developing this proposal, one of the guiding principles was to provide transparency

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[130] Janney, Luxor, MML, SIFMA, Wulff Hansen.

regarding the proposal's application, so that firms could largely identify with available data the specific set of disclosure events that would count towards the proposed criteria and whether a proposed business change would trigger the need for a materiality consultation. This is why FINRA's proposal is based mostly on events disclosed on the Uniform Registration Forms, which are generally available to firms and FINRA.

While FINRA generally agrees with the comments that the proposed materiality consultation process should account for situations where numerous "specified risk events" are related,[131] it does not believe that modifying the rule-based criteria is the best way to do so. Rather, FINRA believes the materiality consultation process should allow it to assess an individual's particular events. Moreover, based on experience gained through the materiality consultations, FINRA may be able to develop guidance for the Department concerning situations involving the "specified risk events" that could affect whether a proposed business expansion is or is not material.

Wulff Hansen suggested that a materiality consultation should be required when a person having two or more "specified risk events" is already associated with a member and seeks to become an owner or control person. FINRA notes that the proposed rule already would require materiality consultations for internal moves. As explained above, however, the proposed rule would not apply when a person who meets the proposed criteria in proposed Rule 1017(a)(7) is already a principal at a member firm and seeks to add an additional principal registration at that same firm. In that instance, the proposed rule amendments would not require a materiality consultation.

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[131] MML, Wulff Hansen.

➢ Materiality Consultation Procedures

FSI and Janney requested that FINRA develop additional procedures for the materiality consultation process. For example, these commenters wrote that FINRA should establish time frames for FINRA staff to issue a decision in a materiality consultation, with one commenter explaining that time deadlines would allow firms to minimize litigation risks when making hiring decisions. FSI asked that FINRA consider establishing rule-based remedies for firms that disagree with FINRA staff's materiality consultation decisions, and a rule-based requirement that FINRA explain in writing a decision that requires a firm to file a CMA.[132] MML suggested that the proposed rule should outline the issues that would be central to the Department's materiality determination and clarify the proposed requirement that a member submit a written letter to the Department in a "manner prescribed by FINRA."

In general, FINRA believes that additional rule-based procedures for the materiality consultation process would undermine its informality, flexibility and expedited nature. By analogy, FINRA's existing materiality consultation process has no written-decision requirement and no appeal process. Nevertheless, FINRA believes it would be helpful to provide guidance about the materiality consultation process that would be required by the proposed rule, to supplement the already published guidance about FINRA's existing materiality consultation process.[133] For that reason, FINRA has

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[132] FSI also wrote that additional procedures would be appropriate because the materiality consultations would be a rule-based requirement, not voluntary.

[133] See The Materiality Consultation Process for CMAs, https://www.finra.org/rules-guidance/guidance/materiality-consultation-process. FINRA's existing guidance provides that a materiality consultation submission should include, but is not limited to, the following: (i) a description of the proposed change in business sufficient for staff to understand the scope of the business and how it will be

explained in detail—both in Regulatory Notice 18-16 and above—the kinds of information that the firm should provide when seeking a materiality consultation required by proposed Rule 1017(a)(7) and what information would be relevant to the Department's materiality decision. FINRA also will provide more guidance as necessary as to what firms should provide when seeking the materiality consultation required by the proposed rule amendments.

Miscellaneous Comments

SIFMA requested that FINRA provide a notification to firms of registered persons who have "specified risk events," similar to how FINRA provides information gathered in its public records searches for information relating to bankruptcies, judgments and liens, asserting that individuals may not identify and disclose "specified risk events" to firms in a timely manner. FINRA appreciates this suggestion, but notes that the events included in the definition are derived from the Uniform Registration Forms and, therefore, firms should generally be able to conduct appropriate due diligence to identify such individuals. Indeed, FINRA Rule 3110(e) already requires firms to establish and implement written procedures reasonably designed to verify the accuracy and completeness of the information contain in an applicant's initial or transfer Form U4, which would include verifying the accuracy and completeness of answers and disclosures

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conducted; (ii) why the firm believes that the proposed new business or product is similar in scope or nature to their existing business; (iii) the anticipated impact the change will have to the firm's supervisory structure; (iv) any impact the proposed change will have to the firm's capital or liquidity; (v) the nature and scope of updates required to written supervisory procedures, systems and firm operations; (vi) any recent disciplinary matters that relate to the proposed activities as well as how the firm's overall regulatory history may impact the ability of the firm to effectively conduct the activity; and (vii) any relevant documentation to support the proposal.

concerning “final criminal matters” and the events covered by the definition of “specified risk events.”

Cambridge commented that persons should have the opportunity to confidentially submit an application seeking a materiality consultation to “pre-qualify” a transition from one firm to another and gain confidence that they are free to make such a transfer. FINRA does not believe, however, that prequalification of a person with a significant history of misconduct would be appropriate, or even possible, in the absence of additional information about, among other things, the specific context in which the person would be associated with a new firm and the activities and history of such proposed new firm.

Better Markets opined that the proposed rule change would reflect an improvement over the status quo but is still insufficient, and that FINRA should do more to reduce the number of brokers with a significant history of misconduct and the prevalence of recidivism. Specifically, Better Markets wrote that FINRA should ban brokers with two criminal convictions or three “specified risk events” at a $5,000 level (instead of the proposed $15,000 level) and immediately and permanently expel a firm where more than 20% of its brokers have three or more “specified risk events.” Better Markets also suggested that FINRA engage in more investor education on the topic of recidivist brokers, design a user-friendly disclosure system that clearly identifies brokers with a demonstrable pattern of violations, and repeal the part of FINRA Rule 9311 that stays a Hearing Panel or Hearing Officer decision pending an appeal to the NAC.

FINRA’s efforts to address the risks posed by brokers with a significant history of misconduct are ongoing, and FINRA appreciates comments on additional steps that FINRA might take. Some of Better Markets’ suggestions, however, amount to a request that FINRA create new categories of "statutory disqualification." Federal law defines the types of misconduct that presumptively disqualify a broker from associating with a firm, and amending what qualifies as a statutory disqualification is beyond FINRA's jurisdiction. In addition, FINRA does not agree that repealing the provision in Rule 9311(b) that stays the effect of a Hearing Panel or Hearing Officer decision would be appropriate at this time. FINRA's rule that stays the effect of a Hearing Panel or Hearing Officer decision is consistent with rules of other self-regulatory organizations and the SEC.[134] Moreover, the proposed rule change would protect investors during a disciplinary appeal by empowering Hearing Officers to impose conditions and restrictions that they consider reasonably necessary for the purpose of preventing customer harm.

Miscellaneous Comments Outside the Scope of the Proposal

Some comments raised concerns regarding broader issues, such as arbitration proceedings and public disclosure of arbitration settlements,[135] the composition of

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[134] See, e.g., 17 CFR 201.360(d) (providing that an SEC ALJ's initial decision shall not become final as to a party or person who timely files a petition for review); CBOE Rule 13.11(b) (providing that sanctions shall not become effective until the Exchange review process is completed or the decision otherwise becomes final); NASDAQ PHLX Rule 9311(b) (providing that an appeal to the Exchange Review Council from a disciplinary decision shall operate as a stay until the Exchange Review Council issues a decision); NYSE CHX Article 12, Rule 6 (providing that the enforcement of any orders or penalties shall be stayed upon the filing of a notice of appeal pending the outcome of final review by a Judiciary Committee or the Board of Directors).

[135] IBN suggested that FINRA should have local arbitration hearings, with panels composed of local representatives and local firms, and that FINRA should eliminate mandatory arbitration or require arbitrators to be lawyers and follow the rule of law. Network 1 commented that FINRA should consider the "prejudicial effect" on brokers of the six-year limitations period for filing an arbitration claim and of nuisance-value arbitration actions brought by non-attorney representatives; that references to arbitration claims brought by a non-attorney representative that

Hearing Panels in FINRA's disciplinary proceedings,[136] questions about whether firms are permitted to pay disqualified persons consistent with FINRA Rule 8311,[137] various Constitutional protections that FINRA should adopt in investigations and disciplinary proceedings,[138] and how FINRA might improve the Taping Rule to prevent non-compliance with that rule.[139] FINRA believes, however, that these comments are all outside the scope of the proposal.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

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are settled or that result in an award in favor of the broker should be removed from the broker's public record; and that an arbitration claim brought by a non-attorney representative that results in a settlement should not be made available to the public at all.

136 Network 1 commented that FINRA adjudicatory panels should include one attorney with a demonstrated history of representing brokers or member firms, securities industry experience, and knowledge of securities laws, regulations and rules and industry practices in the investment banking and securities businesses. It also commented that FINRA should establish a process for soliciting "bona fide neutrals" to sit on adjudicatory panels.

137 Network 1.

138 Network 1.

139 NASAA.

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2020-011 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2020-011. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2020-011 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[140]

Jill M. Peterson
Assistant Secretary

140 17 CFR 200.30-3(a)(12).

EXHIBIT 2a

Regulatory Notice 18-16

High-Risk Brokers

FINRA Requests Comment on FINRA Rule Amendments Relating to High-Risk Brokers and the Firms That Employ Them

Comment Period Expires: June 29, 2018

Summary

FINRA seeks comment on proposed rule amendments that would impose additional restrictions on member firms that employ brokers with a history of significant past misconduct. These brokers, while relatively small in number, may present heightened risk of harm to investors, and any misconduct by them also may undermine confidence in the securities markets as a whole. The rule proposals would strengthen the existing controls, some of which are highlighted below, FINRA has applied to such brokers to further promote investor protection and market integrity.

The new proposals are one part of FINRA's initiatives to confront high-risk brokers. FINRA will continue to evaluate various rules, examination and risk-monitoring programs, and technologies to determine further enhancements that FINRA can make to keep high-risk brokers from potentially harming investors and compromising the integrity of the financial markets.

FINRA is requesting comment on proposed amendments to:

1. the Rule 9200 Series (Disciplinary Proceedings) and the 9300 Series (Review of Disciplinary Proceedings by National Adjudicatory Council and FINRA Board; Application for SEC Review) to allow a Hearing Panel to impose conditions or restrictions on the activities of member firms and brokers while a disciplinary matter is on appeal to the National Adjudicatory Council (NAC), and to require member firms to adopt heightened supervisory procedures for brokers during the period the appeal is pending;
2. the Rule 9520 Series (Eligibility Proceedings) to require member firms to adopt heightened supervisory procedures for brokers during the period a statutory disqualification (SD) eligibility request is under review by FINRA;

April 30, 2018

Notice Type
- Request for Comment

Suggested Routing
- Compliance
- Legal
- Operations
- Registered Representatives
- Senior Management

Key Topics
- BrokerCheck Disclosure
- Disciplinary Proceedings
- Eligibility Proceedings
- Heightened Supervision
- Statutorily Disqualified Persons
- Supervision
- Taping Rule

Referenced Rules & Notices
- FINRA Rule 3110
- FINRA Rule 3170
- FINRA Rule 8312
- FINRA Rule 9200 Series
- FINRA Rule 9300 Series
- FINRA Rule 9520 Series
- FINRA Rule 9556
- NASD IM-1011-1
- NASD IM-1011-2
- NASD Rule 1010 Series
- Regulatory Notice 18-15

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3. Rule 8312 (FINRA BrokerCheck Disclosure) to disclose the status of a member firm as a "taping firm" under Rule 3170 (Tape Recording of Registered Persons by Certain Firms); and
4. the NASD Rule 1010 Series (Membership Proceedings) (MAP rules) to place additional limitations on member firms by requiring a member firm to first submit a written letter to FINRA's Department of Member Regulation, through the Membership Application Program Group (MAP Group), seeking a materiality consultation when a natural person that has, in the prior five years, one or more final criminal actions or two or more specified risk events seeks to become an owner, control person, principal or registered person of an existing member firm. Specified risk events (as described in detail below) generally means final, adjudicated disclosure events disclosed on a person's or firm's Uniform Registration Forms.[1]

The proposed rule text is available in Attachment A. With respect to proposal number 4, FINRA also seeks specific comment on the proposed numeric threshold and criteria that would trigger a materiality consultation. A detailed economic analysis of the proposed rule amendments, including the numeric threshold and criteria used for identifying brokers that would be impacted by the proposed amendments, is discussed below, and the exhibits referenced in this economic impact assessment are available in Attachment B, Exhibits 1, 2, 3 and 4.

In addition, FINRA is focusing attention on high-risk brokers by publishing *Regulatory Notice 18-15* to reiterate the existing obligation of member firms to adopt and implement tailored heightened supervisory procedures under Rule 3110 (Supervision) for high-risk brokers;[2] and revising FINRA's qualification examination waiver guidelines and related procedures to more broadly consider past misconduct when considering examination waiver requests.[3]

Questions concerning this *Notice* should be directed to:

- Kosha Dalal, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-6903.

Questions concerning the Economic Impact Assessment in this *Notice* should be directed to:

- Jonathan Sokobin, Senior Vice President and Chief Economist, Office of the Chief Economist (OCE), at (202) 728-8248; and
- Hammad Qureshi, Senior Economist, OCE, at (202) 728-8150.

Action Requested

FINRA encourages all interested parties to comment on the proposal. The comment period ends June 29, 2018.

Comments must be submitted through one of the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

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

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[4]

The proposed rule change must be filed with the Securities and Exchange Commission (SEC) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).[5]

Background & Discussion

FINRA uses a combination of tools to reduce misconduct by member firms and the brokers they hire, including SD processes, review of membership applications, disclosure of brokers' regulatory backgrounds,[6] supervision requirements, focused examinations, risk monitoring and disciplinary actions. These tools, among others, serve to further the Exchange Act goals reflected in FINRA's mission of protecting investors and market integrity, including protecting investors from brokers with a history of significant past misconduct and the firms that choose to employ them.

Formal action to bar or suspend a broker requires FINRA to satisfy procedural safeguards established by federal law and FINRA rules to ensure fair process and to protect the rights of brokers to engage in business unless proven guilty of serious misconduct. Those safeguards include the right to defend oneself before a hearing panel and the right to appeal to the NAC, the SEC, and ultimately the federal courts. In addition, federal law and regulations define the types of misconduct that presumptively disqualify a broker from associating with a firm, and also govern the standards and procedures FINRA must follow when a broker who was found to have engaged in such misconduct applies to remain in or re-enter the industry.[7]

Current Programs

As discussed further below, FINRA strives to prevent and deter misconduct by member firms and the individuals they hire through a number of different measures.

- **Licensing and Registration**

To become a FINRA member, a firm is subject to review through FINRA's membership application program. As part of a new membership application (NMA) or a continuing membership application (CMA) under the Rule 1010 Series, FINRA reviews, among other factors, whether persons associated with an applicant have material disciplinary history, customer complaints, pending and final arbitrations, civil actions or other industry-related matters that could pose a threat to public investors. Where FINRA can show strong cause for concern, we can deny membership or place restrictions on membership to mitigate the risk. The membership application process also provides procedural safeguards for the applicant: applicants have the right to request review by the NAC of an adverse decision or the FINRA Board may call for a discretionary review of a membership proceeding. The applicant also may appeal final FINRA decisions to the SEC and the circuit courts.

- **Statutory Disqualifications – Eligibility Proceedings**

FINRA administers the SD process by assessing applications from member firms that wish to retain or employ an individual who is the subject of an SD. In conducting the assessment, FINRA seeks to exclude individuals who pose a risk of recidivism from continuing in the securities business. As a general framework, the Exchange Act sets out the types of broker misconduct that presumptively exclude brokers from engaging in the securities business. These types of misconduct, entitled "statutory disqualifications," are actions against an individual or member firm taken by a regulator or court based on a finding of serious misconduct that calls into question the integrity of the broker or firm. SDs include any felony and certain misdemeanors for a period of 10 years from the date of conviction; expulsions or bars (and current suspensions) from membership or participation in a self-regulatory organization; bars (and current suspensions) ordered by the SEC, Commodity Futures Trading Commission, or other appropriate regulatory agency or authority; willful violations of the federal securities and commodities laws or MSRB rules; and certain final orders of a state securities commission.

- **Monitoring and Examinations**

FINRA addresses high-risk brokers or high-risk activity through several of its examination programs. First, FINRA executes a High-Risk Registered Representative (HRR) Program that uses various methodologies to identify brokers from across the entire securities industry whose individual risk profiles suggest they are more likely than the general broker population to engage in misconduct. A specialized High-Risk

Registered Representative Examination Unit is responsible for the identification, monitoring and examination activities of high-risk registered representatives with additional examination support provided by examiners located in FINRA's various district offices.

FINRA also reviews individual brokers as part of the firm examination program where every broker-dealer receives an examination at least once every four years. Because our firm examinations are risk-based, the focus on individual brokers varies depending on the specific firm. Also covered during these examinations are assessments of the firms' supervisory and compliance controls over the conduct of brokers.

Further, FINRA examines individual brokers through its cause examination program. These examinations are allegation driven, and triggered by specific and sometimes high-risk events such as a customer complaint, whistleblower tip, arbitration referral or call to the FINRA Securities Helpline for Seniors™.

Lastly, FINRA conducts high-risk branch office examinations that focus on business conduct risks at the point of sale. Branch office examinations look at the core activities conducted from the specific branch location, including customer transactions, money and security movements, customer complaints, communications, account designation changes and credit extensions. The identification of high-risk branch offices is determined in large part by the aggregation of individual registered representative risk assessments.

► BrokerCheck

BrokerCheck provides the public with information on the professional background, business practices, and conduct of FINRA member firms and their associated persons, as well as on firms and their associated persons who are registered with national securities exchanges that use the Central Registration Depository (CRD®). BrokerCheck information is derived from the CRD system to, among other things, help investors make informed choices about the individuals and firms with which they conduct business. In addition to BrokerCheck disclosure, FINRA publishes on its website a list of individuals who have been barred by FINRA from association with any member firm in any capacity.[8] The list is updated on a monthly basis.

► Supervision Obligations of Member Firms

FINRA Rule 3110 requires member firms to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and FINRA rules. Further, the rule requires member firms to establish, maintain and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules. An effective supervisory system plays an essential role in the prevention of sales abuses, and thus, enhances investor protection and market integrity. As such, FINRA has long emphasized that member firms have a fundamental obligation to implement a supervisory system, including written supervisory procedures, that is tailored specifically to the member firm's business and addresses the activities of all its associated persons.[9]

► **Enforcement and Disciplinary Actions**

An important part of FINRA's supervision of firms and the individuals they employ is our ongoing enforcement of FINRA and MSRB rules, and federal securities laws and rules. We aggressively investigate potential securities violations and, when warranted, bring formal disciplinary actions against member firms and their associated persons.

With respect to problem individuals, FINRA can take a range of formal actions, including barring them from the industry. As previously noted, formal action to bar or suspend a broker requires satisfying procedural safeguards required by the Exchange Act and, with respect to FINRA actions, safeguards include the right to a hearing before a FINRA hearing panel; appeal to the NAC; appeal to the SEC; and ultimately to the circuit courts of appeal.

Proposed Amendments

As part of FINRA's ongoing initiatives to protect investors from high-risk brokers, FINRA is proposing rule amendments that would impose additional obligations on member firms that seek to associate with high-risk brokers. The proposed rule amendments are designed to strengthen oversight of high-risk brokers and the firms that employ them.

1. **Proposed Amendments to the Rule 9200 Series (Disciplinary Proceedings) and Rule 9300 Series (Review of Disciplinary Proceedings by National Adjudicatory Council and FINRA Board; Application for SEC Review)**

A. Overview of Current Disciplinary Process

FINRA's Department of Enforcement initiates a formal disciplinary action by filing a complaint with FINRA's Office of Hearing Officers (OHO) when it believes that a member firm or associated person of a member firm is violating or has violated any FINRA rule, SEC regulations or federal securities laws, and formal disciplinary action is necessary. Following the filing of the complaint, the Chief Hearing Officer will assign a Hearing Officer to preside over the disciplinary proceeding, and appoint a Hearing Panel, or an Extended Hearing Panel, if applicable, to conduct a hearing and issue a decision.[10]

At a hearing, the parties present evidence for the Hearing Panel to determine whether a member firm or broker has engaged in conduct that violates FINRA rules, MSRB rules, SEC regulations or federal securities laws. The Hearing Panel also considers previous court, SEC, NAC and Hearing Panel decisions to determine if violations occurred.

For each case, the Hearing Panel, or the Hearing Officer in the case of default decisions,[11] will issue a written decision explaining the reasons for its ruling and consult the FINRA *Sanction Guidelines* to determine the appropriate sanctions if violations have occurred. FINRA also, when feasible and appropriate, can order member firms and brokers to make restitution to harmed customers.

Under FINRA's disciplinary procedures, a member firm or broker has the right to appeal a Hearing Panel or Hearing Officer decision to the NAC, or the NAC may on its own initiate a review of a decision. On appeal, the NAC will determine if a Hearing Panel's or Hearing Officer's findings were legally correct, factually supported and consistent with FINRA's Sanction Guidelines. The NAC's decision constitutes a final disciplinary action of FINRA, unless the FINRA Board calls the case for review and issues its own decision. A member firm or broker may appeal a final disciplinary action of FINRA to the SEC, and further to a U.S. Court of Appeals.

Currently, while a Hearing Panel or Hearing Officer decision is on appeal to the NAC, any sanctions imposed by the Hearing Panel or Hearing Officer, including bars or expulsions, are automatically stayed and not enforced against the member firm or broker during the pendency of the appeal.[12]

B. Proposed Rule 9285 (Interim Orders While on Appeal)

FINRA is proposing new FINRA Rule 9285 (Interim Orders While on Appeal) to bolster investor protection during the pendency of an appeal to the NAC of a Hearing Panel or Hearing Officer decision.

- *Conditions and Restrictions*

Proposed Rule 9285(a) would provide that the Hearing Panel or, if applicable, the Extended Hearing Panel, or Hearing Officer may impose such conditions or restrictions on the activities of a respondent as the Hearing Panel or Hearing Officer considers reasonably necessary for the purpose of preventing customer harm.[13] This approach would be consistent with the rules of several exchanges that have provisions that allow an exchange adjudicator to impose restrictions on the respondent during the exchange's appeal process.[14]

Under the proposal, as part of the hearing, FINRA's Department of Enforcement could request that the Hearing Panel or Hearing Officer order conditions and restrictions imposed against the respondent. The Hearing Panel or Hearing Officer would consider the request at the same time it makes findings of violations and imposes sanctions for the misconduct. FINRA believes the Hearing Panel's or Hearing Officer's knowledge about the violations would provide the qualifications to evaluate the potential for customer harm and craft tailored conditions and restrictions to minimize that potential harm. The order would describe the activities that the respondent shall refrain from taking and any conditions imposed.

In considering whether conditions or restrictions should be imposed on the activities of a respondent, the Hearing Panel or Hearing Officer would be guided by the principle of imposing conditions and restrictions reasonably necessary for the purpose of preventing customer harm. These conditions or restrictions could include, for example, prohibiting a member firm or broker from offering private placements in cases of misrepresentations and omissions made to customers, or prohibiting penny stock liquidations in cases involving violations of the penny stock rules. A condition could also include posting a bond to cover harm to customers before the sanction imposed becomes final or precluding a broker from acting in a specified capacity. The conditions and restrictions would be tailored to the specific risks posed by the member firm or broker during the appeal period.

Unlike sanctions imposed in the Hearing Panel or Hearing Officer decision, the proposal would amend FINRA Rule 9311 (Appeal by Any Party; Cross-Appeal) to expressly state that the conditions and restrictions imposed by the Hearing Panel or Hearing Officer would not be stayed during the pendency of the appeal to the NAC. The interim order of conditions and restrictions would remain effective and enforceable until issuance of the NAC's decision in the matter.

FINRA believes authorizing the Hearing Panel or Hearing Officer to order conditions and restrictions during an appeal would allow FINRA to target the demonstrated bad conduct of a respondent during the pendency of the appeal to the NAC. In addition, the proposal would amend FINRA Rule 9556 to grant FINRA staff the authority to start an expedited proceeding in accordance with Rule 9556 if a respondent failed to abide by the conditions and restrictions ordered.[15]

- *Expedited Review*

Proposed Rule 9285(b) would establish an expedited review process to allow a respondent that has conditions or restrictions imposed by a Hearing Panel or Hearing Officer to file a motion with the Review Subcommittee of the NAC to modify or remove any or all of the restrictions.

Specifically, proposed Rule 9285(b)(1) would establish an expedited review process available to a respondent that has conditions or restrictions imposed by a Hearing Panel or Hearing Officer to file a motion with the Review Subcommittee of the NAC to modify or remove any or all of the restrictions. Proposed Rule 9285(b)(2) would provide that the respondent has the burden to show that the Hearing Panel or Hearing Officer committed an error by ordering the condition or restrictions imposed. The respondent must show that the conditions or restrictions are not reasonably necessary for the purpose of preventing customer harm. The respondent's motion to modify or remove conditions or restrictions must be filed with FINRA's Office of General Counsel and served simultaneously on OHO and all other parties to the disciplinary proceedings.

Proposed Rule 9285(b)(3) would give FINRA's Department of Enforcement five days from service of the respondent's motion to file an opposition to the motion. As proposed, unless ordered otherwise by the Review Subcommittee, the motion to modify or remove conditions or restrictions would be decided based on the moving and opposition papers and would be decided in an expeditious manner and no later than 30 days after the filing of the opposition.

Proposed Rule 9285(b)(4) would provide that the filing of such an expedited motion to modify or remove a condition or restriction would stay the effectiveness of the ordered conditions and restrictions until the Review Subcommittee issues its ruling.

- *Mandatory Heightened Supervision*

Proposed Rule 9285(c) would require any firm with which a respondent is associated to adopt a written plan of heightened supervision if any party appeals a Hearing Panel or Hearing Officer decision to the NAC, or if the NAC calls the case for review.[16] The proposed amendments would require a firm to adopt a plan of heightened supervision regarding such respondents within ten days of filing an appeal, and this requirement would need to take into account any conditions or restrictions imposed by the Hearing Panel or Hearing Officer.

Specifically, when a Hearing Panel or Hearing Officer issues a decision pursuant to Rule 9268 or Rule 9269 in which the adjudicator finds that an associated person, the respondent, has violated a statute or rule provision, the proposed rule would require any firm with which the respondent is associated to adopt a written plan of heightened supervision that must remain in place until FINRA's final decision takes effect.[17] The member firm would be required to submit the written plan of heightened supervision within ten days of any party filing an appeal or the case being called for review by filing a copy of the plan of heightened supervision with FINRA's Office of General Counsel and serving a copy on the Department of Enforcement. If a respondent becomes associated with another firm while the Hearing Panel's or Hearing Officer's decision is on appeal to the NAC, that member firm must file a copy of a plan of heightened supervision, taking into account any conditions or restrictions imposed by the Hearing Panel or Hearing Officer, with the Office of General Counsel and serve a copy on the Department of Enforcement within ten days of the respondent becoming associated with the firm.

The proposed rule would require a member firm to implement tailored supervisory procedures that are reasonably designed to prevent or detect a reoccurrence of the violations found by the Hearing Panel or Hearing Officer. In addition, the plan of heightened supervision must comply with Rule 3110, which requires firms to establish and maintain supervisory systems for each of their associated persons that are reasonably designed to achieve compliance with applicable securities laws and FINRA rules. The plan of heightened supervision must, at a minimum, include the designation of an appropriately registered principal who is responsible for carrying out the plan of heightened supervision. The plan of heightened supervision also must be signed by the designated principal, and include an acknowledgement that the principal is responsible for implementing and maintaining the plan of heightened supervision.

2. Proposed Amendments to the Rule 9520 Series (Eligibility Proceedings)

A. Overview of Current Statutory Disqualification Eligibility Process

Brokers who have engaged in the types of misconduct specified in the Exchange Act statutory disqualification provisions must undergo special review by FINRA before they are permitted to re-enter or continue working in the securities industry. In conducting its review, FINRA seeks to exclude brokers who pose a risk of recidivism from continuing in the securities business, subject to the limits developed in SEC case law.

As a general framework, the Exchange Act sets out the types of misconduct that presumptively exclude brokers from engaging in the securities business, identified as statutory disqualifications or SDs.[18] These SDs are the result of actions against a broker taken by a regulator or court based on a finding of serious misconduct that calls into question the integrity of the broker, and include any felony and certain misdemeanors for a period of ten years from the date of conviction; expulsions or bars (and current suspensions) from membership or participation in a self-regulatory organization; bars (and current suspensions) ordered by the SEC, Commodity Futures Trading Commission, or other appropriate regulatory agency or authority; willful violations of the federal securities and commodities laws or MSRB rules; and certain final orders of a state securities commission.

The Exchange Act and SEC rules thereunder establish a framework within which FINRA evaluates whether to allow individuals who are the subject of an SD to associate with a member firm.[19] A member firm that seeks to employ or continue the employment of an individual who is the subject of an SD therefore files an application (SD Application) seeking approval from FINRA.[20] FINRA Rule 9520 Series sets forth eligibility proceedings under which FINRA may allow a member, person associated with a member, potential member, or potential associated person subject to an SD to enter or remain in the securities industry.[21] A firm's SD Application is subject to careful scrutiny by FINRA to best ensure that the individual's association with the member firm is subject to heightened supervision and is consistent with the public interest and the protection of investors. To determine whether the SD Application will be approved or denied, FINRA takes into account factors that include the nature and gravity of the disqualifying event; the length of time that has elapsed since the disqualifying event and any intervening misconduct occurring since; the regulatory history of the disqualified individual, the firm and individuals who will act as supervisors; and any proposed plan of supervision.[22]

If FINRA recommends approval of the SD Application, the recommendation is submitted either directly to the SEC for its review or to the NAC and ultimately to the SEC for their reviews and approvals. If FINRA recommends disapproval of the SD Application, the member firm has the right to a hearing before a panel of the Statutory Disqualification Committee and the opportunity to demonstrate why the SD Application should be approved.[23] If the NAC denies the SD Application, the member firm can appeal the decision to the SEC and the federal circuit courts.[24]

As part of an SD Application, a member firm will propose a written plan of heightened supervision to closely monitor the SD individual's securities-related activities. A heightened supervisory plan must be acceptable to FINRA, and FINRA will reject any plan that is not specifically tailored to address the SD individual's prior misconduct and to mitigate the risk of future misconduct. In this regard, FINRA's primary consideration is a heightened supervisory plan carefully constructed to best ensure investor protection.

Despite the requirement of heightened supervision to receive approval of an SD Application, there is currently no explicit rule requirement that these SD individuals be placed on heightened supervision by their employing member firm during the pendency of the SD Application review.[25]

B. Proposed Amendments to Require Automatic Heightened Supervision During Review Period

FINRA is proposing to amend Rule 9523 (Acceptance of Member Regulation Recommendations and Supervisory Plans by Consent Pursuant to SEA Rule 19h-1) to require a member firm to immediately place an individual on an interim plan of heightened supervision once an SD Application is filed. The proposed amendments would delineate the circumstances under which an individual who is statutorily disqualified may remain associated with a FINRA member while FINRA is reviewing his or her SD Application.

As with proposed Rule 9285 that would require a plan of heightened supervision during an appeal of a disciplinary action, proposed amendments to Rule 9523 provides flexibility regarding the details of specific interim plans of heightened supervision. However, the proposal would provide that, in order for supervision over a disqualified individual to be reasonable under Rule 3110, the interim plan of heightened supervision must be tailored to the disqualified individual, and must take into account the nature of the disqualification, the nature of the firm's business, the disqualified person's current and proposed activities at the firm, and the qualifications of the supervisor. Every interim plan would be required to identify a qualified principal responsible for carrying out such plan who has evidenced his or her acknowledgement of such responsibility by signing such plan.

The proposed amendments would require that a copy of the interim plan of heightened supervision be submitted with the SD Application, and that the plan be in effect throughout the entire SD Application review process. The proposal would also make clear that an interim plan of heightened supervision may be modified by FINRA through the SD eligibility proceeding, that compliance with the interim plan of heightened supervision will be monitored through FINRA's examination program, and that the firm or individual could be subject to further disciplinary proceedings for failure to comply with the interim plan. The proposed amendments also would provide that an SD Application may be determined to be substantially incomplete if the interim plan is not reasonably designed in compliance with the standards of the proposed amendments. If the applicant fails to timely remedy a substantially incomplete SD Application, FINRA will provide written notice to the member that the SD Application has been rejected, its reasons for so doing, and refund the application fee, less $1,000 as a FINRA processing fee. Upon such rejection, the SD Application is terminated and the member firm must promptly disassociate with the individual. FINRA would generally cover compliance with interim plans of heightened supervision as part of its examination program.

3. **Proposed Amendments to Rule 8312 (FINRA BrokerCheck Disclosure)**

Rule 8312 governs the information FINRA releases to the public through its BrokerCheck system.[26] BrokerCheck helps investors make informed choices about the brokers and member firms with which they conduct business by providing extensive registration and disciplinary history to investors at no charge. FINRA has required member firms to inform their customers of the availability of BrokerCheck.[27]

FINRA is proposing to amend Rule 8312 to disclose the status of a member firm as a "taping firm" under Rule 3170 (Tape Recording of Registered Persons by Certain Firms)[28] through BrokerCheck. Rule 3170 is designed to ensure that member firms with a significant number of registered persons that previously were employed by "disciplined firms" have specific supervisory procedures in place to prevent fraudulent and improper sales practices or other customer harm.[29] Under the rule, a member that hires a specified percentage of registered persons from disciplined firms is designated as a "taping firm" and must establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all its registered persons.[30]

A taping firm must adopt procedures that include tape-recording all telephone conversations between such firms' registered persons and both existing and potential customers. Such firms also are required to review the tape recordings, maintain appropriate records, and file quarterly reports with FINRA.

To assist member firms in complying with Rule 3170, FINRA publishes on its website a "Disciplined Firms List" identifying those member firms that meet the definition of "disciplined firm."[31] A member firm that either is notified by FINRA or otherwise has actual knowledge that it is a taping firm is subject to the requirements of the rule.

FINRA believes disclosing the status of a member firm as a taping firm through BrokerCheck will help inform investors of the heightened procedures required of the firm, which may incent the investors to research more carefully the background of a broker associated with the firm.

Currently, Rule 8312 provides that FINRA will release whether a particular member firm is a taping firm subject to Rule 3170 in response to telephonic inquiries via the BrokerCheck toll-free telephone listing. To better inform investors, the proposed amendment would permit FINRA to release information through BrokerCheck, in general, as to whether a particular member is subject to the provisions of Rule 3170.

4. Proposed Amendments to the NASD Rule 1010 Series (MAP Rules)

A. Current MAP Process

FINRA also seeks to prevent member firm recidivism by reviewing new member applications or membership changes pursuant to the NASD Rule 1010 Series.

Rule 1014(a) (Standards for Admission) sets forth the 14 standards for admission applied by FINRA's Department of Member Regulation, through the MAP Group (collectively, the Department) in determining whether to approve a New Member Application (NMA) or a Continuing Member Application (CMA). The MAP rules require an applicant to demonstrate its ability to comply with the federal securities laws and FINRA rules, including observing high standards of commercial honor and just and equitable principles of trade applicable to its business. The Department evaluates an applicant's financial, operational, supervisory and compliance systems to ensure that each applicant meets these standards for admission. The Department considers whether persons associated with an applicant have material disciplinary actions taken against them by other industry authorities, customer complaints, adverse arbitrations, pending or unadjudicated matters, civil actions, remedial actions imposed or other industry-related matters that could pose a threat to public investors.

In addition, Rule 1017 provides, among other things, that a member shall file a CMA when there are certain changes in ownership, control or business operations.[32] IM-1011-1 creates a safe harbor for specified changes that are presumed not to be a "material change in business operations" and, therefore, do not require a member to file a CMA for approval of the change. One such change is an increase in the number of associated persons involved in sales within the parameters prescribed in the safe harbor. FINRA is concerned about instances where a member may onboard high-risk associated persons without prior consultation or review by FINRA.

Currently the materiality consultation process is used when a member contemplates a change in business operations that may not squarely fall within one of the categories or definitions that would require a CMA under Rule 1017 and the member firm seeks guidance to determine how best to proceed with the proposed change by voluntarily seeking a materiality consultation from the Department. A request for a materiality consultation is a written request from a member firm for a determination from the Department of whether a proposed change is material. There is no fee associated with submitting this request to the Department. The characterization of a proposed change as material depends on an assessment of all the relevant facts and circumstances. The Department may communicate with the member firm to obtain further information regarding the proposed change and its anticipated impact on the member firm. Where the Department determines that a proposed change is material, the Department will instruct the member to file a CMA if it intends to proceed and will advise that effecting the change without approval would constitute a violation of NASD Rule 1017.

B. Proposed Amendments to MAP Rules

FINRA is proposing amendments to the MAP rules to impose additional obligations on member firms that associate with persons who have, in the prior five years, either one or more final criminal matters, or two or more specified risk events. The proposed amendments to the MAP rules would allow FINRA to review and potentially restrict or deny a member firm from allowing such a person to become an owner, control person, principal or registered person. FINRA believes the proposed MAP rules would further promote investor protection by applying stronger standards for continuing membership with FINRA and for changes to a current member firm's ownership, control or business operations.

- *Materiality Consultation*

Proposed IM-1011-2 (Business Expansions and Persons with Specified Risk Events) would require an existing member firm to submit a written letter seeking a materiality consultation to the Department, if the member is not otherwise required to file a CMA, when a natural person that has, in the prior five years, one or more final criminal matters or two or more specified risk events seeks to become an owner, control person, principal or registered person of the member.

In addition, the proposed rule would expressly state that the safe harbor for business expansion in IM-1011-1 (Safe Harbor for Business Expansions) would not be available to member firms in this circumstance.

The proposed rule would provide that the member may not effect the contemplated activity until the member has first submitted a written letter to the Department seeking a materiality consultation for the contemplated activity, and would require that the letter address the issues that are central to the materiality consultation, in a manner prescribed by FINRA. The Department would consider the letter and other information or documents and determine in the public interest and the protection of investors that either (1) the member is not required to file a CMA in accordance with

Rule 1017 and may effect the contemplated activity; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the contemplated activity, unless the Department approves the CMA.

In this regard, the materiality consultation would focus on, and the submitting member firm would need to provide information relating to, the conduct underlying the specified risk events, as well as other matters relating to the subject person such as disciplinary actions taken by FINRA or other industry authorities, adverse examination findings, customer complaints, pending or unadjudicated matters, terminations for cause or other incidents that could pose a threat to public investors. The Department's assessment would factor in, among other things, whether the events are customer-related; represent discrete actions or are based on the same underlying conduct; the anticipated activities of the person; the disciplinary history, experience and background of the proposed supervisor, if applicable; the disciplinary history, supervisory practices, standards, systems and internal controls of the member firm and whether they are reasonably designed to achieve compliance with applicable securities laws and regulations, and FINRA rules; whether the member firm employs or intends to employ in any capacity multiple persons with one or more final criminal matters or two or more specified risk events in the prior five years; and any other impact on investor protection raised by seeking to make the person an owner, control person, principal or registered person of the member firm.

► *Definitions*

The proposal would amend Rule 1011 to define a "final criminal matter" as a criminal matter that resulted in a conviction of, or guilty plea or nolo contendere (no contest) by, a person that is disclosed, or was required to be disclosed, on the applicable Uniform Registration Forms.[33]

The proposal would further amend Rule 1011 to define a "specified risk event" as any one of the following events that are disclosed, or are or were required to be disclosed, on the applicable Uniform Registration Forms:

i. a final investment-related,[34] consumer-initiated customer arbitration award or civil judgment against the person for a dollar amount at or above $15,000 in which the person was a named party;

ii. a final investment-related, consumer-initiated customer arbitration settlement or civil litigation settlement for a dollar amount at or above $15,000 in which the person was a named party;

iii. a final investment-related civil action where the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000; and

iv. a final regulatory action where (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000; or (B) the sanction against the person was a bar (permanently or temporarily), expulsion, rescission, revocation or suspension from associating with a member.

As noted above, the proposed additional MAP obligations would apply only where the person has, within the prior five years, one or more final criminal matters or two or more specified risk events, and seeks to become an owner, control person, principal or registered person of the member firm.[35]

Economic Impact Assessment

1. Regulatory Need

As discussed above, FINRA continually strives to strengthen its oversight of the brokers and firms it regulates in order to further its mission of protecting investors and market integrity, including protecting investors from brokers with a history of significant past misconduct and the firms that choose to employ them. Moreover, recent studies provide evidence of the predictability of future regulatory-related events for brokers with a history of past regulatory-related events such as repeated disciplinary actions, arbitrations and customer complaints.[36] Therefore, notwithstanding the extensive protections afforded by the federal securities laws and FINRA rules, investors may reasonably continue to be concerned that without additional protections, the risk of potential customer harm may continue where these patterns exist. The proposals discussed in this *Notice* are designed to further promote investor protection by mitigating these concerns while recognizing the need to preserve principles of fairness.

2. Economic Baseline

The following provides the economic baseline for each of the current proposals. These baselines serve as the primary points of comparison for assessing economic impacts, including incremental benefits and costs of the proposed rule amendments. For this proposal, FINRA reviewed and analyzed relevant data over the 2013-2016 period (review period).

A. Proposed Amendments to the Rule 9200 Series and Rule 9300 Series

The economic baseline used to evaluate the economic impacts of the proposed rule changes to the Rule 9200 Series and Rule 9300 Series is the current regulatory framework under these rules. FINRA analyzed disciplinary matters that were appealed to the NAC over the review period that reached a final decision by the NAC.[37] During the review period, there were approximately 18 such appeals filed each year, of which approximately 82 percent were filed by brokers, 8 percent were filed by firms, and the remaining 10 percent were filed jointly by brokers and firms.[38] FINRA determined that, on average, these disciplinary decisions were on appeal for approximately 14 months.[39]

B. Proposed Amendments to the Rule 9520 Series

The economic baseline used to evaluate the economic impacts of the proposed rule changes to the Rule 9520 Series is the current regulatory framework under these rules. FINRA analyzed SD Applications filed during the review period and determined that there were 122 SD Applications filed for 119 individuals by 105 firms, or approximately 31 requests that were filed by 26 firms each year.[40] Approximately 54 percent of these applications were associated with small firms, 17 percent with mid-sized firms and 29 percent with large firms.[41] FINRA also examined the resolution of these applications and determined that approximately 21 percent of the SD Applications were approved, 8 percent were denied, 9 percent were pending during the review period, and the remaining applications (62 percent) did not require a resolution because the SD individual's registration with the filing firm was terminated or the SD Application was subsequently withdrawn.[42] FINRA determined that, on average, the processing time for an SD Application that reached a final resolution (*i.e.*, an approval or a denial) was approximately 10 months.[43]

C. Proposed Amendments to the BrokerCheck Rule

The economic baseline used to evaluate the economic impacts of the proposed rule changes to the BrokerCheck Rule is the current regulatory framework under Rules 8312 and 3170. During the review period, FINRA determined that 13 firms hired or retained enough registered persons from previously disciplined firms to be designated as a "taping firm" under Rule 3170 and were notified about their status during this period. All of these firms were small firms with the average size of approximately 40 registered persons. Of these 13 firms, nine firms did not become subject to the rule's tape-recording requirements because they either took advantage of the one-time opportunity to reduce the number of their registered persons from previously disciplined firms below the specified thresholds or terminated their FINRA membership, and one firm was exempted from the requirements of the rule pursuant to Rule 3170(d). As a result, only three of the 13 firms designated as "taping firms" during the review period became subject to the requirements of Rule 3170.

D. Proposed Amendments to the MAP Rules

The economic baseline used to evaluate the economic impacts of the proposed rule changes to the MAP rules is the current regulatory framework under these rules. The proposed rule change would directly impact individuals with one or more final criminal matters or two or more specified risk events within the prior five years, who seek to become owners, control persons, principals or registered persons of a member firm. The criteria used for identifying individuals for this proposal and the number of individuals meeting the proposed criteria are discussed below.

3. Economic Impacts

The following provides the economic impacts, including the anticipated benefits and the anticipated costs for each of the current proposals.

A. Proposed Amendments to the Rule 9200 Series and Rule 9300 Series

The proposed rule amendments would directly impact firms and brokers whose disciplinary matters are on appeal to the NAC. These impacts would vary across appeals and depend on, amongst other factors, the nature and severity of the conditions or restrictions imposed on the activities of respondents and the likely risk that they would continue to harm customers if permitted to remain working during the appeal period without those conditions or restrictions. As discussed above, the scope of these conditions or restrictions would depend on what the Hearing Panel determines to be reasonably necessary for the purpose of mitigating the risk of customer harm. Further, the conditions and restrictions would be tailored to the specific risks posed by the brokers or firms during the appeal period. Accordingly, the conditions and restrictions are not intended to rise to the level of the underlying sanctions and would likely not be economically equivalent to imposing the sanctions during the appeal.

The primary benefit of this proposal accrues from limiting the potential risk of continued harm to customers by respondents during the appeal period by imposing conditions or restrictions on their activities as well as imposing mandatory heightened supervision of brokers while their disciplinary matter is on appeal. In order to evaluate these benefits and assess the potential risk posed by brokers during the appeal period, FINRA examined cases that were appealed to the NAC during the review period and determined whether the brokers associated with an appeal to the NAC had a disclosure event at any time from the filing of the appeal through 2016. Specifically, FINRA identified brokers that were associated with one or more final criminal matters or specified risk events, as defined above, that occurred after they filed their appeals to the NAC.[44] Based on this analysis, FINRA estimates that 16 of the 65 brokers who appealed to the NAC were associated with a total of 21 disclosure events that occurred subsequent to the filing of their appeal to the NAC.[45] FINRA anticipates that the proposed heightened supervision requirement and the conditions or restrictions placed on the activities of these brokers would lead to greater oversight of their activities by their firm during the appeal period, thereby reducing the potential risk of future customer harm during this period.

The cost of this proposal would primarily fall upon brokers or firms whose activities during the appeal period would be subject to the specific conditions or restrictions imposed by the Hearing Panel. In addition, firms would incur costs associated with implementing heightened supervision for brokers while their disciplinary matters are under appeal. These costs would likely vary significantly across firms and could escalate if the broker acts in a principal capacity. For example, firms employing brokers that serve as principals, executive management, owners, or operate in other senior capacities would likely take on more costs in developing and implementing tailored supervisory plans. Such plans may entail re-assignments of responsibilities, restructuring within senior management and leadership, and more complex oversight and governance approaches. These potential costs, in turn, may result in some brokers voluntarily leaving the industry rather than waiting for the resolution of the appeal process.[46]

The costs associated with this proposal would apply to brokers and their employing firms only while the brokers are employed during the pendency of the NAC appeals. While the disciplinary decisions are on appeal for approximately 14 months on average, many brokers filing an appeal to the NAC are not employed at the time the appeal is filed or leave shortly after the appeal is filed. FINRA examined the employment history, including the employment start and end dates, of the 65 brokers associated with NAC appeals during the review period, and estimates that 31 (or 48 percent) of these brokers were not employed by any member firm at any point during the appeal process, 14 (or 21 percent) of the brokers were employed by a member firm only for part of the appeal process, and the remaining 20 (or 31 percent) of the brokers were employed by a member firm throughout the appeal process.

In developing the proposal, FINRA considered the possibility that, in some cases, this proposal may limit activities of brokers and firms, while their disciplinary matter is under appeal, in instances where the restricted activities do not pose a risk to customers. In such cases, these brokers and firms may lose economic opportunities and their customers may lose the benefits associated with the provision of these services. FINRA believes that the proposed rule changes mitigate such risks by requiring the conditions or restrictions imposed to be reasonably necessary for the purpose of reducing the potential risk of future customer harm and by providing a respondent with the right to seek to modify or remove any or all of the conditions and restrictions in an expedited proceeding. Further, as discussed above, only 31 percent of the brokers associated with NAC appeals were employed by a member firm for the full duration of their appeals. Approximately 69 percent of the brokers were not employed by a member firm at any time during the appeal process or were employed by a member firm only for part of the appeal process. Accordingly, these brokers would not be impacted by this proposal or would be subject to the proposed limitations only for a limited period of time.

B. Proposed Amendments to the Rule 9520 Series

The proposed rule amendments would impact SD individuals and their firms while the SD Application goes through an eligibility proceeding. The primary benefit of this proposed rule change would arise from greater oversight by firms of the activities of SD individuals during the pendency of their SD Applications. In order to assess the potential risk posed by these individuals during the pendency of their SD Applications, FINRA examined whether individuals associated with an SD Application filed during the review period had a disclosure event at any time from the filing of the application through 2016. Based on this analysis, FINRA estimates that 18 (or 15 percent) of the 119 individuals that filed SD Applications during the review period were associated with a total of 20 disclosure events subsequent to the filing of their SD Application.[47] FINRA anticipates that the proposed heightened supervision requirement would lead to greater oversight by firms of the activities of these individuals during the pendency of their SD Application, thereby reducing the potential risk of customer harm during this period.

Firms may incur costs associated with implementing a tailored heightened supervision program for these individuals while their SD Application is under review. As discussed above, the costs would likely vary significantly across firms and could escalate if the SD individuals also serve as principals, executive management, owners or operate in other senior capacities. Moreover, the heightened supervision requirement may deter some firms from filing an SD Application for these individuals who, as a result, may find it more difficult to remain in the industry.

C. Proposed Amendments to the BrokerCheck Rule

The proposed amendments would impact taping firms and their registered persons. Taping firms have a proportionately significant number of registered persons that were associated with firms that were expelled by a self-regulatory organization or had their registration revoked by the SEC for sales practice violations, and as a result, may pose greater risk to their customers. Disclosing a firm's status as a "taping firm" through BrokerCheck would help investors make more informed choices about the brokers and firms with which they conduct business. This proposal to disclose a firm's status as a "taping firm" would not impose any direct costs on brokers or firms. Nonetheless it may impact their businesses, as investors may also rely on this information in determining whom to engage for financial services and brokerage activities. Disclosing the status of a firm as a "taping firm" through BrokerCheck may also further deter firms from hiring or retaining brokers that previously were employed by disciplined firms in order to avoid the "taping firm" disclosure on BrokerCheck.

D. Proposed Amendments to MAP Rules

The primary benefit of the proposed amendments would be to reduce the potential risk of future customer harm by individuals who meet the proposed criteria and seek to become an owner, control person, principal, or registered person of a member firm. FINRA believes the proposed rule change would further promote investor protection by applying stronger standards for continuing membership with FINRA and for changes to a current member firm's ownership, control or business operations. These benefits would primarily arise from changes in broker and firm behavior and increased scrutiny by FINRA of brokers who meet the proposed criteria during the review of the applications.

The cost of these proposals would fall on the firms that seek to add owners, control persons, principals or registered persons who meet the proposed criteria. These firms would be directly impacted by the proposals through the requirement to seek a materiality consultation with FINRA and potential requirement to file a CMA. While there is no FINRA fee for seeking a materiality consultation, firms may incur internal costs or costs associated with engaging external experts in conjunction with the filing of a CMA if necessary. The requirement of a materiality consultation could result in delays to a firm's ability to add owners, control persons, principals or registered persons who meet the proposed criteria. Based on its review of the materiality consultation, FINRA may require the firm to file a CMA and the firm may not effect the applicable activity until the CMA is approved. FINRA examined the time to process materiality consultations and determined that, on average, these consultations are completed within 8-10 days, although this time period could be longer depending on the complexity of the contemplated expansion or transaction. FINRA recognizes that these anticipated costs may deter some firms from hiring individuals meeting the proposed criteria, who as a result may find it difficult to remain in the industry or bear other labor market related costs.

To provide transparency regarding the application of this proposal, the proposed criteria is based on disclosure events required to be reported on the Uniform Registration Forms. These Uniform Registration Forms are generally available to firms and FINRA.[48] Accordingly, firms, with a few exceptions, can identify the specific set of disclosure events that would count towards the proposed criteria and replicate the proposed thresholds using available data.[49] In determining the proposed numeric threshold, FINRA considered three key factors: (1) the different types of reported disclosure events; (2) the counting criteria or number of reported events required to trigger the obligations; and (3) the time period over which the events are counted. In evaluating the proposed numeric threshold versus alternative criteria, significant attention was given to the impact of possible misidentification of individuals; specifically, the economic trade-off between including individuals who are less likely to subsequently pose risk of harm to customers, and *not* including individuals who are more likely to subsequently pose risk of harm to customers but do not meet the proposed numeric threshold. There are costs associated with both types of misidentifications. For example, subjecting individuals who are less likely to pose a risk to customers to the MAP process would impose additional costs on these individuals, their affiliated firms and customers. The proposed numerical threshold aims to appropriately balance these costs in the context of economic impacts associated with the proposed amendments to the MAP rules.

The proposal may create incentives for changes in behavior to avoid meeting the proposed threshold. For example, brokers and firms may be more likely to try to settle customer complaints or arbitrations below $15,000 so that their settlements do not count towards the proposed threshold.[50] To the extent, if any, that customers also would be willing to settle for less, this change may reduce the compensation provided to customers. Brokers and firms also may consider underreporting the disclosure events in an effort to avoid the attendant costs. However, this potential impact is mitigated by the fact that many of the events are reported by FINRA or other regulators and any incorrect or missing reports can trigger regulatory action by FINRA. FINRA rules require firms to take appropriate steps to verify the accuracy and completeness of the information contained in the Uniform Registration Forms before they are filed. FINRA also has the ability to check for unreported events, particularly those that are reported in a separate public notice by a third party, such as the outcome of some civil proceedings.

FINRA recognizes that in some instances, firms may not be able to identify certain individuals with disclosure events that may seek to become owners, control persons, principals or registered persons of the firm. Similarly, firms may have less incentive to conduct appropriate due diligence on those individuals for whom firms may not have readily available disclosure history.[51] Firms, in these instances, would however still be required to seek information on relevant disclosure events from those individuals who seek to become principals or otherwise act as registered persons of the firm as part of their employment and registration process and take reasonable steps (*e.g.*, by conducting background checks) to verify the accuracy and completeness of the information provided by them. Nonetheless, FINRA recognizes that in some cases, even after conducting reasonable due diligence, firms may not have the required information to identify certain individuals that meet the proposed criteria, and these individuals may continue to pose risk of future investor harm to investors. FINRA believes that these risks are mitigated by its own examination risk programs that monitor and examine individuals for which there are concerns of ongoing misconduct or imminent risk of harm to investors. These programs identify high-risk individuals based on the analysis of data available to the firms as well as additional regulatory data available to FINRA.[52]

In developing this proposal, FINRA analyzed disclosure events reported on the Uniform Registration Forms for all individuals during the review period. For each year, FINRA evaluated the data and determined the approximate number of individuals who would have met the proposed numeric threshold of one or more final criminal matters or two or more specified risk events in the prior five years. Exhibit 1 shows the disclosure categories that FINRA considered and the subcategories that were used for identifying final criminal matters and specified risk events. The exhibit also shows the mapping of these disclosure categories to the underlying questions in the Uniform Registration Form U4.[53] Exhibit 2 shows the corresponding mapping between these disclosure categories to the questions in the Uniform Registration Form BD.[54] Exhibit 3 provides a breakdown of the disclosure categories for all individuals registered with FINRA in 2016.[55] The exhibit illustrates the impact of refining subcategories of reported disclosure events and the impact of different numeric thresholds on the number of disclosure events and registered persons associated with these events.[56] This analysis has led FINRA to initially propose the numeric threshold set forth in the current proposal.

The additional proposed obligations would only apply to individuals with one or more final criminal matters or two or more specified risk events within the prior five years who seek to become owners, control persons, principals or registered persons of a firm. Accordingly, FINRA examined registration information in order to identify all individuals that would have met the proposed criteria during the review period. Those identified serve as a reasonable estimate for the number of individuals who would have been directly impacted by this proposal had it been in place at the time they were seeking to become an owner, control person, principal or registered person of a firm. This analysis indicates that there were approximately 100 – 160 such individuals, per year, as shown in Exhibit 4. These individuals represent 0.09 percent – 0.14 percent of individuals who became owners, control persons, principals, or registered persons with a new member in any year during the review period.[57]

FINRA also analyzed firms that employed individuals who would be directly impacted by this proposal. The analysis shows that in each year over the review period, there were between 115 and 170 firms employing individuals meeting the proposed conditions. Approximately 50 percent of these firms were small, 13 percent were mid-sized and the remaining 37 percent were large firms.[58] FINRA estimates that approximately 38 percent of the individuals meeting the proposed criteria were employed by small firms, 17 percent by mid-sized firms and 45 percent by large firms.

4. Alternatives Considered

FINRA recognizes that the design and implementation of the rule proposals may impose direct and indirect costs on a variety of stakeholders, including member firms, associated persons, regulators, investors and the public. Accordingly, in developing its rule proposals, FINRA seeks to identify ways to enhance the efficiency and effectiveness of the proposals while maintaining their regulatory objectives. FINRA seeks comment on potential alternatives to the proposed amendments in this *Notice* and why these alternatives may be more efficient or effective at addressing broker misconduct than the proposed amendments.

FINRA considered several alternatives to the numerical and categorical thresholds for identifying individuals that would be subject to the proposed MAP rules amendments. In determining the proposed threshold, FINRA focused significant attention on the economic trade-off between incorrect identification of individuals that may *not* subsequently pose risk of harm their customers, and *not* including individuals that may subsequently pose risk of harm to customers but do not meet the proposed numeric threshold. FINRA also considered three key factors: (1) the different types of reported disclosure events, (2) the counting criteria or number of reported events, and (3) the time period over which the events are counted. FINRA considered several alternatives for each of these three factors.

A. Alternatives Associated With the Types of Disclosure Events

In determining the different types of disclosure events, FINRA considered all categories of disclosures events reported on the Uniform Registration Forms, including the financial disclosures and the termination disclosures. FINRA decided to exclude financial disclosures because they include personal bankruptcies, civil bonds, or judgments and liens. While these events may be of interest to investors in evaluating whether or not to engage a broker, these types of events by *themselves* are not evidence of customer harm. FINRA also considered whether termination disclosures should be included as specified risk events. Termination disclosures include job separations after allegations against the brokers.[59] FINRA notes that certain termination disclosures reflect conflicts of interest between the firm and the broker and, as a result, may not necessarily be indicative of misconduct. Further, the underlying allegations in the termination disclosures may result in other disclosure events, such as those associated with customer settlements or awards, regulatory actions or civil actions, which are already included in the proposed criteria. If so, the underlying customer harm conduct would be captured in the proposed criteria. As a result, FINRA did not include termination disclosures as specified risk events. Accordingly, FINRA considered the remaining five categories of disclosure events listed in Exhibit 1.

Within each disclosure category included in the proposed criteria, FINRA considered whether pending matters should be included or if the criteria should be restricted to final matters that have reached a resolution not in favor of the broker. Pending matters include disclosure events that may remain unresolved or subsequently get dismissed because they lack merit or suitable evidence. For example, customers may file complaints that are false or erroneous and such complaints may subsequently be withdrawn by the customers or get dismissed by firms or arbitrators. Accordingly, FINRA excluded pending matters from the proposed criteria because these events may not always be associated with customer harm or misconduct.[60]

Exhibit 1 shows the five categories of disclosure events that were considered and the subcategories that were included in the proposed criteria. For criminal matters, FINRA considered whether criminal charges that do not result in a conviction, or guilty plea or nolo contendere (no contest), should be included in the proposed criteria. These events correspond to criminal matters in which the associated charges were subsequently dismissed or withdrawn, and, as a result, are not necessarily evidence of misconduct. Accordingly, FINRA only included criminal convictions, including guilty plea or nolo contendere (no contest), in the proposed criteria.

For customer settlements and awards, FINRA considered whether settlements and awards in which the broker was **not** "named" should be considered as a specified risk event. These "subject of" customer settlements and awards correspond to events where the customer initiates a claim against the firm and does not specifically name the broker, but the firm identifies the broker as required by the Uniform Registration Forms.[61] In these cases, the broker is not party to the proceedings or settlement. There may be conflicts of interest between the firm and the broker such that the claim may be attributed to the broker without the ability of that broker to directly participate in the resolution. Accordingly, FINRA excluded "subject of" customer settlements and awards from the proposed criteria. FINRA recognizes that excluding these events may also undercount instances where the broker may have been responsible for the alleged customer harm.

For civil actions and regulatory actions, FINRA considered whether all sanctions associated with final matters should be included or certain less severe sanctions be excluded from the proposed criteria. Final regulatory action or civil action disclosures may be associated with a wide variety of activities, ranging from material customer harm to more technical rule violations, such as a failure to file in time or other events not directly related to customer harm. However, due to the way in which such information is currently reported, it is not straightforward to distinguish regulatory or civil actions associated with customer harm from other such actions.[62] In the absence of a reliable way to identify regulatory and civil actions associated with customer harm, FINRA considered using a proxy of severity of the underlying sanctions as a way to exclude events that are likely not associated with material customer harm. Specifically, FINRA only included regulatory actions or civil actions that are associated with more severe sanctions, such as bars and suspensions or monetary sanctions above a *de minimis* dollar threshold of $15,000. FINRA notes that relying strictly on a proxy for severity would likely exclude certain regulatory actions or civil actions that are associated with customer harm.

FINRA also considered several alternative *de minimis* dollar thresholds used for identifying disclosure events that are included in the proposed criteria. For example, FINRA considered higher dollar thresholds of $25,000, $50,000 and $100,000 for customer settlements, customer awards, and monetary sanctions associated with regulatory actions and civil actions. A dollar threshold may capture a dimension of severity of the alleged customer harm. FINRA has established a *de minimis* dollar reporting threshold of $10,000 for complaints filed prior to 2009 and $15,000 afterwards. The reporting threshold may, however, be low and possibly include instances where the payment was made to end the complaint and minimize litigation costs. However, the dollar threshold does not account for the value of the customers' account and there are likely cases where even low dollar amounts represent remuneration of a significant portion of customer investments. Accordingly, a dollar threshold may be both under-inclusive and over-inclusive, and as a result FINRA considered a range of alternative thresholds. Increasing the dollar threshold from $15,000 to $25,000, $50,000 and $100,000 for identifying individuals that would have met the proposed criteria would decrease the number of individuals impacted by this proposal from 100 – 160 individuals each year to approximately 90 – 155 individuals, 80 –145 individuals and 65 – 135 individuals each year, respectively, over the review period. Finally, FINRA notes that establishing a *de minimis* dollar threshold that is different from that for the current reporting requirements would likely create incentives for individuals and firms to keep future settlements below the dollar level that would trigger the restrictions.

B. Alternatives Associated With the Counting Criteria

FINRA considered a range of alternative criteria used for counting criminal matters or specified risk events for classifying individuals. For example, FINRA considered whether the counting criteria for final criminal matters should be two or more final criminal matters or one final criminal matter and another specified risk event. This alternative would effectively count final criminal matters the same way as other specified risk events. FINRA believes that final criminal matters are generally more directly tied to serious misconduct than some of the other specified risk events. Accordingly, FINRA believes that one final criminal matter, as defined by this proposal, by itself should be sufficient to trigger the proposed criteria.[63] FINRA also considered alternative criteria for counting specified risk events. For example, FINRA considered decreasing the proposed threshold for counting specified risk events from two to one such event during the prior five-year period. This alternative would change the proposed criteria to one or more final criminal matters or one (instead of two) or more specified risk events during the prior five-year period. This approach would increase the number of individuals impacted by this proposal from 100 – 160 individuals to 360 – 620 individuals each year, over the review period. FINRA also considered increasing the proposed threshold for counting specified risk events from two to three such events, thereby changing the proposed criteria to one or more final criminal matter or three (instead of two) or more specified risk events during the prior five year period. This approach would decrease the number of individuals impacted by this proposal from approximately 100 – 160 individuals to 55 – 105 individuals each year, over the review period.

C. Alternatives Associated With the Time Period Over Which the Disclosure Events Are Counted

FINRA also considered alternative criteria for the time period over which final criminal matters and specified risk events are counted for classifying individuals. For example, FINRA considered whether final criminal matters or specified risk events should be counted over the individual's entire reporting period or counted over a more recent period. Based on its experience, FINRA believes that events that are more than ten years ago do not necessarily pose the same level of possible future risk to customers as more recent events. Further, counting final criminal matters or specified risk events over an individual's entire reporting period would imply that individuals with such events would be subject to the criteria for their entire career, even if they subsequently worked without being associated with any future events. Accordingly, FINRA decided only to include final criminal matters or specified risk events in the more recent period. In addition to the proposed criteria based on a five year period, FINRA considered a criteria that would count two (or more) specified risk events in individuals' reported histories over a ten-year and a five-year period; specifically, the first specified risk event having resolved during the previous ten years and the second specified risk event resolved during the previous five years, or one or more final criminal matters having resolved in the prior five-year period. This approach would increase the number of individuals impacted by this proposal from 100 – 160 individuals to 115 – 200 individuals each year, over the review period.

Request for Comment

FINRA requests comment on all aspects of the proposal, including specifically the proposed amendments to the MAP rules. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues.

1. How could current FINRA rules be amended to better address the problem(s) of broker misconduct? To what extent have the original purposes of and need for the rules been affected by subsequent changes to the markets, the delivery of financial services, the applicable regulatory framework, or other considerations?
2. What have been your experiences with current FINRA rules, including specifically Rule 3110 (Supervision), including any ambiguities in the rules or challenges to effectively address the problem(s) of broker misconduct?
3. Are there alternative ways to address broker misconduct that should be considered? What are the alternative approaches, other than the proposal, that FINRA should consider?
4. Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposal? If so:
   a. What are these economic impacts and what are their primary sources?
   b. To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models?
   c. What would be the magnitude of these impacts, including costs and benefits?

5. Are there any expected economic impacts associated with the proposal not discussed in this *Notice*? What are they and what are the estimates of those impacts?

6. As discussed above, FINRA considered several numerical and categorical thresholds for identifying individuals that would be subject to the proposed MAP rules amendments. In determining the proposed threshold, FINRA paid significant attention to the economic trade-offs associated with misidentifications, including both over- and under-identification of individuals. FINRA specifically seeks comments on the proposed numerical threshold, including (1) the different types of reported disclosure events, (2) the counting criteria, and (3) the time period of which the events are counted:

   a. Are there any other types of disclosure events that FINRA should consider including in the proposed criteria? Which other disclosure events should FINRA consider including and how does including them improve the economic trade-offs associated with misidentifications?

      i. What counting criteria should FINRA consider for counting these additional disclosure events? What time period should FINRA consider for counting these events?

   b. Are there any reported disclosure events in Exhibit 1 that FINRA should consider excluding from the proposed criteria? Which events should FINRA consider excluding and how does excluding these events impact the economic trade-offs associated with misidentifications?

   c. Should FINRA consider alternative counting criteria for the specified risk events or the final criminal matter? What are these alternative counting criteria and why are they a better alternative to the proposed counting criteria of one or more final criminal matters or two or more specified risk events?

   d. Should FINRA consider alternative time periods over which one or more final criminal matters or two or more specified risk events are counted? Should FINRA consider using different time periods for criminal matters and specified risk events? Should FINRA consider different time periods for the four different types of specified risk events? What are these alternative approaches and why could they be better alternatives to the proposed period of prior five years?

7. As discussed above, the proposed MAP rules amendments would apply to individuals that meet the proposed criteria and seek to become an owner, control person, principal or registered person of a member firm. Should FINRA consider expanding the scope of the MAP requirements to:

   a. all individuals who meet the proposed criteria and are currently owners, control persons, principals, or registered persons with a firm; or

   b. all individuals who meet the proposed criteria and are currently associated with a firm, irrespective of their registration type or ownership and control status?

What are the incremental economic impacts, including incremental costs and benefits associated with these alternatives and why are they better than the proposed requirements?

8. Should FINRA consider expanding the scope of the proposed MAP rule amendments to individuals meeting the proposed numerical threshold who are already a principal and seek to add an additional principal registration with their existing firm?

9. FINRA is proposing to disclose information through BrokerCheck on the status of a firm as a "taping firm." Should FINRA also consider disclosing information of a broker's association with a "taping firm" through BrokerCheck?

In addition to comments responsive to these questions, FINRA invites comment on any other aspects of the rules that commenters wish to address. FINRA further requests any data or evidence in support of comments. While the purpose of this *Notice* is to obtain input as to whether or not the current rules are effective and efficient, FINRA also welcomes specific suggestions as to how the rules should be changed.

Endnotes

1. The Uniform Registration Forms for firms and brokers are the Uniform Application for Broker-Dealer Registration (Form BD), the Uniform Application for Securities Industry Registration or Transfer (Form U4), the Uniform Termination Notice for Securities Industry Registration (Form U5) and the Uniform Disciplinary Action Reporting Form (Form U6). Firms have access to disclosure events reported on the Form U4, U5, and U6 filings for brokers who were previously registered with the same firms or with other firms. Firms, however, do not readily have available to them disclosure events for persons who were not previously registered, including control affiliates, that are reported on another firm's Form BD. FINRA would expect firms to take reasonable steps to obtain information on the disciplinary history of non-registered individuals that may be disclosed on another firm's Form BD through for example, questionnaires, certifications, and reasonable background checks for those individuals seeking to become an owner, control person, principal or registered person of the firm.

2. *See Regulatory Notice 18-15* (Heightened Supervision, Guidance on Implementing Effective Heightened Supervisory Procedures for Associated Persons With a History of Past Misconduct (April 2018)).

3. FINRA also expects to file a proposed rule change to amend Schedule A to the FINRA By-Laws to increase current application fees for individuals, and impose new application fees for member firms, subject to an SD that are seeking approval by FINRA to enter or remain in the securities industry. In connection with our on-going efforts to address high-risk brokers, FINRA also will be publishing revised Sanction Guidelines shortly.

4. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.

5. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.

6. *See* Individuals Barred by FINRA. The list is updated monthly.

7. *See* General Information on FINRA's Eligibility Requirements.

8. *See supra* note 6.

9. *See supra* note 2.

10. This *Notice* will refer to both a Hearing Panel and Extended Hearing Panel collectively as "Hearing Panel" unless otherwise noted. The Hearing Panel is chaired by the assigned Hearing Officer who is an employee of OHO. The Chief Hearing Officer appoints two industry panelists, drawn primarily from a pool of current and former securities industry members of FINRA's District Committees, as well as its Market Regulation Committee, former members of FINRA's NAC and former FINRA Governors. The NAC is the national committee that reviews initial decisions rendered in FINRA disciplinary and membership proceedings.

11. If a respondent fails to answer the complaint, or a party fails to appear at a pre-hearing conference, or a party fails to appear at any hearing that the party is required to attend, the Hearing Officer may issue a default decision in accordance with Rule 9269.

12. *See* FINRA Rule 9311(b), which further provides that an appeal will not stay a decision, or part of a decision, that imposes a permanent cease and desist order.

13. As such terms are defined in Rule 9120 (Definitions).

14. *See, e.g.,* CBOE Rule 17.11(b) ("Pending effectiveness of a decision imposing a sanction on the Respondent, the Business Conduct Committee may impose such conditions and restrictions on the activities of the Respondent as the Committee considers reasonably necessary for the protection of investors and the Exchange"); BATS Rule 8.11 ("Pending effectiveness of a decision imposing a penalty on the Respondent, the CRO, Hearing Panel or committee of the Board, as applicable, may impose such conditions and restrictions on the activities of the Respondent as he, she or it considers reasonably necessary for the protection of investors, creditors and the Exchange."); CHX Article 12, Rule 6 (explaining that sanctions are stayed during appeal process "subject, however, to the power of the Hearing Officer to impose such limitations on the respondent as are necessary or desirable, in the judgment of the Hearing Officer for the protection of the respondent's customers, creditors or the Exchange or for the maintenance of just and equitable principles of trade"); Nasdaq PHLX Rule 960.10(b) ("Pending effectiveness of a decision imposing sanctions on a Respondent, the Hearing Panel may impose such conditions and restrictions on the activities on such Respondent which it finds to be necessary or appropriate for the protection of the investing public, members, member organizations and the Exchange and its subsidiaries.")

15. Proposed Rule 9556(a)(2) would permit FINRA staff to issue a notice to a respondent stating that the failure to comply with the conditions or restrictions imposed under Rule 9285 within seven days of service of the notice will result in a suspension or cancellation of membership or a suspension or bar from associating with any member. Proposed Rule 9556(c)(2) would govern the content of the notice similar to current Rule 9556(c).

16. *See* FINRA Rule 3110. The rule requires member firms to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and FINRA rules. An effective supervisory system plays an essential role in the prevention of sales abuses, and thus, enhances investor protection and market integrity. As such, irrespective of whether a matter is on appeal or under review, a firm should routinely evaluate its supervisory procedures to ensure they are appropriately tailored for each associated person and take into consideration, among other things, the person's activities and history of industry and regulatory-related incidents. FINRA and the SEC have emphasized the need for heightened supervision when a member firm associates with persons who have a history of industry or regulatory-related incidents.

17. *See supra* note 16.

18. SDs are defined in Section 3(a)(39) of the Exchange Act.

19. *See* 15 U.S.C. § 78o-3(g)(2) ("A registered securities association may, and in cases in which the Commission, by order, directs as necessary or appropriate in the public interest or for the protection of investors shall, deny membership to any registered broker or dealer, and bar from becoming associated with a member any person, who is subject to a statutory disqualification."); *see also* Exchange Act Rule 19h-1.

20. *See supra* note 7.

21. The Rule 9520 Series stems from Section 3(a)(39) of the Exchange Act, which sets forth the definition of SD. In 2007, FINRA amended the definition of SD in its By-Laws to incorporate by reference Exchange Act Section 3(a)(39). This change incorporated three additional SD categories, including willful violations of the federal securities or commodities laws, grounds for SD that were enacted by the Sarbanes-Oxley Act of 2002, and associations with certain other persons subject to SD. As a result, there was an increase in the number of individuals subject to SD pursuant to FINRA's By-Laws, and by derivation, an increase in the number of individuals seeking FINRA's approval to enter or remain in the securities industry despite their status as a disqualified individual.

22. FINRA's review of many SD applications is governed by the standards set forth in *Paul Edward Van Dusen*, 47 S.E.C. 668 (1981) and *Arthur H. Ross*, 50 S.E.C. 1082 (1992). These standards provide that in situations where an individual's misconduct has already been addressed by the SEC or FINRA, and certain sanctions have been imposed for such misconduct, FINRA should not consider the individual's underlying misconduct when it evaluates an SD application. In *Van Dusen*, the SEC stated that when the period of time specified in the sanction has passed, in the absence of "new information reflecting adversely on [the applicant's] ability to function in his proposed employment in a manner consonant with the public interest," it is inconsistent with the remedial purposes of the Exchange Act and unfair to deny an application for re-entry. 47 S.E.C. at 671. The SEC also noted in *Van Dusen*, however, that an applicant's re-entry is not "to be granted automatically" after the expiration of a given time period. Id. Instead, the SEC instructed FINRA to consider other factors, such as: (1) "other misconduct in which the applicant may have engaged"; (2) "the nature and disciplinary history of a prospective employer"; and (3) "the supervision to be accorded the applicant." *Id.* Further, in *Ross*, the SEC established a narrow exception to the rule that FINRA confine its analysis to "new information." 50 S.E.C. at 1085. The SEC stated that FINRA could consider the conduct underlying a disqualifying order if an applicant's later misconduct was so similar that it formed a "significant pattern." *Id.* n.10.

23. The hearing panel considers evidence and other matters in the record and makes a written recommendation on the SD Application to the Statutory Disqualification Committee. *See* Rule 9524(a)(10). The Statutory Disqualification Committee, in turn, recommends a decision to the NAC, which issues a written decision to the member firm that filed the SD Application. *See* Rule 9524(b).

24. Approximately 75 percent of the applications filed in 2016 that have reached a resolution were either denied by FINRA, withdrawn because the applicant expected FINRA would recommend denial of its application or closed as the SD application was not required by operation of law. For the other 25 percent, FINRA approval resulted from legal principles, including those embodied in the Exchange Act and in case law, as noted above, which limits FINRA's discretion to deny an application.

25. *But see Regulatory Notice 18-15* (reminding member firms of their obligation to tailor the firm's supervisory systems to account for brokers with a history of industry or regulatory-related incidents, including disciplinary actions).

26. *See* BrokerCheck.

27. *See* Rules 2210(d)(8) and 2267.

28. Rule 3170(a)(5)(A) defines a "taping firm" to mean:

    (i) A member with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years;

    (ii) A member with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years;

    (iii) A member with at least twenty registered persons where 20% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years.

29. Rule 3170(a)(2) defines a "disciplined firm" to mean:

    (A) a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the SEC revoking its registration as a broker-dealer;

    (B) a futures commission merchant or introducing broker that has been formally charged by either the Commodity Futures Trading Commission or a registered futures association with deceptive telemarketing practices or promotional material relating to security futures, those charges have been resolved, and the futures commission merchant or introducing broker has been closed down and permanently barred from the futures industry as a result of those charges; or

    (C) a futures commission merchant or introducing broker that, in connection with sales practices involving the offer, purchase, or sale of security futures is subject to an order of the SEC revoking its registration as a broker or dealer.

30. Rule 3170 provides member firms that trigger application of the taping requirement a one-time opportunity to adjust their staffing levels to fall below the prescribed threshold levels and thus avoid application of the rule.

31. There are currently 11 firms identified as "disciplined firms," and one firm is identified as a taping firm under Rule 3170.

32. Specifically, such changes are (1) a merger of the member with another member, unless both are members of the New York Stock Exchange (NYSE) or the surviving entity will continue to be a member of the NYSE; (2) a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the NYSE; (3) direct or indirect acquisitions or transfers of 25 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues composing 25 percent or more in the aggregate of the member's earnings measured on a rolling

36-month basis, unless both the seller and acquirer are members of the NYSE; (4) a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or (5) a material change in business operations as defined in Rule 1011(k). The term "material change in business operations" includes, but is not limited to: (1) removing or modifying a membership agreement restriction; (2) market making, underwriting or acting as a dealer for the first time; and (3) adding business activities that require a higher minimum net capital under Rule 15c3-1 of the Exchange Act.

33. Proposed Rule 1011(p) would define the "Uniform Registration Forms," to mean the Uniform Application for Broker-Dealer Registration (Form BD), the Uniform Application for Securities Industry Registration or Transfer (Form U4), the Uniform Termination Notice for Securities Industry Registration (Form U5) and the Uniform Disciplinary Action Reporting Form (Form U6).

34. Form U4 *Explanation of Terms* defines the term "investment-related" as pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association).

35. The proposed MAP rules amendments would apply to individuals that meet the proposed criteria and seek to obtain their first principal registration at one of their existing firms or at a new firm. It would not apply to individuals who meet the proposed numerical threshold and are already a principal but seek to add an additional principal registration with one of their existing firms.

36. For example, in 2015 the Office of the Chief Economist (OCE) published a study that examined the predictability of disciplinary and other disclosure events associated with investor harm based on past similar events. The OCE study showed that past disclosure events, including regulatory actions, customer complaints, arbitrations and litigations of brokers have significant power to predict investor harm. In a subsequent research paper by academics at the University of Chicago and the University of Minnesota, the authors present evidence that suggests a higher rate of new disciplinary and other disclosure events is highly correlated with past disciplinary and other disclosure events, as far back as nine years prior. *See* Qureshi & Sokobin, Do Investors Have Valuable Information About Brokers? (2015); Mark Egan et al., The Market for Financial Adviser Misconduct (2016).

37. This analysis included all NAC appeals filed during the review period that reached a final decision by the end of 2017. The analysis includes all NAC decisions, including affirmations, modifications or reversals of the findings in the disciplinary matters. The analysis excludes appeals that were withdrawn prior to the resolution of the appeal process.

38. FINRA further estimates that approximately 94 percent of the appeals filed by brokers involved one broker and the remaining 6 percent involved two brokers. All the appeals filed by firms were associated with one firm.

39. The median processing time was approximately 15 months, while the 25th and the 75th percentiles were approximately 11 months and 18 months, respectively.

40. Three of these 119 individuals were associated with multiple SD Applications over the review period. Approximately 90 percent of the firms filed one request during the review period, and the remaining 10 percent filed two or more requests.

41. 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.

42. In approximately 12 percent of the SD Applications, the application was withdrawn because the decision leading to the disqualifying event was overturned, thus the individual was no longer subject to an SD or the sanctions were no longer in effect. In one of the 122 SD Applications, the resolution of the application was subsequently reversed.

43. The median processing time was approximately 9 months and the 25th and the 75th percentiles were approximately 3 months and 14 months, respectively.

44. To be consistent with the definitions used for classifying brokers for the proposed MAP requirements, FINRA based its analysis on the occurrence of one or more final criminal matters or specified risk events, as defined in the proposed amendments to the NASD Rule 1010 Series discussed above.

45. These estimates are based on appeals filed by brokers, or jointly filed by brokers and firms, and excludes appeals that were filed only by firms. These estimates likely underrepresent the overall risk of customer harm posed by these brokers because they are based on a specific set of events and outcomes used for classifying brokers for the proposed amendments to the MAP rules. In addition, these brokers had other disclosure events after their appeal was filed and some of these other events may also be associated with risk of customer harm.

46. The proposal may also impose costs on issuers in limited instances where a firm is enjoined from participating in a private placement and the issuer is especially reliant on that firm. The private issuer may incur search costs to find a replacement firm or individual and incur other direct and indirect costs associated with the offering.

47. These estimates are based on the definitions for specified risk events and final criminal matters used for the proposed the MAP requirements, and as result, likely underrepresents the overall risk of customer harm posed by these SD individuals.

48. Firms have access to disclosure events reported on the Form U4, U5 and U6 filings for individuals who were previously registered with the same firms or with other firms. Firms do not, however, readily have available to them disclosure events for individuals where such individuals were not previously registered, including control affiliates, or where information regarding such individuals is reported on another firm's Form BD

49. *See supra* note 48.

50. The proposed $15,000 threshold for customer settlement corresponds to the reporting threshold for the Uniform Registration Forms and for the settlement information to be displayed through BrokerCheck. As a result, brokers and firms already have incentives to settle below the $15,000 amount. Accordingly, FINRA does not anticipate that the proposed dollar threshold would result in a material change in customer settlements.

51. For example, FINRA uses disclosure events reported on Form BD across all firms to identify disclosure records of non-registered control affiliates.

52. For example, as discussed above, firms do not have access to disclosure events for non-registered control affiliates at other firms.

53. The Uniform Registration Forms U5 and U6 have questions similar to Form U4 that can also be mapped to the disclosures categories in Exhibit 1.

54. The Uniform Registration Form BD includes information on disclosures events for individual control affiliates, including non-registered control affiliates, that may not have Form U4, U5 or U6 filings. Form BD is the primary source of information on disclosure events for these unregistered control affiliates. Form BD includes information on final criminal matters and certain specified risk events associated with regulatory actions and civil actions, but does not include information on customer awards or settlements.

55. Exhibit 3 does not include information on individuals that were not registered with FINRA in 2016. These non-registered individuals may include non-registered associated persons, including non-registered control affiliates.

56. Exhibit 3 shows the number of criminal disclosures and disclosures considered in developing specified risk events (regulatory action disclosures, civil judicial disclosures, and customer complaint, arbitration and civil litigation disclosures), including pending and final disclosures, over the entire reporting history of brokers who were registered with FINRA in 2016. The exhibit also reports the number of brokers associated with these disclosure events and the impact of refining the disclosure categories and the period over which these events are counted. For example, the exhibit shows that there are a total of approximately 20,900 criminal disclosures and 140,200 disclosures considered in developing specified risk events over the entire reporting history of these brokers. Refining the disclosure categories to include final criminal matters and specified risk events, as defined in this proposal, would result in approximately 155 final criminal matters and 3,425 specified risk events. Exhibit 3 also shows that there were approximately 490 brokers who were registered with FINRA in 2016 and met the proposed numeric threshold of one or more final criminal matters or two or more specified risk events in the prior five years.

57. These percentages are calculated by dividing FINRA's estimate of the number of individuals who met the proposed criteria each year during the review period (approximately 100 – 160 individuals per year), by the number of individuals who became owners, control persons, principals, or registered persons with a new member each year during the review period (approximately 105,500 – 112,800 individuals per year).

58. *See supra* note 41.

59. Termination disclosures involve situations where the individual voluntarily resigned, was discharged, or was permitted to resign after allegations.

60. More than 50 percent of the pending matters during the review period remain unresolved or were subsequently dismissed. For example, Exhibit 3 shows that approximately 69,000 (or 49 percent) of the 140,000 disclosures considered in developing specified risk events resulted in final matters. Accordingly, more than 50 percent of the pending matters remain unresolved or were subsequently dismissed or did not reach a resolution that was unfavorable to the broker.

61. For example, the Instructions to Form U4, Questions 14I(4) or 14I(5) provide that the answer should be "yes" if the broker was not named as a respondent/defendant but (1) the Statement of Claim or Complaint specifically mentions the individual by name and alleges the broker was involved in one or more sales practice violations or (2) the Statement of Claim or Complaint does not mention the broker by name, but the firm has made a good faith determination that the sales practice violation(s) alleged involves one or more particular brokers.

62. For example, the Uniform Registration Forms contain a description on the allegation, which could be useful in identifying regulatory actions or civil actions associated with customer harm, but this information is stored as "free-text" and, therefore, cannot be reliably compared across disclosures.

63. FINRA recognizes that final criminal matters include felony convictions that may not be investment related (*e.g.*, a conviction associated with multiple DUIs).

Attachment A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

Text of Proposed New FINRA Rules
(Marked to Show Changes from NASD Rule 1010 Series; NASD Rule 1010 Series to be Deleted in their Entirety from the Transitional Rulebook)[i]

* * * * *

1000. MEMBERSHIP APPLICATION AND ASSOCIATED PERSON REGISTRATION

* * * * *

[1010. Membership Proceedings]

1011. Definitions

* * * * *

(g) "final criminal matter"

The term "final criminal matter" means a final criminal matter that resulted in a conviction of, or guilty plea or nolo contendere ("no contest") by a person that is disclosed, or was required to be disclosed, on the applicable Uniform Registration Forms.

(g) through **(m)** renumbered to (h) through (n)

(o) "specified risk event"

The term "specified risk event" means any one of the following events that are disclosed, or are or were required to be disclosed, on an applicable Uniform Registration Form;

(1) a final investment-related, consumer-initiated customer arbitration award or civil judgment against the person for a dollar amount at or above $15,000 in which the person was a named party;

(2) a final investment-related, consumer-initiated customer arbitration settlement or civil litigation settlement for a dollar amount at or above $15,000 in which the person was a named party;

(3) a final investment-related civil action where the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000; and

(4) a final regulatory action where (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000; or (B) the sanction against the person was a bar (permanently or temporarily), expulsion, rescission, revocation, or suspension from associating with a member.

([n]p) "Subcommittee"

The term "Subcommittee" means a subcommittee of the National Adjudicatory Council that is constituted pursuant to Rule 1015 to conduct a review of a Department decision issued under the Rule [1010]1000 Series.

(q) "Uniform Registration Forms"

The term "Uniform Registration Forms" means the Uniform Application for Broker-Dealer Registration (Form BD), the Uniform Application for Securities Industry Registration or Transfer (Form U4), the Uniform Termination Notice for Securities Industry Registration (Form U5) and the Uniform Disciplinary Action Reporting Form (Form U6), as such may be amended or any successor(s) thereto.

* * * * *

IM-1011-2. Business Expansions and Persons with Specified Risk Events

If a natural person who has, in the prior five years, one or more final criminal matters or two or more specified risk events seeks to become an owner, control person, principal, or registered person of a member, and the member is not otherwise required to file a Form CMA in accordance with Rule 1017, the member may not effect the contemplated activity until the member has first submitted a written letter to the Department, in a manner prescribed by

FINRA, seeking a materiality consultation for the contemplated activity. The letter must address the issues that are central to the materiality consultation. The Department will consider the letter and other information or documents and determine in the public interest and the protection of investors that either (1) the member is not required to file a CMA in accordance with Rule 1017 and may effect the contemplated activity; or (2) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the contemplated activity, unless the Department approves the CMA.

* * * * *

1017. Application for Approval of Change in Ownership, Control, or Business Operations

(a) Events Requiring Application

A member shall file an application for approval of any of the following changes to its ownership, control, or business operations:

(1) through (5) No Change.

(6) Notwithstanding subparagraphs (4) and (5) of Rule 1017(a), whenever the natural person seeking to become an owner, control person, principal or registered person of a member has, in the prior five years, one or more final criminal matters or two or more specified risk events, and the member is not otherwise required to file a Form CMA in accordance with Rule 1017, unless the member has submitted a written letter to the Department, in a manner prescribed by FINRA, seeking a materiality consultation for the contemplated activity. The letter must address the issues that are central to the materiality consultation. As part of the materiality consultation, the Department shall consider the letter and other information or documents provided by the member to determine in the public interest and the protection of investors that either (A) the member is not required to file a CMA in accordance with Rule 1017 and may effect the contemplated activity; or (B) the member is required to file a CMA in accordance with Rule 1017 and the member may not effect the contemplated activity, unless the

Department approves the CMA. The safe harbor for business expansions under IM-1011-1 shall not be available to the member in such circumstance.

* * * * *

8310. Sanctions for Violation of the Rules

* * * * *

8312. FINRA BrokerCheck Disclosure

(a) No Change.

(b)(1) No Change.

(2) The following information shall be released pursuant to this paragraph (b):

(A) any information reported on the most recently filed Form U4, Form U5, Form U6, Form BD, and Form BDW (collectively "Registration Forms");

(B) currently approved registrations;

(C) summary information about certain arbitration awards against a BrokerCheck Firm involving a securities or commodities dispute with a public customer;

(D) the most recently submitted comment, if any, provided to FINRA by the person who is covered by BrokerCheck, in the form and in accordance with the procedures established by FINRA, for inclusion with the information provided through BrokerCheck. Only comments that relate to the information provided through BrokerCheck will be included;

(E) information as to qualifications examinations passed by the person and date passed. FINRA will not release information regarding examination scores or failed examinations;

(F) [in response to telephonic inquiries via the BrokerCheck toll-free telephone listing,]information as to whether a particular member is subject to the provisions of Rule 3170 ("Taping Rule");

(G) Historic Complaints (i.e., the information last reported on Registration Forms relating to customer complaints that are more than two (2) years old and that have not been settled or adjudicated, and customer complaints, arbitrations or litigations that have been settled for an amount less than $10,000 prior to May 18, 2009 or an amount less than $15,000 on or after May 18, 2009 and are no longer reported on a Registration Form), provided that any such matter became a Historic Complaint on or after August 16, 1999; and

(H) the name and succession history for current or former BrokerCheck Firms.

(c) through (f) No Change.

• • • Supplementary Material: --------------

.01 through **.03** No Change.

* * * * *

9000. CODE OF PROCEDURE

* * * * *

9200. DISCIPLINARY PROCEEDINGS

* * * * *

9285. Interim Orders While on Appeal

(a) Conditions and Restrictions

The Hearing Panel or, if applicable, the Extended Hearing Panel ("Hearing Panel"), or Hearing Officer may impose such conditions or restrictions on the activities of a Respondent as the Hearing Panel or Hearing Officer considers reasonably necessary for the purpose of preventing customer harm.

(b) Expedited Review

(1) Availability

A Respondent that has conditions or restrictions imposed by a Hearing Panel or Hearing Officer may file a motion with the Review Subcommittee of the National Adjudicatory Council to modify or remove any or all of the conditions or restrictions.

(2) Requirements for the Motion

The Respondent has the burden to show that the Hearing Panel or Hearing Officer committed an error by ordering the conditions or restrictions imposed. The Respondent must show that the conditions or restrictions are not reasonably necessary for the purpose of preventing customer harm. The Respondent's motion to modify or remove conditions or restrictions shall be filed with FINRA's Office of General Counsel and shall be served simultaneously on the Office of Hearing Officers and all other parties to the disciplinary proceeding. Respondent's motion and the opposition to the motion shall comply with Rules 9133, 9134, 9135, 9136 and 9137.

(3) Opposition to the Motion

The Department of Enforcement shall have five days from service of Respondent's motion to file an opposition to the motion. The Respondent may not file a reply to the opposition. Unless ordered otherwise by the Review Subcommittee, the motion to modify or remove conditions or restrictions shall be decided based on the moving and opposition papers and without oral argument. The Review Subcommittee shall issue a written order ruling upon a motion to modify or remove conditions or restrictions in an expeditious manner and no later than 30 days after any opposition filed pursuant to this paragraph (b)(3), and serve the order on all parties.

(4) Effectiveness

The filing of a motion to modify or remove a condition or restriction shall stay the effectiveness of the conditions or restrictions ordered by a Hearing Panel or Hearing Officer until the Review Subcommittee rules on the motion.

(c) Mandatory Heightened Supervision

(1) Requirement

When a Hearing Panel or Hearing Officer issues a decision pursuant to Rule 9268 or Rule 9269 in which the adjudicator finds that a Respondent violated a statute or rule provision, any firm with which the Respondent is associated must adopt a written plan of heightened supervision if any party appeals the decision to the National Adjudicatory Council, or if the National Adjudicatory Council calls the case for review. The firm must submit the written plan of heightened supervision within ten days of any party filing an appeal or the case being called for review. Respondent shall file a copy of the plan of heightened supervision with FINRA's Office of General Counsel and shall serve a copy on the Department of Enforcement. If a Respondent becomes associated with another firm while the Hearing Panel's or Hearing Officer's decision is on appeal to the National Adjudicatory Council, that firm, within ten days of the Respondent becoming associated with the firm, shall file a copy of a plan of heightened supervision with FINRA's Office of General Counsel and shall serve a copy on the Department of Enforcement.

(2) Provisions

The plan of heightened supervision shall comply with Rule 3110, and shall be reasonably designed and tailored to include specific supervisory policies and procedures that address the violations found by the Hearing Panel or Hearing Officer and shall be reasonably designed to prevent or detect a reoccurrence of those violations. The plan of heightened supervision shall, at a minimum, include the designation of an appropriately registered principal who is responsible for carrying out the plan of heightened supervision, and take into account any conditions and restrictions imposed by the Hearing Panel or Hearing Officer pursuant to paragraph (a) of this Rule.

(3) Signature of Principal

The plan of heightened supervision shall be signed by the designated principal, and shall include an acknowledgement that the principal is responsible for implementing and maintaining the plan of heightened supervision.

(4) Duration

The plan of heightened supervision shall remain in place until FINRA's final decision takes effect.

* * * * *

9300. REVIEW OF DISCIPLINARY PROCEEDING BY NATIONAL ADJUDICATORY COUNCIL AND FINRA BOARD; APPLICATION FOR SEC REVIEW

9310. Appeal to or Review by National Adjudicatory Council

9311. Appeal by Any Party; Cross-Appeal

(a) No Change.

(b) Effect

An appeal to the National Adjudicatory Council from a decision issued pursuant to Rule 9268 or Rule 9269 shall operate as a stay of that decision until the National Adjudicatory Council issues a decision pursuant to Rule 9349 or, in cases called for discretionary review by the FINRA Board, until a decision is issued pursuant to Rule 9351. Any such appeal, however, will not stay a decision, or that part of a decision, that imposes a permanent cease and desist order. Notwithstanding the stay of sanctions under this Rule, the Hearing Panel or Hearing Officer may impose such conditions and restrictions on the activities of a Respondent as the Hearing Panel or Hearing Officer considers reasonably necessary for the purpose of preventing customer harm in accordance with Rule 9285(a).

(c) through (f) No Change.

* * * * *

9500. OTHER PROCEEDINGS

* * * * *

9520. Eligibility Proceedings

* * * * *

9523. Acceptance of Member Regulation Recommendations and Supervisory Plans by Consent Pursuant to SEA Rule 19h-1, and Requirements for an Interim Plan of Heightened Supervision

(a) through (b) No Change.

(c) Submission of an Interim Plan of Heightened Supervision

An application filed pursuant to FINRA Rule 9522(a)(3) or FINRA Rule 9522(b)(1)(B) or (C) that seeks the continued association of a disqualified person must include:

(1) An interim plan of heightened supervision. The application shall identify an appropriately registered principal responsible for carrying out the interim plan of heightened supervision, who has signed the plan and acknowledged his or her responsibility for implementing and maintaining such plan. The interim plan of heightened supervision shall be in effect throughout the entirety of the application review process which shall be considered concluded only upon the final resolution of the eligibility proceeding. The interim plan of heightened supervision shall comply with the provisions of Rule 3110, and be reasonably designed and tailored to include specific supervisory policies and procedures that address any regulatory concerns related to the nature of the disqualification, the nature of the sponsoring member's business, and the disqualified person's current and proposed activities during the review process. As a condition to the eligibility proceeding, the Department of Member Regulation, in its discretion and consistent with the public interest and the protection of investors, may modify any interim plan of heightened supervision.

(2) A written representation from the sponsoring member that the disqualified person is currently subject to an interim plan of heightened supervision as set forth in paragraph (c)(1) of this Rule.

(d) Determination that an Application is Substantially Incomplete

If the Department of Member Regulation determines that an application is substantially incomplete, it may reject the application and deem it not to have been filed. In such case, the Department of Member Regulation shall provide the disqualified member or sponsoring member notice of the delinquency and its reasons for so doing. The disqualified member or sponsoring firm shall have ten business days to remedy the application, or such other time period prescribed by FINRA. An application will be deemed to be substantially incomplete if:

(1) It does not include the representation required by paragraph (c)(2) of this Rule; or

(2) FINRA determines that it does not include a reasonably designed interim plan of heightened supervision that complies with the standards of paragraph (c)(1) of this Rule.

(e) Consequences for Failure to Timely Remedy an Application that is Substantially Incomplete

If an applicant fails to remedy an application that is substantially incomplete, the Department of Member Regulation shall serve a written notice on the disqualified member or sponsoring member of its determination to reject the application and its reasons for so doing. FINRA shall refund the application fee, less $1,000, which shall be retained by FINRA as a processing fee. Upon such rejection, the disqualified member or sponsoring member must promptly terminate association with the disqualified person.

* * * * *

9550. Expedited Proceedings

* * * * *

9556. Failure to Comply with Temporary and Permanent Cease and Desist Orders, or Hearing Panel or Hearing Officer Decisions that Impose Conditions or Restrictions

(a) Notice of Suspension, Cancellation or Bar

(1) If a member, person associated with a member or person subject to FINRA's jurisdiction fails to comply with a temporary or permanent cease and desist order issued under the Rule 9200, 9300 or 9800 Series, FINRA staff, after receiving written authorization from FINRA's Chief Executive Officer or such other senior officer as the Chief Executive Officer may designate, may issue a notice to such member or person stating that the failure to comply with the temporary or permanent cease and desist order within seven days of service of the notice will result in a suspension or cancellation of membership or a suspension or bar from associating with any member.

(2) If a respondent fails to comply with conditions or restrictions imposed pursuant to Rule 9285 in a Hearing Panel's or Hearing Officer's decision issued pursuant to Rule 9268 or Rule 9269, FINRA staff may issue a notice to a respondent stating that the failure to comply with the conditions or restrictions within seven days of service of the notice will result in a suspension or cancellation of membership or a suspension or bar from associating with any member.

(b) No Change.

(c) Contents of Notice

(1) [The]A notice issued pursuant to paragraph (a)(1) shall explicitly identify the provision of the permanent or temporary cease and desist order that is alleged to have been violated and shall contain a statement of facts specifying the alleged violation. The notice shall state when the FINRA action will take effect and explain what the respondent must do to avoid such action. The notice shall state that the respondent may file a written request for a hearing with the Office of Hearing Officers pursuant to Rule 9559. The notice also shall inform the respondent of the applicable deadline for filing a

request for a hearing and shall state that a request for a hearing must set forth with specificity any and all defenses to the FINRA action. In addition, the notice shall explain that, pursuant to Rules 8310(a) and 9559(n), a Hearing Officer or, if applicable, Hearing Panel, may approve, modify or withdraw any and all sanctions or limitations imposed by the notice, and may impose any other fitting sanction.

(2) A notice issued pursuant to paragraph (a)(2) shall explicitly identify conditions or restrictions that are alleged to have been violated and shall contain a statement of facts specifying the alleged violation. The notice shall state when the FINRA action will take effect and explain what the respondent must do to avoid such action. The notice shall state that the respondent may file a written request for a hearing with the Office of Hearing Officers pursuant to Rule 9559. The notice also shall inform the respondent of the applicable deadline for filing a request for a hearing and shall state that a request for a hearing must set forth with specificity any and all defenses to the FINRA action. In addition, the notice shall explain that, pursuant to Rules 8310(a) and 9559(n), a Hearing Officer or, if applicable, Hearing Panel, may approve, modify or withdraw any and all sanctions imposed by the notice, and may impose any other fitting sanction.

(d) through (h) No Change.

* * * * *

[i] FINRA will separately issue a *Regulatory Notice* soliciting comment on proposed changes to the membership application rules resulting from a retrospective review of the rules.

Exhibit 1: Disclosures Categories Considered for Criminal Matters and Specified Risk Events (Mapped to the Uniform Form U4)

	Subcategories Considered		Subcategories Included	
Disclosure Categories*	**Subcategories**	**U4 Question #**	**Subcategories**	**U4 Question #**
Final Criminal Matters	I) Convictions II) Adjudicated charges with unspecified outcomes	I) 14A(1)a, (2)a; 14B(1)a, (2)a II) 14A(1)b, (2)b; 14B(1)b,(2)b	I) Convictions	I) 14A(1)a, (2)a; 14B(1)a, (2)a
Specified Risk Events				
a) Customer Awards (above de minimis threshold)**	Customer awards in which: I) Individual was named II) Individual was subject of	I) 14I (1)b II) 14I (4)b	Customer awards in which: I) Individual was named	I) 14I (1)b
b) Customer Settlements (above de minimis threshold)**	Customer settlements in which: I) Individual was named II) Individual was subject of	I) 14I (1)c-d II) 14I (2)a-b; 14I (4)a	Customer settlements in which: I) Individual was named	I) 14I (1)c-d
c) Final Civil Judicial	Sanctions ordered: I) Monetary Sanctions II) Cease and Desist Sanctions III) Other Sanctions	Civil Judicial DRP, Q12A I) Civil and Administrative penalties, Disgorgement, Monetary Penalty other than fines, Restitution II) Cease and Desist, Injunction III) Other Sanctions	Sanctions ordered: I) Monetary Sanctions (above de minimis threshold)**	Civil Judicial DRP, Q12A I) Civil and Administrative penalties, Disgorgement, Monetary Penalty other than fines, Restitution
d) Final Regulatory Actions	Sanctions ordered: I) Bars and Suspensions II) Monetary Sanctions III) Cease and Desist Sanctions IV) Other Sanctions	Regulatory Action-DRP 13 A. I) Bar(permanent), Bar (temporary), Rescission, Suspension, Revocation, Expulsion II) Civil and Admin Penalties/Fines, Restitution, Disgorgement, Monetary penalties and other fines III) Censure, Cease and Desist, Prohibition IV) Undertaking, Requalification, Denial, Letter of Reprimand, Other	Sanctions ordered: I) Bars and Suspensions II) Monetary Sanctions (above de minimis threshold)**	Regulatory Action-DRP 13 A. I) Bar(permanent), Bar (temporary), Rescission, Suspension, Revocation, Expulsion II) Civil and Admin Penalties/Fines, Restitution, Disgorgement, Monetary penalties and other fines

Notes and Assumptions:
* Excludes matters that are pending or are known to have reached a resolution in favor of the Individual (e.g. pending or dismissed complaints).
** Corresponds to a dollar threshold of $15,000.

Exhibit 2: Disclosures Categories Considered for Criminal Matters and Specified Risk Events (Mapped to the Uniform Form BD)

	Subcategories Considered		Subcategories Included	
Disclosure Categories*	**Subcategories**	**Form BD Question #**	**Subcategories**	**Form BD Question #**
Final Criminal Matters	I) Convictions II) Adjudicated charges with unspecified outcomes	I) 11A(1), 11B(1) II) 11A(2), 11B(2)	I) Convictions	I) 11A(1), 11B(1)
Specified Risk Events				
a) Customer Awards (above de minimis threshold)**	Customer awards in which: I) Individual was named II) Individual was subject of	NA***	Customer awards in which: I) Individual was named	NA***
b) Customer Settlements (above de minimis threshold)**	Customer settlements in which: I) Individual was named II) Individual was subject of	NA***	Customer settlements in which: I) Individual was named	NA***
c) Final Civil Judicial	Sanctions ordered: I) Monetary Sanctions II) Cease and Desist Sanctions III) Other Sanctions	Civil Action-DRP Part II, 13 A. I) Bar, Suspension, Revocation, Expulsion II) Disgorgement, Restitution, Monetary Fine III) Censure, Cease and Desist Injunctions IV) Other Sanctions	Sanctions ordered: I) Monetary Sanctions (above de minimis threshold)**	Civil Action-DRP Part II, 13 A. I) Bar, Suspension, Revocation, Expulsion II) Disgorgement, Restitution, Monetary Fine
d) Final Regulatory Actions	Sanctions ordered: I) Bars and Suspensions II) Monetary Sanctions III) Cease and Desist Sanctions IV) Other Sanctions	Regulatory Action-DRP Part II, 12 A. I) Bar, Suspension, Revocation, Expulsion II) Disgorgement, Restitution, Monetary Fine III) Censure, Cease and Desist Injunctions IV) Other Sanctions	Sanctions ordered: I) Bars and Suspensions II) Monetary Sanctions (above de minimis threshold)**	Regulatory Action-DRP Part II, 12 A. I) Bar, Suspension, Revocation, Expulsion II) Disgorgement, Restitution, Monetary Fine

Notes and Assumptions:

* Form BD includes information on these disclosure categories for individual control affiliates. These disclosure categories exclude matters that are pending or are known to have reached a resolution in favor of the Individual (e.g. pending or dismissed complaints).

** Corresponds to a dollar threshold of $15,000.

*** Form BD does not include information on customer awards or settlements.

Exhibit 3: Breakdown of Criminal Matters and Specified Risk Events

	Look-back Period?	Criminal Matters			Disclosures Considered in Developing Specified Risk Events (SREs)									Criminal Matters OR SREs	
					Regulatory Action Disclosures		Civil Judicial Disclosures		Customer Complaint, Arbitration, Civil Litigation Disclosures		Any SREs				
		Disclosure Subcategory	Events	Individuals with ≥1 events	Disclosure Subcategory	Events	Disclosure Subcategory	Events	Disclosure Subcategory	Events	Events	Individuals with ≥1 events	Individuals with ≥2 events	Events	Individuals with ≥1 Criminal Event Or ≥2 SREs
[1]	All years	All Criminal Disclosures	20,895	17,813	All Regulatory Action Disclosures	13,567	All Civil Judicial Disclosures	1,282	All Customer Complaint, Arbitration, Civil Litigation Disclosures	125,348	140,197	69,376	27,924	161,092	44,060
[2]	All years	Final Criminal Matters	17,491	14,970	Final Regulatory Actions	12,298	Final Civil Judicial Disclosures	529	Customer Awards and Settlements above de minimis threshold	55,731	68,558	39,658	12,858	86,049	26,957
[3]	5 years	Final Criminal Matters	846	805	Final Regulatory Actions	2,296	Final Civil Judicial Disclosures	117	Customer Awards and Settlements above de minimis threshold	7,435	12,410	9,271	1,551	13,256	2,345
[4]	5 years	Criminal Convictions	154	145	Final Regulatory Actions associated with i) bars and suspensions or ii) monetary sanctions above de minimis threshold	1,311	Final Civil Judicial Actions with monetary sanctions above de minimis threshold	10	Customer Awards and Settlements above de minimis threshold in which Individual was "named"	2,105	3,426	2,870	348	3,578	493

Notes and Assumptions:

[1]: Disclosures within each subcategory include all disclosures including pending and resolved events, regardless of the resolution.

[2]: Final events exclude matters that are pending or are known to have reached a resolution in favor of the Individual. Final criminal matters include convictions and outcome that are not specified.

[3]: 5 year look-back is based on resolution date being within the last 5 years.

[4]: Regulatory Actions corresponding to bars and suspensions include, permanent or temporary bar, suspension, revocation, rescission or expulsion. Customer Awards and Settlements in which the individual was "named" exclude any settlements prior to initiation of arbitration or civil litigation.

[5]: De minimis threshold corresponds to a dollar threshold of $15,000

Exhibit 4: Individuals and Firms Impacted by the Proposed MAP Requirement

Year	Individuals impacted by proposed MAP requirement				Firms impacted by the Proposed MAP requirement			
	Individuals meeting the Proposed Criteria who became:*							
	(1) Principal	(2) Registered Person	(3) Owner or Control Person	(1) or (2) or (3)	Small Firms	Medium Firms	Large Firms	All Firms
2013	42	146	11	160	91	24	55	170
2014	30	111	13	124	72	14	59	145
2015	34	114	10	129	72	20	49	141
2016	17	94	7	99	51	16	46	113

Notes and Assumptions

* Proposed criteria corresponds to individuals with one final criminal matter or two or more specified risk events within the prior five years reported on Uniform Registration Forms U4, U5, U6 and Form BD.

Exhibit 2b

Alphabetical List of Written Comments
Regulatory Notice 18-16

1. Ellie Bertwell, Aderant (May 31, 2018)
2. Joseph P. Borg, North American Securities Administrators Association ("NASAA") (August 1, 2018)
3. Richard J. Carlesco Jr., IBN Financial Services, Inc. ("IBN") (June 25, 2018)
4. Bernard V. Canepa, Securities Industry and Financial Markets Association ("SIFMA") (June 24, 2018)
5. Chris Charles, Wulff, Hansen & Co. ("Wulff Hansen") (June 27, 2018)
6. Dennis M. Kelleher, Stephen W. Hall, and Lev Bagramian, Better Markets, Inc. ("Better Markets") (June 29, 2018)
7. Seth A. Miller, Cambridge Investment Research, Inc. ("Cambridge") (June 29, 2018)
8. Ken Norensberg, Luxor Financial Group ("Luxor") (June 28, 2018)
9. Courtney Rogers Reid, MML Investors Services, LLC ("MML") (June 29, 2018)
10. W. Alan Smith, Janney Montgomery Scott LLC ("Janney") (June 29, 2018)
11. Andrew Stoltmann, Public Investors Arbitration Bar Association ("PIABA") (June 28, 2018)
12. Damon D. Testaverde, William R. Hunt, Jr., and Joseph C. Cascarelli, Esq., Network 1 Financial Securities, Inc. ("Network 1") (June 26, 2018)
13. Robin Traxler, Financial Services Institute ("FSI") (June 29, 2018)

Exhibit 2c

Re: Regulatory Notice 18-16 FINRA Rule Amendments Relating to High-Risk Brokers and the Firms That Employ Them

Aderant submits the following comment in response to FINRA's proposed rule amendments relating to high-risk brokers and the firms that employ them.

Proposed Rule 9523(d) provides in part, "If the Department of Member Regulation determines that an application is substantially incomplete, it may reject the application and deem it not to have been filed. In such case, the Department of Member Regulation shall provide the disqualified member or sponsoring member notice of the delinquency and its reasons for so doing. The disqualified member or sponsoring

firm shall have ten business days to remedy the application, or such other time period prescribed by FINRA. [ ]"

The proposed rule is ambiguous because it does not expressly identify the event that triggers the deadline to remedy a substantially incomplete application. To resolve the ambiguity, the deadline could be revised to state, for example, "The disqualified member or sponsoring firms shall have ten business days after service of the notice of delinquency to remedy the application, or such other time period prescribed by FINRA." [Suggested language underlined.]

Thank you for considering our comment.

Ellie Bertwell
Senior Rules Attorney

NASAA

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Washington, D.C. 20002
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August 1, 2018

By electronic mail 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 18-16 – High-Risk Brokers

Dear Ms. Piorko Mitchell:

On behalf of the North American Securities Administrators Association, Inc. ("NASAA"),[1] I am submitting the following comments and recommendations in response to FINRA Regulatory Notice 18-16 (the "Proposal") regarding member firms' responsibilities when employing brokers with a history of significant past misconduct (*i.e.*, "high risk" brokers).[2] This comment letter is organized into four parts corresponding to the four parts of the Proposal.

High risk brokers are a perennial problem for investors. NASAA members continue to bring a large number of enforcement actions against bad actors in the brokerage industry.[3] Our capital markets function and grow in large part due to the trust investors place in securities market participants. Maintaining that trust is essential to the continued primacy of our markets in an ever-competitive global marketplace. Expelling bad actors from the industry and reining in the activities of negligent or irresponsible brokers serves the interests of investors and the law abiding businesses and securities professionals that endeavor to comply with applicable securities laws and regulations.

[1] NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as a forum for these regulators to work with each other to protect investors at the grassroots level and promote fair and open capital markets.

[2] *See* FINRA Regulatory Notice 18-16, *High-Risk Brokers – FINRA Requests Comment on FINRA Rule Amendments Relating to High-Risk Brokers and the Firms that Employ Them* (Apr. 30, 2018), *available at* http://www.finra.org/industry/notices/18-16.

[3] *See* NASAA 2017 Enforcement Report Based on 2016 Data (Sept. 27, 2017), *available at* http://www.nasaa.org/43311/nasaa-releases-annual-enforcement-report-3/.

1. Proposed Amendments to Rule 9200 Series (Disciplinary Proceedings) and Rule 9300 Series (Review of Disciplinary Proceedings)

The first part of the Proposal would amend FINRA rules to allow for the imposition of temporary conditions or restrictions on practice during the internal FINRA disciplinary appeals process. Currently, if a hearing panel or hearing officer finds a respondent liable in a FINRA disciplinary action and orders sanctions, the actual imposition of those sanctions – including suspensions, bars, expulsions, monetary fines or practice limitations – will be stayed if the action is appealed to (or called for review by) the National Adjudicatory Council ("NAC"). The NAC then reviews the disciplinary decision, including the sanctions assessed, and issues its own opinion affirming, rejecting or modifying the hearing panel's decision. The NAC's order is considered the final decision of FINRA, and any sanctions the NAC assesses will become enforceable (unless a respondent appeals to the U.S. Securities and Exchange Commission and, potentially further, to a United States Court of Appeals, in which case all or part of the sanctions may be stayed during the pendency of these actions).[4] Under current practice, therefore, respondents in FINRA enforcement actions can stay the imposition of sanctions, including orders of expulsion or suspension, through at least the NAC appeals process.[5] NAC appeals take on average 14 months to complete.[6]

NASAA supports the proposed changes to allow for temporary conditions or restrictions on practice during the pendency of NAC appeals. FINRA's current practice of delaying the imposition of sanctions without an opportunity for temporary remedies during the NAC appeals process is contrary to standards under federal and state law, whereby civil and criminal awards or penalties generally become effective automatically after trial.[7] And although defendants in civil and criminal court proceedings may be able to stay trial remedies by filing timely appeals, unlike FINRA practice, courts usually impose temporary remedies on parties that lose at trial (such as by requiring the posting of supersedeas bonds).[8] It is entirely appropriate, therefore, for FINRA to revise its disciplinary procedures to bring them more into line with federal and state law.

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[4] *See, e.g.*, In re Thaddeus J. North, SEC Release No. 34-80490 (Apr. 19, 2017); In re William Scholander and Talman Harris, SEC Release No. 34-74437 (Mar. 4, 2015). *See also* Section 25(c)(2) of the Securities Exchange Act of 1934, 15 U.S.C. § 78y(c)(2).

[5] The Proposal would not affect current FINRA rules governing customer or industry arbitrations, though. Arbitration awards thus would continue to be final and non-appealable (though there are limited grounds upon which federal courts can modify or vacate arbitration awards). *See* Awards FAQ, https://www.finra.org/arbitration-and-mediation/faq-awards-faq; Fitzgerald v. H&R Block Fin. Advisors, No. 08-cv-10784, 2008 WL 2397636 (E.D. Mich. June 11, 2008).

[6] *See* Proposal p.16 & fn.39.

[7] *See, e.g.*, Fed. R. Civ. Pro. 62; Fed. R. Crim. Pro. 38.

[8] *See, e.g.*, Athridge v. Iglesias, 464 F. Supp. 2d 19 (D.D.C. 2006); Segal v. Goodman, 851 P.2d 471 (N.M. 1993). Supersedeas bonds act like escrow accounts, protecting appellees by preventing appellants from potentially dissipating their assets during the appeals process and thereby rendering a trial court's monetary award unrecoverable.

We recommend one change to this part of the Proposal, though. Proposed Rule 9285(b)(4) would stay the effectiveness of temporary conditions or restrictions if a respondent appealed the imposition of those conditions or restrictions. This subparagraph should be deleted from the proposed rule. To ensure investor protection and prevent customer harm, temporary conditions or restrictions imposed by a hearing panel or hearing officer should not be stayed if a respondent objects to them (which respondents likely always will do). Furthermore, subparagraph (b)(4) is inconsistent with proposed Rule 9285(c), which would require mandatory heightened supervision of individuals whose disciplinary cases are appealed to (or called for review by) the NAC. Allowing individuals to stay the imposition of temporary conditions or restrictions ordered by a hearing panel merely by appealing them runs counter the basic purpose of mandating heightened supervision for all persons under proposed Rule 9285(c).

2. Proposed Amendments to Rule 9520 Series (Eligibility Proceedings)

The second part of the Proposal would amend FINRA Rule 9523 to require interim plans of heightened supervision whenever a member firm seeks to associate with someone who is the subject of a statutory disqualification ("SD"). As explained in the Proposal, "there is currently no explicit rule requirement that these SD individuals be placed on heightened supervision by their employing member firm during the pendency of the SD Application review."[9] We agree this is a regulatory gap that should be closed and, for the reasons outlined in the Proposal, we support the proposed amendments to Rule 9523 as presented.

3. Proposed Amendments to Rule 8312 (BrokerCheck Disclosure) to Disclose the Status of "Taping Firms"

We agree with the third part of the Proposal to identify on BrokerCheck those "taping firms" subject to FINRA Rule 3170. This change would advance investor protection. The Proposal does not indicate precisely how this change would be implemented, though. How this disclosure is actually made on BrokerCheck is important, and we offer the following suggestions.

According to FINRA statistics, there are currently *eleven* firms subject to the taping rule.[10] Given the extreme rarity of taping firms, the BrokerCheck disclosures of the 99.7% of FINRA member firms not subject to the taping rule should stay unchanged.[11] Taping rule disclosures should only appear on the reports of those few firms actually subject to the rule. For these firms,

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[9] Proposal p.11.

[10] *See* Disciplined Firms Under FINRA Taping Rule (FINRA Rule 3170), http://www.finra.org/industry/disciplined-firms-under-finra-taping-rule-finra-rule-3170.

[11] As an aside, NASAA encourages FINRA to reopen Rule 3170 for potential revision. NASAA members have witnessed broker-dealers purposefully avoiding the disclosure of disciplinary events in order to evade the taping rule. We believe consideration should be given to ways the rule might be revised so as to prevent noncompliance.

BrokerCheck should identify them as subject to the rule and explain in plain English what this means. We suggest a standardized BrokerCheck disclosure for taping firms such as the following:

> *This broker-dealer is a disciplined firm within the meaning of the FINRA "Taping Rule" (FINRA Rule 3170). The Taping Rule identifies FINRA member firms that employ comparatively high percentages of registered persons who previously were associated with firms disciplined for violations of applicable laws and regulations. As a FINRA member subject to the Taping Rule, this broker-dealer must tape record all telephone conversations between its registered persons and customers and review these conversations for compliance with applicable laws and regulations (in addition to meeting all its other regulatory obligations).*

4. Proposed Amendments to NASD Rule 1010 Series (MAP Rules)

The final part of the Proposal would impose additional obligations on member firms that seek to "onboard high-risk associated persons without prior consultation or review by FINRA."[12] Specifically, the Proposal would amend the NASD Rule 1010 Series to require that FINRA members request materiality consultations with the Department of Member Regulation (the "Department") before associating with any owner, control person, principal or registered person that, within the past five years, has been the subject of one or more "final criminal matters" or two or more "specified risk events." These two terms are defined in the Proposal and capture most disclosable events on the uniform registration forms (*e.g.*, the questions in section 14 of the Form U4). Upon the Department's receipt of a notice of such requested association, the Department would either permit the association or require the member to submit a continuing membership application ("CMA") under FINRA Rule 1017, thereby subjecting the request to more formal Department review.

We agree with the objective of getting the Department more involved in FINRA members' decisions to associate with individuals who have significant disciplinary histories. We believe the Proposal presents a reasonable means of achieving this objective, although we recommend some revisions to this part of the Proposal.

First, we agree with the proposed definition of "final criminal matters." This definition appropriately captures the scope of criminal disclosable events on the uniform forms. We believe the definition of "specified risk events" should not be limited solely to individuals "named" in customer arbitrations, though. Instead, the definition of specified risk events should apply to all individuals who are the subject of customer settlements or awards and we note that this approach is also consistent with the approach taken on the Form U4. NASAA members have observed situations in which broker-dealer representatives are not named in customer arbitrations but clearly

[12] Proposal p.13.

bear significant personal responsibility for the broker-dealer's offending conduct. The mere fact that a plaintiff has not chosen to name a registered representative as a party in an arbitration proceeding in what may be a litigation strategy should not provide that person with a free pass under the Proposal.

In addition, we believe the lookback period for disclosures under the Proposal should be adjusted. IM-1011-2 as drafted contemplates a five-year lookback requirement for disclosure of final criminal matters or specified risk events. We believe this lookback period should be increased to ten years. This would bring IM-1011-2 closer into line with the uniform forms (Form U4 is not time-limited, while Form BD calls for a ten-year criminal lookback period).[13] IM-1011-2 should mirror the uniform forms for consistency and to better safeguard customers from potential harm.

* * *

In conclusion, for the reasons discussed herein, we broadly support the Proposal and encourage its adoption. If you have any questions about this letter or would like to discuss these issues, please contact NASAA's Broker-Dealer Section Chair, Frank Borger-Gilligan (frank.borger-gilligan@tn.gov or 615-532-2375), or General Counsel, A. Valerie Mirko (vm@nasaa.org or 202-737-0900).

Sincerely,

Joseph P. Borg
NASAA President
Director, Alabama Securities Commission

[13] *See* Form U4 Questions 14A-14B and Form BD Question 11A.

Comment to proposed rule change NASD Rule 1010

I applaud FINRA's attempt to address the problem of rogue registered representatives, however it does not address the harm to innocent registered representatives and small firms. My argument is that very often innocent upstanding registered representatives and their firms can be ruined simply because of the arbitration system.

Lawyers are now recruiting clients to file arbitration cases. They tell potential clients that filing an arbitration will cost them nothing and they will do all the work. The lawyer knows that the firm that they file against will settle because the cost to take a case to arbitration is prohibitive. When an attorney files an arbitration case against the firm, the firm's cost is three to ten thousand dollars just for arbitration fees. Then add two to five thousand dollars for legal costs to file a FINRA response. By the time the case goes to arbitration the cost is now sixty to one hundred thousand dollars. The incentive is to settle the claim, which typically is north of fifteen thousand dollars. You could be totally innocent, still the reality is that the cost is prohibitive and your E&O carrier will force you to settle or they won't provide coverage.

Arbitration is out of control. It literally is the opinion of three people. Only one attorney is required, and if you are lucky you may have one person that is even in the industry. So essentially, they do not have to follow the rule of law. It is the rule of their opinion and if you had the case heard by three different arbitration panels you are likely to get three different opinions. It is in the best interest of the firm and registered representative to settle prior to arbitration regardless of innocence.

I hope you realize the problem this creates. That totally innocent people (reps and firms) are harmed because there is no longer risk in investing. You can invest anywhere you want, lose whatever, and get your money back. If you don't believe me just watch CNBC and you will see 10 commercials making this claim in the course of an eight-hour business day.

Lawyers are making a killing here as well, because they know that what I am saying is a fact. Six years ago, I had never received a complaint much less an arbitration. I have been a FINRA member firm since 2000 and a registered representative since 1991. I now have to budget $100,000 per year for frivolous arbitrations where investors made a nice return as clients of our firm. They lose money on one investment, get contacted by one of these predatory attorneys and are told that they don't have to pay for anything and they will get their money back. Large firms have no issue with this because they have deep pockets and they know the end result is the total destruction of small independent firms.

If the goal of FINRA and the SEC is the elimination of all small firms then at least have the common courtesy to tell us and let us “fire sale” our firms to the Mega Large firms and be done with it. It breaks my heart to think I have worked my whole professional career to have it yanked away from me because of predatory attorneys and an over reaching bureaucracy.

The solution here is to eliminate the mandatory arbitration clause and make arbitration a mutual agreement between the client and the firm or allow us to go to court where the rule of law prevails. Another solution is to have arbitrators be lawyers and force them to follow the rule of law. We currently have clients sign more paperwork than I signed when I purchased my house. All of this paperwork is absolutely worthless in arbitration. The only use for it is to prove to regulators that we did our job as far as suitability.

It would also be useful for FINRA to have a local hearing (made up of local reps and firms) to determine if the rep or the firm was negligent. This would go a long way to getting rogue representative out of the business.

Sincerely,

Richard J. Carlesco Jr. CEO

Cc: John Katko Representative NY 24th Disctrict

President Donald J. Trump

Senator Chuck Schumer

Richard J. Carlesco Jr. LUTCF

IBN Financial Services, Inc.

sifma®
Invested in America

June 24, 2018

By Electronic Mail (pubcom@finra.org)

Jennifer Piorko Mitchell
Vice President and Deputy Corporate Secretary
Office of Corporate Secretary
FINRA
1735 K Street NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-16:
SIFMA Comment on FINRA Rule Amendments Relating to High-Risk Brokers and the Firms That Employ Them

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA") Regulatory Notice 18-16 ("RN 18-16"), which seeks comment on proposed rule amendments that would impose additional restrictions on member firms that employ brokers with a history of significant past misconduct.[2]

SIFMA is supportive of the proposed amendments because we are committed to protecting investors and ensuring confidence in our markets through effective supervision. For that reason, our comments below concern mainly procedural issues, with one exception where we believe that the costs outweigh the benefits to FINRA, investors, and firms alike. SIFMA also seeks FINRA's assistance to better enable us to comply with certain amendments.

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[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] FINRA Regulatory Notice 18-16 (Apr. 30, 2018), http://www.finra.org/industry/notices/18-16.

<u>Comments on New FINRA Rule 9285(a)</u>

FINRA Rule 9285(a) would provide that the Hearing Panel or, if applicable, the Extended Hearing Panel, or Hearing Officer may impose such conditions or restrictions on the activities of a respondent as the Hearing Panel or Hearing Officer considers *reasonably necessary* for preventing customer harm during an appeal.

SIFMA supports this provision but suggests that a respondent or a respondent's firm be given the opportunity to propose conditions or restrictions for consideration by the Hearing Panel or Hearing Officer, similar to what firms do when negotiating the approval of state registrations for their registered persons. As currently proposed, a Hearing Panel or Hearing Officer unilaterally chooses conditions that he or she deems "reasonably necessary" for preventing customer harm. Accordingly, there is the potential that they could impose conditions or restrictions that are not tailored to a firm's business model. It is also possible that they could extrapolate from the actions of one or a small number of individuals changes onto firms that have the effect of firm-wide changes in policies and procedures or broad restrictions on activities – e.g., a finding that there were deficiencies in supervision of a product that results in the imposition of additional requirements for all sales. Certainly, conditions and restrictions on firm activities and products may be appropriate if the conduct is found to be widespread at the firm, but not in the instance where an individual or small number of individuals violated existing firm policies and procedures.

Allowing a respondent or a respondent's firm the opportunity to propose conditions or restrictions ensures that they will be "reasonably necessary" to address the conduct and prevent investor harm. And while Rule 9285(b) would allow for expedited review of the conditions or restrictions imposed by the Hearing Panel or Hearing Officer, it would reduce motions for review if a respondent or respondent's firm could propose conditions or restrictions for consideration by the Hearing Panel or Hearing Officer. Rule 9285(b) could still be utilized for modifying or removing conditions or restrictions if warranted by the circumstances.

<u>Comments on New FINRA Rule 9285(c)</u>

FINRA Rule 9285(c) would require, *within 10 days*, a firm with which a respondent is associated to adopt a written plan of heightened supervision if any party appeals a Hearing Panel or Hearing Officer decision to the NAC, or if the NAC calls the case for review.

SIFMA suggests that that firms have 30 days to submit a written plan of heightened supervision. A 10-day period is insufficient for firms to do everything necessary to implement a heightened supervisory plan. This may include analyzing the conduct at issue to be able to identify supervisory conditions reasonably designed to address the conduct, coordinating with several internal stakeholders, and making policy and procedure and system changes. This may also include consulting with counsel and/or FINRA staff. On top of this, a firm already must implement conditions or restrictions imposed under 9285(a). SIFMA does not believe that providing a slightly longer period for firms to adopt a plan would be detrimental to investors; rather, it would ultimately benefit them because firms would have sufficient time to adopt a well-thought-out plan.

Comments on Amended IM-1011-2

Amended IM-1011-2 would require an existing member firm to submit a written letter seeking a materiality consultation to FINRA's Department of Member Regulation, if the member is not otherwise required to file a Continuing Membership Application (CMA), when a natural person that has, in the prior five years, one or more final criminal matter or two or more specified risk events, defined in proposed Rule 1011(g) and (o), respectively, seeks to become an owner, control person, *principal, or registered person of the member firm*.

At the outset, this proposal is contrary to the spirit of the materiality consultation guidance, which focuses on changes to a firm's business model, not the activity of individuals.[3] That being said, SIFMA is more concerned about the potentially significant impact this rule has on many of its members, despite FINRA's backward-looking assessment that the impact would be low.[4] The broad scope of this rule to include registered persons and principals who do not own or control a firm and set its policies, as well as the thresholds set for specified risk events in amended FINRA Rule 1011(o), would drain both FINRA and firm resources unnecessarily and not provide any benefits to investors.

First, the likelihood that the association of a registered person or a principal who is not an owner or control person would be material to a medium or large firm's business such that a CMA would be required is negligible. The time, costs, and resources devoted to materiality consultations, which are not supposed to be lengthy and laborious events but in practice are, when the chances are low that a CMA would be required is a waste of both FINRA and firm resources. Second, because of the low thresholds set for specified risk events, a medium to large-sized firm could be significantly impacted if it sought to associate with several or more registered persons or principals with specified risk events resulting from a product failure, for example. In this example, these individuals are not a risk to investors arguably, but the firm would nevertheless be required to file materiality consultations that more likely than not result in no CMA being required. Again, this would be a fruitless effort by FINRA and the firm.

To address our concerns and still retain the benefits to investors of this proposed amendment, SIFMA suggests narrowing the scope of amended IM-1011-2 to only require materiality consultations for owners or control persons with specified risk events seeking to become associated with a firm. We believe this tailoring to be more appropriate because they would exercise authority over a firm and its policies. Their association would therefore be material to the firm's business. Alternatively, SIFMA suggests excluding as

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[3] *See* Overview of Materiality Consultation Process, http://www.finra.org/industry/overview-materiality-consultation-process.

[4] *See* Exhibit 4 to RN 18-16, *supra* note 2.

non-material per se registered persons and principals seeking to associate with a firm over a certain size (as established by FINRA).

Request for Assistance in Complying with Amended Rule 1011

SIFMA is concerned that specified risk events may not be properly identified and disclosed by the individual to the firm in a timely manner. To facilitate compliance with the rule, SIFMA respectfully requests that FINRA provide a notification, through appropriate means such as CRD, to firms for individuals with specified risk events. This would be in the same helpful vein as FINRA's announced enhancements to its disclosure review process wherein, beginning July 9, 2018, FINRA will conduct a public records search within fifteen calendar days from the date of an applicant's Form U4 and provide member firms any information resulting from such a search if such information is different from what was reported in the applicant's Form U4.[5]

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We appreciate your time and consideration of our comments. If you have any questions about them or would like additional information, please contact me at (202) 962-7300 or bcanepa@sifma.org.

Sincerely,

Bernard V. Canepa
Vice-President &
Assistant General Counsel

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[5] FINRA Information Notice (May 18, 2018), http://www.finra.org/sites/default/files/notice_doc_file_ref/Information-Notice-051818.pdf.

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June 27, 2018

Jennifer Piorko Mitchell
Vice President and Deputy Corporate Secretary
FINRA
1735 K Street NW
Washington, DC 20006-1506

Dear Ms. Mitchell:

We are writing in response to FINRA's request for comment on its RN18-16 regarding changes intended to protect the public against high-risk brokers.

We are acutely aware of the problem posed by registered representatives who move from firm to firm leaving injured investors in their wake. Their conduct harms the reputation of the entire industry, and we fully support measures to make it more difficult for such bad actors to continue their careers. However, we believe that certain aspects of the proposal will result in unnecessary burdens on both firms and on FINRA.

Specifically, we agree with SIFMA's proposal that Amended IM-1011-2 be altered to require materiality consultations only where the person is seeking to become associated with the firm as an owner or control person. In addition, we would go a step further by requiring the materiality consultation when a person having the specified risk events is already associated with the firm and then seeks to become an owner or control person.

We also suggest that the proposal is potentially unfair to persons who have multiple risk events stemming from a single act or incident. This happens from time to time where, for example, a single product-related issue results in multiple customer complaints and settlements. In other cases a single act may have triggered both a customer settlement and a separately reportable FINRA disciplinary action. To treat such cases as two separate and independent events is simply wrong.

Finally, we believe that the type of criminal action should be taken into account, with the materiality consultation required only where the conviction was investment- or fraud-related. FINRA notes in Footnote 63 that it recognizes that the proposal would encompass convictions triggered by entirely non-business conduct, and we are puzzled as to the perceived investor benefit of requiring a materiality consultation in connection with the hiring of an individual with such a non-business-related criminal conviction.

Thank you for the opportunity to comment on this proposal.

Very truly yours,

Chris Charles
President

June 29, 2018

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

Re: High-Risk Brokers, Regulatory Notice 18-16

Dear Mrs. Mitchell:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Regulatory Notice ("Notice" or "Release") released for comment by the Financial Industry Regulatory Authority ("FINRA").

SUMMARY

As FINRA knows and has been well-documented (as we detail below), there are too many investors who are victims of predatory brokers[2] who willfully, knowingly, and repeatedly break the law. These are not close calls. These are not one-time offenders. These are not technical, victimless crimes. These are the worst-of-the-worst and give all brokers and law-abiding brokerag firms a bad name and ruined reputation. It is long past time to put a stop to this and prioritize protecting investors.

FINRA's Release, therefore, gestures in the right direction, but FINRA must do significantly more to reduce the number of bad brokers and the prevalence of recidivism. This

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 In our comment letter, we use the term "broker" to refer to individuals and "brokerage firms" to refer to registered broker-dealer firms.

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Release falls far short. While we urge FINRA to adopt some specific changes to the Release, FINRA must go far beyond this proposal to credibly claim that it is serious in its intention not just to hold brokers accountable but also to protect investors from brokers who have demonstrated a proclivity to violate the law. As a Congressionally mandated regulatory body with its mission of investor protection and market integrity, FINRA should impose a lifetime ban on brokers with two criminal convictions, and impose a lifetime ban on brokers who have three specified risk events (a "Three Strikes Rule"). FINRA should immediately and permanently expel firms where more than 20% of the brokers have 3 or more misconduct records.

BACKGROUND

As documented by a recent rigorous, peer-reviewed study, misconduct in the broker-dealer profession is widespread.[3] Over 12% of active brokers' records contain misconduct events.[4] Over 15% percent of brokers at some of the largest brokerage firms have misconduct records.[5] For example, at Oppenheimer & Co, Inc., as of May 2015, over 28% percent of its "client facing" brokers had a misconduct record.[6] Oppenheimer is not an outlier: in at least 8 other firms, employing tens of thousands of brokers, over 18% of brokers had misconduct records.[7]

Not only is misconduct prevalent, but recidivism among those engaged in misconduct is also high. About one-third of brokers who have engaged in misconduct are repeat offenders: recidivists.[8] Over 50% of those who have been reprimanded for misconduct remain with the firm, and another 20% simply switch to another firm.[9] The study also found that some firms indeed specialize in hiring recidivists, and those firms that are controlled by officers who themselves have had disclosure events are much more likely to hire recidivists.[10]

Another study put the number of brokers with misconduct records even higher: At least 30% of brokers at 48 firms registered with FINRA had misconduct records.[11] The same study also found that at least 14 firms employ brokers over 50% of whom have misconduct records, and at some firms the percentage of brokers with misconduct records is as high as 70%.[12] These 14 firms collectively employ over 826 brokers, which means tens of thousands of investors are being needlessly exposed to a heightened risk of fraud and abuse, and in many cases, are undoubtedly

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3 *See* Mark Egan, Gregor Matvos, Amit Seru, *The Market for Financial Adviser Misconduct*, JOURNAL OF POLITICAL ECONOMY, Forthcoming (Sept. 1, 2017), *available at* https://ssrn.com/abstract=2739170.

4 *Id.* at 7-8.

5 *Id.* at 1.

6 *Id.* at 73.

7 *Id.* at 73, Table A16.

8 *Id.* at 1.

9 *Id.* at 34.

10 *Id.* at 23.

11 *See Wall Street's Self-Regulator Blocks Public Scrutiny of Firms with Tainted Brokers*, REUTERS INVESTIGATES (June 12, 2017), *available at* https://www.reuters.com/investigates/special-report/usa-finra-brokers/.

12 *See* Reuters Table, available at https://www.reuters.com/investigates/special-report/usa-finra-brokers/#interactive-brokers-link.

suffering financial harm. This is the price that investors have been paying for too long, as firms seek the revenues that come with hiring, retaining, and rewarding bad brokers.

Broker misconduct, particularly among the recidivists, is more prevalent in counties and cities with a large proportion of retirees and a lower educated population.[13] Said differently, bad brokers and the firms that employ and reward them specifically target and flourish in areas where there are unsophisticated investors and vulnerable adults who can more easily be preyed upon. This is despicable and FINRA simply must make it a priority to end this practice.

While unscrupulous brokers do indeed target unsophisticated and vulnerable investors, they also do not ignore those who are deemed "accredited investors." Within the last week, a study by the Wall Street Journal[14] showed that brokers with three or more misconduct records are also adept at peddling private placements to investors who are ostensibly sophisticated and have the financial means to withstand significant losses. An investor is considered an "accredited investor" if he or she "earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, OR has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence and any loans secured by the residence (up to the value of the residence))."[15]

The Journal exposed a deeply troubling fact: There are over 100 firms—

> "where 10% to 60% of the in-house brokers had three or more investor complaints, regulatory actions, criminal charges or other red flags on their records… These brokerages helped sell to investors more than $60 billion of stakes in private companies."[16]

The Journal gave an example of one still operating and seemingly flourishing broker-dealer, Newbridge Securities Corp., in Boca Raton, FL,[17] employing over 100 brokers, showing that—

> "Investors have a one in four chance of getting a broker there with at least three red flags. Regulators sanctioned the firm 20 times—an average of twice a year—over the past decade, with fines of $1.75 million."[18]

The pernicious practices described above cry out for a fundamental re-thinking of how brokers with misconduct records are regulated by both the self-regulatory organizations, FINRA

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13 *See* Egan, *supra* note 3, at 27.

14 *See Firms with Troubled Brokers Are Often Behind Sales of Private Stakes*, WALL ST. J. (June 24, 2018), *available at* https://www.wsj.com/articles/firms-with-troubled-brokers-are-often-behind-sales-of-private-stakes-1529838000.

15 *See Investor Bulletin: Private Placements Under Regulation D*, SEC (last visited June 25, 2018), *available at* https://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html.

16 *See* article, *supra* note 14.

17 *See* "Join Us" webpage of Newbridge Securities. (last visited on June 25, 2018), *available at* http://www.newbridgesecurities.com/join-us.html.

18 *See* article, *supra* note 14.

and the Municipal Securities Rulemaking Board (MSRB), and by the Securities and Exchange Commission.

We are not alone in holding this view. Over two years ago, Senators Elizabeth Warren and Tom Cotton wrote[19] to then-FINRA Chairman Rick Ketchum expressing their deep concern about recidivism, and FINRA's apparent inaction to rid the ranks of brokers of recidivists. FINRA's current President, Mr. Robert Cook, in a 2017 speech, agreed with SEC Chairman Jay Clayton that there is "zero room for bad actors in our capital markets."[20] In stark contrast to "zero room," however, this Release tinkers on the margins by, essentially, making it a little bit costlier for firms to hire bad brokers, and by making them jump through an additional hoop before they can hire brokers with checkered pasts. This is a significant missed opportunity and will continue FINRA's failure to protect investors. Half-measures as proposed in the Release, and as sensible as they may be, will not solve this well-documented, long-known, pervasive problem of bad brokers.

While we will offer comments to improve the Release, we urge FINRA to address the issue of bad brokers more boldly and fundamentally. The Release is primarily focused on a few new measures to contain the damage that a bad broker may inflict on investors, without taking steps to actually rid the industry of those brokers altogether.

Investors need and deserve more: honest, qualified, and competent brokers, with clean records, who have the best interest of the investor in mind when offering their services and financial products. Americans need those brokers to help them meet their life goals, including saving for their children's college education, preparing for retirement, and enjoying a decent standard of living. As the front-line regulator of brokers and brokerage firms, FINRA has a paramount responsibility to ensure that all investors—from the unsophisticated, elderly, and less-educated to the putatively "accredited"—are protected and not preyed upon by unscrupulous brokers who repeatedly break the law with impunity with little or nothing to fear from FINRA.

BRIEF DESCRIPTION OF THE PROPOSAL

FINRA proposes to amend its rules to:

1. Allow (but not require) hearing officers, after an enforcement case is complete and a disciplinary decision is reached, to impose unspecified restrictions upon individual brokers or brokerage firms while these firms or individuals appeal the enforcement decision to FINRA's National Adjudicatory Council (NAC);

2. Require firms to adopt heightened supervision of individuals who are appealing a disciplinary matter to the NAC;

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19 *See* Letter from Senators Elizabeth Warren and Tom Cotton to Rick Ketchum (May 11, 2016), *available at* https://www.warren.senate.gov/files/documents/2016-5-11_Warren-Cotton_Letter_to_FINRA.pdf.

20 *See* Robert Cook, Remarks delivered at the Georgetown University McDonough School of Business, "Protecting Investors From Bad Actors" (June 12, 2017), *available at* https://www.finra.org/newsroom/speeches/061217-protecting-investors-bad-actors.

3. Require firms to place individuals fighting a Statutory Disqualification (SD) decision under heightened supervision while FINRA is reviewing the SD decision;

4. Flag on BrokerCheck's website any firms that tape the interactions (e.g., phone calls, emails, etc.) between the firm's brokers and customers; and

5. Require firms that hire individuals who, in the past five years, have one (or more) criminal record or two (or more) "risk events" to seek further consultation with FINRA's Membership Committee.

COMMENTS

FINRA's Primary Mission Is to Protect Investors and the Integrity of the Securities Markets, Not Serve the Interests of Brokers Who Violate the Law.

As the front-line regulator of broker-dealers, FINRA has a paramount responsibility to ensure that investors—particularly the vulnerable population of retail and unsophisticated investors—are protected and not preyed upon by unscrupulous brokers. Yet, this Notice fails to adequately address the issue of recidivist brokers. Instead of boldly and fundamentally working to rid the ranks of brokers of those who have indisputable records of repeat misconduct, this Notice tinkers on the margins by essentially making it slightly costlier for firms to hire or retain brokers with checkered pasts by raising the firm's regulatory costs. While some firms may indeed decide to fire or not hire a broker with a rap-sheet due to the costs associated with heightened supervision (as proposed in the Release) and potential liability, it would still leave untouched those firms that, as documented in multiple studies,[21] actually seek out and embrace recidivist brokers because these firms will stand to profit, on a net basis, by employing unscrupulous brokers who are especially skilled at preying on investors. These brokers often peddle unsuitable investments that generate high commissions for themselves and profits for their brokerage firms.

FINRA has not been charged by Congress to ensure that brokers have gainful employment in the financial industry. FINRA exists to protect investors and promote market integrity.[22] If FINRA indeed has investors' best interest in mind, it should not compromise that interest for the benefit of brokers who are either unable or unwilling to abide by the law. Nor can the hiring challenges facing brokerage firms outweigh what is best for the investing public.

The Measures in the Proposal Are Beneficial, but they Should Be Stronger in Specific Respects.

All of the proposed FINRA rule changes and additions are an improvement over the status quo, but they are simply not enough to address the harm investors are facing daily at the hands of brokers with bad records. They should be strengthened in several key respects.

1. The imposition of restrictions pending appeal should be mandatory, not merely authorized.

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21 *See* studies cited *supra*, notes 3 and 14.

22 *See* FINRA "About" webpage (last visited on June 25, 2018), *available at* http://www.finra.org/about.

We support granting FINRA hearing officers the authority to impose temporary restrictions on brokers who have been found to have violated FINRA rules, SEC rules, MSRB rules, or the federal securities laws, pending any appeal of a hearing officer's decision to the NAC. This is an obviously appropriate and necessary measure, and as the Release notes, it is already the practice at some exchanges.[23] However, this step only goes halfway: Hearing officers should be **required** to impose any restrictions that are necessary to protect investors pending appeal.

This too is an obviously appropriate measure for the protection of investors, and it is hardly unfair to the broker. If a broker has had his or her "day in court," the evidence has been weighed, and an impartial hearing officer has found against the broker, then restrictions on the broker's conduct, at the very least, are warranted and reasonable to protect investors pending the outcome of the appeal. This is especially important, given the multiple layers of appeal that a broker's case may wind through: the NAC, FINRA itself, the SEC, and the federal appellate courts.

This mandatory approach to restrictions pending appeal also aligns with analogous procedures under federal law. For example, a losing party in a case involving injunctive and declaratory relief faces a heavy burden if they seek a stay pending appeal. And those who have lost their case at trial and are subject to a monetary judgment are typically required to post a bond pending appeal to ensure they have the wherewithal to pay if they ultimately lose on appeal—the most likely outcome as a statistical matter. The proposal is in fact comparatively modest, in that it only authorizes for the imposition of tailored restrictions pending appeal for the protection of investors, and does nothing to effectuate the remedies or penalties that the hearing officer has found appropriate pending the appeal process. Making such restrictions mandatory simply ensures that the necessary prophylactic measures are in place.

2. FINRA should not allow expedited review of restrictions that have been imposed pending appeal, nor should it allow expedited review to stay the effectiveness of those restrictions.

We also believe brokers should not be afforded an opportunity to request an expedited review of these temporary and customized restrictions. It is enough that a broker may seek review of any such restrictions; expediting the process has no justification, and the Release offers none. Even more objectionable is the proposal to stay the effectiveness of any restrictions immediately upon the filing of a motion seeking expedited review of the restrictions. Here too, the Release appears to favor the rights of brokers already found to have violated the law over the rights of innocent investors.

These measures are unwarranted from a practical standpoint as well. If the NAC has the bandwidth and ability to conduct any hearing on an expedited schedule, it should perhaps consider devoting additional bandwidth to shortening the appeals processes itself. The Release states that the NAC takes an average of 14 months to reach a decision on an appeal. If the NAC is repeatedly burdened with requests to expeditiously review temporary restrictions imposed by hearing officers (as proposed in the Release), the NAC would take even longer to actually dispense with the underlying appeal, and the successful and timely completion of NAC's other duties.

[23] *See* Release at 7.

3. The monetary thresholds should be lowered.

The Release establishes monetary thresholds that trigger "specified risk events." Under the proposal, FINRA Rule 1011 would define "specified risk event" as, among other events, any: "final investment-related, consumer-initiated customer arbitration award or civil judgement against the person for a dollar amount at or above $15,000 in which the person [*e.g.*, broker] was a named party."[24] The Notice includes other provisions that use the $15,000 threshold.

We recommend that these monetary thresholds be lowered to $5,000 as the threshold for **all** "specified risk event." With the median brokerage account balance of US investors at only $6,200, setting the "risk event" threshold at $5,000 would better serve the investing public.[25] Moreover, lowering the threshold from the proposed $15,000 threshold to $5,000, would enable FINRA to capture more misconduct, and this lowered threshold could serve as a more sensitive gauge for FINRA to assess the quality of the service and the level of integrity among brokers and the firms that employ them.

4. It is appropriate to impose heightened supervision of brokers pending their appeals.

We support requiring firms to immediately impose heightened supervision on brokers who appeal either a disciplinary matter to the NAC or a Statutory Disqualification (SD) decision to FINRA, other regulatory organizations, or the courts. As we argued above, individuals who have been sanctioned by FINRA have already gone through FINRA's fair enforcement proceedings and the firms who employ these brokers have a reasonable basis to assume that the decisions will be upheld at the end of the appeals process and that heightened supervision pending review is necessary and appropriate. We further support the immediate imposition of heightened supervision on brokers who have been found to have committed such acts that Congress itself has deemed grounds for disqualification from offering financial advice, services, or products to investors. Firms can easily reassign the clients of any broker who is appealing a FINRA or SD decision to other brokers within the firm who are not involved in any appeals, and therefore investors would continue being served, perhaps served by an even more qualified broker.

5. Additional disclosure regarding "taping" firms is appropriate, but additional requirements are necessary to ensure that this is a meaningful measure.

We support flagging "taping" firms on BrokerCheck. Unfortunately, the Release offers scant information about the taping process and what it signifies. In general, taping the interactions between brokers and their clients by a firm is required when a firm has an unusually high number

[24] *See* Proposed Rule Text at 1, *available at* http://www.finra.org/sites/default/files/Attachment-A_RN-18-16.pdf.

[25] *Brokerage Accounts in the United States*, Advanced Analytical Consulting Group and Deloitte, (November 30, 2015), *available at* https://www.dol.gov/sites/default/files/ebsa/researchers/analysis/retirement/brokerage-accounts-in-the-us.pdf.

of brokers with misconduct records.[26] We understand there are very few firms that are required to tape the interactions of the brokers associated with the firm and their clients, since the bar is set so high. Nevertheless, we support flagging these firms on BrokerCheck with the expectation that the disclosure of taping status is accompanied by clear and complete information, comprehensible to investors, explaining what it means to be such a firm. This reddest of red flags ought to be clearly explained to investors.

We also believe individual brokers associated with taping firms should also be flagged under their BrokerCheck profile. This latter disclosure might actually be more useful to an investor as it would cause an appropriate pause and prompt the investor to raise questions with his or her broker about the disciplinary history of the firm that caused regulators to impose the requirement that it record its own brokers.

6. Requiring MAP consultations before hiring is an important regulatory innovation and must be maintained, but the triggering "risk event" must be $5,000 or more.

We strongly support the new proposal to require firms that associate with brokers "who have, in the prior five years, either one or more final criminal matters, or two or more specified risk events"[27] to seek consultation with FINRA's Membership Application Program group (under FINRA's Membership Proceedings rules). Under the proposal, FINRA would have the authority to restrict or outright "deny a member firm from allowing such a person to become an owner, control person, principal or registered person."[28] This would essentially mean firms would need to pre-clear with FINRA before they can hire and onboard bad brokers. We support this proposal with the caveat that it also change the definition of "specified risk event" from the proposed $15,000 level to $5,000.

Half Measures Will Not Solve the Serious Problem of Recidivist Brokers or Reduce the Number of Brokers with Misconduct Records, and therefore Stronger Remedies are Essential to Protect Investors from Bad Brokers.

As detailed above, the proposals in the Release are beneficial and can be made even more effective with the changes we have suggested. However, even when fortified, they will not fully address the chronic problem of bad brokers allowed to remain in the industry. To more effectively address this issue, FINRA should take a number of additional steps, set forth below.

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26 The Release, in endnote 28, describes "taping firm" to mean: "(i) A member with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years; (ii) A member with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years; (iii) A member with at least twenty registered persons where 20% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity within the last three years."

27 *See* Release at 14.

28 *Id.*

Adopt Three Strikes Rule: FINRA should make it impossible for brokers with a rap-sheet containing three or more specified risk events (at the $5,000 threshold level we proposed above) over the preceding 10 years to remain in the industry. FINRA should adopt a simple, clearly defined "Three Strikes" rule. There is no public policy justification to allow bad brokers to continually harm investors.

Allowing them to remain operational is also unfair to the vast majority of brokers who want to serve their clients honestly and well. These bad brokers sully the reputation of an entire industry, and erode the confidence of the entire investing public and the public at large who also lose faith in the regulators who are supposed to be vigilant against fraudsters.

Finally, investors who have been hurt by an unscrupulous broker are further demoralized and victimized when they see that the same fraudsters are still holding a license— a public privilege—and continue to work in the industry. Investors are the constituency to whom FINRA must cater, and all of its regulatory actions and proposals should be designed for the maximal benefit of investors and *not* the brokers who have decided to cheat time and time again.

Bold and Unmistakable Warnings About Bad Brokers: If FINRA refuses to do what is right and necessary and ban bad brokers with multiple misconduct records (as we argued above), and expel firms who specialize in hiring bad brokers (as we argue below), FINRA must at least use much more robust disclosures to empower investors to better protect themselves. Regulators that protect the public from harmful substances such as cigarettes have long deployed such techniques. FINRA should engage in more investor education on the topic, clearly explaining what a recidivist broker is and why they pose a threat to investors. In addition, FINRA should design and implement a disclosure system, either on BrokerCheck or through a separate user-friendly database, that clearly identifies those brokers with a demonstrable pattern of violating the law. Such an enhanced education and disclosure regime will prove more effective at warning investors that the use of these brokers and brokerage firms will be harmful to the investor's financial health.

Repeal Rule 9311: FINRA should repeal its Rule 9311 that allows a stay to be in-place while a party appeals a disciplinary matter to either the NAC, FINRA's board, the SEC, or any courts. There should be a blanket prohibition on stays while appeals are underway. Assuming FINRA reaches its disciplinary decisions through appropriate due process, there is no justification to allow a broker or firm to continue potentially harming investors while they file appeal after appeal.

Expel Bad-Broker Specialized Firms: FINRA should expel member-firms whose brokers' roster is 20% or more composed of brokers who have three or more specified risk events on their records. As documented by the studies noted above, having firms that enjoy the privilege and the imprimatur of being a firm regulated by FINRA and yet specialize in fraud and misconduct is a disgrace that needs immediate resolution. FINRA has the authority and the capability to solve this issue and send a strong signal to the brokerage industry that it will no longer tolerate boiler-rooms and fraud-houses, even in the guise of legitimate firms.

We support fair and appropriate measures designed to ensure that all brokers receive all the process to which they are due. But none of the procedural or fairness arguments advanced to date can justify the excessive leniency that FINRA has displayed toward bad brokers and brokerage firms. The priority must be to protect investors and to eject recidivist brokers and brokerage firms from the industry.

CONCLUSION

We hope these comments are helpful. FINRA has the authority, duty, and competency to do what is in the best interest of investors: reduce the prevalence of recidivism and the number of bad brokers. Now FINRA must apply its resolve to achieve this goal. FINRA must go beyond the specifics of this Release and fundamentally change its treatment of and tolerance for bad brokers and the firms who hire them.

Sincerely,

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June 29, 2018

Ms. Jennifer Piorko Mitchell
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1735 K Street, NW
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Re: Regulatory Notice 18-16: Request for Comment on Proposed Amendments Relating to High-Risk Brokers and the Firms That Employ Them

Dear Ms. Mitchell:

Cambridge Investment Research, Inc. ("Cambridge") appreciates the opportunity to comment on Regulatory Notice 18-16: "Request for Comment on Proposed Amendments Relating to High-Risk Brokers and the Firms That Employ Them." Cambridge understands these amendments are being proffered to address concerns relating to high risk associated persons who, by way of their bad acts, pose a heightened risk of harm to the investing public; and that the goal of these amendments is to promote investor protection and market integrity. It is with these goals in mind that Cambridge assessed the impact of the Proposed Amendments.

While Cambridge supports FINRA's efforts to ensure the goals of investor protection and market integrity are being met, Cambridge believes changes to the amendments proposed to the Rule 9200 Series, the Rule 9300 Series, and the NASD Rule 1010 Series are needed. We support strengthening controls to protect investors from high risk associated persons and would support the Proposed Amendments if certain requirements were altered to afford associated persons and member firms the opportunity to take additional remedial measures to address these issues.

A. Rule 9200 and 9300 Series

The Proposed Amendments to the Rule 9200 Series (Disciplinary Proceedings) and Rule 9300 Series (Review of Disciplinary Proceedings) would allow a Hearing Panel to impose conditions or restrictions on the activities of member firms and associated persons while a disciplinary matter is on appeal before the National Adjudicatory Council (NAC), and would require member firms to adopt heightened supervisory procedures while the appeal is pending.

As written, the Proposed Amendments to Rule 9285(a) and Rule 9311(b) would grant the Hearing Panel unilateral authority to impose any conditions or restrictions on the activities of the respondent member firm or associated person absent any input, opinions or opposing views from the member firms who would be required to act upon those conditions and restrictions. The language in the Proposed Amendment could be interpreted by Hearing Panels as a grant of extensive power, possibly resulting in Hearing Panels imposing overly broad conditions and restrictions. Overly broad conditions or restrictions (those that are not substantially related to the violation) would not be fair to the respondent member firm or to the associated person and have little investor protection value because the condition or restriction is not tailored to address, prevent, or deter future instances of the alleged violation.

Though it may seem proper for the Hearing Panel to unilaterally "impose such conditions or restrictions on the activities of a respondent as the Hearing Panel considers reasonably necessary" while interim orders are on appeal to the NAC, a better measure would be to require the Hearing Panel to solicit and consider input from the respondent member firm regarding any conditions or restrictions being contemplated by the Hearing Panel. Instead of imposing mandates, penalties, and remedial actions, the Hearing Panel should instead confer with the respondent member firm regarding the facts and circumstances material to the disciplinary review. This would allow the respondent member firm to suggest ways it could adequately alter its compliance systems, within the context of the member firm's size, resources, and overall ability to supervise, to insure that appropriate investor protection measures are taken. Cambridge believes that before unilaterally ordering conditions and restrictions, a more effective approach would entail the Hearing Panel considering input from the respondent member firm as to what remedial steps that member could employ to specifically address the activity that caused the alleged violation.

Additionally, with respect to any restriction or condition imposed on a member firm or associated person, Cambridge is concerned about possible actions that would need to be taken after a Hearing Panel has imposed restrictions on an associated person and the NAC reverses the Hearing Panel's finding. How will lost income, lost opportunities and lost clients be addressed by the member firms or by FINRA? For example, what recourse would be available to a member or associated person if a Hearing Panel restricted business activities or suspended the member's or associated person's registration only to have their decision reversed by the NAC? As this rule proposal is drafted, the imposition of any conditions or restrictions by the Hearing Panel, coupled with the grant of authority to FINRA Enforcement under Proposed Rule change 9556(a)(2) (which allows for expedited proceedings against members for non-compliance with those conditions and restrictions, and authorizes the suspension or cancellation of a members registration), essentially amounts to an exaction of punishment before the determination of a final decree on the merits. Giving the impacted member firm an opportunity to address the Hearing Panel before the determination of whether any conditions or restrictions are warranted, and what those might be, could alleviate some of this concern.

Cambridge understands the need for investor protection and appropriate compliance controls, however, we believe FINRA's efforts to strengthen controls and enhance investor protection could more effectively be accomplished by considering input from the member firm as to how the member might establish reasonably designed supervisory systems, controls, and programs to address the specific alleged violations rather than imposing mandated requirements which may or may not be appropriately tailored to the member firm's business, size, and structure. As such Cambridge respectfully requests FINRA reconsider the current Proposed Amendments, and in the alternative seek remedial measures with a collaborative approach whereby member firms are given the opportunity to advise the Hearing Panel regarding any conditions or restrictions needed.

B. Expedited Review Proceedings of Interim Orders

A respondent member firm may seek an expedited review of the conditions and restrictions imposed by a Hearing Panel. The respondent's burden of proof in that proceeding is to demonstrate that the Hearing Panel committed an error and that the conditions or restrictions are not necessary to prevent customer harm. Cambridge proposes FINRA adjust to the Proposed Rule so that the respondent's burden of proof should be whether: a) the Hearing Panel committed an error; b) the conditions or restrictions are overly broad; or c) the restrictions or conditions are not narrowly tailored to prevent future occurrences of the underlying violations.

C. NASD Rule 1010 Series

The Proposed Amendments to NASD Rule 1010 Series seek to place additional limitations on member firms by requiring a member firm to first submit a written letter to FINRA's Department of Member Regulation, through the Membership Application Program (MAP), seeking a materiality consultation, when a natural person, who has in the prior five years one or more final criminal actions or two or more specified risk events, seeks to become an owner, control person, principal, or registered person of an existing member firm.

Cambridge generally supports this Proposed Amendment as it relates to the criteria requiring a firm to file a material consultation where a proposed owner, control person, principal or registered person of a member firm has one or more criminal matters, or two or more specified risk events in the prior five years. However, Cambridge respectfully requests FINRA reconsider the dollar threshold as provided in the proposed definition of the "specified risk event" contained in the proposed amendments to Rule 1011. As we believe the *de minimis* dollar thresholds are unreasonably low, and for the following reasons, we request FINRA reconsider raising the *de minimis* amounts to at least $50,000.

Cambridge believes the proposed dollar thresholds applied to consumer initiated customer arbitration awards, arbitration settlements, and total monetary sanctions would impose unreasonable limitations on prospective owners, control persons, or registered persons who do not truly belong in the high risk category but are due to the methodology used to determine that classification. In some instances, the employment of a strictly quantitative approach to classifying an associated person as a high risk broker would result in unfairly categorizing an individual as a high risk broker because of the number of qualifying "specified risk event" disclosures that appear on that associated persons U4, whether the associated person committed any violation or not. This is often the case with control persons, principals, and registered persons who were required to disclose events due to a managerial role in the chain of supervision, and thus responsible for, but likely not directly involved in, the actions causing the violations resulting in the disclosures. Leaders in our industry can delegate authority but they cannot delegate responsibility – Chief Compliance Officers and Presidents of member firms are routinely held responsible for the actions of those under their purview. Here, as a point of reference, Cambridge would note that just as Regulatory Notice 18-15 regarding heightened supervision describes how member firms should employ a qualitative approach when determining which associated persons should be placed on heightened supervision, a qualitative approach to determining which associated persons should be classified as high risk brokers for purposes to this rule would also not only be more meaningful but would be more appropriate. Since, however, a qualitative classification is not being contemplated, raising the *de minimis* dollar threshold could eliminate some of those unfair characterizations.

Additionally, Cambridge is particularly concerned that the impact of the low dollar threshold on non-high risk brokers would temper and interfere with a member firm's ability to raise capital through the sale of ownership interests, transition control persons or principals as part of a merger or acquisition, or to recruit multiple registered persons who operate as a singular branch office. Cambridge believes the transition from one member firm to another is not the most appropriate time to mitigate the challenges associated with high risk brokers. Rather, the low thresholds imposed and the actions required of member firms would likely result in frustrating brokers who are not high risk, impeding choice, and confusing clients by holding up the registration process for those registered persons who might transition from one member to another. Furthermore, it is likely that these measures will not be viewed favorably by the investing public when their registered representative is mired in re-registration, awaiting approval to join a new member firm, while their accounts could potentially lie dormant and unmanaged at the registered representative's former broker dealer.

Accordingly, Cambridge believes that this rule change likely poses an unreasonable restraint on a registered person's ability to transfer their practice to a member firm when such a transfer may be in the best interest of clients or the broker, or to transition from a business relationship whereby neither party envisions a future in the relationship. Thus, we would argue the low threshold levels as proposed do not serve as investor protection measures, but could actually harm investors whose registered representatives seek to change registration from one member to another, and potentially into a better situation for those clients.

Lastly, the proposed measure may result in other unintended consequences to member firms and associated persons. Often customer arbitrations, regulatory and civil actions are settled for the projected cost of defense. In many cases today, that dollar amount is likely nearer to or greater than $50,000 rather than $15,000. Cambridge believes the $15,000 threshold will incentivize associated persons, who may face such actions, to continue arbitrating these types of proceedings rather than settle because of the impairment presented by this proposed rule change. This in turn will likely increase litigation costs for all involved and result in a greater number of proceedings, and more expansive proceedings as well.

Thus, a higher threshold would be less likely to interfere with those who seek to become an owner, control person, principal, or registered person of a new member firm and are not intended to be targets of FINRA's efforts to protect investors under this Proposed Amendment, would temper the proposed burden on member firms in this area, and would mitigate the potentially high economic impact which could result from this proposed rule.

Cambridge also recommends FINRA amend this process to afford associated persons contemplating transition, but who may be considered a high risk broker, the opportunity to directly and confidentially submit an application seeking a materiality review through MAP as an alternative to member firms submitting an application on behalf of an associated person for a materiality review through MAP. When an associated person to whom the rule applies contemplates a transition from one member to another, that associated person should be able to apply to FINRA on their own behalf in advance of any contemplated move. The associated person should have the opportunity to submit the application to FINRA, and to then obtain approval in anticipation of changing member registration, rather than requesting his or her current firm or any number of prospective firms he or she is looking to join to submit an application on his or her behalf. This alteration would save time and money, and would give associated persons confidence that they are free to separate from one member and move to the next without interruption. As written, the proposed rule could create an environment where, because of these disclosures, if an associated person is not permitted to join a new member firm, but does not want to continue associating with his or her current firm, the only remedial measure for the member firm would be to terminate the associated person who wants to leave that firm. A better measure would be to allow the associated person with the disclosure events noted in the rule proposal to pre-qualify their transition with FINRA on their own.

Cambridge is committed to constructive engagement in the regulatory process and welcomes the opportunity to work with FINRA on this important regulatory issue.

Respectfully submitted,

// Seth A. Miller

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June 28th 2018

VIA ELECTRONIC FILING: Pubcom@finra.org

Jennifer Piorko Mitchell
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RE: **Proposed Rule Changes Proposed in Regulatory Notice 18-16 to Amend Rule 9200 Series, 9300 Series, 9520 Series, Rule 8312, NASD Rule 1010 Series**

Dear Ms. Mitchell:

Luxor Financial Group and Managing Director, former Member of FINRA Board of Governors Mr. Ken Norensberg, thank you for the opportunity to comment on the proposed rule changes put forth in Regulatory Notice 18-16. As a New York based broker dealer consulting firm, Luxor Financial Group regularly consults with broker dealers and their registered representatives when they are directly impacted by implemented rule changes. As such, we are compelled to voice our opinion to some of the proposed rule changes as follows:

1. <u>Proposed Amendment to Rule 9285</u>

The proposed rule change would authorize the order of sanctions during the pendency of an appeal to the NAC, including bars or expulsions. The "reasonably necessary" test suggested as a guide in considering whether sanctions should be imposed on a respondent is no bar to the imposition of sanctions in nearly every case. This standard will have a chilling effect on respondents who may legitimately seek to preserve their reputation and livelihood through the appeals process. Depending on the sanctions imposed, respondents will find themselves unable to afford ongoing legal representation, or will prevail only to find their book of business and reputation have suffered irreversible damage. Conditions and restrictions on respondents must be stayed during pendency of appeal except upon a showing of clear and convincing evidence of *imminent harm to the public.* This is consistent with past practice. The Hearing Panel or Hearing Officer must follow a strict standard if we seek to preserve the even-handed nature of the self-regulatory process. Additionally, if the proposed rule change is deemed sufficient to prevent customer harm during the pendency of an appeal, it should not also be necessary to further impose an automatic trigger for a mandatory written heightened supervision regime under proposed Rule 9285(c).

2. <u>Proposed Amendment to Rule 8312</u>

The proposed rule change to disclose the status of a Member Firm as a "Taping Firm" is unconscionable and is seemingly designed as a punitive measure that will disproportionately cause reputational damage to small Firms. This type of reporting is likely to damage public trust in the industry unnecessarily. It may impact the ability of a small Firm to expand their business to a degree that is both unforeseeable and unmeasurable. Further, this will encourage a public perception that the Firm and all registered representatives of that Firm to be viewed negatively by association for behavior which had been perpetrated by another Firm and NOT by the current Firm for which the scarlet letter will now be attached to merely by taking in representatives through no fault of their own who are now guilty by past association and NOT of their own actions.

The notion that BrokerCheck, in conjunction with the taping rule itself, is insufficient to protect the public and incentivize careful research before investing, is simply wrong. It indicates a disregard for the agency of investors and the reputation and livelihoods of those serving them in this industry by unfairly maligning them through negative inference. We strongly object to this proposed change.

3. <u>Proposed Amendment to Rule 1010 Series (MAP Rules)</u>

Staff should reconsider the size and scope of the proposed definitions and to the degree that the proposed rule change would restrict the safe-harbor for expansion under IM-1011-1 and to the extent that restrictions to Membership may soon be imposed due to a criminal history for non-investment related activity.

The application process, whether, NMA or CMA, is already subject to a comprehensive review process in which the Department considers the material disciplinary history of associated persons. FINRA should not simply restrict ownership of a Member Firm due to any final criminal manner in the past five years which are not investment related and do not pose a future risk to the investment public. The Notice is indicating that the term "final criminal matter" seems to be a barometer for refusal simply by placing the word "criminal" as a prefix as opposed to the nature of the activity for which one was convicted. Certainly, jumping a turnstile or drinking in the public square or activities of a similar nature should not hold the same weight as a conviction of an egregious "criminal matter" or one that would be pertinent to ownership of a Member Firm such as perpetrating a fraud on the investing public. Broad based use of this type of definition would amount to double jeopardy and staff should reconsider the scope and nature of the "final criminal matter" and use a more narrow definition of the types of criminal events that would be considered as a disqualifier. Moreover, FINRA staff is well aware of a person's status through the Disclosure Reporting System and if they are currently registered without restriction, why would an additional consultation be necessary merely because such person is now in a non-controlling ownership position? MAP and Staff currently have the ability to question and consider explanations for "criminal events" at their will and no additional rules need to be created. In cases as specified in the notice, which, under Safe Harbor require no CMA or NMA to be filed, there is certainly no reason why a Firm should be required to file any consultation with MAP.

High Risk Brokers

As indicated in the Notice, Safe Harbor allows for the hiring of additional registered representatives over a specified number in a Member's Membership Agreement. The idea that staff should have the ability to determine who a Firm hires and that a Firm would have to consult with and give detailed explanations as to why they hire registered representatives who FINRA has given license to operate and who are not under a ban nor restricted in their business activities is counterintuitive. If Staff has not made an objection for them to continue in a licensed capacity and has not barred or otherwise precluded such registered persons from operating, then by extension, no additional "consultation" when a Firm wishes to hire someone should be required. The Safe Harbor Rule relating to personnel is primarily used by small Firms who may hire a small number of such representatives and would therefore be disproportionally affected by such a rule. Such a rule would then require an extension of time, effort and money which places an undue burden on such Firms when seeking to expand a small business.

FINRA has ample resources including a migration program which tracks the transfer of all registered persons. Staff can and does contact Firms on a regular basis when they have deemed a Firm to have hired "high risk brokers". Staff currently and consistently asks for detailed explanations from the Firms as to hiring criteria and supervision of such representatives whom FINRA themselves have seen fit to allow to remain licensed. As such, no additional requirements are necessary to be placed on Firms in order for FINRA to perform their mandate.

Specified Risk Event

The definitions of a "specified risk event" should have a higher dollar threshold ($50,000) as well as a shorter time limit for considerations placed on such events (12 months) and a larger number of events (5). Additionally, considerations such as the length of time that a registered representative has been active in the industry versus the number of events as well as the circumstances surrounding those events need to be considered when making a determination.

The current system in which plaintiff's counsel, or for that matter a non-attorney may file an action against a registered representative claiming any number of violations for the sole purpose of eliciting a quick settlement in which a person makes a business decision simply to avoid the time, energy and expense of a protracted arbitration to settle such action needs to be taken into consideration as well. Negative inference should never automatically be drawn simply because an event occurred.

Staff always has the ability to question events and ask for explanations. As such, a blanket policy cannot be made based simply on the occurrence of an event which can happen under many circumstances and would not be considered a risk to the public and therefore no additional mandates are necessary which place additional undue burdens on Firms.

Thank you for considering our comment,

Ken Norensberg

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MassMutual

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June 29, 2018

Via ELECTRONIC Mail (pubcom@finra.org)

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

Re: Regulatory Notice 18-16: Comment on FINRA Rule Amendments Relating to High-Risk Brokers

Dear Ms. Mitchell:

Please accept this submission as MML Investors Services, LLC's ("MMLIS") comments in response to FINRA's Regulatory Notice 18-16: FINRA Requests Comment on FINRA Rule Amendments Relating to High-Risk Brokers and the Firms That Employ Them("RN 18-16" or the "Notice.")

MMLIS is MassMutual's retail broker-dealer and is headquartered in Springfield, Massachusetts. The firm's 8,500 registered representatives offer a variety of investment products and services to retail clients, including mutual funds and variable products.

Comment from the Firm

RN 18-16 proposes to amend a series of rules as follows to impose additional restrictions on firms that may have employed registered persons with a history of misconduct:

1. FINRA proposes to amend the Rule 9200 Series and the 9300 Series to allow hearing panels in enforcement matters to impose conditions and restrictions on the activities of a respondent in order to minimize customer harm, and for those conditions to be effective during an appeal of the Panel's decision to the National Adjudicatory Council and FINRA Board. The proposal also mandates heightened supervision while the enforcement hearing decision is on appeal;

2. FINRA proposes to amend the Rule 9520 Series to require that firms impose heightened supervision procedures on brokers who are subject to statutory disqualification and are seeking to have their eligibility reviewed by FINRA;

3. FINRA proposes to amend Rule 8312 to include in BrokerCheck reports disclosure of a firm being subject to the taping rule under Rule 3170; and

4. FINRA proposes to amend the NASD Rule 1010 Series by requiring that firms seek a materiality consultation from FINRA Member Regulation through the Membership Application Program Group ("MAP") when a natural person has, in the prior five years, one or more final criminal actions or two

or more specified risk events, and that individual seeks to become an owner, control person, principal or registered person of an existing member. Under this proposal, a firm would be required to file a CMA if FINRA determines that associating the individual constitutes a material change to the member's business.

MMLIS supports FINRA in its efforts to strengthen the rules concerning high-risk brokers and their impact on investors at large. Rule 3110 already requires broker-dealers to establish and maintain a system of supervision over associated persons and to take appropriate steps to provide oversight of any broker whose conduct does not comport with the standards of the firm or of FINRA rules. To that end, MMLIS supports and has no comment on the first three rule amendment proposals that are contained within the Notice. Instead, we direct our commentary to the fourth proposal, which concerns the materiality consultation requirement before MAP.

A. *FINRA's proposed numeric thresholds for criminal actions and specified risk events are too low.*

1. *Criminal Actions*

The amendment to the NASD Rule 1010 Series imposes a materiality consultation requirement where an individual who seeks to become an owner, control person, principal, or registered person has one or more final criminal matters or two or more specified risk events in a five-year period. The proposed rule defines a "final criminal matter" as "a final criminal matter that resulted in a conviction of or guilty plea or nolo contendere ('no contest') by a person that is disclosed or was required to be disclosed, on the applicable Uniform Registration Forms." Currently, an individual is required to amend their CRD if they have any felony charge or conviction (including felony DUI), as well as certain misdemeanor charges and convictions involving: investments or an investment-related business; any fraud, false statements or omissions; wrongful taking of property (stealing, theft or bounced checks); bribery; perjury; forgery; counterfeiting; extortion; or a conspiracy to commit any of the above.

While we agree that a firm should carefully perform due diligence before associating with an individual who has a final criminal matter on their CRD, the proposal as written establishes a threshold that will unfairly tarnish brokers who otherwise may not have any risk factors. For instance, a broker who was charged with a felony DUI that was subsequently reduced by plea agreement to a misdemeanor is still required to amend their disclosure form. As drafted, a firm would arguably be required to seek a materiality consultation on this history. Driving under the influence is a serious societal problem, but from an investor protection standpoint, this type of event presents a risk much lower than a misdemeanor forgery. Similarly, there could be an instance where an eighteen-year-old erroneously wrote a check with insufficient funds and was charged with, and convicted of, a misdemeanor. It is hard to see why such an event should trigger a materiality consultation in the interests of investor protection.

The Notice is also unclear as to how firms should treat individuals whose sentences have been deferred. Such individuals typically are able to clear their convictions if they complete the requisite court-ordered program. Are firms expected to treat these convictions as a final matter where the matter is pending completion of a court-ordered program and could ultimately be expunged?

MMLIS proposes that FINRA re-examine the criminal matter threshold and tailor it to only include those matters that would generate a risk of customer harm. In addition, MMLIS recommends that FINRA examine scenarios related to deferred sentencing and issue guidance to firms in connection with this proposal.

2. Specified Risk Events

MMLIS also has concerns regarding FINRA's proposal to require a materiality consultation when an individual has two or more specified risk events in a five-year period. The proposal defines "specified risk event" as:

> [A]ny one of the following events that are disclosed or are or were required to be disclosed on an applicable Uniform Registration Form:
>
> (1) a final investment-related, consumer initiated customer arbitration award or civil judgment against the person for a dollar amount at or above $15,000 in which the person was a named party;
> (2) a final investment-related, consumer-initiated customer arbitration settlement or civil litigation settlement for a dollar amount at or above $15,000 in which the person was a named party;
> (3) a final investment-related civil action where the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000; and
> (4) a final regulatory action where (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines or restitution) were ordered for a dollar amount at or above $15,000; or (B) the sanction against the person was a bar (permanently or temporarily), expulsion, rescission, revocation, or suspension from associating with a member.

We believe that this threshold is too low and would have the effect of classifying a broker (or other named firm personnel) with an otherwise spotless record as "high risk" when, for example, one or more of the multiple complaints is baseless or relates to a product failure or a market downturn. This proposal also penalizes and tarnishes brokers and named firm personnel if the settlement is made by the firm strictly on economic grounds. Often these settlements are over $15,000, but are more likely to be less than $100,000. The low threshold of $15,000 will discourage named individuals from cooperating with these types of settlements, which will result in higher litigation and arbitration costs for all parties involved and a likely increase of expungement actions. MMLIS proposes that FINRA re-examine this provision and consider raising the number of risk events to two or more *unrelated* events. Also, FINRA should raise the settlement threshold to $100,000 or more. Such large settlements are far more likely to implicate the investor protection concerns behind this proposal.

B. The materiality consultation provision is vague.

The proposed rule as drafted does not clearly describe the materiality consultation requirements but merely states that the member must submit "a written letter to the Department, in a manner prescribed by FINRA, seeking a materiality consultation for the contemplated activity." While page 15 of the Notice does provide some guidance on information that should be included in the consultation, the rule itself is not specific. MMLIS recommends that FINRA clarify the rule to include an outline of those issues that would be central to the materiality determination as well as clarify the "manner prescribed "requirement.

C. The proposed rule is similarly vague on applicability.

Finally, the proposal lacks clarity on the population subject to the new requirements. For instance, it is unclear whether the rule will apply prospectively to new hires or whether a firm will be required to examine its existing associated persons. Similarly, it is not clear how the proposal would apply to individuals who change roles within a firm and may require a new registration level. This could lead to a significant burden and expense to firms if FINRA requires a firm to submit a materiality consultation for individuals who have already been affiliated with the firm in some capacity. MMLIS requests that FINRA clarify the scope of individuals impacted and tailor this rule to apply prospectively to new hires only.

Conclusion

MMLIS appreciates the opportunity to provide its comments to this proposal. If you should have any further questions regarding this comment, please do not hesitate to contact me.

Best regards,

Courtney R. Reid

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June 29, 2018

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

Re: Regulatory Notice 18-16
Comment Letter of Janney Montgomery Scott LLC on FINRA Rule Amendments Relating to High Risk Brokers and the Firms That Employ Them

Dear Ms. Mitchell:

Thank you for this opportunity to comment on the proposed rule amendments ("Proposal") to Financial Industry Regulatory Authority ("FINRA") rules 9200, 9250, 8312 and, in particular, legacy NASD rule 1010. Janney traces its roots in Philadelphia to 1832 and is one of the oldest full service financial services firms in the country with 116 offices and 779 Financial Advisors. As Janney has been actively shaping its roster of Financial Advisors over the course of the last decade, the firm is well positioned to offer feedback regarding the Proposal.

Janney shares the goal of protecting investors and understands that imposing additional restrictions on both Financial Advisors with a material history of misconduct and the firms that employ them is a reasonable approach. Consequently, the firm is generally supportive of three of the proposed amendments. However, Janney has significant reservations related to the proposed amendments to NASD Rule Series 1010, which as drafted would require submission of a Membership Application for registered persons who are the subject of "specified risk events," as detailed below.

I. Comments on Amended IM-1011

Amended Rule 1011 would require that an existing member firm submit a Materiality Consultation ("MAP") to FINRA in the event a natural person seeks to become an owner, control person, principal or registered person of the member firm who, in the prior five years, has one or more final criminal matter disclosure or two or more "specified risk" events. The Proposal as drafted further requires that the hire not be completed until FINRA responds with guidance as to whether a full Continuing Membership Application ("CMA") is required.

a) The Proposal Exceeds the Stated Purpose of MAP Consultation

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As noted in the June 24, 2018 comment letter submitted by the Securities Industry and Financial Markets Association ("SIFMA"), the Proposal appears contrary to the purpose of the MAP process. While acting as gatekeeper to the community of Broker Dealers is clearly within the MAP group's mission, the process, as pertains to existing firms, is designed to review material changes in business operations, not the "employability" of individuals. FINRA has previously articulated the appropriate tests to determine "material changes":

> *As defined in Rule 1011(k), the term "material change in business operations" includes, but is not limited to:*
>
> - *removing or modifying a membership agreement restriction;*
> - *market making, underwriting or acting as a dealer for the first time; and*
> - *adding business activities that require a higher minimum net capital under SEC Rule 15c3-1.*

This guidance appears centered on business operations rather than review of transitions, for which a separate and distinct process already exists. FINRA should employ the existing tools associated with registration and examination to achieve the stated purpose.

b) Covered Persons are Interpreted Unnecessarily Broadly

To the extent that an individual's employment may be deemed a "material change in business operations," that status should be reserved for owners and control persons rather than *all registered persons and principals*. It is unlikely that the hire of a registered person in a non-control role would be considered a material event at a firm of significant scale. In contrast, for Broker Dealers employing hundreds of registered persons, it is predictable that the creation and evaluation of request letters will consume significant resources more effectively engaged elsewhere at both the employer and FINRA.

FINRA should eliminate registered persons generally from the definition of Covered Persons. In the alternative, FINRA should restore the materiality safe harbor from the existing MAP process to recognize that firms of sufficient scale will have the supervisory resources in place to monitor its registered persons.

c) The Specified Risk Event Definition Thresholds are too Low

As drafted, the Proposal treats any arbitration award or settlement in excess of $15,000 as a specified event. This threshold is far too low. As a threshold issue, it is crucial to appreciate that the CRD system mandates reporting of a mere sales practice *allegation*, without any regard for underlying *merit.*

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Regardless of the size or merit of a single arbitration claim, defense costs are significant. Prior to hearing, filing fees are assed against member firms in addition to conferences, drafting an answer, discovery, witness preparation and hiring of experts. These unavoidable elements typically consume between *$50,000 and $100,000*. If a matter reaches hearing, it is typical for the combined costs of representation, FIRNA session fees, travel and experts to consume an additional $10,000 *per day*.

Thus any arbitration claim, regardless of merit, will cost between $100,000 and $150,000 *to win* even if the Award to Claimant is zero. Firms often respond to this arithmetic by rapidly resolving claims where possible because a $15,000 settlement represents a bottom line savings of at least $85,000.

Claimant's counsel know this calculus and the resulting business pressures and are therefore unlikely to settle any case for less than $15,000. This means two things. First, the Proposal will encompass thousands of meritless "cost of business" settlements each year and second, ironically, Broker Dealers will be incented *not to resolve client issues* with lower settlements and instead fight them to conclusion, where a zero Award is often the result.

FINRA should raise the threshold for a risk event to at least the de facto minimum cost of successful litigation, currently approximately $100,000.

d) The Logistical and Timing Issues are Unworkable

The recruitment of Financial Advisors is a competitive marketplace already rife with litigation. As background, note recent withdrawals from the broker hire "protocol" and the sheer volume of promissory note, defamation and retaliation claims already filling the arbitration docket. It is foreseeable that the introduction of additional hurdles and delays in the hiring process with engender new litigation risks.

By design, the Proposal requires potential hiring firms to submit consultations prior to a registered person leaving their existing firms. Indeed, the request pragmatically must be made prior to departure in order to avoid making an employment offer the new Broker Dealer may not be permitted to honor by FINRA. It is predictable that existing employers will learn of the requests. When this inevitably occurs, terminations and claims for breach of protocol, duty of loyalty, which will likely involve FINRA, are sure to follow.

The Proposal states that a member firm "may not effect the contemplated activity until the member has first submitted a written letter to the Department.." In essence, the firm must file and await a response prior to completing a hire. However, while FINRA observes that "on average" consultations are completed "within 8-10 days," it is acknowledged that some could be "longer" and no service level agreement is proposed by FINRA. Further, this already uncertain

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timeframe is based on the flow of requests under the existing rule. It is reasonable to anticipate the timeframe would lengthen if the number of requests grows under the Proposal. Each day of delay under this proposed process introduces another layer of litigation risk to both firms, the registered person and FINRA itself.

If the Proposal goes forward, FINRA should establish a clear response deadline to permit firms to responsibly conduct their hiring practices to minimize litigation risks.

e) FIRNA Already Has Access to the Information at Issue

FINRA appears to already be in possession of all of the information that would be collected under the Proposal. Note that every occurrence covered under the definition of "specified event" is already required to be reported under the existing form U4 and form U5. This is demonstrated by the very document presented in FINRA's impact analysis. Intuitively, the analysis could not have been prepared without the data already in hand. Similarly, member firms are required to register all new hires and registered representatives must update their form U4s when they change firms. Further, all firms are subject to continuous examination and nearly all "specified events" result in issuance of an 8210 inquiry by FINRA today.

In the instance where FINRA might hypothetically conclude that a Registered Representative presents a risk sufficient to justify preventing transition pursuant to a MAP review, but was already in possession of this information, it must be questioned why moving from one firm to another constitutes the triggering event for FINRA to take action. The investing public and markets appear better protected by taking contemporaneous action rather than disrupting the hiring practices of an unrelated firm as many as five years later.

g) It is Unclear How FINRA Intends to Use the Information Requested

If FINRA is already in possession of the information requested, it necessary to understand how the Proposal may differ from the existing reporting and examination requirements. It appears the issue is timing and that FINRA would like to review transitions specifically in the context of an affiliation change and that is it FINRA's intention to create the ability to prevent transition of a Registered Representative without taking enforcement action otherwise.

If so, this suggests FINRA might conclude an existing employer has the supervisory resources to oversight the individual in question. However, this is counter intuitive given the existing employer is likely where the specified events occurred in the first instance. Conversely, it also suggests FINRA might conclude the hiring firm lacks the supervisory resources required to oversight the new employee. This is troubling as it suggests FINRA might have evidence that the new employer is unable to supervise staff, but without taking enforcement action otherwise.

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As suggested above, it appears FINRAs has both the tools and information necessary to prevent both contemplated scenarios.

In short, While Janney shares FINRA's investor protection mandate it is Janney's recommendation that the Proposal as relates superficially to changes in NASD rule series 1011 not be implemented. As contemplated, it appears to unnecessarily impact hiring practices by creating new process outside the designed scope of MAP that request information FINRA is already in possession of. If the Proposal does go forward, the thresholds for both Covered Individuals and specified events should be more narrowly tailored to minimize the disruptive impact.

Best Regards,

W. Alan Smith
Deputy General Counsel

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June 28, 2018

Ms. Jennifer Piorko Mitchell
Vice President and Deputy Corporate Secretary
Office of the Corporate Secretary
FINRA
1735 K. Street, NW
Washington, D.C. 20006-1506

Re: **Regulatory Notice 18-16** (Comment on FINRA Rule Amendments Relating To High-Risk Brokers and the Firms that Employ Them)

Dear Ms. Mitchell:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitration proceedings. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes in order to protect the rights and fair treatment of the investing public.

FINRA seeks comment on proposed rule amendments that would impose additional restrictions on member firms that employ brokers with a history of significant reportable misconduct. These brokers, while relatively small in number, may present a heightened risk of harm to investors, and their continued misconduct could undermine confidence in the securities industry as a whole. PIABA believes that the proposed rules, which will impose additional and stronger controls over high-risk brokers and their employing firms, will benefit the investing public.

The Rule 9200 Series (Disciplinary Proceedings)

Proposed Rule 9285 addresses situations wherein an order sanctioning a broker is appealed. In particular, proposed Rule 9285(a) allows a hearing officer or panel to impose conditions or restrictions on the activities of a representative or firm, as the officer or panel considers necessary, for the purpose of preventing customer harm. PIABA supports this measure. If a broker is sanctioned for wrongful conduct (especially particularly egregious conduct), he or she should not be permitted to go about 'business as usual' while an appeal is pending; rather, the broker should be subjected to a higher level of supervision during this time. PIABA suggests that the rule specify that the representative's broker-dealer be notified immediately of any such conditions or restrictions imposed by a hearing officers. For these same reasons, PIABA supports the proposed amendments to Rule 9311, which make clear that a pending appeal would not stay any conditions and restrictions imposed by the hearing panel or officer.

Proposed Rule 9285(b) provides for an expedited review process for a representative or firm subject to restrictions or conditions pursuant new Rule 9285(a). PIABA believes that these procedures make sense and should be enacted. While an expedited review process is a good thing, there should also include a clear, relevant standard built into the Rule. For example, the Rule could state that the appealing party must provide clear and convincing evidence of a manifest error on behalf of the trier of fact. The appealing representative or firm should carry the burden of showing the likelihood of success of the underlying appeal in order to lift or ease any restrictions or conditions. If a clear standard is not incorporated into the Rule, PIABA fears that the procedures under Rule 9285(b) would be subject to abuse.

Proposed Rule 9285(c) requires firms to adopt a written plan of heightened supervision while the appeal is pending. PIABA also supports this proposed rule. PIABA also believes that the firm should be required to document its enforcement of the heightened supervision plan, subject to review by FINRA.

The Rule 9520 Series (Eligibility Proceedings)

Proposed Rule 9520 would require member firms to adopt heightened supervisory procedures for brokers during the period a Statutory Disqualification (hereinafter "SD") eligibility request is under review by FINRA. While the number of SD eligibility requests is modest, and FINRA has found that more than half of those requests are withdrawn because the representative's registration was terminated or the request simply withdrawn, there is an obvious benefit to requiring the application of heightened supervision to those registered representatives whose conduct is egregious enough that they face statutory disqualification.

Rule 8312 (FINRA BrokerCheck Disclosure)

FINRA proposed amendments to Rule 8312 to disclose the status of a member firm as a taping firm under Rule 3170, through its BrokerCheck system. Rule 3170 was instituted to address concerns regarding the need for heightened supervision of certain high-risk brokers with disciplinary histories. A firm with enough registered representatives formerly employed by "disciplined firms" is required to maintain special written procedures for supervising the telemarketing activities of *all* of its registered persons. In short, a "taping firm" is one that employs a significant percentage of high-risk brokers. While PIABA supports the disclosure on Broker-Check that a firm is a "taping firm," it is concerned that simply noting the firm's status as such, and without explanation, will be devoid of meaning to virtually all investors. If a disclosure is made, it must be meaningful. PIABA would therefore insist that any "taping firm" disclosure be explained in BrokerCheck, with a specific narrative description of why the disclosure is being made.

NASD Rule 1010 Series (Membership Proceedings)

FINRA proposed amendments to the NASD Rule 1010 series ("MAP Rules") to require member firms to seek materiality consultations when an individual who has one or more final criminal convictions, or two or more specified risk events within the previous five years, seeks to become an owner, control person, principal or registered person of the firm. The amendments would allow FINRA to review and potentially restrict or deny a member firm from allowing such person to become an owner, control person, principal or registered person. PIABA supports the proposed amendments and agrees with FINRA that the proposed amendments would promote investor protection.

As FINRA is aware, the hiring practices of certain brokerage firms are a threat to investors. Oftentimes, brokers with significant disciplinary histories change brokerage firms, with little to no attention given to their checkered pasts. PIABA believes that such increased due diligence, on this relatively small group of individuals, is consistent PIABA's and FINRA's goals. Requiring firms to go through the materiality consultation process will also surely remind those firms of the need to keep those new representatives under a well-defined and well-enforced supervisory system.

PIABA further believes that the numerical threshold and criteria proposed to trigger a materiality consultation are appropriate and clear enough to avoid confusion. As FINRA states, the proposal focuses attention on "the economic trade-off between incorrect identification of individuals that may not subsequently pose a risk of harm their customers, and not including individuals that may subsequently pose risk of harm." PIABA agrees and emphasizes that the minor costs of complying with the amendments will be far outweighed by the increased investor protections. Further, the easily-definable criteria proposed to trigger a materiality consultation (a final criminal conviction and disclosure events required to be reported on the Uniform Registration Forms) remove doubt as to which individuals require a materiality consultation. The proposal adequately applies stronger standards for continuing membership with FINRA and promotes investor protection from high-risk brokers.

Conclusion

In summary, PIABA supports the proposed rules since we agree that the proposed rules would benefit the investing public by imposing additional restrictions while strengthening existing controls over high-risk brokers and their employing firms.

Respectfully submitted,

Andrew Stoltmann

NETWORK 1 FINANCIAL
SECURITIES, INC.

26 June 2018

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

Comment Submitted via Email:
pubcom@finra.org

Re: Comment to Regulatory Notice 18-16
Proposed Rule Amendments Relating to High-Risk Brokers and Firms that Employ Them

Dear Ms. Mitchell:

This letter is being timely filed with FINRA in response to certain proposed amendments identified in FINRA Regulatory Notice 18-16.

Regulatory Notice 18-16 identifies desirable amendments to the Rule 9200 Series (Disciplinary Proceedings); to the Rule 9300 Series (Review of Disciplinary Proceedings by the National Adjudicatory Council and FINRA Board, including application for SEC Review; to the Rule 9520 Series (Eligibility Proceedings); to Rule 8312 (FINRA BrokerCheck Disclosure); and finally, to the NASD Rule 1010 Series (Membership Proceedings).

This Comment Letter's analysis will follow the order corresponding to the order in which these proposals are presented in Regulatory Notice 18-16. This Comment Letter will analyze each proposal separately: firstly, from the perspective of consistency with FINRA's mission; secondly, from the perspective of consistency with principles of jurisprudence and other criteria higher than this mission; and lastly, from the perspective of an industry member, *recommendations to remedy* what we have identified as deficiencies that come to light as a result of this comparison.

With this perspective in mind, Network 1 Financial Securities expresses sincere appreciation for this opportunity to respond to the proposals set forth in Regulatory Notice 18-16. Network 1 Financial Securities is an industry member that has been engaged primarily in investment banking and secondarily in securities brokerage, since 1983.

1. **Whether Proposed Rule 9285 (relating to Interim Orders While on Appeal) is Consistent with FINRA's Mission.**

Under proposed Rule 9285(a), conditions and restrictions can be imposed against a broker who, in an enforcement action, loses his case. Such conditions and restrictions can be requested by FINRA's Department of Enforcement, or a Hearing Officer or Hearing Panel can take it upon themselves to order such conditions and restrictions as they deem "reasonably necessary for the purpose of

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preventing customer harm."[1] Additionally, such conditions and restrictions would not be stayed during the pendency of the appeal to the National Adjudicatory Council (NAC).[2]

Appreciating the severity of this measure, FINRA aims to bring things into a more equitable balance by extending the losing broker the opportunity to request that NAC expeditiously review and, hopefully from the broker's perspective, modify some or all of the restrictions imposed by the Office of Hearing Officers (OHO).

Under proposed Rule 9285(b), the NAC would have no more than thirty (30) days to rule on the broker's motion for reconsideration of the OHO's imposition of these conditions and restrictions.[3]

That said, the burden of persuasion appears to rest on the broker to show that the conditions or restrictions imposed on the broker are not necessary for the purpose of preventing customer harm.

Given that FINRA's mission is "to provide investor protection and promote market integrity";[4] and, because this proposed Rule 9285(b) attempts to ameliorate the rather draconian aspects of Rule 9285(a), proposed Rule 9285 is consistent with this mission and, on the whole, appears to be both balanced and fair on the basis of these two perspectives.

1.A **Whether Proposed Rule 9285 is Consistent with Principles of Fundamental Law.**

Whether these proposals are, *objectively*, truly fair and balanced as defined by higher principles, these proposed amendments must be judged by principles that are fundamental to American jurisprudence.

In matters that are judicial in nature or, in the case of enforcement actions, quasi-judicial in nature the operating principle – *that adjudicatory determinations must be made by a neutral decision- maker* - is and should be the final arbiter.[5]

"Determination by a neutral decision maker" is so fundamental to adjudicatory justice that no reasonable person would waste time questioning the relevancy of this principle inherited from ancient

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[1] Regulatory Notice 18-16, p. 6.

[2] Regulatory Notice 18-16, p. 7.

[3] Regulatory Notice 18-16, p. 7.

[4] https://www.finra.org/about/our-mission.

[5] *See e.g.*, Marshall v. Jerrico, 446 U.S. 238, 242 (1980); Schweiker v. McClure, 456 U.S. 188, 195 (1982): "The neutrality requirement helps to guarantee that life, liberty, or property will not be taken on the basis of an erroneous or distorted conception of the facts or the law. . . . At the same time, it preserves both the appearance and reality of fairness . . . by ensuring that no person will be deprived of his interests in the absence of a proceeding in which he may present his case with assurance that the arbiter is not predisposed to find against him." *See also* Martin H. Redish & Lawrence C. Marshall, Adjudicatory Independence and the Values of Procedural Due Process, 95 Yale L.J. 455, 475 (1986), *supra* note 3, at 475: "*participation of an independent adjudicator*" is the core procedural due process requirement, *more paramount even than* participatory rights to notice and an opportunity to be heard." (Emphasis supplied)

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NETWORK 1 FINANCIAL
SECURITIES, INC.

English common law and engrafted onto American constitutional law since the time of our country's Founding, and is now the rock bed of American understanding of what is just.[6]

"Determination by a neutral decision maker" translates to impartiality; and, impartiality is the heart of procedural justice. As the courts have put it, "[p]rocedural fairness requires internal separation between advocates and decision-makers to preserve neutrality."[7]

Accordingly, the following constitutionally recognized principles need to be in play in order for proposed Rule 9285 to be judged consistent with principles of fundamental justice:

- As enshrined in the traditional statement of due process: "No man shall be a judge in his own cause", and therefore *a decision-maker cannot act as both a party and a neutral,* because the two roles are fundamentally incompatible.[8] (Emphasis supplied)

- A neutral decision-maker is not simply a person without a financial interest in the outcome of the case, but *more broadly a person who is not affiliated with, or biased in favor of or against, one side or the other.*[9] (Emphasis supplied)

- The decision-maker must be scrupulously neutral - neither biased in favor of either side, *nor charged with responsibilities that would interfere with his ability* "to hold the balance nice, clear and true" between the parties.[10] (Emphasis supplied)

1.B The Structure of FINRA Disciplinary Proceedings: Impartiality Presumed.

FINRA states that the "Office of Hearing Officers is an independent office of impartial adjudicators who preside over disciplinary cases brought by FINRA's Department of Enforcement."[11]

This statement about impartiality claimed by FINRA notwithstanding, as well as FINRA's assertion about separation of powers (i.e., judiciary and enforcement powers),[12] it must still be asked: Does the

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[6] Justice Black noted in his opinion for the Court in Chapman v. California, 386 U.S. 18, 23 (1967), that "there are some constitutional rights *so basic to a fair trial* that their infraction can never be treated as harmless error." (Emphasis supplied). Relevant to this Comment Letter, Justice Black cites Tumey v. Ohio, 273 U.S. 510 (*impartial decision-maker*).

[7] Withrow v. Larkin, 421 U.S.35, 47, 51-52 (1976). *And see* Morongo Band of Mission Indians v. California State Water Resources Control Bd., 45 C4th 731 (2009), at 737, citing Department of Alcohol Beverage Control v. Alcohol Beverages Appeals Bd. (2006) 40 Cal.4th 1, 10.

[8] *See* Arnett v. Kennedy, 416 U.S. 134, 197 (1974) (White, J., concurring in part and dissenting in part) (quoting Dr. Bonham's Case, 77 Eng. Rep. 646, 652 (King's Bench, 1610).

[9] *See, e.g.,* Morrissey v. Brewer, 408 U.S. 471, 486 (1972).

[10] Tumey v. Ohio, 273 U.S. 510, 532 (1927). *See, e.g.,* Hamdi v. Rumsfeld, 542 U.S. 507, 535 (2004) (O'Connor, J., plurality opinion) (noting that due process requires an "impartial adjudicator").

[11] FINRA, Office of Hearing Officers, http://www.finra.org/industry/oho.

[12] FINRA states: "The Office of Hearing Officers maintains strict independence from FINRA's regulatory and enforcement programs, and is physically separated from other FINRA departments. Hearing Officers are not involved in the investigative process. Furthermore, employment protections exist for Hearing Officers to ensure their independence. Only FINRA's Chief Executive Officer can terminate a Hearing Officer, and the termination can be appealed to the Audit Committee of FINRA's Board of Governors." http://www.finra.org/industry/guide-disciplinary-hearing-process.

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structure of the FINRA adjudicatory process support these claims? Is this process entitled to a presumption of impartiality? It is in the light of these two questions in conjunction with American principles of fundamental justice that proposed FINRA Rule 9285 must be judged.

According to current FINRA Rule 9231(a), the Chief Hearing Officer appoints the Hearing Panel or Extended Hearing Panel who, for all intents and purposes, acts as the "trial court" in a FINRA enforcement action.[13]

But who qualifies to be Chief Hearing Officer?

According to FINRA rule 9120(b), the Chief Hearing Officer is an individual "designated by the Chief Executive Officer of FINRA to manage the Office of Hearing Officers". With this management mission in mind, it would not be unreasonable to infer that the Chief Hearing Officer, at a minimum, has a "financial interest" in appointing to Hearing Panels individuals who are loyal to FINRA's mission, which is "to provide investor protection and promote market integrity".

Therefore, who qualifies to be Hearing Officers?

According to FINRA Rule 9120(r), a Hearing Officer is "an employee of FINRA, or former employee of FINRA who previously acted as a Hearing Officer, who is an attorney and who is appointed by the Chief Hearing Officer to act in an adjudicative role and fulfill various adjudicative responsibilities and duties" that are part and parcel of the process set forth in the Rule 9200 series, which relates to enforcement and adjudication of violations of FINRA rules as well as federal securities laws and regulations.

As such, it would not be unreasonable to infer that a Hearing Officer, at a minimum, has a "financial interest" in being and continuing to be loyal to FINRA's mission, which is "to provide investor protection and promote market integrity".

The Hearing Officer serves as the chair of the Hearing Panel.[14] According to FINRA Rule 9210(w), a Panelist is "a member of a Hearing Panel or Extended Hearing Panel who is not a Hearing Officer".

Therefore, who qualifies to serve on the Hearing Panel for disciplinary proceedings purposes (i.e., for "trial" as opposed to "appellate" purposes)?

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[13] The authors fully appreciate all that is involved in the technical distinction between a "hearing" and "trial". The purpose of using "trial court" in this Comment Letter is to commence this discussion with a layman's appreciation of the common ground between the aforementioned technical distinction, namely, the taking of testimony under oath subject to cross-examination, the weighing of evidence by a decider of fact and law who is impartial, and the rendering of a decision either in favor or against the accused consistent with relevant legal principles applied to the weight of this evidence. For the reader of this Comment Letter who is not an industry member, the word "trial court" is likely to be the more common expression that captures the essence of this "common ground".

[14] Rule 9231(b).

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According to FINRA Rule 9231(b), it depends:

- If the Enforcement Complaint alleges at least one cause of action alleging violations of law involving the quotation of securities, the execution of transactions, the reporting of transactions, and trading practices, including rules prohibiting manipulation and insider trading, the Chief Hearing Officer is at liberty to appoint to the Hearing Panel an individual who "currently serves on the Market Regulation Committee or who previously served on the Market Regulation Committee…."[15]

- Otherwise, the Hearing Officer is required to select as a Panelist a person who "currently serves or previously served on a District Committee; previously served on the National Adjudicatory Council; previously served on a disciplinary subcommittee of the National Adjudicatory Council or the National Business Conduct Committee, including a Subcommittee, an Extended Proceeding Committee, or their predecessor subcommittees; or, previously served as a Director or a Governor, but does not serve currently in any of these positions."[16]

In short, in order to be a "judge", so to speak, in a FINRA disciplinary "trial", one needs to be a current or former FINRA employee – *in contradistinction to a current industry participant in a FINRA member broker/dealer.* Moreover, this individual needs to have performed a function in one of FINRA's important Committees relevant to market conduct and regulatory governance. In short, this individual must be one who is committed, first and foremost, to FINRA's mission – in contradistinction to being committed, first and foremost, to member issues in the competitive market place. While both commitments should and must center on justice,[17] it is this difference in perspective or nuance that is at the heart of the discussion in the next section.

1.C FINRA Enforcement Process Examined under the Microscope of Fundamental Law.

To summarize, the Chief Hearing Officer, the Hearing Officer, and the members of the Hearing Panel appointed by Hearing Officer, as well as members of the National Adjudicatory Council, are current or former employees of FINRA. It has already been pointed out that, as employees of FINRA, they have a "financial interest" in being and continuing to be loyal to FINRA's mission, which is "to provide investor protection and promote market integrity".

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[15] Rule 9231(b)(2).

[16] Rule 9231(b)(1)(A) through (E), inclusive.

[17] The fundamental understanding of justice in Western Civilization is grounded in the maxim: ***Justitia suum cuique distribuit*** - Justice renders to everyone his due. *See e.g.*, Plato, The Republic, 4.433; Aristotle, Nichomachean Ethics, 1131 a 29 ("distributive" or proportionate justice); Cicero, De Legibus (c. 43 BC), I, 15; Justinian, Corpus Juris Civilis, book 1, title 1; Aquinas, Summa Theologica, IIaIIae58: "Justice comes down to "giving to each his due". Thus, justice from a FINRA perspective is focused on the investor and giving to the investor protection from bad brokers. From a FINRA member firm's perspective justice is focused devising just rules that level the playing field for brokers so that good brokers are not disadvantaged by the actions of bad brokers in a super competitive marketplace. *Accord* William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, at pages 9 – 12, and 33 – 35: "In a world in which investors cannot readily distinguish between "good" and "bad" brokers before choosing one, perversely good brokers are worse off and better brokers are better off. But if good brokers can somehow differentiate themselves in advance, they can charge more for their services. This discrimination might be hard to effectuate without a neutral third party [e.g., an SRO committed to effecting this justice?] to serve as a credible source of enforcing regulation that distinguish between the two." Id. at 34.

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But there is another conflict of substantial importance that is even more compelling when scrutinizing *impartiality*:

- The Chief Hearing Officer, Hearing Officer, and members of the Hearing Panel appointed by Hearing Officer, as well as members of the National Adjudicatory Council, are persons who are *affiliated* with FINRA. This is an important factor when scrutinizing impartiality.

- The fundamental principle that is the foundation of impartiality as stated in Supreme Court cases – namely, that a neutral decision-maker is not simply a person without a financial interest in the outcome of the case, *but more broadly a person who is not affiliated with ... one side or the other*[18] – is violated.

- It begs the obvious, that there are no industry participants from FINRA member broker/dealers on the Hearing Panel to balance the clearly one-sided participation of the regulator who both brings charges against brokers and decides outcomes in enforcement matters that, when considering the number of enforcement cases that result in a bar from the industry, amounts to "capital punishment."[19]

Granted, FINRA's espoused purpose in keeping the Hearing Officer (as well as Hearing Panel members and members of the National Adjudicatory Council) *all-in-the-family* is to tap into the advantage of having "experienced, licensed attorneys who have previously acted in the same adjudicative role and fulfilled the same adjudicative responsibilities and duties for FINRA"[20] as well as taking "advantage of the expertise of former Hearing Officers who remain well-versed in the typical law violations that are resolved in FINRA disciplinary proceedings."[21] And, granted, these former

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[18] *See e.g.*, Morrissey v. Brewer, 408 U.S. 471, 486 (1972)

[19] The use of this word, "capital punishment" is not hyperbole. It is the language of the U.S. Court of Appeals for D.C. Circuit. In Saad v. Securities and Exchange Commission, No. 15-1430, 2017 WL 4557511, at *5–6 (D.C. Cir. Oct. 13, 2017) *remanding* Saad v. SEC, 718 F.3d 904 (D.C. Cir. 2013), FINRA brought a disciplinary proceeding against John M.E. Saad, a broker at a FINRA member firm, charging the broker with violating FINRA rules when he submitted false expense reports for reimbursement for nonexistent business travel and for a fraudulently purchased cellular telephone. The Office of Hearing Officers found that the broker violated NASD Conduct Rule 2010 and sanctioned the broker with a permanent bar against his association with a member firm in any capacity. This sanction was affirmed by FINRA's National Adjudicatory Counsel and later by the U.S. Securities and Exchange Commission. In his petition to the D.C. Circuit for review, the broker did not contest his culpability, but instead argued only that the SEC abused its discretion in upholding the lifetime bar. The Court pointed out that, when reviewing a disciplinary sanction imposed by FINRA, the SEC must determine whether this sanction is excessive or oppressive as measured by the "due regard for the public interest and the protection" standard. The Court reminded the SEC that, as part of its review, the SEC must carefully consider whether there are any aggravating or mitigating factors that are relevant to the SEC's determination of an appropriate sanction. Then the Court, citing the previously decided D.C. Circuit decision of PAZ Sec. Inc. v. SEC, 494 F.3d 1059, 1065 (2007), reminded the SEC: "***This review is particularly important when the respondent faces a lifetime bar, 'the securities industry equivalent of capital punishment.'*** " (Emphasis supplied) The D.C. Circuit then remanded the case back to the SEC for further consideration of its sanction in light of this Court's opinion. Source: https://www.cadc.uscourts.gov/internet/opinions.nsf/0/45CCF265B19136C4852581B8004DE8C5/$file/15-1430.pdf

It bears mentioning here that, next to the U.S. Supreme Court, the D.C. Circuit stands superior to the other Circuit Courts. It has been recently stated: "In contrast, even in comparison to other regional circuits, ***the D.C. Circuit enjoys unmatched prestige***. Such prestige results at least in significant part from (1) the D.C. Circuit's role as a "feeder court" for four of the Supreme Court's current nine Justices [citation omitted] and (2) the D.C. Circuit's regular handling of high-profile administrative law cases involving questions of broad significance. [citation omitted] ***When the D.C. Circuit addresses questions*** such as the constitutionality of legislative vetoes of agency rulemaking [citation omitted] or the validity of agency rules of facially national scope * * * [citation omitted] ***the significance for policymakers and members of the general public is plain***." (Emphasis supplied) *See* John Golden, The Federal Circuit and the D.C. Circuit: Comparative Trials of Two Semi-Specialized Courts, 78 George Washington Law Review 553, 554 (2010). Source: http://www.gwlr.org/wp-content/uploads/2012/08/78-3-Golden1.pdf

[20] Securities and Exchange Commission, Release No. 34-72543, Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend the Definition of Hearing Officer to Include Former FINRA Employees Who Previously Worked as Hearing Officers (3 July 2014), at page 3.

[21] Id at 4.

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employees would, according to FINRA, "be subject to the same rules in the Code of Procedure ... with respect to prohibited communications, independent advice, conflicts of interest, and bias."[22]

These credentials, experiences, and code of conduct formalities notwithstanding, it nonetheless must be asked: Can the Hearing Officers and Panel Members be truly neutral and impartial when they are in fact long term employees – and *therefore affiliates* - of FINRA (as opposed to outsiders, as for example, defense attorneys at law firms that represent brokers in regulatory enforcement cases)?

But these affiliates of FINRA are not simply employees of an ordinary not-for profit organization – they are employees whose bias is, naturally, tied-at-the-hip with its very important and very focused mission: FINRA's mission being "to provide investor protection and promote market integrity".[23]

Before we consider the issue of bias, or potential for bias and/or prejudice in the FINRA enforcement process that includes prosecuting enforcement attorney and the OHO panel alike, let us consider, ***analogously***, the experience in criminal prosecutions in the court or judicial system.

Consider the mission statement of the Manhattan District Attorney's Office: "Moving Justice Forward". What does "moving justice forward" likely mean for a prosecutor?

One former prosecutor answers this question this way:

> "Just as the brotherhood of prosecutors was premised on shared experience, it was also premised on shared fear. As a defense attorney, I fear that I'll fail my client and they will be unjustly imprisoned. But as a prosecutor, the culture taught me to fear that I'd make a mistake and a guilty defendant would go free to wreak havoc on society. That fear constantly colored my assessment of legal issues."[24] (Emphasis supplied)

Surely most prosecutors in a criminal case can and do intellectually assent to the important constitutional doctrine of presumption of innocence; but, do they really passionately embrace presumption of innocence?

The same former prosecutor answers this question pointedly:

> "Three types of culture—the culture of the prosecutor's office, American popular culture, and the culture created by the modern legal norms of criminal justice—shaped how I saw the rights of the people I

[22] Id at 5. It bears noting that "responsibilities and duties *for* FINRA" is the only relevant experience required.

[23] https://www.finra.org/about/our-mission.

[24] Ken White, Confessions of an Ex-Prosecutor: Culture and law conspire to make prosecutors hostile to constitutional rights. (June 23, 2016) Source: http://reason.com/archives/2016/06/23/confessions-of-an-ex-prosecutor. *Accord* Christine Alice Corcos, Prosecutors, Prejudices, and Justice: Observations on Presuming Innocence in Popular Culture and Law, 34 University of Toledo Law Review 793, 794 (2003), where this law review commentator writes: "[W]e do not find the presumption of innocence easy or natural to adopt, particularly in times of crisis. It runs counter to our intuition and makes us uncomfortable. If the individual on trial might be innocent, then the guilty person is still "out there" and leads to the conclusion that the legal system is not infallible. Therefore, an innocent person could be accused and convicted. If the innocent can be convicted and the guilty go free, where is justice? And of what use is the legal system." Source: https://digitalcommons.law.lsu.edu/cgi/viewcontent.cgi?article=1254&context=faculty_scholarship.

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> prosecuted. If you had asked me, I would have said that it was my job to protect constitutional rights and strike only what the Supreme Court once called "hard blows, not foul ones." But in my heart, and in my approach to law, I saw rights as a challenge, as something to be overcome to win a conviction. Nobody taught me that *explicitly*—nobody had to." [25] (Emphasis via underlining, supplied; italics in original)

Analogously, would not the same factors (personal ethos, cultural philosophy, internal training at the prosecutor's office, or simply many years on the job trying and winning cases, not wanting the guilty to go free and harm the public) operate and create a bias in favor of the investor and a prejudice against the broker in the FINRA Enforcement Process?

This may very well be a matter of nuance: namely, that while a prosecutor may assent intellectually to presumption of innocence, in practice, the scales of justice are always or nearly always tipped, consciously or subconsciously, in favor of "moving justice forward" towards obtaining a conviction; but, this nuance is exactly what differentiates and separates prosecutor from defense attorney as a career move, *and likewise makes enforcement attorney and ultimately hearing officers and adjudicators in FINRA enforcement hearings and appeals choose not to become a securities broker defense attorney.*

As stated now many times, the mission of FINRA is "to provide investor protection and promote market integrity". It is expected that hearing officers and adjudicators in this Enforcement Process intellectually assent to, and fully intend to extend the presumption of innocence to the broker;[26] but, the perception of the members of the industry is that the scales of presumption seem always or nearly always tipped *against the broker as guilty* in favor of the innocence of the investor – even when investors are "innocent as a fox".

There are important factors imbedded in the FINRA Enforcement Process that support this prejudice on the part of the members of the securities industry:

- There is *no* FINRA *requirement* that the attorney who will sit on a Office of Hearing Officers Panel in judgment of broker conduct in Enforcement cases, or for that matter who will review broker sanctions on appeal to the National Adjudicatory Council have experience as either an industry participant at a FINRA member broker/dealer or defense litigation experience at a law firm representing brokers.

If neutrality and impartiality is standard of measure in matters of fundamental law, the failure to have this "other side of the house" experience in the OHO and the NAC is one very important factor that, not only argues that the FINRA process falls short of being truly impartial or neutral, but also gives rise to the question whether "the Code of Procedure ... with respect to prohibited communications,

[25] Ken White, Confessions of an Ex-Prosecutor: Culture and law conspire to make prosecutors hostile to constitutional rights. (June 23, 2016) Source: http://reason.com/archives/2016/06/23/confessions-of-an-ex-prosecutor (Retrieved 8 June 2018).

[26] The authors fully appreciate the fact that FINRA Enforcement cases are not criminal cases and that this legal term of art, "presumption of innocence", is or may not be used in this forum, at least not regularly; that said, we don't think we want to go in the direction of saying that innocence presumed is not applicable in enforcement actions, which would be translated into a presumption that brokers are and should be presumed guilty. Therefore, this doctrine in criminal law has, we think, analogous application in enforcement cases and is at least implicitly accepted by FINRA OHO and NAC has having operation in rendering justice in their decisions.

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independent advice, conflicts of interest, and bias"[27] are ultimately adequate to overcome healthy skepticism about the Process' impartiality and neutrality – especially in view of the momentous changes that FINRA seeks to make to the Rule 9200 Series (relating to Disciplinary Proceedings) and the Rule 9300 Series (relating to Review of Disciplinary Proceedings by National Adjudicatory Council and FINRA Board and Application for SEC Review).

This in turn gives rise to a serious doubt, at this point, that the proposed Rule 9285 is consistent with *fundamental law*. For, as the U.S. Supreme Court has written: The decision-maker must be scrupulously neutral - neither biased in favor of either side, *nor charged with responsibilities that would interfere with his ability* "to hold the balance nice, clear and true" between the parties.[28]

There is an additional consideration – the positive law consideration – that augments the fundamental law argument in this Section I.C. This positive law aspect is considered in the following section to this Comment Letter.

1.D <u>FINRA Enforcement Process Examined under "Fair Principle" Doctrine of the Exchange Act.</u>

Disciplinary proceedings against members of an exchange and their associated persons are governed by Section 6(b)(7) of the Exchange Act, which provides that an exchange may not be registered with the Commission unless its rules "provide a fair procedure for the disciplining of members and persons associated with members[.]"[29]

Section 19(e)(1)(A) of the Exchange Act governs the SEC's review of disciplinary actions taken by self-regulatory organizations ("SROs"), such as FINRA.

Section 19(e)(1)(A) provides that, in reviewing an SRO proceeding, the SEC shall determine whether the member or person engaged in the conduct found by the SRO, whether the conduct violated the SRO rules at issue, and whether those rules were applied in a manner consistent with the purposes of the Exchange Act.[30]

[27] SEC Release No. 34-72543; File No. SR-FINA-2014-031 (3 July 2014) (Self-Regulatory Organizations; Financial Industry Regulatory Authority; Filing and Immediate Effectiveness of a Proposed Rule Change to Amend the Definition of Hearing Officer to Include Former FINRA Employees Who Previously Worked as Hearing Officers), at page 5. Source: https://www.sec.gov/rules/sro/finra/2014/34-72543.pdf.

[28] <u>Tumey v. Ohio</u>, 273 U.S. 510, 532 (1927). *See, e.g.*, <u>Hamdi v. Rumsfeld</u>, 542 U.S. 507, 535 (2004) (O'Connor, J., plurality opinion) (noting that due process requires an "impartial adjudicator").

[29] 15 U.S.C. § 78f(b)(7) (1994).

[30] 15 U.S.C. § 78s(e)(1)(A) (1994).

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In applying this section, the SEC has consistently held that a fundamental principle governing all SRO disciplinary proceedings is *fairness*.[31]

When submitted to the SEC for approval, the SEC is required to review proposed FINRA Rule 9285 in light of the "fair principle" doctrine.

In the course of its "fair principle" review, we believe the SEC should and will review proposed FINRA Rule 9285 in the light of the principle of "impartiality and neutrality", grounded in fundamental law.

Rule 9285, as proposed, appears at this juncture to violate fundamental law relevant to "impartiality and neutrality", and the "fair principle" doctrine that derives from Section 19(e) of the Exchange Act for the reasons set forth in Sections 1.A, 1.B, and 1.C in this Comment Letter.

2. Whether Proposed Rule 9523 (relating to Eligibility Proceedings) is Consistent with FINRA's Mission.

FINRA states that brokers who have engaged in the types of misconduct specified in the Exchange Act's statutory disqualification provisions must undergo special review by FINRA before they are permitted to re-enter or continue working in the securities industry. The Exchange Act sets out the types of misconduct that presumptively exclude brokers from engaging in the securities business, identified as statutory disqualifications ("SDs").

Despite the requirement of heightened supervision to receive approval of an SD Application, FINRA points out that there is currently no explicit rule requirement that these SD individuals be placed on heightened supervision by their employing member firm *during the pendency* of the SD Application review.

This is the issue that FINRA seeks to address in proposing amendments to Rule 9253: FINRA is proposing to require a member firm *to immediately place an individual on an interim plan of heightened supervision once a Statutory Disqualification Application is filed*[32] and FINRA would require that a copy of the interim plan of heightened supervision[33] be submitted with the SD

[31] "In applying Section 19(e)(1)(A) of the Exchange Act, 15 U.S.C. Section 78s(e)(1)(A), which governs our review of disciplinary actions taken by SROs, we have indicated that a fundamental principle governing all SRO disciplinary proceedings is fairness." U.S. Associates, Inc., 51 S.E.C. 805, 810 (1993). *See also* Scattered Corporation, 53 S.E.C. 948, 958 (Commission must first examine whether SRO's disciplinary proceeding was fair, noting that past cases involving "fairness" analyses "have focused on the fairness of the SRO's internal procedures, ***including organization structure as it affects the fairness and impartiality of the course of the proceeding.***") (Emphasis supplied)

[32] Regulatory Notice 18-16, p. 11.

[33] Because "reasonable criteria" is a fundamental aspect of American understanding of what is just, FINRA would require the interim plan of heightened supervision to be tailored to the disqualified individual, and to take into account the nature of the disqualification, the nature of the firm's business, the disqualified person's current and proposed activities at the firm, and the qualifications of the supervisor.

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Application, and that the plan be in effect throughout the entire SD Application review process. Other specifics are set forth in Regulatory Notice 18-16.

FINRA unabashedly states that it seeks to exclude brokers who pose a risk of recidivism from continuing in the securities business, subject to the limits developed in SEC case law.[34] But this is consistent with FINRA's mission, which is "to provide investor protection and promote market integrity".[35]

2.A <u>Whether Proposed Rule 9523 (relating to Eligibility Proceedings) is Vague and Overbroad.</u>

The proposed amendments to Rule 9523 relating to heightened supervision and statutory disqualification did not spend much time on the important related issue, which is paying compensation to a broker who *may or may not* be statutorily disqualified during operation of the amended rules. As this issue can be of paramount importance to the firm – the firm can face seriously rule violation charges if the firm does not get this right – the proposed Rule 9523 changes must first be analyzed in the light of the compensation issue.

Prior to the proposed Rule 9523 amendments, the Eligibility Process was already confusing about whether a member Firm can or cannot pay a broker subject to Statutory Disqualification:

> FINRA does write that "Generally speaking, a person who is subject to disqualification may not associate with a FINRA member in <u>any capacity</u> unless and until approved in an Eligibility Proceeding * * * <u>However</u>, a person who is currently associated with a FINRA member at the time the disqualifying event occurs <u>may be</u> permitted to continue to work in limited circumstances, provided that:
>
> - The member and the person are in compliance with FINRA Rule 8311,[36] and,
> - The member promptly files a Form MC-400 application."[37]

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[34] Regulatory Notice 18-16, pp. 4, 10.

[35] https://www.finra.org/about/our-mission

[36] According to Regulatory Notice 15-07 (relating to Payments to Unregistered Persons), FINRA offers this explanation: "Rule 8311 provides that if a person is subject to a sanction or other disqualification, a member firm may not allow such person to be associated with it in any capacity that is inconsistent with the sanction imposed or disqualified status, including a clerical or ministerial capacity. A member firm may not pay or credit to any person subject to a sanction or disqualification, during the period of the sanction or disqualification or any period thereafter, any salary, commission, profit, or any other remuneration that the person might accrue, not just earn, during the period of the sanction or disqualification. However, a member firm may make payments or credits to a person subject to a sanction that are consistent with the scope of activities permitted under the sanction where the sanction solely limits an associated person from conducting specified activities (such as a suspension from acting in a principal capacity) or to a disqualified person that has been approved (or is otherwise permitted pursuant to FINRA rules and the federal securities laws) to associate with a member firm."

[37] FINRA, Special Permission to Continue in or Enter the Securities Industry Notwithstanding a Disqualification. Source: http://www.finra.org/industry/general-information-finras-eligibility-requirements

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It is this clause – "may be permitted to continue to work in limited circumstances" – is a source of vagueness in the SD application process. Until one can figure out, prior to resolution at the conclusion of the MC-400 application, whether a broker's statutory disqualification status prohibits or permits a firm to pay a broker, the member firm operates in a mine field, always at risk of violating the FINRA prohibition against paying securities transaction based compensation to an "unregistered person", i.e., a broker subject to disqualification.

Figuring out whether a broker is or is not disqualified (again, prior to final disposition) is anything but clear. As one practicing attorney in the securities industry puts it:

> I feel like I know as much about statutory disqualification as anyone in the industry, yet, I keep a copy of Reg Notice 09-19 handy on my desk because at least a couple of times each week I find a need to refer to it to ensure that my understanding of what triggers a statutory disqualification, and the consequences of being statutorily disqualified, is correct. Even so, I still call FINRA's Registration and Disclosures group regularly with questions, as 09-19 is hardly a model of clarity.[38]

So the question is begged: Why would a member firm, *especially a Small Broker/Dealer*,[39] expend its very limited resources – taking compliance personnel off of their daily routine, already working several jobs and working at one pay grade or, alternatively, paying outside legal counsel at high hourly rates – to draft a heightened supervisory program for (let alone put heightened supervision into action for) a broker for whom the firm is anything but clear about the broker's being in compliance with Rule 8311?

The practical result incentivizing a member firm *against hiring* a broker amounts to enforcing a *de facto* bar of the broker from the securities business without the broker having been properly adjudicated a "bad broker".

Indeed, this appears to be FINRA's motivation. FINRA has stated that it seeks to exclude brokers who pose a risk of recidivism from continuing in the securities business,[40] subject to the limits developed in SEC case law. Again, this is consistent with FINRA's mission;[41] but, is it fair from the perspective of higher principles that operate in American jurisprudence, such as "Void for Vagueness" and "Overbroad" constitutional standards?

"Void for Vagueness" standard:

As one Law Commentator explains this standard in Plain English:

[38] Alan Wolper, Esq., Statutorily Disqualified? FINRA Says "Deal With It", (November 18, 2016) Source: https://www.bdlawcorner.com/2016/11/statutorily-disqualified-finra-says-deal-with-it/

[39] FINRA defines a small firm as a member with at least one and no more than 150 registered persons. *See* Regulatory Notice 18-16, p. 35, note 41.

[40] Regulatory Notice 18-16, pp. 4, 10, 13.

[41] https://www.finra.org/about/our-mission.

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> The "void for vagueness" doctrine argues that a law cannot be enforced if it is so vague or confusing that the average person could not figure out what is being prohibited or what the penalties are for breaking that law. Vagueness is generally considered to be a **due process** issue, because a law that is too vague to understand does not provide adequate notice to people that a certain behavior is required or is unacceptable.[42] * * * A law can be unconstitutionally vague in one of two main ways. First, the law may be void for vagueness if it does not adequately explain or state what behavior the law is meant to affect. If the average citizen cannot figure out from reading the law what he should or should not do, a court may find that the law violates due process. Second, a law may be void for vagueness if it does not adequately explain the procedures that law enforcement officers or courts must follow when enforcing the law or handling cases that deal with certain legal issues. Specifically, a law may be found to be unconstitutionally vague if it gives a judge no idea how to approach or handle a case based on that law.[43] (Emphasis in original)

"Overbroad" Standard:

As the same Law Commentator explains this standard in Plain English:

> The "overbreadth" doctrine is related to the vagueness doctrine. Under the overbreadth doctrine, a law is unconstitutional or void for being too broad if it covers activities that are protected by the federal Bill of Rights[44] or the rights listed in state constitutions. * * * Overbreadth is related to vagueness because an overbroad law is often too vague for a reasonable person to understand what behavior is covered and what behavior is not. In order to avoid breaking an overbroad law, then, many people will voluntarily

[42] Law Commentator's statements are corroborated in a recent U.S. Supreme Court decision dealing with the "void for vagueness" doctrine. *See e.g.*, Sessions, Attorney General v. Dimaya,584 U.S. ___ (2018), *affirm'd*, 803 F. 3d 1110 (9th Cir.2015), where Justice Gorsuch, concurring in the Court's ruling that 18 U.S.C. §16(b)'s residual clause is unconstitutionally vague, argues (as summarized in the syllabus) that "the void for vagueness doctrine, at least properly conceived, serves as a faithful expression of ancient due process and separation of powers principles the Framers recognized as vital to ordered liberty under the Constitution." Note that *Dimaya* was not cited by this Law Commentator; rather, *Dimaya* is cited by the authors of this Comment Letter as support for the Law Commentator's statement. That said, Justice Gorsuch writes: "Vague laws invite arbitrary power. * * * Today's vague laws may not be as invidious [as the laws imposed on the Colonies by Great Britain at the time of the American Revolution], but they ***can invite the exercise of arbitrary power*** all the same—by leaving the people in the dark about what the law demands and allowing prosecutors and courts to make it up. * * * Although today's vagueness doctrine owes much to the guarantee of fair notice embodied in the Due Process Clause, ***it would be a mistake to overlook the doctrine's equal debt to the separation of powers***. * * * Today's "civil" penalties include confiscatory rather than compensatory fines, forfeiture provisions that allow homes to be taken, remedies ***that strip persons of their professional licenses and livelihoods***, and the power to commit persons against their will indefinitely * * * [Vagueness in statutes and regulations alike] ***leaves the people to guess about what the law demands—and leaves judges to make it up***." (Emphasis Supplied)

[43] This entire quote is taken from the Rottenstein Law Group article: What does it mean when a law is "void for vagueness" or "overbroad"? http://www.rotlaw.com/legal-library/what-does-it-mean-when-a-law-is-void-for-vagueness-or-overbroad/.

[44] There is a constitutionally protected right, under the Commerce Clause of the U.S. Constitution, to engage in interstate commerce. *See* Dennis v. Higgins, 498 U.S. 439, at 448 (1991): "The Court has often described the Commerce Clause as conferring a "right" to engage in interstate trade free from restrictive state regulation. In Crutcher v. Kentucky, 141 U. S. 47 (1891), in which the Court struck down a license requirement imposed on certain out-of-state companies, the Court stated: "To carry on interstate commerce is not a franchise or a privilege granted by the State; it ***is a right which every citizen of the United States is entitled to exercise under the Constitution and laws of the United States***." Id. at 141 U. S. 57 (Emphasis supplied). Similarly, Western Union Telegraph Co. v. Kansas ex rel. Coleman, 216 U. S. 1, 216 U. S. 26 (1910), referred to "the substantial rights of those engaged in interstate commerce." And Garrity v. New Jersey, 385 U. S. 493, 385 U. S. 500 (1967), declared that engaging in interstate commerce is a "righ[t] of constitutional stature." More recently, Boston Stock Exchange v. State Tax Comm'n, 429 U. S. 318 (1977), held that ***regional stock exchanges had standing to challenge a tax on securities transactions as violating the Commerce Clause*** because, among other things, the exchanges were "asserting their right under the Commerce Clause to engage in interstate commerce free of discriminatory taxes on their business and they allege that the transfer tax indirectly infringes on that right."

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choose not to engage in behavior protected by law or another basic right, just to be sure they're not accidentally breaking the overbroad law.[45] (Emphasis supplied)

Proposed Rule 9523 (relating to Eligibility Proceedings) is Vague precisely because the Rule 9520 series, as expounded by Regulatory Notice 09-19, is already "hardly a model of clarity" [46] – confusing, in other words.

When coordinated with Rule 8311 (relating to Payments to Unregistered Persons), the average broker and his firm cannot figure out, after reading the rules and their corresponding official guidance, what the broker and his firm *should or should not do*. This is the essence of the constitutional probation against laws that are *Vague and therefore Void*.

Because of this, member firms – especially Small Broker/Dealers – will *voluntarily choose not to hire a broker whose statutory disqualification status is anything but clear* because of the expense and regulatory risk. Why? Because proposed Rule 9523 requires the member firm to create a heightened supervisory program in advance of conclusion to the Form MC-400 Application, Small Broker/Dealers will need to either pay outside legal counsel at high hourly rates or take compliance personnel (already working several jobs but working at one pay grade) away from their daily routine to draft a heightened supervisory program for the broker. Either way, this is expensive (especially for Small Broker/Dealers) and will be an otherwise *unnecessary* cost when a broker is found not to be statutorily disqualified.

To this expensive cost is added the risk of violating the Rule 8311 if the firm pays commissions to the broker during the limbo period – what reasonable broker is going to work for free in advance of conclusion to the Form MC-400 Application? But paying the broker involves risk to the firm of violating Rule 8311[47] if, at the conclusion that the MC-400 application, the broker is found by FINRA to be statutorily disqualified. Because of this regulatory exposure risk and the significant monetary cost involved, a member firm, *especially a Small Broker/Dealer*, will choose not to engage in hiring the broker to engage in securities business – an act that is otherwise protected by common law property principles and by the Commerce Clause to the U.S. Constitution. Voluntarily choosing not to engage in behavior that is a basic right protected by law just to be sure that one is not accidentally breaking the law is the essence of the constitutional prohibition against laws that are *Overbroad*.

[45] In a non-First Amendment situation (such as a claim for constitutionally protected conduct under the Commerce Clause to the U.S. Constitution), the Court will simply void the application of an unconstitutional statute, regulation, or rule (e.g., an SRO rule) to constitutionally protected conduct. *See e.g.*, Kunz v. New York, 340 U.S. 290 (1951); Aptheker v. Secretary of State, 378 U.S. 500 (1964); United States v. Robel, 389 U.S. 258 (1967); Zwickler v. Koota, 389 U.S. 241 (1967); Lewis v. City of New Orleans, 415 U.S. 130 (1974); Massachusetts v. Oakes, 491 U.S. 576, 581 (1989).

[46] Alan Wolper, Esq., Statutorily Disqualified? FINRA Says "Deal With It", (November 18, 2016) Source: https://www.bdlawcorner.com/2016/11/statutorily-disqualified-finra-says-deal-with-it/

[47] As well as violating FINRA Rule 2010 (relating to Commercial Honor and Principles of Trade): "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." The violation of most FINRA rules almost always triggers violation of Rule 2010.

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Member Firms – again, *especially Small Broker/Dealers* – will be "chilled" from exercising their constitutionally protected conduct under the Commerce Clause to the U.S. Constitution as well as common law and state constitutionally protected property rights, as an employer, to expand their interstate securities business through hiring brokers, precisely because (1) proposed Rule 9523 and 8311 are vague and overbroad, and (2) precisely because the risk of violating these rules are so high – and expensive, *especially to Small Broker/Dealers* – that firms will simply "voluntarily choose not to engage in behavior protected by law or another basic right, just to be sure they're not accidentally breaking the overbroad law." This amounts to Regulatory Taking of Property without just compensation under state and federal constitutions,[48] triggering the Doctrine of Unconstitutional Conditions.[49]

Regulatory Taking is a situation in which a government regulation – including a state actor's regulation[50] – limits the use of private property to such a degree that the regulation effectively deprives the property owner of economically reasonable use or value of his/her property, even though the regulation does not formally divest them of title to it.[51]

In addition to constitutional law, Regulatory Taking violates federal statutory law: "[T]he obtaining of property from another, with his consent, induced by wrongful use of actual or threatened force, violence, or fear, or under color of official right" is a violation of the Hobbs Act.[52] And courts have found that the Hobbs Act protects such intangible property rights "as the right to hire employees and to solicit customer accounts,"[53] as well as the right to continue to operate one's business.[54]

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[48] The Fifth and Fourteenth Amendments to the U.S. Constitution restrict the power of federal and state governments (and their "state actors") from infringing on the rights or life, liberty and property, requiring the government and their "state actors" to bear the burden of demonstrating the need for government involvement. U.S. Const. amends. V, XIV, §1: "No person shall be ... deprived of life, liberty, or property, without due process of law."

[49] The Doctrine of Unconstitutional Conditions can be traced back to Home Ins. Co. of New York v. Morse, 87 U.S. 445, 451 (1874)("A man may not barter away his life or his freedom, or his substantial rights.")

[50] *See* Section 4.B, *infra*, addressing "Whether the Proposal to Amend the NASD Rule 1010 Series (MAP Rules) Amounts to Taking of Property Making FINRA a "State Actor"?"

[51] The Supreme Court first held that state regulations that go too far may effect a taking in the 1922 case of Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1922). In this decision, Justice Holmes, writing for the majority, stated that "*[t]he general rule at least is that while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a taking.*"

[52] 18 U.S.C. § 1951(b)(2) (1994).

[53] The Fourth Circuit held in United States v. Santoni that "the property extorted was the right ... to make a business decision free from outside pressure"; extortion of this right was sufficient to invoke the Hobbs Act. United States v. Santoni, 585 F.2d 667, 673 (4th Cir. 1978), *cert. denied*, 440 U.S. 910 (1979); *see also* United States v. Zemek, 634 F.2d 1159, 1174 (9th Cir. 1980), *cert. denied*, 450 U.S. 916 (1981). (including the right to "make business decisions ... free from wrongful coercion" in the definition of property). *And see* Feminist Women's Health Ctr. v. Roberts, No. C86-161Z, 1989 WL 56017, at *7 (W.D. Wash. May 5, 1989); United States v. Lewis, 797 F.2d 358, 364 (7th Cir. 1986), *cert. denied*, 479 U.S. 1093 (1987); United States v. Hoelker, 765 F.2d 1422, 1425 (9th Cir. 1985), *cert. denied*, 475 U.S. 1024 (1986); United States v. Nadaline, 471 F.2d 340, 344 (5th Cir.), *cert. denied*, 411 U.S. 951 (1973); United States v. Tropiano, 418 F.2d 1069, 1075-76 (2d. Cir 1969), *cert. denied*, 397 U.S. 1021 (1970).

[54] "The right to pursue a lawful business including the solicitation of customers necessary to the conduct of such business has long been recognized as a property right within the protection of the Fifth and Fourteenth Amendments of the Constitution (Louis K. Ligget Co. v. Baldridge, 278 U. S. 105 (1928); cf., Duplex Printing Press Co. v. Deering, 254 U. S. 443, 465 (1921)" quoted in Scheidler v. National Organization for Women, Inc., 537 U.S. 393, 414 (2003) (J. Stevens, dissenting). *See also* United States v. Lewis, 797 F.2d 358, 364 (7th Cir. 1986), *cert. denied*, 479 U.S. 1093 (1987); United States v. Hoelker, 765 F.2d 1422, 1425 (9th Cir. 1985), *cert. denied*, 475 U.S. 1024 (1986); United States v. Nadaline, 471 F.2d 340, 344 (5th Cir.), *cert. denied*, 411 U.S. 951 (1973); United States v. Tropiano, 418 F.2d 1069, 1075-76 (2d. Cir 1969), *cert. denied*, 397 U.S. 1021 (1970).

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The Doctrine of Unconstitutional Conditions states that the government (including state actor) may never grant a privilege subject to the condition that the recipient not exercise a constitutional right; placing such pressure upon constitutional rights is absolutely prohibited under this version of the doctrine.[55]

Accordingly, convincing is the argument that proposed Rule 9523 (relating to Eligibility Proceedings) especially in relation to Rule 8311 (relating to Payment to Unregistered Persons) is unconstitutionally vague, and therefore void, as well as overbroad – chilling a broker/dealer's constitutionally protected common law property right of an employer to "hire, fire, promote, or demote", thereby forcing member firms, *especially Small Broker/Dealers*, to "voluntarily choose not to engage in behavior protected by law or another basic right" (in this instance, the right to hire brokers to increase their interstate securities business protected by the Commerce Clause to the U.S. Constitution)[56] "just to be sure they're not accidentally breaking the overbroad law".

This "chilling" effect violates the Doctrine of Unconstitutional Conditions, as well as violates FINRA member firms' – *especially Small Broker Dealers'* – constitutionally protected conduct under the Commerce Clause. In so doing, proposed Rule 9523 (relating to Eligibility Proceedings) especially in relation to Rule 8311 triggers Regulatory Taking.

3. Whether the Proposal to Amend Rule 8312 (Identifying "Bad Brokers" as former associates of "Disciplined Firms" in a BrokerCheck Disclosure) is Consistent with FINRA's Mission.

FINRA is proposing to amend Rule 8312 to disclose the *status of a member firm* as a "taping firm"[57] under Rule 3170 (Tape Recording of Registered Persons by Certain Firms) through BrokerCheck.[58]

[55] The mention of the phrase "unconstitutional conditions" by the U.S. Supreme Court occurred in Doyle v. Continental Ins. Co., 94 U.S. 535, 543 (1976) (Bradley, J., dissenting) ("Though a State may have the power, if it sees fit to subject its citizens to the inconvenience, of prohibiting all foreign corporations from transacting business within its jurisdiction, it has no power to impose unconstitutional conditions upon their doing so.") *See, e.g.*, Elrod v. Burns, 427 U.S. 347, 359 n.13 (1976); Perry v. Sindermann, 408 U.S. 593, 597 (1972). *See also* L. Tribe, American Constitutional Law, 510 (1978)("government may not condition the receipt of its benefits upon the non-assertion of constitutional rights even if receipt of such benefits is in all other respects a 'mere privilege' "); Hale, Unconstitutional Conditions and Constitutional Rights, 35 Colum. L. Rev. 321 (1935). note 4, at 321 ("a condition attached by a state to a privilege is unconstitutional if it requires the relinquishment of [a] constitutional right"); Danielle Stampley, Comment, New Life for the Doctrine of Unconstitutional Conditions?, 58 Wash. L. Rev. 679 (1983) note 8, at 680 ("The doctrine of unconstitutional conditions prevents the government from conditioning the grant of a benefit upon the waiver of a constitutional right.").

[56] *See* Dennis v. Higgins, 498 U.S. 439, at 448 (1991), *infra*: "The Court has often described the Commerce Clause as conferring a "right" to engage in interstate trade free from restrictive state regulation. *Accord* Boston Stock Exchange v. State Tax Comm'n, 429 U. S. 318 (1977), holding that ***regional stock exchanges*** had standing to challenge a tax on securities transactions as violating the Commerce Clause because, among other things, the exchanges were "asserting their right under the Commerce Clause to engage in interstate commerce free of discriminatory taxes on their business and they allege that the transfer tax indirectly infringes on that right."

[57] Regulatory Notice 18-15, note 5. When a firm hires numerous individuals from a "disciplined firm", the Hiring Firm can become a "taping firm," and be required to tape record all of its registered persons' phone calls with investors.

[58] Under Rule 3170, a member that hires a specified percentage of registered persons from disciplined firms is designated as a "taping firm" and must establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all its registered persons."

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Pursuant to Rule 3170, FINRA already publishes on its website a "Disciplined Firms List" identifying those member firms that meet the definition of "disciplined firm."[59]

FINRA states in Regulatory Notice 18-16 that it believes that disclosing the status of a member firm as a "taping firm" through BrokerCheck will help inform investors of the heightened procedures required of the firm, "which may incent the investors to research more carefully the background of a broker associated with the firm."[60]

FINRA is also clear about its motive: Disclosing the status of a firm as a "taping firm" through BrokerCheck may also further deter firms from hiring or retaining brokers that previously were employed by disciplined firms in order to avoid getting the "taping firm" disclosure on BrokerCheck.[61]

To better inform investors, the *proposed amendment would permit FINRA to release information through BrokerCheck, in general*, as to whether a particular member is subject to the provisions of Rule 3170: That is, whether the member firm (1) is a "taping firm"; (2) is a "disciplined firm"; (3) is a firm that has hired a specified percentage of registered persons from a firm that has already been identified as a "disciplined firm"; and (4) should be "researched more carefully" in regards to the "background of a broker [or brokers] associated with" this "disciplined firm".

As stated in Section 1 of this Comment Letter, FINRA's stated mission is "to provide investor protection and promote market integrity".[62]

And as one Law Commentator has written: "Brokerage is amenable to self-regulation because the harm caused by bad brokers (that is, ones taking too little care or engaging in too much deleterious activity) is primarily borne by the individuals who are in a contractual relationship with the broker."[63]

Aptly, Regulatory Notice 18-16 is captioned, "High-Risk Brokers", and this particular proposed amendment to Rule 8312 clearly aims at informing and ultimately protecting investors against bad brokers by identifying them specifically.

That said, FINRA's proposed amendment to Rule 8312 does need to be read against the backdrop of the SEC's recently expressed intent to create a website that will contain "a searchable database of

[59] FINRA defines "disciplined firm" in Rule 3170(a)(2)(A), in part, as follows: "For purposes of this Rule, the term "disciplined firm" means: (A) a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been ***expelled*** from membership or participation in any securities industry self-regulatory organization or is ***subject to an order of the SEC revoking its registration*** as a broker-dealer; * * * " (Emphasis supplied)

[60] Regulatory Notice 18-16, pp. 13, 21.

[61] Regulatory Notice 18-16, pp. 4, 20.

[62] https://www.finra.org/about/our-mission.

[63] *See* William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, at page 10.

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individuals" who have been barred or suspended as a result of federal securities law violations, according to SEC Chairman Jay Clayton.[64]

Hence there may be some duplication with the SEC effort and the FINRA proposal to amend Rule 8312 identifying "Bad Brokers" and linking them to "Disciplined Firms" in a BrokerCheck Disclosure. It is expected that FINRA would point out that the proposal to amend the Broker/Check disclosure to connect "bad brokers" with "disciplined firms" goes one step beyond the SEC's intended project. In any event, the FINRA proposal aims at intending to be consistent with its mission.

That said, there are legitimate concerns that need to be addressed beyond the duplication issue surrounding the SEC and FINRA effort.

3.A Whether the Proposal to Amend Rule 8312 (Identifying "Bad Brokers" as former associates of "Disciplined Firms" in a BrokerCheck Disclosure) Violates Fundamental Justice.[65]

As the previously cited Law Commentator writes: "The problem that observers encounter in evaluating the efficacy and legitimacy of self-regulation is that the steps to create and enforce a cartel[66] are hard to distinguish from steps necessary to help investors through the policing of bad brokers."[67] (Emphasis supplied)

As this concern relates to the proposed amendment to Rule 8312 identifying "Bad Brokers" and linking them to "Disciplined Firms" in a BrokerCheck Disclosure, the authors of this Comment Letter have this additional concern: What is this going to look like on the *individual's* BrokerCheck, especially when the individual *has no disciplinary history yet works at a* "Disciplined Firm"? In other words, how does FINRA intend to address this *association*?

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[64] *See* Melanie Waddell, Think Advisor, "SEC Creating Searchable Database of Bad Brokers" (November 08, 2017). This intention was announced by SEC Chairman, Jay Clayton, at the Practising Law Institute's 49th Annual Institute on Securities Regulation conference in New York on Wednesday November 8th 2017. Source: https://www.thinkadvisor.com/2017/11/08/sec-creating-searchable-database-of-bad-brokers/. It should be noted that the authors of this Comment Letter has not, as of this writing, located any SEC Press Release on its official website confirming this "searchable database".

[65] This phrase – "fundamental justice" – is a term used by Justice Sonia Sottomayor when she delivered the opinion of the Supreme Court in Peugh v. United States, 569 U.S. __, at 15; 133 S. Ct. 2072 (2013), writing: "… contrary to the dissent's view, *see post*, at 11–13, the Ex Post Facto Clause does not merely protect reliance interests. It also reflects principles of "fundamental justice." *Carmell*, 529 U. S., at 531." (Emphasis supplied).

[66] "*Cartel*, noun, Late 19th century: from German *Kartell*, from French *cartel*, from Italian *cartello*, diminutive of *carta*, from Latin *carta* (card). It was originally used to refer to the coalition of the Conservatives and National Liberal parties in Germany (1887), and hence any political combination; later to denote a trade agreement (early 20th century)." Source: **Google Dictionary** https://www.google.com/search?ei=1TgRW67_F437zgKlpLiACw&q=definition+of+%22cartel%22&oq=definition+of+%22cartel%22&gs_l=psy-ab.12..0l3j0i22i30k1l4j0i22i10i30k1j0i22i30k1l2.2056.2056.0.13361.1.1.0.0.0.0.121.121.0j1.1.0....0...1.1.64.psy-ab..0.1.120....0.tl5iN4NOYmI

Birdthistle and Henderson's use of the word "cartel" (see footnote immediately below) refers to the combination of Self-Regulators, or the combination of FINRA and the SEC, with the object of promoting their common interest, which is, protecting the investing public; but, Birdthistle and Henderson's concern is that, because the line is not a bright line, this mission can cross over into a monopoly that ends up as a tyranny that adversely impacts personal liberty, private enterprise, capital formation, and ultimately the nation's economy.

[67] *See* William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, at page 12.

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That is, if a Hiring Firm becomes a "Taping Firm" by virtue of hiring "bad brokers"[68] from a "Disciplined Firm", *then in the public's mind the Hiring Firm is also a "Disciplined Firm"*. There is little likelihood that the public will drill down through Rule 3170 in order to differentiate "Disciplined Firms" from "Taping Firms". For all intents and purposes, the Hiring Firm now has a *Scarlet Letter*.[69]

But it is not only the Hiring Firm that may be wearing a Scarlet Letter. It could be every associated person at the Hiring Firm – including, especially, brokers with clean records, operations personnel with clean records, compliance personnel with clean records, and senior management with clean records. As the saying goes, "the devil is in the details", and the FINRA proposal does not spell out very clearly what the BrokerCheck Disclosure for will actually look like for brokers with clean records, operations personnel with clean records, compliance personnel with clean records, and senior management with clean records.

We get the general picture: The "disciplined firm" and the "bad broker" will be linked, somehow, on BrokerCheck.

But what will BrokerCheck actually look like in the public's eye for those who are not "bad brokers" as well as for those associated persons who work in operations and compliance departments of "taping firms" – or more accurately, "disciplined firms by association", who, themselves, have no disciplinary history?

In short, what is FINRA going to do to avoid "guilt by association"? This may be an innocent oversight, but this concern is not clearly, if at all, addressed in Regulatory Notice 18-16.

More than two hundred years of Federal jurisprudence, not to mention more than eight hundred years of Common Law jurisprudence,[70] is premised on the fundamental principle of law[71] that the innocent

[68] It bears repeating, here, that it is by no means very clear that a "bad broker" is or should be adjudged "bad" because of arbitration cases being brought against him by "Non-Attorney Representation" firms that are essentially nuisance cases that the broker settles, not because the claimant's case has merit, but because it is more costly to settle than to continue his/her defense. *See* Section 4.A below for complete discussion of the complexity of this problem.

[69] The term "scarlet letter" comes from the Nathaniel Hawthorne novel, The Scarlet Letter: A Romance. Its fundamental theme centers on ***shaming and social stigmatizing***, In the novel, Hester Prynne, a young woman who has given birth to a baby of unknown parentage. She is required to wear a scarlet "A" on her dress when she is in front of the townspeople to shame her. The letter "A" stands for adulteress.

[70] Writing for the U.S. Supreme Court, in Coffin v. United States, 156 U.S. 432; 15 S. Ct. 394 (1895), Justice Edward Douglass White traced the doctrine of presumption of innocence to English common law (i.e., Fortescue, Hale, Blackstone), as well as to American common law (Lilienthal v. United States, 97 U.S. 237; Hopt v. Utah, 120 U.S. 430; Commonwealth v. Webster, 5 Cush. 295, 320; State v. Bartlett, 43 N.H. 224; Alexander v. People, 96 Illinois, 96; People v. Fairchild, 48 Michigan, 31; People v. Millard, 53 Michigan, 63; Commonwealth v. Whittaker, 131 Mass. 224; Blake v. State, 3 Tex. App. 581; Wharton v. State, 73 Alabama 366; State v. Tibbetts, 35 Maine 81; Moorer v. State, 44 Alabama 15) and ultimately back to Ancient Greece, Ancient Rome, Medieval Canon Law, and back to Deuteronomy.

[71] *See* Michael Heyman, Due Process Limitations to Accomplice Liability, 99 Minnesota Law Review 132, 139-140 (2015): "That necessary link between personal fault and criminal liability is too basic, ***too fundamental to even require explanation***. It so inheres in our notion of criminal responsibility as not ***even to require justification***, as we cannot properly assign blame—or even conceive of doing so—in the absence of personal wrongdoing . . . ***substantive Due Process that cannot tolerate punishment without fault*** . . . Perhaps Justice Kagan's language reflects that [citing Rosemond v. United States, 134 S. Ct. 1240 (2014)]. But those comments do not stand alone. ***Analyzing decades of Supreme Court opinions***, one commentator noted that: 'At its core, the rule prohibits 'guilt by association' in the absence of a substantial relationship between the defendant and the third party's criminal activity. An individual cannot be held vicariously liable merely because she associates with a group or third party that commits a crime. There must be a sufficient, 'non-tenuous,' link between her association and the third party's criminal actions.' " (Emphasis supplied) Source: http://www.minnesotalawreview.org/wp-

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are not to be adjudged guilty by nothing more than association[72] with those who are truly guilty. Presumption of innocence is a fundamental principle of American jurisprudence that is centuries older than the Constitution, itself.

If FINRA does not correctly address and more importantly resolve this issue, FINRA risks crossing over from self-regulation designed to protect investors to self-regulation that results in monopoly or worse – *cartelization*, in other words.[73]

4. Whether the Proposal to Amend the NASD Rule 1010 Series (MAP Rules) is Consistent with FINRA's Mission.

FINRA proposes amendments to the Membership Application Program (MAP) rules to impose additional obligations on member firms that associate with persons who have, in the prior five years, either one or more final criminal matters, or two or more "specified risk events". The proposed amendments to the MAP rules would allow FINRA to review and potentially restrict or deny a member firm from allowing such a person to become an owner, control person, principal or registered person.

Under this proposed amendment, whenever a firm seeks to register additional reps – even if only a single rep – the firm is encouraged, but not required, to undertake a "materiality consultation" or MatCon with FINRA for each rep who has "one or more final criminal matters or two or more specified risk events" in the five years prior to registering the individual(s).

That said, if the firm registers a "bad broker", without first undertaking a materiality consultation, the firm risks violating its membership agreement with FINRA, triggering enforcement proceedings.

The proposed rule enumerates certain "bad broker" criteria. If the individual falls within this criteria, the firm's "materiality consultation" will invariably conclude that the addition of this broker constitutes a material change to the firm's membership agreement with FINRA. This, in turn, triggers need for the firm to file a continuing membership application (CMA) with FINRA under Rule 1017.

If during the "materiality consultation" FINRA determines that the "change" (that is, the hiring of a broker) is not material (because the hired broker is not a "bad broker"), the registration of the subject individual does not trigger a 1017 CMA with FINRA's MAP program.

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content/uploads/2015/08/Heyman_1fmt1.pdf, *citing* Alex Kreit, Vicarious Criminal Liability and the Constitutional Dimensions of Pinkerton, 57 AM. U. L. REV. 585, 606 (2008).

[72] The U.S. Supreme Court has declared guilt-by-association "alien to the traditions of a free society and the First Amendment itself". NAACP v Claiborne Hardware, 458 US 886, 932 (1982). In Scales v United States, 367 US 203, 225-226 (1961), the Supreme Court stated: "***In our jurisprudence guilt is personal***, and when the imposition of punishment on a status or on conduct can only be justified by reference to the relationship of that status or conduct to other concededly criminal activity, … that relationship must be sufficiently substantial to satisfy the concept of personal guilt in order to withstand attack under the Due Process Clause of the Fifth Amendment." (Emphasis supplied)

[73] *See* William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, at page 12.

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In other words, the proposed amendment will make the Safe Harbor for Business Expansions set forth in IM-1011-1 unavailable to a firm that seeks to register a potentially "bad broker" – that is, a broker who has "one or more final criminal matters or two or more specified risk events" in the five years prior to registering the individual(s).[74]

Because this proposed amendments to the NASD Rule 1010 Series (MAP Rules) aims at keeping "bad brokers" from participating in the securities industry; and, because FINRA's mission is "to provide investor protection and promote market integrity", these proposed amendments appear to be consistent with this mission.

But there is another aspect of the proposed amendments to Rule 1010 Series (MAP Rules) that needs to be seriously considered.

We believe that FINRA should disregard, for purposes of the proposed amendments to the Rule 1010 Series (MAP Rules), any consideration of arbitrations brought against a broker by a "Non-Attorney Representative" "stock loss recovery" firm (such as but not limited to Cold Springs Advisory Group), no matter what the dollar amount of the settlement.

Based on our assessment of and reliance on fundamental law, "nuisance-value" cases brought by Non-Attorney Representative "stock loss recovery" firms should always be held suspect for reasons explained in Section 4.A *infra* – and therefore should be excluded from MAP consideration – precisely because, to not do so, detracts from FINRA's legitimate mission.

4.A <u>Whether FINRA Should Exclude Certain Arbitration Settlements Entirely From "Materiality" Considerations in the Proposal to Amend the NASD Rule 1010 Series (MAP Rules).</u>

Appreciating the severity of proposed MAP measures, FINRA aims at bringing things into a more equitable balance by deciding that, when a customer complaint triggers a "specified risk event" for FINRA consideration, only "final" customer complaints will be considered – customer arbitration <u>awards</u> or civil <u>judgments</u> or <u>settlements</u>. FINRA has set the finality of these events at "in excess of \$15,000".[75]

While "finality" of customer initiated arbitration awards and civil judgments, arguably, helps bring back into balance the scales of justice, the settlement of arbitration and civil lawsuits at, below, ***or above*** the \$15,000 threshold does not, ***when the underlying case is a "nuisance-value" case.***

[74] Regulatory Notice 18-16, pp. 13, 14.

[75] Regulatory Notice 18-16, pp. 21, 25, especially note 50.

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"Nuisance-value" cases are claims without legal merit. These are routinely brought against brokers with a specific litigation strategy in mind: That being, from the time of retaining the customer and filing the statement of claim, the representative (attorney or otherwise), knowing that the claim has no merit, goes ahead with filing the claim anyway with the express and deliberate intent of maneuvering the broker into ***settling the claim at or near the FINRA U-4 Reporting threshold amount*** (currently at $15,000) short of going to trial.

Advocates who bring "nuisance-value" claims (whether in arbitration or in a judicial forum) on behalf of customers know right-out-of-the-gate that, while their case has no merit in the law, the case ***does have economic value*** as far as the opponent (broker) is concerned – namely the cost of retaining legal counsel for defense against the claim, payment of court or arbitration filing costs, payment of mediator/arbitrator fees, ***plus that intangible value to the broker of*** "just making the customer go away").

As one Law Commentator has bluntly put the matter in plain English:

> All this fuss is still about the same thing: there are lots of reps in the industry who are fantastic, who provide a wonderful service to their clients, but who have to deal with the fact that they live in a day and age in which it is ridiculously easy for a customer to lodge a complaint and exact a nuisance settlement from the BD, resulting in a permanent mark on the reps' U-4. Granted, there are also reps with marks on their U4s who are bad apples, true recidivists who don't care about rules or fiduciary duty or suitability or whatever. But, the problem is that FINRA cannot distinguish between these two groups, so its solution is to treat them all the same, which is, in essence, to presume everyone is a bad apple.[76] (Emphasis supplied)

Litigation lawyers – plaintiffs'/claimants' counsel and defense counsel, alike – understand this. Plaintiffs'/claimants' counsel understand that, ***whatever*** the dollar threshold set by FINRA (currently set at $15,000) can be exploited for settlement purposes in ***their*** favor in "nuisance-value" cases.

FINRA's point – that the "proposed $15,000 threshold for customer settlement corresponds to the reporting threshold for the Uniform Registration Forms and for the settlement information to be displayed through BrokerCheck [and as] a result, brokers and firms already have incentives to settle below the $15,000 amount[77] – is one-sided to a fault. FINRA fails to take into consideration what really happens when a "nuisance-value" case is brought against a broker: *It is plaintiff's/claimant's counsel who is seeking to exploit whatever the reporting threshold turns out to be.*

The "nuisance-value" claimant already knows that his case lacks merit and therefore, as a matter of law, is *worthless*. The "nuisance-value" claimant, therefore, wants to get as much money as he can, as close to this reporting threshold (currently, the $15,000) figure as possible, knowing that the broker is very likely "to put something on the table just to make the claimant go away". Therefore, ***a worthless***

[76] Alan Wolper, Esq., FINRA Knows Best – At Least According To FINRA – When It Comes To Hiring Decisions (4 May 2018) https://www.bdlawcorner.com/2018/05/finra-knows-best-at-least-according-to-finra-when-it-comes-to-hiring-decisions/

[77] Regulatory Notice 18-16, note 50.

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case has economic value just shy of whatever the FINRA reporting threshold is (again, currently $15,000).

In short, the U-4 requirement settlement reporting requirement just below the reporting threshold (currently, $15,000) ***incentivizes, first and foremost, the "nuisance-value" claimant.*** It incentivizes the claimant to get the broker to settle when the broker shouldn't be settling at all.

If the $15,000 threshold incentivizes the broker at all, it incents the broker to opt for being practical over trying his hand at playing Don Quixote: Instead of the latter, the broker pays a hefty price (in terms of money plus reporting of a bogus DRP[78]) despite being not at all at fault, "just to make the case go away" so that the broker can focus again on his securities business without anxiety, interruption, and disruption of his daily routine, which is so essential to earning a living.

FINRA's preconception that brokers settle, or attempt to settle, all cases just below the $15,000 in order to avoid DRP reporting fails to account for the reality in the practice of law that many, if not most, of these broker cases settle even though they have no merit whatsoever; they settle precisely because the high cost of defending the claim, both in terms of money as well as intangibles like anxiety and distraction of one's focus from conducting business day-to-day, makes settlement of "nuisance-value" cases "always the better option".[79] Practitioners of "barratry" know this.[80]

Accordingly, a case that has no merit violates fundamental justice precisely because justice is not its objective – exploiting economic value of a case that has no merit and therefore no legal value is the objective of a "nuisance-value" case. For this reason, "nuisance-value" cases should not be included in the MAP Rules calculus, as a matter of public policy.

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[78] DRP stands for "Disclosure Reporting Pages", which are pages on Form U-4 where a broker is required to report certain disciplinary related disclosures. Effectively, these DRPs are equivalent to a Scarlet Letter.

[79] *See* David Rosenberg and Randy J. Kozel, Solving the Nuisance-Value Settlement Problem: Manadatory Summary Judgment, 90 Virginia Law Review 1850, 1851-1852 (2004): "***The civil justice system is rife with situations in which the difference in cost between filing and ousting meritless claims or defenses makes the nuisance-value strategy profitable***" (emphasis supplied) *citing* Laurino v. Syringa Gen. Hosp., 279 F.3d 750, 758 (9th Cir. 2002) (Kozinski, J., dissenting) ("By paying a $150 filing fee (and then sitting back), plaintiff launched a lawsuit that dragged on for over thirteen months and caused defendants to spend over $10,000, not including the time they spent on the rule 60(b) motion, the motion for reconsideration or this appeal."). This Law Commentator continues: "How big is the problem of nuisance-value litigation? Reported instances of abuse abound. See, e.g., Burlington Indus. v. Dayco Corp., 849 F.2d 1418, 1422 (Fed. Cir. 1988) (characterizing the frequent filing of groundless charges of inequitable conduct in patent cases as an "absolute plague"); Restatement (Second) of Contracts § 176 cmt. d (listing cases refusing enforcement of settlement agreements in frivolous suits on grounds of duress); Barry F. McNeil & Beth L. Fancsali, Mass Torts and Class Actions: Facing Increased Scrutiny, 167 F.R.D. 483 (1996) (asserting that defendants in the asbestos litigation are being pressured by high litigation costs to settle non-meritorious claims in both separate and class action contexts); Jonathan D. Glater, California Says State Law Was Used as Extortion Tool, N.Y. Times, Apr. 5, 2003, at A8 (discussing a California law firm alleged to have ***filed lawsuits against "thousands of small businesses" to extract nuisance-value settlements***). This experience has prompted calls for stronger judicial and regulatory efforts to deal with the nuisance-value settlement problem. *See, e.g.*, Warren E. Burger, Annual Report on the State of the Judiciary-1980, 66 A.B.A. J. 295, 296 (1980) (focusing attention of trial judges on problem of frivolous litigation). Notable recent responses include the 1983 and 1993 revisions of Federal Rule of Civil Procedure 11 and The Private Securities Litigation Reform Act of 1995, 15 U.S.C. §§ 77z-1-78u-5 (2000). Despite the general consensus that a problem exists, there is a paucity of empirical research substantiating its extent. ***Notably, the field of securities litigation*** has yielded studies of both class and separate actions. *See, e.g.*, Roberta Romano, The Shareholder Suit: Litigation without Foundation?, 7 J.L. Econ. & Org. 55 (1991); Eric Helland, A Secondary Market Test of the Merits of Class Action Securities Litigation: Evidence from the Reputation of Corporate Directors, (Contracting and Organizations Research Institute, Working Paper No. 2004-05, 2004), at http://ssm.com/abstract=517183 (on file with the Virginia Law Review Association).

[80] See Section 6.B below for more detailed discussion.

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Admittedly, both FINRA and the industry venture into murky waters when attempting to draw a "settlement dollar amount" bright line for purposes of when to report and when not to report an "arbitration settlement" for purposes of proposed MAP Rules.

That said, there is a certain group of "Nuisance-value cases" that FINRA should exclude from the proposed MAP rule, as a matter of policy. This should be done in order to remedy or set right the inequity of allowing "Nuisance-value cases" to be brought in FINRA Arbitration by non-lawyer "arbitration mills", otherwise known in the securities industry as "Non-Attorney Representative" stock loss recovery firms or NARs,[81] precisely because customers in these cases do not have the protections afforded the public when brought by attorneys subject to the oversight of their respective State Supreme Court disciplinary arms.

Research has been conducted on the FINRA Arbitration website on the cases brought by Cold Spring Advisory Group. The results are as follows and the supporting documentation appears as Appendix A to the Comment Letter:

- During the review period (1 January 2016 to 27 June 2018), there were 35 cases that Cold Spring Advisory brought to arbitration on behalf of the customers.

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[81] For example, Cold Spring Advisory Group. The Cold Spring Advisory Group *modus operandi* appears to be set forth in a recent lawsuit brought against Cold Spring Advisory Group LLC. The case is Hilton M. Weiner vs. Frank Mulligan, Marianne Mulligan, Cold Spring Advisory Group, LLC, Jennifer Tarr, et al., Supreme Court of New York, Suffolk County, Dkt. Index No. 602501/17, filed 18 April 2017, https://securitiesarbitrations.com/wp-content/uploads/2017/09/HWSUIT4.pdf

- Cold Spring Advisory Group is not a law firm but a Nevada limited liability company; is owned by a former executive officer of EKN Financial Services, a former broker/dealer that was expelled from its FINRA membership in 2015 for violating federal and state securities laws as well as FINRA rules and SEC regulations. In 2017, this owner himself was barred from associating with any FINRA member broker/dealer in any capacity. (¶4, ¶14 of Plaintiff's Complaint).

- Cold Spring Advisory Group engages in telemarketing practices that targets individuals from around the world who at one time or another maintained an account or accounts at FINRA member broker/dealer firms located in the United States. (¶15 of Plaintiff's Complaint).

- Cold Spring Advisory Group "pitches" FINRA arbitration to the recipient at the other end of the call for the recovery of losses in the recipient's account (hereafter, "client"). (¶16 of Plaintiff's Complaint).

- Cold Spring Advisory Group requires the "client" to pay a substantial sum of money up front to conduct forensics study of the "client's" account with the FINRA member broker dealer, charging the "client" anywhere from $10,000 to $25,000 for this forensics investigation. (¶16, ¶18 of Plaintiff's Complaint).

- Cold Spring Advisory Group then refers the "client" to an attorney duly admitted to practice the law in the appropriate jurisdiction; the attorney works the case pursuant to a Legal Services Contract (usually, a contingent fee arrangement) with the "client"; and then Cold Spring Advisory Group contacts the "client" and convinces the "client" that the "client" would be better served by withdrawing his/her contingent fee arrangement with the lawyer and, instead, allow Cold Spring Advisory to take over the case, raising the "client's" expectation that the case will be more expeditiously settled. (¶19 through ¶31 of Plaintiff's Complaint).

- Cold Spring Advisory Group would then proceed to negotiate a settlement of the "client's" FINRA Arbitration case through FINRA mediation, in effect keeping the $10,000 - $25,000 "forensics" investigation and then taking a percentage of the "client's" mediation / settlement arrangement, cutting out the attorney's share that would have been paid via the Legal Services Contract, as evidenced by seven (7) other similar cases referenced in ¶80 of Plaintiff's complaint.

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- There were twenty-five (25) cases that meet the criteria for "nuisance-value lawsuits",[82] or 71.428%
- There were three (3) cases that meet, in-part, the criteria for "nuisance-value lawsuits", or 8.572%
- There are seven (7) cases that did not meet the criteria for "nuisance-value lawsuits", or 20.000%

- At least two (2) cases were dismissed because Cold Spring Advisory Group engaged in the unauthorized practice of law under the laws of Arizona and Kansas law.
- There were four (4) cases where the arbitration panel granted expungement.

In the meantime, here are a few of the many reasons why arbitration cases brought by NARs should not be considered whatsoever by FINRA for MAP purposes:

- Whenever a NAR is allowed to bring a customer claim against a broker in FINRA arbitration, FINRA facilitates this non-lawyer in the unauthorized practice of law.[83]
- Often, the final outcome of the case is detrimental to the very investors whose mission it is for FINRA to protect.[84]
- The "advocate" acting on behalf of the NAR representing a customer in FINRA arbitration is not an attorney admitted to the Bar(s) in any jurisdiction in the United States, and therefore has no formal legal advocacy training and no formal

[82] Again, any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

[83] *See e.g.*, In Disciplinary Counsel v. Alexicole Inc., 822 N.E.2d 348 (Ohio 2004), an Ohio court enjoined a corporation owned by a layperson from representing clients in arbitrations venued in Ohio. In that case, a non-lawyer was found to be engaging in the unauthorized practice of law when he "regularly prepares statements of claim, conducts discovery, participates in prehearing conferences, negotiates…settlements, and participates in mediation and arbitration hearings, all on behalf of Alexicole clients." That being the case, FINRA arguably facilitates the unauthorized practice of law, at least in the State of Ohio, whenever a non-lawyer represents a customer in FINRA arbitration. *See also* Illinois State Bar Association Professional Advisory Opinion, Opinion No. 13-03 (January 2013), advising ***attorneys who assist non-lawyers representing customers in FINRA arbitration*** run the risk of violating the Illinois prohibition against ***facilitating the unauthorized practice of law***. Source: http://lawprofessors.typepad.com/files/ill.13-031.pdf. Ergo: if a lawyer facilitating a non-lawyer in FINRA arbitration equals facilitating unauthorized practice of law, should not FINRA be held to same standard since FINRA is the forum that facilitated the lawyer for doing so? This may be the next unanswered question to be decided by the courts, namely, that by allowing NARs to arbitrate cases in the FINRA arbitration forum FINRA either engages in or facilitates the unauthorized practice of law.

[84] Again, FINRA's mission is "to provide investor protection and promote market integrity". Source: https://www.finra.org/about/our-mission. ***But see*** A Menace to Investors: Non-Attorney Representatives in FINRA Arbitration, Andrew Stoltmann, Stoltmann Law Offices, Chicago, Illinois; and David Neuman, Partner, Israels & Neuman PLC, Seattle, Washington: "NARs [non-attorney representatives] have been alleged to have ***charged investors $25,000 in non-refundable deposits for representation***; ***taken settlement money that the investors were not aware of***; and represented ***some investors without their consent***. FINRA is fully aware of these issues. In October 2017, FINRA Director of Dispute Resolution, Richard Berry, discussed these allegations in a public forum. FINRA is not alone in recognizing the problems associated with NARs - ***the SEC have*** [sic] ***also warned the public about "recovery companies" that charge a fee to assist individuals to recover money from investment scams***." At page 6 Source: https://piaba.org/system/files/2017-12/PIABA%20Report%20-%20Non-Attorney%20Representatives%20%28December%2018%2C%202017%29.pdf

In support of these statements, these authors cite: Rita Raagas de Ramos, FINRA Warns Against Rogue Non-Lawyer Reps, FINANCIAL ADVISOR IQ (Oct. 13, 2017); What You Should Know About Asset Recovery Companies, SEC (Aug. 9, 2016)] and NASAA (the North American Securities Administrators Association) [citing Securities Industry Conference on Arbitration, Report on Representation of Parties in Arbitration by Non-attorneys, 22 FORDHAM URB. L.J. 507, 512 (1995); Ariel Kaminer, Swatting at Wall Street from a Bunker in Brooklyn, N.Y. TIMES (May 21, 2010) (quoting one defense lawyer as stating that dealing with a particular NAR "is one of the most frustrating experiences I've ever dealt with…It's like hondling at a flea market with these guys"); Adam J. Gana, Should Non-Attorneys Represent Parties in FINRA Arbitration for Compensation?, NYSBA JOURNAL (Jan. 2015); Aegis J. Frumento & Stephanie Korenman, Rethinking Non-Lawyer Advocacy in FINRA Customer Arbitrations, SECURITIES ARBITRATION COMMENTATOR Vol. 16, No. 8 (Mar. 2017)

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license evidencing an objectively ascertainable threshold of knowledge of the law in regards to both the law of securities, law of pleading, and law of evidence, and other relevant areas of the law.

- As a result, the "advocate" representing a customer in FINRA arbitration is not subject to liability for damages and professional license penalties for engaging in abuse of process, malicious prosecution, and/or filing frivolous arbitration (i.e., bringing a meritless claim) against a broker, which conduct is actionable at common law, under statutory law, and prohibited by the Codes of Professional Responsibility adopted by the several States' Supreme Courts.[85]

- The "advocate" represents customers in FINRA arbitration in the several States, yet is not or is rarely prosecuted for engaging in the unauthorized practice law, which means the "advocate" generally "flies under the radar" as far as consumer protection is concerned, and therefore FINRA facilitates this avoidance of consumer protection.

- The "advocate" acting on behalf of a NAR is permitted under FINRA rules to file arbitration in a State where an attorney cannot represent his broker client: That is, non-lawyers can represent a claimant in a State [e.g., New York] without fulfilling any requirement to be admitted to the Bar in that State [e.g., New York] but, because the attorney is duly admitted *in the States of Connecticut or Maine*, the attorney is precluded from representing his client broker in the FINRA forum located in New York since the attorney is not admitted in that State [i.e., New York]:[86] This is an absurd result.[87]

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[85] *Compare* how the State courts and legislatures handle Vexatious Litigants. *See* Brett Herbert, Serial Suers and Vexatious Litigants: Can Courts Prevent Someone From Filing a Lawsuit? (July 5, 2017) ("The Court ultimately adopted the Fourth Circuit Court of Appeals' (the federal circuit court of appeals that encompasses Virginia) framework and held that pre-filing injunctions are appropriate in certain circumstances. The Court decided that the factors a court should look at in determining whether to enter a pre-filing injunction are: (i) a history of filing vexatious and duplicative lawsuits, (ii) without any good faith basis, (iii) at the expense of opposing parties and the court system, and (iv) the adequacy of alternative sanctions to stop the abuse. The Court specifically noted that ***imposing sanctions (monetary and other penalties) against Ms. Adkins would not be sufficient to curb the abuse because she could still persist in filing pleadings*** even if sanctions were imposed. After considering all of these factors, the Court imposed the pre-filing injunction against Ms. Adkins. Accordingly, ***Ms. Adkins is prohibited from filing any further pleading whatsoever with the Court unless she (i) hires a Virginia attorney, or (ii) obtains permission from the Court. Vexatious litigants are a real and expensive problem in the legal system.***") (Emphasis supplied) Source: https://estateconflicts.com/serial-suers-and-vexatious-litigants-can-courts-prevent-someone-from-filing-a-lawsuit/. The State of Nevada maintains a Vexatious Litigants List..Source: https://nvcourts.gov/AOC/Administration/Judicial_Council/Vexatious_Litigant_List/ (click Download Vexatious Litigant List). The State of California likewise maintains a Vexatious Litigant List. Source: http://www.courts.ca.gov/12272.htm (click Vexatious Litigant List).

[86] New York, allows NARs to represent investors as long as the forum's (FINRA's) rules allow such representation. Yet, an attorney admitted to the Connecticut or Maine Bar cannot represent a broker unless the attorney is also admitted to the New York Bar. *See* DePalo v. Lapin, Index No. 114656/2008 (Sup. Ct. NY June 30, 2009) (stating that "New York has no prohibition which would have prevented Lapin from representing an individual in a FINRA arbitration") (citing Williamson v. John D. Quinn Construction, 537 F.Supp. 613, 616 (S.D.N.Y. 1982) (noting that under New York law representation of a party in an arbitration proceeding by a non-lawyer does not constitute the unauthorized practice of law). *And see* In re Glatthaar, No. CV054015630, 2005 WL 3047275, at *1 (Conn. Super. Ct. Oct. 24, 2005) (finding that Connecticut's *pro hac vice* admission procedures did not apply to arbitrations, thus the court could not allow the New York attorney to represent his clients in Connecticut arbitration). *See also* Committee on Arbitration, Unauthorized Practice of Law and the Representation of Parties in Arbitrations in New York by Lawyers Not Licensed to Practice in New York, 63 THE RECORD OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK 700, at 730 (June 2008) (noting that a state court in Maine held that no rule or statute permitted the court to grant permission to out-of-state attorneys to practice before arbitrators) (citing State v. Shimko, No.CV-06-053, at *3 (Me. Super. Ct. Apr. 26, 2006)). For those States that are silent on this issue, *see* Andrew Stoltmann and David Neuman, A Menace to Investors: Non-Attorney Representatives in FINRA Arbitration, p. 9. Source: https://piaba.org/system/files/2017-12/PIABA%20Report%20-%20Non-Attorney%20Representatives%20%28December%2018%2C%202017%29.pdf

[87] There is an ancient common law principle called "the absurd result principle": "The Law Abhors an Absurd Result". *See* K Mart Corp. v. Cartier, Inc., 486 U.S. 281, 324 n.2 (1988) (Scalia, J., concurring in part and dissenting in part) ("[I]t is a venerable principle that a law will not be interpreted to produce absurd results.") and notes 108-11 (discussing how judicial use of absurd result principle involves notions of ***rationality and common sense***):

> "[I]t is a venerable principle that a law will not be interpreted to produce absurd results."The common sense of man approves the judgment mentioned by Puffendorf, that the Bolognian law which enacted 'that whoever drew blood in the streets should be punished with the utmost severity,' did not extend to the surgeon who opened the vein of a person that fell down in the street in a fit. The same common sense accepts the ruling, cited by Plowden, that the statute of 1st Edward II, which enacts that a prisoner who breaks prison shall be guilty of felony, does not extend to a prisoner who breaks out when the prison is on fire-'for he is not to be hanged because he would not stay to be burnt." KMart Corp

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- Despite the fact that FINRA's mission is "investor protection", FINRA, pointedly, does not disclose to the investing public on an especially identifiable web page that the ***owners*** of many/most of these "Non-Attorney Representative" "stock loss recovery" firms have been ***barred*** from associating with FINRA member firms or otherwise ***expelled*** from the industry.[88]
- At this time, FINRA's only "sanction" against NARs is a *caveat emptor* to the investor.[89]
- Despite the fact that FINRA does not specifically point out to the investing public that the owners of many of these "Non-Attorney Representative" (NAR) "stock loss recovery" firms have been barred from associating with any FINRA member firms in any capacity, FINRA still allows their "Non-Attorney Representative" "stock loss recovery" firms to continue to conduct business in the FINRA arbitration forum as non-attorney advocates for customers – even though lawyers whose licenses are suspended in the FINRA venue are not permitted to represent their broker clients.[90]

In short, the NAR has nothing to lose and everything to gain when it files a "nuisance-value case" in FINRA arbitration. For these reasons, any arbitration brought *by any* "Non-Attorney Representative" should be excluded from FINRA calculation in the proposed amendments to the Membership Application Program (MAP) rules.

Whenever any "Non-Attorney Representative" firm (such as but not limited to Cold Spring Advisory Group) brings and settles a claim with a broker, the presumption should not be that the broker is a "bad apple", for all the reasons that have been set forth in this Section 4.A.

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v. Cartier, Inc., 486 U.S. 281,325 (1988) (Scalia, J., concurring in part and dissenting in part) (quoting United States v. Kirby, 74 U.S. 482, 487 (1868)).

[88] If the investor knows the name of the owner of a particular NAR, the investor of course can search FINRA Broker/Check. But, given the fact that the NAR is acting in the public forum ***as if it were a law firm***, it is not immediately obvious to the investor that he/she should search the owner of the NAR for broker violations on BrokerCheck. That said, the Public Investors Arbitration Bar or PIABA ***has*** issued such an investor alert that should be issued by FINRA: Non-Attorney Representatives Are Real and Growing "Menace to Investors" in FINA Arbitration: NAR Firms Found to Include Individual Who Pled Guilty in Insurance Scheme and Brokers Barred from Industry: Unwary Investors have None of the Protections of Dealing with Attorneys and Often Recover Little of Lost Funds. (December 18, 2017, 13:57 ET). Source: https://piaba.org/piaba-newsroom/report-nar In this alert, PIABA summarizes the disciplinary history of the owners of and key figures in (1) Cold Spring Advisory Group; (2) Stock Market Recovery Consultants; (3) Investors Arbitration Specialists; (4) Investors Recovery Service; and (5) Vindication Recover Services. The PIAB specifically point out that ***"Non-attorney representatives often do not maintain malpractice insurance, have no ethical code or constraints like attorneys do not face potential sanctions from any regulatory or licensing body like a state bar association. Essentially, this system exposes the investor who was victimized by his or her broker to potential further victimization, with little chance of recovering damages caused by an unscrupulous or negligence NAR."*** (Emphasis supplied)

[89] *See* FINRA Investor Alerts, It Can Be Hard to Recover from "Recovery" Scams: (19 September 2016) Source: https://www.finra.org/investors/alerts/it-can-be-hard-to-recover-from-recovery-scams "It's an alluring offer. You hear from someone who claims to be able to help you recover money you lost from a previous investment. The information sounds credible and the organization sounds legitimate. Documents you receive also look authentic, and the money that's promised is not only welcome, but seems well-deserved compensation for previous losses. The catch? They want you to pay money upfront for the recovery "services," which in some cases are purely fraudulent. In addition to the original money you lost, you now may lose more money at the hands of professional con artists." (19 September 2016) (Emphasis supplied)

[90] Note also that FINRA would ***not*** allow to practice before FINRA arbitration those ***attorneys whose law licenses are suspended. See*** FAQ - Arbitration & Mediation Rules, Question No.1: "Parties to an arbitration or mediation may represent themselves o***r be represented by an attorney admitted to practice and in good standing in any jurisdiction***." Source: http://www.finra.org/arbitration-and-mediation/faq-rules-faq. Attorneys who are not in "good standing" are attorneys whose law license has been suspended. ***Thus suspended attorneys cannot practice in FINRA Arbitration but owners of NARs who are themselves barred from the industry can engage in the unauthorized practice of law in FINRA arbitration***! Once more: "The Law Abhors an Absurd Result". *See* K Mart Corp. v. Cartier, Inc., 486 U.S. 281, 324 n.2 (1988).

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Because this proposed amendments to the NASD Rule 1010 Series (MAP Rules) aims at keeping "bad brokers" from participating in the securities industry, FINRA should not treat good brokers as bad brokers: Thus, when certain settled cases are founded on illegal grounds – cases lacking in merit brought by non-lawyers engaged in the unauthorized practice of law with no risk of penalty or liability for bringing frivolous claims – FINRA is encouraged to disregard, as a matter of policy, any consideration of arbitrations brought against a broker by a NAR, ***no matter what the dollar amount of the settlement is.***

For these reasons, FINRA Should Exclude "Non-Attorney Representative" stock loss recovery firm Arbitration Settlements entirely from "Materiality" considerations in the proposal to amend the NASD Rule 1010 Series (MAP Rules).

4.B Whether the Proposal to Amend the NASD Rule 1010 Series (MAP Rules) Amounts to Taking of Property thereby Making FINRA a "State Actor".

One Law Commentator has recently queried: "Under current case law, it is unclear ***what it would take*** to make FINRA a state actor subject to constitutional claims."[91]

The answer to this question may be that the proposed amendments set forth in Regulatory Notice 18-16, starting with the proposed amendments to the NASD Rule 1010 Series affecting the MAP rules, gives answer to this question. Why? Because the proposed amendments to the NASD Rule 1010 Series will grant FINRA powers (much broader than those already possessed by FINRA) to dictate *whom* member firms are permitted hire, and also *how many* brokers a firm may hire.

Right now, FINRA does not interfere with whom a member hires, and interferences, only somewhat, with the number of new hires that member firms can register.

Currently, the Safe Harbor for Business Expansions, as set forth in IM-1011-1, does limit the number of new hires that a member firm can register, but this limitation is mathematically formulated (and therefore, in the main, objective) and is also progressive in the sense that a member firm can, generally speaking, increase annually the number of brokers it can hire without seeking any formal approval from FINRA. If the broker turns out to be a "bad apple", FINRA can ultimately, through its enforcement process, suspend or even bar the broker from association with any FINRA member firm. But a so-called "bad broker" is not currently precluded *a priori* from being hired by a FINRA member firm. When all the dust settles, right now it is the member firm who is in charge of *whom* it hires and, for the most part, *how many* brokers the firm hires.

The proposed amendments would change this. If the SEC approves the proposed amendments to the NASD Rule 1010 Series, it will be FINRA – not the member firm – ***that holds the power to hire.***

[91] *See* Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 23-24, *citing* Michael Deshmukh, Is FINRA a State Actor? A Question That Exposes the Flaws of the State Action Doctrine and Suggests a Way to Redeem It, Vanderbilt Law Review 67, no. 4 (2014), at 1173.(Emphasis supplied)

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This may seem to be a matter of insignificant nuance, but it is not. This proposed change opens the door to ramifications that will change the course of the economic freedom inherited from our common law and therefore transform the status of FINRA as a "self-regulatory organization" to "government regulator". As one Law Commentator states the case: "As FINRA expands its regulatory reach beyond broker-dealer oversight, it will look even less like an SRO and more like a governmental regulator."[92]

We begin with basics: Economic Freedom.

At common law, the role of government was to enforce, not interfere with, contracts. This means that, at common law, an employer would not be prohibited from hiring, firing, promoting, or demoting whomever he wants and for whatever reason he wants.[93] Fundamentally, this is a question of property rights, according to common law. Common law respects and reinforced the principle that, "if another person owns a business, I do not have a right to interfere with his choices as to what he does with his property".[94] That said, today we have seen this principle whittled away by the condition subsequent: "so long as the employer does not interfere with statutes and regulations of the government regulating the labor market."

And so, today we know that government can and does step in the hiring and firing, promotion and demotion process, when an employer discriminates based on race, color, religion, sex, or national origin.[95] As a result, an employer cannot fire an employee because of an employee's inability to work on Saturdays when the employee chooses to honor Saturday as a Sabbath on religious conviction.[96] Employers can suffer liability for damages when failing to promote an employee because of her gender, despite qualifications.[97] And more recently, state governments have entered into the "hiring,

[92] Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 24. https://www.mercatus.org/system/files/Peirce-FINRA.pdf

[93] *See* Clyde W. Summers, Employment At Will in the United States: The Divine Right of Employers, 3.1 U. PA. Journal of Labor and Employment Law 65 (2000): "The Tennessee Supreme Court articulated the employment at will doctrine in 1884, thus endowing employers with divine rights over their employees. This doctrine has been, and still is, a basic premise undergirding American labor law. The United States, unlike almost every other industrialized country and many developing countries, has neither adopted through the common law or by statute a general protection against unfair dismissal or discharge without just cause, nor even any period of notice." Source: https://www.law.upenn.edu/journals/jbl/articles/volume3/issue1/Summers3U.Pa.J.Lab.&Emp.L.65(2000).pdf
And see Howard Johnson Co. v. Detroit Local Joint Executive Board, 417 U.S. 249 (1974) where selling-company (or transferor), had a collective agreement which prohibited discharge without cause and provided for arbitration of discharges. When the buying-company (or transferee) refused to continue to employ many of the employees, the union sought arbitration of their discharge. The Supreme Court held that the transferee (i.e., the new employer) had the right not to hire any of the transferor's (i.e., the former employer's) employees, and that the transferee/new employer was not bound by the transferor/old employer's collective agreement to arbitrate.

[94] *See* David J. Mitchell, Government Intervention in Labor Markets: A Property Rights Perspective, 33 Villanova Law Review 1043, 1051 (1988). https://digitalcommons.law.villanova.edu/cgi/viewcontent.cgi?article=2620&context=vlr

[95] 42 U.S.C. Section 200003-2 (1982).

[96] Drazewski v. Waukeegan Dev. Center, 651 F.Supp. 754 (N.D. Ill. 1986).

[97] Thurber v. Jack Reilly's, Inc., 521 F.Supp. 238 (D.Mass. 1981), *aff'd*, 717 F.2nd 633 (1st Cir. 1983), *cert. denied*, 466 U.S. 904 (1984).

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firing, promoting, or demoting" arena, with at least 25 States having passed one form or another of "right-to-work" laws.[98]

The point here is that, *interfering* with an employer's traditional common law prerogative of "hiring, firing, promoting, or demoting" *is precisely what state and federal governments do* these days. Interfering with an employer's traditional common law prerogative of "hiring, firing, promoting, or demoting" is an accepted action of the state.[99] It is "state action" pure and simple.

And the point here is that the proposed amendments to the NASD Rule 1010 Series giving FINRA power to dictate *whom* member firms are *can* hire drags FINRA across the threshold of becoming a "state actor".

Next basic: Governmental Regulator.

FINRA has consistently maintained that it is not a "state actor" – despite the fact that, in *Standard Investment Chartered Inc. v. National Association of Securities Dealers*, NASD (now FINRA) affirmatively argued and the Second Circuit U.S. Court of Appeals agreed that FINRA and its predecessor organization (NASD and NYSE) *are government actors* on grounds that "... The statutory and regulatory framework highlights to us the extent to which an SRO's bylaws are intimately intertwined with the regulatory powers delegated to SROs by the SEC ..."[100] (Emphasis added).

It should be noted that, in *Standard Investment*, FINRA wanted the Court to hold that FINRA is a "government actor" because, in that lawsuit, FINRA wanted immunity from private lawsuits. This benefit notwithstanding, FINRA has consistently maintained that it is not a "state actor".[101]

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[98] *See* National Conference of State Legislatures, Right-to-Work Resources, http://www.ncsl.org/research/labor-and-employment/right-to-work-laws-and-bills.aspx#chart

[99] *See generally* Daniel J. Mitchell, Government Intervention in Labor Markets: A Property Rights Perspective, 33 Villanova Law Review 1043 (1988). Under Title VII of the Civil Rights Act of 1964 and related federal laws enforced by Equal Employment Opportunity Commission, it is illegal to discriminate against someone (applicant or employee) because of that person's race, color, religion, sex (including gender identity, sexual orientation, and pregnancy), national origin, age (40 or older), disability or genetic information. It is also illegal to retaliate against a person because he or she complained about discrimination, filed a charge of discrimination, or participated in an employment discrimination investigation or lawsuit. ***Federal law forbids discrimination in every aspect of employment.*** A majority of states also have wrongful termination laws that prevent employers from terminating employees for all of the reasons listed under the federal laws. Some states also take their wrongful termination laws further and add more "protected classes." *See* U.S. Equal Employment Opportunity Commission, Prohibited Employment Policies/Practices. Source: https://www.eeoc.gov/laws/practices/

[100] 637 F.3d 112 (9th Cir. 2012). But this is not the only case in which NASD (now FINRA) argued that it should be treated as if it were a "government actor". *And see* Ross v. Bolton, 106 F.R.D. 315 (S.D.N.Y. 1984). NASD argued that ***when it is exercising its law enforcement functions, NASD acts as a governmental body***. *See also* the 2017 Eleventh Circuit decision, Turbeville v. FINRA, 2017 WL 4938821 (11th Cir. Nov. 1, 2017), where a panel of the Eleventh Circuit held that a former registered representative's purported state-law claims against FINRA were properly dismissed because there exists no private right of action against FINRA, a self-regulatory organization ("SRO"). The Court held that "When exercising these [disciplinary and disclosure action] functions, ***SROs act under color of federal law as deputies of the federal government.*** To sue these actors, a litigant must obtain permission from the federal sovereign; otherwise, any state-law claims asserted against them for carrying out their federally mandated duties crash headlong into the shoals of preemption" *citing* McCulloch v. Maryland, 4 Wheat. 316, 317 (1819). (Emphasis supplied)

[101] *See e.g.* D'Alessio v. N.Y. Stock Exch., Inc., 258 F.3d 93, 105 (2d Cir. 2001); *see also* Scher v. Nat'l Assoc. of Sec. Dealers, Inc. (NASD), 218 Fed. App'x 46 (2d Cir. 2007) (holding that NASD actions were actions within the scope of regulatory authority and were correspondingly entitled to immunity); Barbara v. N.Y. Stock Exch., 99 F.3d 49 (2d Cir. 1996) (concluding that NASD had absolute immunity from liability arising out of administration of its disciplinary function).

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Putting aside this question for the moment, the evidence is persuasive that FINRA is no longer a *true* "self-regulatory organization" (SRO), as it was originally organized under the Maloney Act, amending the Exchange Act of 1934. Although FINRA's predecessor organizations (NASD and the NYSE's regulatory arm) were once *true* SROs, FINRA is not, at least according to a number of highly respected Law Commentators.[102]

While once a *voluntary* membership organization, this ceased to be the case in 1983, when membership with NASD (now FINRA) became mandatory (unless the broker/dealer was a member of an Exchange, such as the NYSE).[103] When the Regulatory Arm of the NYSE merged with NASD to become FINRA in 2007, there effectively became only one "SRO" for the securities industry – namely, FINRA.[104] As one Law Commentator states the case:

> The bottom line is this. FINRA has a monopoly. It is the only SRO for broker-dealers. Broker-dealers must be a member of FINRA in order to do business. Quitting FINRA is not an option given the legal requirement to be a member of an SRO.[105]

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[102] *See* David R. Burton, Reforming FINRA, Backgrounder No. 3181 (The Heritage Foundation, February 2017). *See also* William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, pp. 1-69; Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015); Roberta S. Karmel, Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?, 14.1 Stanford Journal of Law & Finance, 151, at 163-164 (Fall 2008); Onnig H. Dombalagian, Self and Self-Regulation: Resolving the SRO Identity Crisis, Brook. J. Corp. Fin. & Com. L., Vol. 1, Issue 2, Article 4, 317-353 (2007); Richard L. Stone and Michael A. Perino, Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law, 1-1-1995 St. John's University School of Law 453 (1995).

In an interesting twist that somewhat defies logic, several State Securities Administrators have complained that FINRA withheld information from them in order to avoid being classified as a state actor. *See* Steven Irwin, Scott Lane, Carolyn Mendelson, and Tara Tighe, Self-Regulation of the American Retail Securities Markets – An Oxymoron for What is best for Investors, 14.4 University of Pennsylvania Journal of Business Law 1055, 1070 (2012): "While FINRA's capacity to compel its members to cooperate with investigations without triggering the "state actor" doctrine is undoubtedly important, ***FINRA's interpretation of its limitations under the "state actor" doctrine is problematic.*** Under current FINRA policy, FINRA will not conduct "joint" examinations or investigations with state securities regulators, nor will it provide state securities regulators access to open FINRA investigations. Because FINRA and the states have overlapping jurisdiction and responsibilities, the sharing of information is vital to regulatory cost, conservation, and effectiveness." (Emphasis supplied) Source: https://www.law.upenn.edu/journals/jbl/articles/volume14/issue4/IrwinLaneMendelsonTighe14U.Pa.J.Bus.L.1055(2012).pdf

[103] In 1983, Congress amended the Exchange Act of 1934 to eliminate the direct oversight of broker-dealers by the SEC. Congress maintained the exception from membership in an Association in Section 15(b)(8) of the Act for those broker-dealers that effected transactions in securities only on an exchange of which they were a member. Under the Rule as amended in 1983, a broker-dealer was not required to become a member of an Association if: (1) It was a member of a national securities exchange, (2) carried no customer accounts, and (3) had annual gross income no greater than $1,000 that was derived from securities transactions effected otherwise than on a national securities exchange of which the broker-dealer was a member. 15 U.S.C. 78o(b)(8), *as amended* by Pub. L. 98-38, 97 Stat. 205, 206 (1983). *See also* H.R. Rep. No. 98-106, at 597 (1983) *See* SEC, 49th Annual Report of the Securities and Exchange Commission for the Fiscal Year Ended September 30, 1983 (Washington, DC: SEC, 1984), vi, https://www.sec.gov/about/annual_report/1983.pdf. *See also* Roberta S. Karmel, Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?, 14.1 Stanford Journal of Law & Finance, 151, at 168 (Fall 2008) ("***Further, although FINRA continues to be a membership organization, it is no longer a voluntary SRO.***" (Emphasis in original) Source: https://brooklynworks.brooklaw.edu/cgi/viewcontent.cgi?article=1376&context=faculty

[104] *See* FINRA Regulatory Notice 07-52 (November 2007), at 2: "As part of the consolidation of NASD and the member regulatory functions of NYSE Regulation, Inc. into FINRA … the SEC approved a rule change to the definition of "member organization" in NYSE Rule 2(b) to require all member organizations that are currently or propose to become, NYSE Member Organizations to become members of FINRA", citing Exchange Act Release No. 56654 (October 12, 2007), 72 FR 59129 (October 18, 2007) (File No. SR-NYSE-2007-67); see also File No. SR-FINRA-2007-019. True, the Municipal Securities Rulemaking Board (MSRB) is the "other" securities SRO; however, while the MSRB writes rules for municipal securities markets, FINRA - not MSRB – is the SRO that is authorized to enforce the municipal securities market rules. *See* MSRB, "Market Regulation" at http://www.msrb.org/About-MSRB/Programs/Market-Regulation.aspx

[105] David R. Burton, Reforming FINRA, Backgrounder No. 3181 (The Heritage Foundation, February 2017), at pp. 4-5. https://www.heritage.org/sites/default/files/2017-02/BG3181.pdf. *Accord* Fiero v. Financial Industry Regulatory Authority, 660 F.3d 569, 576 (2nd Cir.

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Law Commentators have pointed out that "*self*" in the phrase "self-regulatory organization" has ceased to apply to FINRA because, despite being mandatory members of this SRO, members of the securities industry (i.e., broker/dealer members of FINRA) do not control FINRA.[106] They point to these factors:

- FINRA is governed by a 23 member board; but pursuant to Article 8 of its Articles of Incorporation, the numbers of "public governors" are required to exceed the number of Industry Governors – that is, those governors on the FINRA Board who are elected by the securities industry.
- Thus, today, there are 10 Industry Governors and 12 Public Governors,[107] which means that the industry controls only 43% of the Board of a membership organization to which the securities industry is required to be a member if it wants to participate in the offering, distribution, and sale of securities in the American market place.

One Law Commentator has concluded this fact to be significant: "The board structure, which is intentionally weighted away from the [securities] industry, is not consistent with self-regulation. An organization run by a board that is dominated by people who are not in the industry is not an SRO; it is [only] a regulator with industry representation."[108] (Emphasis supplied)

This Law Commentator goes one step further:

> The independence from the industry extends beyond the board. Omnig H. Dombalagian, professor of law at Tulane University School of Law, has documented the trend away from an SRO staff with deep industry expertise and its replacement with a bureaucratized staff.[109] (Emphasis supplied)

The reason why FINRA is no longer a *true* "self-regulatory organization" is persuasive: Securities industry members are not regulating themselves; they are being regulated by a "bureaucratized" organization that is "dominated by people who are not in the securities industry" – FINRA – just as

2011): "One cannot deal in securities with the public without being a member of FINRA. When a member fails to pay a fine levied by FINRA, FINRA can revoke the member's registration, resulting in exclusion from the industry."

[106] David R. Burton, Reforming FINRA, Backgrounder No. 3181 (The Heritage Foundation, February 2017), at p. 2 ("Because the industry does not control FINRA, it is inappropriate to regard FINRA as an SRO."); Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 27 ("FINRA has become a very powerful force in the securities markets. As its choice to characterize itself as an "independent regulator" reflects, FINRA is not a self-regulator. Its members are not regulating themselves; they are being regulated by FINRA, just as they are regulated by the SEC.")

[107] According to article VII, Section 4(a) of FINRA *ByLaws of the Corporation*, "public governors" cannot have any "material business relationship" with a broker, a dealer, or another SRO.

[108] Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 18. https://www.mercatus.org/system/files/Peirce-FINRA.pdf

[109] Id. at 18, *citing* Onnig H. Dombalagian, Self and Self-Regulation: Resolving the SRO Identity Crisis, Brooklyn Journal of Corporate Finance & Commercial Law, Vol. 1, Issue 2, Article 4, 317, 329-330 (2007). Source: https://brooklynworks.brooklaw.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1179&context=bjcfcl

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they are regulated by the SEC.[110] In other words, FINRA is a ***government regulator with industry representation.***[111]

And indeed a former SEC Commissioner has raised similar concerns about the true nature of today's FINRA, as well as its perhaps too-close-relationship with the SEC. Former Commissioner Daniel M. Gallagher writes:

> This decrease in the "self" aspect of FINRA's self-regulatory function has been accompanied by an exponential increase in its regulatory output. As FINRA acts more and more like a "deputy" SEC, concerns about its accountability grow more pronounced.[112] (Emphasis supplied)

As Professor Karmel has correctly assessed:

> Although FINRA may not be a government entity,[113] in all or virtually all of its activities, it can be viewed as exercising powers delegated to it by the SEC.[114]

Finally, Professors Birdthistle and Henderson argue that FINRA is a subordinate agency of the SEC:

> SROs do not enjoy full and independent control of their regulatory authority but rather now exist as subordinate agents of the governmental entities that ultimately control their activities.[115]

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[110] Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 27. https://www.mercatus.org/system/files/Peirce-FINRA.pdf

[111] Id. at 18.

[112] Hon. Daniel M. Gallagher, U.S. Broker-Dealer Regulation, Chapter 6. Reframing Financial Regulation: Enhancing Stability and Protecting Consumers. Arlington, VA: Mercatus Center at George Mason University, 2016, p. 149. https://www.mercatus.org/system/files/peirce_reframing_ch6.pdf. Daniel M. Gallagher served as a Commissioner of the U.S. Securities and Exchange Commission (SEC) from November 7, 2011 to October 2, 2015. Commissioner Gallagher was appointed to the SEC by President Barack Obama. Former Commissioner Gallagher is currently President of Patomak Global Partners, LLC.

[113] It is worth mentioning that another federal government agency – the Internal Revenue Service of the U.S. Treasury Department – concurs, stating: "***FINRA is a corporation serving as an agency or instrumentality of the United States***" for purposes of determining whether FINRA fines are deductible expense as a business expense. *See* Internal Revenue Service, Memorandum No. 201623006, Office of Chief Counsel, 3 June 2016. https://www.irs.gov/pub/irs-wd/201623006.pdf: "FINRA has been delegated the right to exercise part of the sovereign power of a government, it performs an important governmental function, and it has the authority to act with the sanction of government behind it. Moreover, FINRA has absolute immunity with respect to actions taken in furtherance of its regulatory duties. Lobaito v. Fin. Indus. Regulatory Auth., Inc., 599 Fed. Appx. 400 (2d Cir. 2015), *cert. denied*, 193 L. Ed. 2d 445 (2015); Santos-Buch v. Fin. Indus. Regulatory Auth., Inc., 591 Fed. Appx. 32 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 43 (2015). Therefore, under the *Guardian Industries* test, ***FINRA is a corporation serving as an agency or instrumentality of the government*** of the United States for purposes of section 1.162-21(a)(3) when it is performing its federally-mandated duties under the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq., of conducting enforcement and disciplinary proceedings relating to compliance with federal securities laws, regulations, and FINRA rules promulgated pursuant to that statutory and regulatory authority. We note that section 162(f) would not apply to a fine paid to FINRA solely for a violation of a "house-keeping" rule that is a matter of private contract between FINRA in its capacity as a professional association and its members. It should be noted that, ***because FINRA is a quasi-governmental agency (i.e., a corporation serving as an agency or instrumentality of the United States),*** a penalty paid to FINRA -- and therefore to a government for the violation of any law -- is not a deductible expense under IRC Section 162(f)." (Emphasis supplied)

[114] Roberta S. Karmel, Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?, 14.1 Stanford Journal of Law & Finance, 151, at 196 (Fall 2008). Professor Karmel asks this question: "Have the SEC's dictates regarding board composition and governance for FINRA and NYSE Regulation transformed these SROs into government agencies?" Professor Karmel answers in the affirmative, stating: "FINRA was created in large part to further the SEC's objectives regarding self-regulation, and the SEC structured its board. So FINRA comes very close to being an organization that would qualify as a government agency." Id. at 168. Source https://brooklynworks.brooklaw.edu/cgi/viewcontent.cgi?article=1376&context=faculty

[115] *See* William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, pp.. https://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=4613&context=clr

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Hence, SEC Commissioner Gallagher has, on a separate occasion asked the rhetorical but incisive question: *Is FINRA becoming a "deputy SEC"?*[116]

As a "deputy SEC" having power and authority to dictate whom member firms are permitted hire (assuming FINRA goes forward with its proposal to amend the NASD Rule 1010 Series and MAP Rules and assuming the SEC approves), FINRA arguably crosses the threshold of "Becoming a Fifth Branch" of government[117] - the Fourth Branch being the administrative agencies (as for example, the SEC) of the federal government. As the D.C. Circuit Court recently put the matter: "… administrative agencies today are rightly said to comprise the 'fourth branch of the U.S. Government,' exerting significant power over the economic and social life of the Nation."[118]

This is important because FINRA makes its own rules and enforces them – in other words, acts as "judge, jury, and executioner" (as that age old adage goes) without meaningful accountability. The following examples of "immunity from accountability" underscore this point, and this has an important bearing (as will later be demonstrated) for Proposed Rule 9285:

- FINRA can set its own rulemaking and disciplinary agendas and budget without SEC input.[119]
- FINRA rules do not typically attract close attention from the SEC's commissioners;[120] in fact, the SEC almost never disapproves a FINRA rule because of "double deference in administrative law".[121]

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[116] Hon. Daniel M. Gallagher, Comm'r, Sec. & Exch. Comm'n. Market 2012: Time for a Fresh Look at Equity Market Struction and Self-Regulation, Speech to SIFMA's 15gh Annual Market Structure Conference (Oct. 4, 2012): https://corpgov.law.harvard.edu/2012/10/19/time-for-a-fresh-look-at-equity-market-structure-and-self-regulation/

[117] *See* William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, pp. 36, citing 15 U.S.C. § 78s (2012) (requiring registration of SROs with the SEC).

[118] PHH Corp. v. Consumer Financial Protection Bureau, 839 F.3d 1, 6 (D.C. Cir. 2016)("*PHH I*"), *vacated, reinstated in part, and remanded*, __F.2d __, 2018 WL 627055 (D.C. Cir. January 31, 2018)(*en banc*).

[119] *See* Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 19. https://www.mercatus.org/system/files/Peirce-FINRA.pdf

[120] *See* Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 19: "Although the SEC has the power to approve or disapprove FINRA rules, the SEC's Division of Trading and Markets typically exercises this authority through a delegation from the commission [17 C.F.R. Section 230.30-3(a)(12]. To rescind the delegation, two commissioners must object in writing within five days of being notified of staff plans to disapprove a rule. [Id.] As a consequence, FINRA rules do not typically attract close attention from the SEC's commissioners." This Law Commentator's opinion is corroborated, ironically, by the dissent of SEC Commissioners Daniel M. Gallagher and Troy A. Paredes voiced, in 2012, against the SEC's approval of an SRO rule on grounds that ***SEC review lacked rigorous analysis***. Commissioner's Gallagher and Paredes write: "If there is any question as to the rigor of an SRO's analysis, then it is all the more paramount that the Commission not defer to the SRO's claims, conclusions, and judgments. The Commission has a fundamental oversight role with respect to SROs, ***and undue deference to an SRO in the SRO rulemaking process undercuts the basic structure of that regulatory relationship***." (Emphasis supplied) *See* Daniel M. Gallagher and Troy A. Paredes, "Statement Regarding Commission Approval of MSRB Rule G-17 Interpretive Notice", SEC, Washington, DC, 14 May 2012: https://www.sec.gov/news/public-statement/2012-spch051412dmgtaphtm.html.

[121] *See* Emily Hammond, Double Deference in Administrative Law, Columbia Law Review, Vol. 116, No. 7 (November 2016), who writes: " * * * the 'understanding' is that SEC review is deferential", *citing* Saule T. Omarova, Rethinking the Future of Self-Regulation in the Financial Industry, 35 Brook. J. Int'l 665, 695 (2010) (arguing that while the SEC has an independent statutory authority to regulate activities of broker-dealers and other market intermediaries directly, in reality it fully delegates these regulatory functions and merely "functions" as the watchful guard and supervisor". Professor Hammond also cites David G. Tittsworth, H.R. 4624: https://financialservices.house.gov/uploadedfiles/hhrg-112-ba-wstate-dtittsworth-20120606.pdf and citing Tittsworth: The Pitfalls of a Self-Regulatory Organization for Investment Advisers and Why User Fees Would Better Accomplish the Goal of Investment Adviser Accountability, 87 St. John's L. Rev. 477, 486 (2013) (noting that "the SEC's oversight of SRO rulemaking may have been largely

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- FINRA's policies can be reviewed by the SEC; however, the SEC's formal power to influence FINRA policy is less than what the Supreme Court in *Free Enterprise Fund*[122] found to be constitutionally sufficient because the SEC does not have the ability to remove FINRA board members – even for cause.[123]

- FINRA enforces its own rules and federal securities laws, *but also enforces the rules of another SRO* – the Municipal Securities Rulemaking Board (MSRB)[124] – in short FINRA has "expansive powers to govern an entire industry".

- FINRA is authorized to bring disciplinary actions when FINRA finds violations of its rules, the rules of the MSRB, and/or violations of federal securities laws.[125]

- FINRA rules can create a conflict with state laws or federal anti-trust laws; but when this happens, FINRA rules can displace state law and anti-trust laws whenever FINRA rules are viewed as federal securities regulation.[126]

- FINRA executive compensation packages are, as matter of practice, subject to limited or no oversight by the SEC, according to the General Accountability Office.[127]

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deferential," due to the SEC's not being required to weigh in on the merits of SRO rules.) (Emphasis supplied) Source: https://columbialawreview.org/content/double-deference-in-administrative-law/.

[122] Free Enterprise Fund et al. v. Public Company Accounting Oversight Board, 130 S.Ct. 3138 (08-861)(June 28, 2010).

[123] *See* Joseph McLaughlin, Partner Sidney Austin Law Firm, Financial Services & E-Commerce: Is FINRA Constitutional? (September 2011), at page 113-114. Source: https://fedsoc-cms-public.s3.amazonaws.com/update/pdf/LU1iFewui2fC3Y2T38B5dK1m88ohNDt1zFtDZMtH.pdf

[124] *See* Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 13.

[125] Id. at 14.

[126] Roberta S. Karmel, Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies? 14.1 Stanford Journal of Law & Finance 151, at 186 (Fall 2008). *See also* Gordon v. New York Stock Exchange, Inc., 422 U.S. 659 (1975); United States v. NASD, Inc., 422 U.S. 694 (1975). In *Gordon*, the Supreme Court held that the New York Stock Exchange ("NYSE") possessed implied antitrust immunity from a federal antitrust suit challenging its fixed-rate commission structure. 422 U.S. at 691. Implied antitrust immunity was necessary, the Court explained, because allowing the antitrust suit to proceed would have subjected the NYSE to conflicting standards of conduct and "unduly interfere[d] . . . with the operation of the Securities Exchange Act." Id. at 686. In *NASD*, the Supreme Court held that an antitrust suit could not be brought challenging agreements fixing the price of mutual funds. 422 U.S. at 694. The suit alleged that mutual fund underwriters and broker-dealers had entered into agreements requiring the broker-dealers to maintain the pre-determined public offering price when selling mutual fund shares. Id. at 702 n.11. The Court held that the SEC had the power to authorize stock price restrictions under the Investment Company Act of 1940, even though the SEC had not exercised that authority. Id. at 729. The Court reasoned that the antitrust laws had to "give way" to ensure the viability of the mutual fund regulatory scheme and that there was "no way to reconcile the Commission's power to authorize these restrictions with the competing mandate of the antitrust laws." Id. at 722. In short, The Supreme Court has repeatedly found conflicts between the antitrust laws and the securities laws, including SEC and FINRA rules. The securities laws have prevailed when the Court has found—using either a test of plain repugnancy or clear incompatibility—that the antitrust laws would produce conflicting guidance in an area that is addressed by the securities laws. Department of Enforcement v. Charles Schwab & Company, Inc., Complaint No. 2011029760201 (FINRA Board of Governors, April 24, 2014) at p. 21.

[127] Government Accountability Office, Securities Regulation: Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority (2012), 7, 18-19: "**Executive compensation**. OCIE has obtained information and data on FINRA executive compensation, including retirement plans and incentive compensation for its executives. OCIE staff have been reviewing the data, specifically focusing on compensation FINRA pays its senior executives and the annual goals set by FINRA's Management Compensation Committee. These goals include those that FINRA senior executives must meet to qualify for incentive compensation and the analysis and deliberations undertaken by FINRA, the Management Compensation Committee, and FINRA's Board of Governors in connection with the award of incentive compensation. According to OCIE's analysis, OCIE officials are also reviewing the firms or entities that FINRA uses for compensation benchmarking purposes and examining studies conducted by FINRA's compensation consultant. [citation omitted] We reviewed the three most recently completed compensation studies conducted by the consultant—in 2009, 2010, and 2011—and found that these studies concluded that FINRA's pay levels are appropriate relative to certain comparable regulators, exchanges, and financial services organizations engaged in brokerage or related banking." Source: https://www.gao.gov/assets/600/591222.pdf *But see* below, where the GAO matrix shows "Never" in connection with "Frequency of SEC's reviews" with respect to FINRA "Executive Compensation":

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These bullets are particularly important when read in light of Justice Alito's recent concurring opinion in *Department of Transportation v. Ass'n of American Railroads.*[128] According to Justice Alito, *if* a private actor (read: FINRA, according to its claim that it is not a government actor) *can make law but is not subject to* the structural protections of the Constitution – because the actor is not part of the constitutional scheme at all – the *constitutional accountability of the actor is simply nonexistent.*

Justice Alito begins his concurring opinion forcefully:

> This case, on its face, may seem to involve technical issues, but in discussing trains, tracks, metrics, and standards, a vital constitutional principle must not be forgotten: **Liberty requires accountability**.
>
> When citizens cannot readily identify the source of legislation or regulation that affects their lives, Government officials can wield power without owning up to the consequences. One way the Government can regulate without accountability is by passing off a Government operation as an independent private concern. Given this incentive to regulate without saying so, everyone should pay close attention when Congress sponsor[s] corporations that it specifically designate[s] *not* to be agencies or establishments of the United States Government. *Lebron v. National Railroad Passenger Corporation*, 513 U. S. 374, 390 (1995)." (Emphasis supplied)

Table 1: SEC's Oversight of FINRA, 2005 to 2010

Areas for SEC oversight of FINRA identified in Section 964 of the Dodd-Frank Act	Frequency of SEC's reviews: Annually or continuous[a]	Occasionally[b]	Never
Examinations and expertise of examiners[c]	√		
Advertising	√		
Rules	√		
Arbitration service		√	
Governance		√	
Funding		√	
Post-employment of former employees[d]		√	
Executive compensation			√
Cooperation with states securities regulators			√
Transparency of governance			√

That said, there appears to have been some improvement since 2012, as the GAO 2016 Report states: "Since our 2012 report, OCIE—primarily through its Market Oversight program—has taken steps to enhance its FINRA oversight by incorporating oversight of certain Section 964 areas into inspections of other FINRA programs and operations (beginning with inspections initiated in fiscal year 2014). Our review of Market Oversight documents, such as scope and planning memorandums and document requests, from inspections not specific to Section 964 areas that were in progress as of June 2014 found evidence of inquiries into or plans to review certain Section 964 areas in all but one open inspection. [citation omitted] Furthermore, plans to conduct some oversight of all but two of the Section 964 areas were included in at least one of these inspections.[41]" That said, footnote 41 is noteworthy: ***"Our review of OCIE documents found that OCIE did not incorporate*** arbitration (or FINRA Dispute Resolution) or ***executive compensation into its inspections of other FINRA programs and operations for fiscal year 2014***. According to OCIE staff, both areas are monitored on an ongoing basis as part of OCIE's risk-based approach in order to determine when to conduct inspections focusing on or incorporating these areas." (Emphasis supplied) Source: https://www.gao.gov/assets/670/669969.pdf

And see FINRA 2016 Annual Financial Report, https://www.finra.org/sites/default/files/2016_AFR.pdf, especially page 25 (Management Compensation Committee Report) (FINRA 2017 Annual Financial Report due to be published sometime in June 2018). *Compare* SEC Compensation for Senior Management and Executive Officers: https://www.sec.gov/ohr/sec-compensation.

[128] 135 S. Ct. 1225, 1237-38 (2015) (Alito, J., concurring). https://supreme.justia.com/cases/federal/us/575/13-1080/concur4.html

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Under the current state of affairs in the courts, FINRA is a "state actor" for tax purposes[129] and for purposes of protecting FINRA from liability when sued (***sovereign immunity***, in other words),[130] ***but is not*** a "state actor" for purposes of extending 4th and 5th and 6th Amendment ***constitutional protections to brokers*** when investigated by FINRA, served with Rule 8210 requests, and required to appear before on-the-record (deposition-like) regulatory interrogations[131] – even though FINRA actively refers potential civil and criminal cases to governmental regulators where a broker's unprotected testimony in a FINRA OTR can become the broker's death knell in an SEC and the Department of Justice proceeding.[132]

Being and at the same time *not being* a "state actor" has important implications for accountability that will be discussed on the following page; but as an aside, ***being and not being*** something at the same time violates Aristotle's greatest contribution to Western Civilization, The Principle of Non-Contradiction, which is:

> It is impossible that the same thing ***both be and not be*** the same thing at the same time and in the same respect.[133]

The importance, and relevance, of this principle is enormous. Positively, it is the foundation of logic, science, and ultimately truth in discourse. Negatively, it is the greatest enemy to arbitrariness in governance.[134]

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[129] *See* Internal Revenue Service, Memorandum No. 201623006, Office of Chief Counsel, 3 June 2016. https://www.irs.gov/pub/irs-wd/201623006.pdf: "FINRA has been delegated the right to exercise part of the sovereign power of a government, it performs an important governmental function, and it has the authority to act with the sanction of government behind it. Moreover, FINRA has absolute immunity with respect to actions taken in furtherance of its regulatory duties."

[130] *See* Zanford v. Nat'l Ass'n of Secs Dealers, 30 F.Supp.2d 1 (D.D.C. 1998) (when SEC set aside NASD sanction, broker sued NASD for malicious prosecution; the court held that, when NASD investigators are acting in a prosecutorial capacity – even though, technically they are not prosecutors – NASD investigators are entitled to absolute immunity from suit.) *See also* Standard Investment Chartered, Inc. et al v. National Association of Securities Dealers, Inc, 637 F.3d 112 (2d Cir. 2011): "There is no question that an SRO and its officers are entitled to absolute immunity from private damages suits in connection with the discharge of their regulatory responsibilities." *See* DL Capital Group, LLC v. Nasdaq Stock Mkt., Inc., 409 F.3d 93, 96 (2d Cir.2005); see also In re NYSE Specialists Sec. Litig., 503 F.3d 89, 96 (2d Cir.2007); D'Alessio v. NYSE, Inc., 258 F.3d 93, 105 (2d Cir.2001); Barbara v. NYSE, 99 F.3d 49, 59 (2d Cir.1996); *accord* Scher v. Nat'l Ass'n of Sec. Dealers, Inc., 218 F. App'x 46, 47-48 (2d Cir.2007) (summary order). This immunity extends both to affirmative acts as well as to an SRO's omissions or failure to act. *See, e.g.*, NYSE Specialists, 503 F.3d at 97 (failure to supervise); Gurfein v. Ameritrade, Inc., 411 F.Supp.2d 416, 423 (S.D.N.Y.2006) (same); Dexter v. DTC, 406 F.Supp.2d 260, 263 (S.D.N.Y.2005) (setting of ex-dividend date); Am. Benefits Group, Inc. v. Nat'l Ass'n of Sec. Dealers, Inc., No. 99 Civ. 4733, 1999 WL 605246, at *4 (S.D.N.Y. Aug. 10, 1999) (creation of reporting requirements for companies included in the OTC Bulletin Board)."

[131] Department of Enforcement v. Mark C. Cohen, OHO Order 18-01 (2014040761001) *citing* Epstein v. SEC, 416 Fed. Appx. 142, 148 (3d Cir. 2010) (unpublished opinion) ("Epstein cannot bring a constitutional due process claim against [FINRA], because [FINRA] is a private actor, not a state actor."); D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., 279 F.3d 155, 162 (2d Cir. 2002) ("It has been found, repeatedly, that [FINRA] itself is not a government functionary."); Desiderio v. NASD, 191 F.3d 198, 206 (2d Cir. 1999) ("[T]he fact that a business entity is subject to 'extensive and detailed' state regulation does not convert that organization's actions into those of the state."); U.S. v. Solomon, 509 F.2d 863, 869 (2d Cir. 1975) (SRO testimony does not implicate fifth amendment protections because "NYSE's inquiry … was in pursuance of its own interests and obligations, not as an agent of the SEC.")."

[132] FINRA referred **785** cases for prosecution to the SEC and other federal or state law enforcement agencies in 2016. *See* 2016 FINRA Annual Financial Report, Source: https://www.finra.org/sites/default/files/2016_AFR.pdf page 4 (Report retrieved on 8 June 2018) (2017 FINRA Annual Financial Report not issued as of this writing.)

[133] Aristotle, Metaphysics §1005b19-20. (Emphasis supplied)

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By avoiding the "state actor" classification, FINRA has managed to exercise governmental powers without governmental accountability, and this has an important bearing (as will later be demonstrated) for Proposed Rule 9285:

- FINRA escapes mechanisms comparable to those that hold government regulators accountable to Congress, the President, and the public.[135]

- FINRA escapes operation of the Appointments Clause of the U.S. Constitution[136] – this clause of the Constitution requires the President to nominate Department heads and "principal officers" of government agencies, such as Commissioners of the SEC, who are then subject to confirmation hearings and vote in the Senate – but, FINRA's equivalents of the SEC Commissioners avoid this public scrutiny.[137]

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[134] ***Nemo iudex in causa sua*** (or *nemo iudex in sua causa*) is a Latin phrase and is the common law principle that means, literally, "no-one should be judge in his own case." Dr. Bonham's Case, 77 Eng. Rep. 646, 652 (King's Bench, 1610). It is a principle of natural justice that no person can judge a case in which he or she has an interest. This is the universally recognized principle that is the foundation for the American constitutional doctrine of ***separation of powers***: Let no man be judge, jury, and executioner. This principle goes to the heart of American and English common law ***protection against arbitrariness in governance***. *See e.g.* Rv Sussex Justices, Ex parte McCarthy ([1924] 1 KB 256, [1923] All ER Rep 233) is a leading English case on the impartiality and recusal of judges. It is famous for its precedence in establishing the principle that the mere appearance of bias is sufficient to overturn a judicial decision. It also brought into common parlance the oft-quoted aphorism "Not only must Justice be done; ***it must also be seen to be done.***" (Emphasis supplied).

[135] William A. Birdthistle and M. Todd Henderson, Becoming a Fifth Branch, Cornell Law Review, Vol. 99, Issue 1, November 2013, at p. 6, cited in Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 21.

[136] Article II, Section 2, Clause 2 of the United States Constitution, which empowers the President of the United States to nominate, and with the advice and consent (confirmation) of the United States Senate. *See* Joseph McLaughlin, Partner Sidney Austin Law Firm, Financial Services & E-Commerce: Is FINRA Constitutional? (September 2011): ". . . it may be that FINRA's structure violates ***not only the separation of powers but also*** the Appointments Clause since FINRA's Board members are collectively just as much "inferior officers" as the PCAOB's board members [referring to the U.S. Supreme Court decision in Free Enterprise Fund et al. v. Public Company Accounting Oversight Board, 130 S.Ct. 3138 (08-861)(June 28, 2010)] and whose appointments should therefore be vested in the SEC. * * * the emphasis under *Free Enterprise Fund* has to be whether the President has the ability to control executive action, and that ability can only be achieved for separation of powers purposes by removal authority directly or through an officer whom the President can remove at all." Id. at 114. That FINRA exercises "executive action" is demonstrated, according to Attorney McLaughlin, in virtue of the fact that "[t]here is no question but that FINRA, even more so than the PCAOB, exercises investigative and prosecutorial functions. Those functions relate not only to FINRA's own rules but also to the provisions of the 1934 Act and the SEC's antifraud, anti-manipulation, and record-keeping rules. * * * There is also no question but that such functions are clearing within the "executive Power" [citing Morrison v. Olson, 487 U.S. 654, 691 (1988) for authority on grounds that] "[t]here is no real dispute that the functions performed by the independent counsel are 'executive' in the sense that they are law enforcement functions that typically have been undertaking by officials within the Executive Branch." Financial Services & E-Commerce: Is FINRA Constitutional?, *supra* at 113.

[137] Things could change however, and have consequences for FINRA OHO hearing officers and NAC adjudicators down the road. *See* Lucia v. Securities and Exchange Commission, __ U.S. __ (2018). In this case a former investment adviser Raymond J. Lucia appeals sanctions handed down by an SEC in-house judge – an administrative law judge or ALJ. The SEC has traditionally hired its ALJs through a competitive merit-based process without involvement from the SEC's presidentially appointed chairman and other commissioners. Lucia argues that the ALJ who fined him and barred him for life from investment adviser work is a constitutional "officer" subject to the Appointments Clause who was required to be appointed directly by the president or a "head of department," in this case the SEC's commissioners. In sum, Lucia says his rights were violated because the judge who heard his case wasn't constitutionally authorized to wield such power. The case is being closely watched because it will determine if ALJs should be appointed by the president or head of a federal agency, as is required under the Appointments Clause, or hired as regular government employees, as has been the practice historically. ***Chief Justice John Roberts said accountability was a primary reason the drafters of the Constitution gave the president the authority to appoint officers. In Lucia's case, however, that accountability doesn't exist, Roberts said, adding that its absence allows the SEC commissioners and the president to deflect blame in controversial cases because they didn't appoint the ALJ in question.*** *See* Dunstal Prial, High Court Split On Accountability Issue In Lucia Arguments, Law360 (April 23, 2018, 7:01 PM EDT) and Daniel Walfish, If Lucia Wins On SEC Judges, What Comes Next?, Law360 (April 20, 2018, 8:19 PM EDT). A ruling in favor of Lucia could potentially have broad ramifications for an array of federal agencies that employ in-house judges. If SEC administrative law judges are deemed to be principal officers of the SEC, as per the Appointments Clause of the U.S. Constitution, then it will be an easy leap towards deciding that FINRA OHO hearing officers and NAC adjudicators – the FINRA equivalents of SEC ALJs – should likewise be appointed by the SEC once it is decided that FINRA is an "SEC deputy", according to former SEC Commissioner Daniel M. Gallagher. *See* Official U.S. Supreme Court Oral Argument Transcript: https://www.supremecourt.gov/oral_arguments/argument_transcripts/2017/17-130_41p3.pdf. At the submission of this Comment Letter, the Supreme Court rendered a decision in *Lucia*. ***In a 7 to 2 decision, Securities and Exchange Commission administrative law judges are "officers of the United States," subject to the Constitution's Appointments Clause.***

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- FINRA escapes operation of the Freedom of Information Act:[138] This federal statute enables the public to obtain documents from government agencies.[139]

- FINRA escapes operation of congressional appropriations which enables Congress to exercise some control over federal government agencies, such as the SEC:

    - Thus, while the SEC receives fees on securities transactions to cover its costs, the Congress determines how much the SEC may spend;[140] but FINRA determines the annual fees that it charges its members (including increasing fees) without any requirement of Congressional oversight or SEC approval, and neither Congress nor the SEC determine how much FINRA can spends or for what purpose FINRA should earmark its spending.[141]

    - Similarly, penalties and disgorgement collected by the SEC are used to compensate victims or are paid to the US Department of the Treasury, and are not used to supplement the SEC's budget.[142]

    - In comparison, fines collected by FINRA are retained by FINRA and its use of fine monies "is limited to capital expenditures and specified regulatory projects that promote compliance and improve markets."[143] Thus FINRA fines do not necessarily go to wronged investors.[144]

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[138] 5 U.S. Code Section 552.

[139] *See* Ross v. Bolton, 106 F.R.D. 315 (S.D.N.Y. 1984). This is a very interesting case. NASD argued that when it is exercising its law enforcement functions, NASD acts as a governmental body. In this case, Ross argued alleged wrongdoing on the part of Bolton in connection with certain OTC trading. NASD had conducted its own investigation of this customer complaint, including taking the testimony of witnesses that Ross believed might be favorable to his case against Bolton. Ross therefore subpoenaed NASD – which was not a party to this lawsuit – demanding production of the transcripts of the witness testimony taken by NASD. Ross filed a motion to compel when ***NASD refused to comply with the subpoena, arguing that NASD is a quasi-governmental entity and is therefore privileged from having to produce the documents "on ground that its law enforcement duties make it a quasi-governmental agency and that, as a result, its investigative files are entitled to the same privilege against discovery as that afforded to a governmental investigative body***." 106 F.R.D. 315, 315-316. (Emphasis supplied) *See* Richard L. Stone and Michael A. Perino, Not Just a Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law, 1-1-1995 St. John's University School of Law 453, 485 (1995). Source: https://scholarship.law.stjohns.edu/cgi/viewcontent.cgi?article=1072&context=faculty_publications. Here, the Court skirted the issue. But what is significant is the fact that NASD argued, and convincingly believed, that it is a quasi-governmental agency when engaged in its law enforcement function. And, of course, ***proposed Rule 9285 (relating to Interim Orders While on Appeal) is unquestionably directly invokes FINRA's law enforcement function, while the remaining proposed rule amendments that the subject matter of Regulatory Notice 18-16 arguably indirectly invoke FINRA's law enforcement function.*** And, as Attorneys Stone and Perino point out: Regulatory investigations in the course of a regulator's law enforcement duties is "exactly the type of activity the public function concept [evidencing when a private actor is engaged in state action] was designed to capture." Id. at 485.

[140] *See* SEC, Section 31 Transaction Fees, https://www.sec.gov/fast-answers/answerssec31htm.html

[141] David R. Burton, Reforming FINRA, Backgrounder No. 3181 (The Heritage Foundation, February 2017), at p. 11 ("FINRA fees are not voluntary. As a matter of economics, though not law, they are effectively a tax. And, at $789 million in 2015, they are substantial. The businesses that pay these fees must recover the costs. Before raising these fees, FINRA should be required to obtain an affirmative vote by Congress or, at least, by the SEC. * * * Currently, it is FINRA policy that FINRA fines are used to fund "capital expenditures and specified regulatory projects. * * * Congress should consider making FINRA "on budget" for purposes of the federal budget, along with various other government-sponsored enterprises, quasi-governmental entities, agency-related nonprofit organizations, and the like that currently escape congressional oversight during the budget process." FINRA fines, in other words, do not go to the U.S. Treasury, unlike SEC fines. *See* Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 21-22: "Most federal agencies are subject to congressional appropriations, which enables Congress to exercise some control over them. The SEC is no exception. Although the SEC receives fees on securities transactions to cover its costs, Congress determines how much the SEC may spend. The penalties and disgorgement collected by the SEC are used to compensate victims or are paid to the US Department of the Treasury; they are not used to supplement the SEC's budget. * * * FINRA, as stated in table 1 [omitted here], uses fines to cover capital expenditures. This practice gives the regulator an incentive to impose fines and thus potentially clouds its disciplinary discretion."

[142] *See* SEC, Fiscal Year 2018, Congressional Budget Justification Annual Performance Plan: "Any funds not returned to investors are sent to the U.S. Treasury or the Investor Protection Fund established pursuant to Section 21F(g) of the Securities Exchange Act of 1934. Neither disgorgement nor penalties are used for the SEC's own expenses." Source: https://www.sec.gov/files/secfy18congbudgjust.pdf, at page 38.

[143] FINRA Fines Policy, Item #4. http://www.finra.org/industry/fines-policy. According to FINRA, "FINRA recognizes fines upon issuance of a written consent or disciplinary decision. We do not view fines as part of our operating revenues. The use of fine monies is limited to capital expenditures and

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- And, unlike the Public Accounting Company Oversight Board ("PCAOB"), whose assessment of finds and penalties cannot exceed $15 million for a firm or $750,000 for an individual, FINRA may impose monetary fines and penalties in an *unlimited* amount.[145]

Accountability is the fundamental concern about the proposed amendments to the FINRA rules that are the subject matter of Regulatory Notice 18-16.

There is no debating whether the proposed amendments are consistent with FINRA's mission. They are.

The debate, rather, is whether FINRA crosses the "state actor" threshold by interjecting itself into the constitutionally protected common law property right of an employer to "hire, fire, promote, or demote" in the name of protecting the investing public, while historically avoiding extending constitutional protections to brokers who are, after all, vicarious members of FINRA through their association with their FINRA member broker/dealers.

Hence, this "state actor" issue is brought to a head by Regulatory Notice 18-16.

But this is a good thing, for as one State Securities Administrator has summed things up hitting the bull's eye:

> Congress should refrain from considering expansion of the SRO model until such time as FINRA correctly interprets the state actor issue, or until the issue is adequately addressed by legislation. Settling the question of whether or not FINRA or any other SRO is or is not a "state-actor" is of vital importance to effective regulation.[146] (Emphasis supplied)

regulatory projects, such as our efforts to leverage technology innovations and the Cloud initiative, and other projects as appropriate, which are reported to and approved by our Finance, Operations and Technology Committee and Board." *See* 2016 FINRA Annual Financial Report at p. 13. Source: https://www.finra.org/sites/default/files/2016_AFR.pdf (2017 FINRA Annual Report to be published sometime in June 2018). As Hester Peirce points out, "FINRA is a not-for-profit organization that is incorporated in Delaware. It funds itself with a mix of fees and fines * * * FINRA * * * uses fines to cover capital expenditures. This practice gives the regulator an *incentive to impose fines and thus potentially clouds its disciplinary discretion.*" (Emphasis supplied) *See* Hester Peirce, The Financial Industry Regulatory Authority: Not Self-Regulation after All, Mercatus Center Working Paper, George Mason University (January 2015), at 21- 22.

[144] Accordingly, in March 2018, Senator Elizabeth Warren (D. Mass.) has introduced a bill (S. 2499) to address this. Warren's legislation would eliminate the budgetary incentive for FINRA to impose "penalties" (i.e., fines). Instead, "penalties" (i.e., fines) would be imposed to the degree they are warranted in light of the gravity of the offense. Rather than send revenue from fines to FINRA to use as it sees fit, Warren's legislation would require that the fine revenue be used to create a fund to compensate wronged investors who are unable to collect arbitration awards from broker-dealers or registered representatives.

[145] *See* Joseph McLaughlin, Partner Sidney Austin Law Firm, Financial Services & E-Commerce: Is FINRA Constitutional? (September 2011), at page 111. Source: https://fedsoc-cms-public.s3.amazonaws.com/update/pdf/LU1iFewui2fC3Y2T38B5dK1m88ohNDt1zFtDZMtH.pdf

[146] Testimony of Steven D. Irwin Pennsylvania Securities Commissioner and Chairman, Federal Legislation Committee North American Securities Administrators Association, Inc. Before the House Subcommittee on Capital Markets and Government Sponsored Enterprises "Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals to Improve Investment Adviser Oversight, (September 13, 2011), at p. 7. https://financialservices.house.gov/uploadedfiles/091311irwin.pdf

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What is not in dispute is the fact that:

> FINRA derives its executive authority from Section 15A of the 1934 Act (added in 1938 by the Maloney Act). * * * FINRA's powers are based on the SEC's recognition of FINRA as a national securities association. Thus armed, FINRA may adopt rules to prevent fraud and manipulation, to promote "just and equitable principles of trade" and to subject its "members" to fines, penalties, suspension, and expulsion for any violation of the 1934 Act, the SEC's rules, or FINRA's rules. FINRA can thus be said to be "exercising significant authority pursuant to the laws of the United States" within the meaning of Article II, §2, clause 2 of the Constitution,[147] an activity that is not typical of "private" organizations that are not "Government-created" or "Government-appointed".[148]

In other words, even if FINRA contends that it is not a "state actor", the evidence is mounting that FINRA is at the brink of crossing the threshold and the proposals set forth in Regulatory Notice 18-16 has probably inched FINRA over that precipice.

5. Constitutional Protections for Brokers Should Be "Quid Pro Quo" for Implementation of Amendments to Rules Proposed in Regulatory Notice 18-16.

Should FINRA withdraw the aforementioned proposed Rule amendments identified in Regulatory Notice 18-16, or should the SEC conduct the kind of rigorous analysis that former Commissioners Gallagher and Paredes urge in order to overcome the "undue deference to an SRO in the SRO rulemaking process" controversy,[149] the "state actor" issue will go away – at least right now, to be revisited another day.

But in the absence of either event, constitutional protections for brokers are and should be the "quid pro quo" for implementing these proposed Rule amendments since Congress, as well as the federal courts, can now appreciate the pivotal fact that interfering with the constitutionally protected common law property right of an employer to "hire, fire, promote, or demote" in the course of conducting interstate securities business crosses the threshold of acting on behalf of the state. On this foundation, the mission of protecting the investing public can no longer withstand the constitutional crisis that has come about as a result of crossing this "state actor" threshold.

As one Law Commentator has prophetically written:

> Because FINRA is tasked with enforcing the securities laws, and its board and officers are not removable for cause, and SEC Commissioners are only removable for cause, it is quite possible that a court would conclude that FINRA, as currently structured, violates the separation-of-powers clause [of the U.S.

[147] This is the language of the U.S. Supreme Court in Buckley v. Valeo, 424 U.S. 1, 126 (1976) (*per curiam*).

[148] *See* Joseph McLaughlin, Partner Sidney Austin Law Firm, Financial Services & E-Commerce: Is FINRA Constitutional? (September 2011), at page 112. Source: https://fedsoc-cms-public.s3.amazonaws.com/update/pdf/LU1iFewui2fC3Y2T38B5dK1m88ohNDt1zFtDZMtH.pdf

[149] Law Professor Emily Hammond refers to FINRA's current status as "double deference", referring to undue deference given to FINRA by both the SEC and the federal courts. Professor Hammond writes: ". . . the combination of oversight agencies' deference to SROs and judicial deference to oversight agencies undermines both the constitutional and regulatory legitimacy of SROs." *See* Emily Hammond, Double Deference in Administrative Law, Columbia Law Review, Vol. 116, No. 7 (November 2016), at 46. https://columbialawreview.org/content/double-deference-in-administrative-law/

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> Constitution]. * * * So the central question becomes whether FINRA is exercising "executive power" within the meaning of the Constitution, or whether it is a truly private self-regulatory organization.[150]

Remedies are necessary to redress the balance between protecting the investing public from "bad brokers" while preserving the presumption of innocence of all brokers until found "guilty"[151] of being a "bad broker", as well as protecting the broker's constitutional rights of due process in all aspects.

Accordingly, to quote Professor Hammond, the reforms proposed in this Comment Letter aim at "better promot[ing] accountability and guard against arbitrariness not only for SROs but also for the modern regulatory state."[152]

5.A <u>FINRA Rule 8210 vs. the U.S. Constitution and Due Process.</u>

One practicing attorney has succinctly spelled out the constitutional due process deficiencies[153] of Rule 8210:[154]

> FINRA Rule 8210 requires members and their associated persons to provide documents, information, and testimony "with respect to any matter involved in the investigation, complaint, examination, or proceeding." Because of the exceedingly broad scope of FINRA Rule 2010 (which requires firms and individuals, "in the conduct of [their] business, [to] observe high standards of commercial honor and just and equitable principles of trade"), the subject matter of an investigation can encompass anything business-related. Moreover, FINRA alone determines what is relevant to its investigations.
>
> Rule 8210 is a tremendous power. If a registered rep does not comply with a request for documents, information, or testimony, FINRA can have the rep barred from the securities industry. [Citation omitted] Once barred, an individual becomes subject to statutory disqualification, which has implications

[150] David R. Burton, <u>Reforming FINRA</u>, Backgrounder No. 3181 (The Heritage Foundation, February 2017) at p. 5. Source: https://www.heritage.org/sites/default/files/2017-02/BG3181.pdf

[151] Again, the authors appreciate the fact that a FINRA enforcement action is not a criminal matter. That said, it bears repeating the D.C. Circuit's opinion that, "***when a broker faces a bar from the securities industry, this is tantamount to "capital punishment***". (Emphasis supplied). <u>Saad v. Securities and Exchange Commission</u>, No. 15-1430, 2017 WL 4557511, at *5–6 (D.C. Cir. Oct. 13, 2017), *remanding* <u>Saad v. SEC</u>, 718 F.3d 904 (D.C. Cir. 2013).

[152] *See* Emily Hammond, <u>Double Deference in Administrative Law</u>, Columbia Law Review, Vol. 116, No. 7 (November 2016), p.46. Source: https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2487&context=faculty_publications.

[153] *See* Michael Gross, Esq., Ulmer & Berne, <u>The Unassailable FINRA Rule 8210</u>, (30 June 2017) https://www.bdlawcorner.com/2017/06/the-unassailable-finra-rule-8210/ We have decided to quote this article in its entirety rather than paraphrase, restate, or summarize this explanation of the constitutional problem that has already been so well written.

[154] Documentary requests and requests for live testimony are made by FINRA pursuant to Rule 8210. In laymen's terms, an 8210 request is ***like*** a subpoena. But the similarity ends here. When a state or federal law enforcement agency issues a subpoena, the recipient has many constitutional rights and, under both federal and state rules of procedure and evidence, the recipient of the subpoena can, at a minimum, challenge the subpoena as being ***"irrelevant, overly broad, or unduly burdensome"*** and the challenge is made to a third party (i.e., a state or federal magistrate) who is independent and has no interest in the outcome. At this time, a broker has no such constitutional rights when challenging an 8210 request. Of course, the broker can go through the motion of challenging an 8210 request as being "irrelevant, overly broad, or unduly burdensome". But, as one law practitioner has explained: "If FINRA does not agree to withdraw or limit the request, you have two choices. First, you can provide the requested documents and information. The case law on this issue is clear: ***only FINRA determines what documents and information are relevant to its investigation***. If you elect not to do that, your only alternative * * * is defend yourself in an Enforcement action. ***If you lose***, however, the consequence is not simply that you have to produce the document or information; the consequence is that ***you will get barred***." (Emphasis supplied) *See* Broker Dealer Law Corner, <u>Frequently Asked Questions About FINRA Rule 8210</u> (October 3, 2016). Source: https://www.lexology.com/library/detail.aspx?g=f3dbaec8-ae31-4335-8a12-9fb81b8c883c

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> beyond the ability to function as a registered rep. Simply put, FINRA's power through Rule 8210 extends beyond the securities industry it governs.

Next, this practicing attorney identifies the potential for FINRA abuse:

> With this much power, Rule 8210 has the potential for abuse. FINRA can seek to expel those whom it deems to be undesirable by making compliance with the nature, volume, or scope of Rule 8210 requests so undesirable or burdensome that providing the requested documents or information is not a real option.
>
> There is no limit on the number of document and information requests that FINRA can issue. It is not uncommon for FINRA to issue pages upon pages of document and information requests, and to follow up one set of overly broad and unduly burdensome set of requests with another set of the same. There likewise is no limit on the number of hours or days for which FINRA can take a rep's testimony. [Citations omitted] Multiple-day on-the-record interviews are not uncommon. Under Rule 8210, FINRA can even compel a rep, who lives within walking distance of its New York office, to travel across the country at his own expense to provide testimony in its Los Angeles office.
>
> In addition, there generally is no limit on the scope of document and information requests that FINRA can issue. [Citations omitted] For example, a rep may possess confidential medical records regarding a client to whom he sold an annuity (which is not a security). FINRA can demand those records, even if the rep did not conduct any securities business with the client. By further example, it may be a violation of state, federal, or international law or a breach of contract to provide certain confidential documents that a rep possesses by virtue of his non-securities-related business, but FINRA still can requests that those documents be produced.
>
> Further, there is no time limitation on the length of a FINRA inquiry. [Citations omitted] It is not uncommon for FINRA to investigate matters long after the fact, or to conduct inquiries that can be measured in years, not months. It likewise is not uncommon from FINRA to receive a response to a Rule 8210 request, not communicate with the rep for months or longer, and then continue to pursue the inquiry. Lengthy inquiries can be quite stressful to those under scrutiny, as well as their families.
>
> The potential for abuse is there. And there are plenty of firms and reps that will testify that they have been harassed by FINRA through its seemingly limitless Rule 8210 power.

Finally, this practicing attorney identifies what we have already said, namely, that FINRA makes its own rules and enforces them – in other words, acts as "judge, jury, and executioner" (as that age old adage goes) without meaningful accountability:

> If a rep believes that FINRA is abusing its Rule 8210 powers, he has limited options – none of which provide appropriate due process.
>
> The first option is to complain to FINRA. This can be done through complaints at the district and national levels or to its Office of the Ombudsman. This route leaves a rep at the mercy of FINRA – the very same people who issued the requests (and who feel compelled to defend the actions of their organization). This is not due process.
>
> The second option is to not provide the requested documents and information. This is a very risky route. It requires a rep to put his license on the line to assert that FINRA has overstepped the bounds of Rule 8210. If FINRA determines that it is entitled to the requested documents and information (which

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> presumably will be the case), then it likely will initiate a disciplinary proceeding in its forum, the Office of Hearing Officers (OHO), which can be appealed to another one of its forums, the National Adjudicatory Council (NAC). If those tribunals, and any tribunals to which subsequent appeals are lodged, determine that any of the requested materials should have been provided, the likely result is a bar from the securities industry. Needless to say, this method of "due process" discourages challenges to Rule 8210 requests, gives FINRA a tremendous amount of leverage in any attempt to negotiate a limit to the scope of Rule 8210 requests, and emboldens FINRA to push the boundaries of the Rule.
>
> There is no body, independent or otherwise, from which a rep can seek interlocutory relief from overly broad, unduly burdensome, harassing, or otherwise abusive Rule 8210 requests, without running the risk of being barred from the securities industry. Given the power that FINRA wields through Rule 8210, there should be.

The potential for and actual abuse that securities industry members privately complain about among themselves can only be rectified by granting brokers *all* the protections afforded by the Fourth, Fifth, and Sixth Amendments – the same protections that the same broker would enjoy if he were being investigated by a federal government agency instead of FINRA.

This is a particularly necessary relief for *Small Broker/Dealers* whose compliance staff is almost always small in size and routinely overwhelmed with multiple Rule 8210 requests by separate FINRA departments, oftentimes addressing the same or closely related potential rule violation with which FINRA is concerned. Sometimes different divisions or departments within FINRA will make 8210 requests in the course of simultaneous investigation investing essentially the same facts, the same or similar compliance issues, and the same or similar purported rule violations. The average person would read harassment into this technique; but neither harassment nor common sense is a defense to Rule 8210 requests. Often the cost of compliance simply drives *Small Broker/Dealers* out of the business – evidenced by the fact that in 2007 there were approximately 5,000 broker/dealer FINRA member firms that reduced to less than 4,000 firms in September 2016.[155]

6. <u>Remedies: Recommendations for Fixing Deficiencies in Amendments Proposed in Regulatory Notice 18-16.</u>

The authors of this Comment Letter offer the following proposed remedies in the spirit of good faith based upon the comprehensive, fair and balanced legal analysis hereinabove conducted.

6.A <u>Necessity for Substantive Fairness in Enforcement Proceedings: Employing Securities Industry Participants as Adjudicator in OHO and NAC Proceedings to Guarantee Neutrality and Impartiality of Decision-Makers.</u>

As has been demonstrated:

[155] David R. Burton, Reforming FINRA, Backgrounder No. 3181 (The Heritage Foundation, February 2017), at p 10. Source: https://www.heritage.org/sites/default/files/2017-02/BG3181.pdf.

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- The OHO Chief Hearing Officer, at a minimum, has a "financial interest" in appointing a Hearing Panel that is loyal to FINRA's mission is "to provide investor protection and promote market integrity".
- Hearing Officers on the Hearing Panel are attorneys who have acted in adjudicative roles on behalf of FINRA.

In short, the attorneys sitting as adjudicators of alleged broker misconduct in enforcement proceedings are attorneys who, themselves, have "tried cases against" – as opposed to "defended" – brokers in FINRA enforcement proceedings.

Experientially (read: enforcement prosecutor), ideologically (read: loyalty to FINRA's stated mission), and financially (read: past, present, and continuing employment with FINRA), the interests of such hearing officers and adjudicators align integrally with FINRA, and not with anything or anyone else. No matter how professional that every attorney aspires to be, attorneys who have actually tried cases know that many cases turn on nuance:

- A prosecutor will see a certain compelling fact as inching in the direction of "conviction".
- A defense attorney will see the same fact as inching in the direction of "acquittal".

Especially in ***close*** cases, the feather that tips the scales of justice in a case whose standard is "clear and convincing evidence" often turns on nuance. This is the essence of conflict in every court room (or hearing room, for that matter). No trial lawyer worth his salt would insist that this just doesn't happen where he or she is concerned. It does. This is the reason why representing both plaintiff and defendant in a civil trial, and government and defendant in a criminal trial, and government agency and respondent in an enforcement matter is a non-waivable conflict of interest.[156] ***This is why there are jury trials in the criminal as well as in civil cases.***

The FINRA enforcement system is fraught with conflicting interests: ***the*** factor that tilts the scales in favor of changing the playing field by employing securities industry attorneys as adjudicators in OHO and NAC proceedings in order to guarantee neutrality and impartiality of decision-makers is the "financial interest" factor.

Financial interest in one of the parties to litigation is one of those fundamental, non-waivable conflicts of interest, especially in the federal judiciary.[157] The outcome is the same in state judiciary.[158] Here,

[156] *See e.g.*, American Bar Association Rule 1.7(a)(3): (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if: (1) the representation of one client will be directly adverse to another client; or * * * (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if: * * * (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal ** *. In other words, "a lawyer may not represent adverse parties in litigation even with their consent. For example, a lawyer may not represent both plaintiff and defendant in a lawsuit requesting an amicable divorce." *See* Lisa G. Lerman, Philip G. Schrag, Ethical Problems in the Practice of Law: Concise Edition, p. 257.

[157] 28 U.S. Code § 455 (relating to disqualification of justice, judge, or magistrate judge): (a) Any justice, judge, or magistrate judge of the United States shall disqualify himself in any proceeding in which his impartiality might reasonably be questioned. See also Canon 3 (relating to Judge Should Perform the Duties of the Office Fairly, Impartially, and Diligently): (C) *Disqualification*. (1) A judge ***shall disqualify*** himself or herself in a proceeding

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OHO and NAC adjudicators are employees (or former employees) of FINRA and in an enforcement matter, FINRA, operating through its Department of Enforcement, is the party to the action being brought against the broker. In a FINRA enforcement matter, prosecutor and hearing officer are on the same side.

While things may in fact be different "on the inside", certainly from the "outsider's point of view" it is the "financial interest" of the FINRA employee / OHO and/or NAC adjudicator – that is, demonstrating ongoing loyalty to FINRA's mission "to provide investor protection and promote market integrity" – that is likely to prove more important than the "experience" and/or "ideological" factors that leads an adjudicator towards bias for FINRA or prejudice against the broker when deciding the outcome in an enforcement case. The kernel of this truth has been reported by one Law Commentator, influenced by certain United States Supreme and Circuit Court decisions:

> Bias has been defined as the propensity, or leaning, toward a certain object or view. It results indirectly from the combination of functions in that there is agency control over the decision making body of the organization. The result of this exercise of control, to a certain extent, forces the policy of the agency or agency head on the decision making body. Then too, the fact that a given hearing examiner's job depends

in which the ***judge's impartiality might reasonably be questioned,*** including but not limited to instances in which: * * * (c) the judge knows that the judge* * * has ***a financial interest in*** the subject matter in controversy or ***in a party to the proceeding***, or any other interest that could be affected substantially by the outcome of the proceeding * * *" *See also* Disqualification Under 28 U.S.C. § 455: §455(b)(4) requires judges to disqualify themselves for financial interest and §455(d) adds "however small", which necessarily includes an interest so small that it could not reasonably call the judge's impartiality into question. Section 455(b)(4) requires disqualification no matter how insubstantial the financial interest and regardless of whether or not the interest actually creates an appearance of impropriety. *See* § 455(d)(4); In re Cement and Concrete Litigation, 515 F.Supp. 1076 (Ariz.1981), ***mandamus denied,*** 688 F.2d 1297 (CA9 1982), ***aff'd, by absence of quorum,*** Arizona v. United States District Court, 459 U.S. 1191 (1983), cited in Liljeberg v. Health Servs. Acquisition Corp., 486 U.S. 847, 860 n.8 (1988) The conflicts enumerated in § 455(b) require automatic disqualification—even if the judge believes he or she is capable of impartial judgment; even if he or she believes that a reasonable person would not question his or her impartiality; and even if the parties are willing to waive any objections. Section 455(f), however, provides an opportunity for the judge to "cure" certain § 455(b) conflicts. The Second Circuit held that a district judge who had unknowingly possessed a substantial financial stake in one of the plaintiffs (i.e., "Chemical Bank (now known as The Chase Manhattan Bank) during a bench trial could not cure this conflict by divesting himself of the interest on remand. Chase Manhattan Bank v. Affiliated FM Ins. Co., 343 F.3d 120, 131 (2d Cir. 2003). In this case, the financial interest was non-waivable; therefore Second Circuit held that the district judge's denial of Affiliated's recusal motion was an abuse of discretion, and reversed, vacated all decisions and orders made in this case. Significantly, the Second Circuit held that "where an earlier 'appearance' of a potentially disqualifying interest mandated recusal under Section 455(a), a divestiture years later cannot cure a judge's presiding over significant proceedings in a case—here rendering a decision after a bench trial—in the intervening years. This raises the point that the only way that only divestiture of employment with FINRA may be sufficient to overcome an otherwise valid motion for recusal in an enforcement action against a broker.

Understood: The FINRA hearing panel members are not federal judges or magistrates. But, aside from the fact that the principles set forth 28 U.S. Code § 455 and Code of Conduct of United States Judges Canon 3(C)(1)(c) are principles of fundamental fairness universally applicable and certainly inherent in the SEC "fair principle" doctrine required by Sections 6(b)(7) and Section 19(e)(1)(A) of the Exchange Act, the U.S. Supreme Court recently heard oral argument in *Lucia v. Securities and Exchange Commission* to decide whether administrative law judges (ALJs) of the Securities and Exchange Commission (SEC or Commission) have been properly appointed. In particular, the Court was asked to determine whether SEC ALJs are "Officers" within the meaning of the Appointments Clause of the United States Constitution. The SEC has historically taken the view that its ALJs are employees (rather than Officers) and do not need to be appointed pursuant to the Appointments Clause. The Supreme Court's questioning focused on competing principles of ***judicial independence and political accountability***. If the Supreme Court finds that SEC ALJs are "officers" and not just employees of the SEC, this outcome will redound to FINRA, especially because of its close relationship with the SEC – FINRA being a "deputy of the SEC". At the submission of this Comment Letter, the Supreme Court rendered a decision in *Lucia*. ***In a 7 to 2 decision, Securities and Exchange Commission administrative law judges are "officers of the United States," subject to the Constitution's appointments clause.***

[158] *See* State of Florida, Supreme Court Judicial Ethics Advisory Committee, Opinion Number: 00-34 (Date of Issue: October 25, 2000): May a judge preside over a case in which a former law partner is an attorney of record, and the attorney's law firm is making payments to the judge pursuant to the terms of a promissory note? **ANSWER:** No. "This Committee concludes that disqualification is required pursuant to Florida Code Judicial Conduct, Canon 3E(1), if a judge is receiving payments from a former law firm pursuant to the terms of a promissory note." Source: http://www.jud6.org/LegalCommunity/LegalPractice/opinions/jeacopinions/2000/2000-34.html

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at times upon the carrying out of the agency policy, must influence his decision, even if only subconsciously."[159] (Emphasis supplied).

In ***close*** cases where a compelling fact that could go either for the investor as witness for FINRA's Department of Enforcement or for the broker, "financial interest" is very likely to be the factor that turns the case against the broker: "Then too, the fact that a given hearing examiner's job depends at times upon the carrying out of the agency policy, must influence his decision, even if only subconsciously."[160] Again, this is how an "outsider" is going to see things. This is inescapable. Appearance is everything in close cases – and, even ones that are not so close.

The critical problem in enforcement proceedings – for FINRA and every agency enforcement proceeding – is the appearance of impartiality, not just the fact of impartiality.[161] When all three members of an OHO or NAC proceeding are FINRA employees, suspicion of bias, prejudice, partiality, presumption of "guilt" in the minds of securities industry member and their brokers is not only to be expected, *it is reasonable*.

Therefore, for each OHO and NAC panel, there should be one (1) attorney who has a demonstrated history of representing brokers or member firms, whether in a litigation or staff attorney capacity representing the interests of his firm's Compliance Department. In short, this attorney is to be chosen because of his securities industry experience, knowledge of federal securities laws and regulations, FINRA rules, and both knowledge of and experience in industry practices in the investment banking and securities business.

Equally important, FINRA needs to establish a process for soliciting bona fide *neutrals* to sit on the OHO and NAC. Certain jurisdictions require attorneys to present their "neutral" credentials to an appropriate authority demonstrating the fact that they have represented "plaintiffs" and "defendants" / "claimants" and "respondents" / "customers" and "brokers and firms" in both litigation and commercial transactions – allowing to determine whether the attorney's demonstrated experience proves to the satisfaction of this authority that the proposed neutral attorney is more likely than not to be a *bona fide* neutral.

[159] *See* The Hoover Report – Procedural Due Process in Required Administrative Hearings, Vol. 30, Issue 2, Number 2, Article 6, St. John's Law Review (May 1956), p. 257, *citing* United States ex rel Accardi v. Shaughnessy, 219 F.2d 77 82 (2d Cir.), *rev'd*, 349 U.S. 280 (1955); Marcello v. Bonds, 349 U.S. 302 (1955); NLRB v. Pittsburgh S.S. Co., 37 U.S. 66 (1949); Fry Roofing Co. v. NLRB, 222 F.2d 938 (1st Cir. 1955); United Statesv. Peebles, 220 F.2d 114 (7th Cir. 1955); NLRB v. Phelps, 146 F.2d 562 (5th Cir. 1943); ***and see*** Schwartz, Administrative Law 1955 Annual Survey of American Law, 31 N.Y.U.L. Rev. 93, 101 (1956). The authors of this Comment Letter acknowledge that the FINRA would contend that it is not a "government agency" and therefore this law review article is inapplicable. However, as has been articulated generally in Section 4.B of this Comment Letter, the mounting evidence is that FINRA has stepped over the "government actor" line. The Hoover Report is relevant, certainly analogously, for the purpose of identifying those factors that contribute towards bias in an individual functioning as finder of fact and law in evidentiary hearings, whether the individual is an administrative law judge in an agency enforcement or a hearing officer in a FINRA enforcement case.
Source: https://scholarship.law.stjohns.edu/cgi/viewcontent.cgi?referer=https://www.bing.com/&httpsredir=1&article=4659&context=lawreview

[160] Id.

[161] Rv Sussex Justices, Ex parte McCarthy ([1924] 1 KB 256, [1923] All ER Rep 233) "Not only must Justice be done; ***it must also be seen to be done.***" (Emphasis supplied).

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With these improvements, FINRA enforcement proceedings can begin to come closer to the fundamental principle that is the foundation of impartiality: Namely, that a neutral decision-maker (here, the collective Panel sitting as a OHO Panel or an NAC Panel) is both a person without a financial interest in the outcome of the case, a person (collectively) who is not affiliated with one side or the other.[162]

6.B FINRA Should Exclude Certain Arbitration Settlements Entirely From "Materiality" Considerations in the Proposal to Amend the NASD Rule 1010 Series (MAP Rules).

As demonstrated above,[163] certain "Non-Attorney Representative" "stock loss recovery" firms or NARs engage in "barratry".[164] Arbitration settlements reached by companies that engage in barratry should be excluded from FINRA's calculation when determining whether a particular broker is a "bad broker" based on a check-the-box for Specified Risk Events.

Approximately 115 and 170 firms will be impacted by this Rule proposal, of which fifty percent (50%) will be *Small Broker/Dealers*.[165] This means that a lot of Small Broker/Dealers that are not and should not be "taping" firms will become "taping" firms – and in the public's minds' eyes will be identified as being "Disciplined Firms" – if FINRA allows "nuisance-value" settlements worked by NARs to be part of the MAP calculation. The injustice here is that "nuisance-value" cases are inherently flawed from the judgment of fundamental law. Thus, a lot of Small Broker/Dealers will be wearing the "taping/disciplined" firm Scarlet Letter, by virtue of having brokers who cross the "bad broker" threshold mainly, if not solely, because they have "nuisance-value" cases having been brought against them by NARs.

These cases, therefore, should be excluded from "bad broker" calculations because the settlements of these cases lack probative value because these cases are what defense lawyers, and insurance adjustors, call "nuisance-value settlement cases".

It bears repeating here: A nuisance-value settlement is an early out of court settlement, made even though the claim is frivolous (i.e., without merit). It is generally accepted among the defense bar and

[162] *See, e.g.*, Morrissey v. Brewer, 408 U.S. 471, 486 (1972)

[163] *See* Section 4A *supra* [relating to "Whether FINRA Should Exclude Certain Arbitration Settlements Entirely From "Materiality" Considerations in the Proposal to Amend the NASD Rule 1010 Series (MAP Rules)"].

[164] "Ambulance chasing" is a synonym for "barratry", which refers to the practice of soliciting business from accident victims or their families at the scene of an accident or disaster, even harassing " victims and their families with hopes of signing them up as clients. Non-lawyers who engage in this activity are called 'case runners' ". Approximately twenty-three (23) jurisdictions in the United States have statutes that proscribe "barratry" in some form or another. *See* Case Runners: The Real Ambulance Chasers. http://www.dopplr.com/ambulance-chasers-and-case-runners/

[165] Without differentiating between the various criteria (i.e., criminal specified events vs. arbitration specialized events), FINRA statistics that impact this amendment rule proposal is as follows: "FINRA also analyzed firms that employed individuals who would be directly impacted by this proposal. The analysis shows that in each year over the review period, there were between 115 and 170 firms employing individuals meeting the proposed conditions. Approximately 50 percent of these firms were small, 13 percent were mid-sized and the remaining 37 percent were large firms.58 FINRA estimates that approximately 38 percent of the individuals meeting the proposed criteria were employed by small firms, 17 percent by mid-sized firms and 45 percent by large firms." *See* Regulatory Notice 18-16, at p. 23.

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their insurance company clients that some people will file any case, with no concern for the merit of their case, in the hope of achieving a settlement, even if only a very small dollar settlement: The nuisance-value plaintiff or claimant knows that certain defendants will pay something, even a small amount of money, to enable the defendant to rid himself of the nuisance-value claim.[166] Such frivolous lawsuits are called "nuisance-value cases" because, by bringing the suit, the plaintiff is causing a nuisance to the defendant.

This is bad enough when perpetrated by lawyers who see the practice of law as a business rather than a profession or a vocation; it is even worse when perpetrated by non-lawyers engaged in the unauthorized practice of law.

In the first instance, the public is at least protected by oversight of the Supreme Courts of the several States and their respective Bar Associations charged with enforcing their respective codes of professional responsibility against lawyers who file frivolous lawsuits. There are real consequences for lawyers who bring frivolous law suits, ranging from substantial fines to loss of professional license.[167] But, in the second instance, the public has little or no protection at all against NARs, especially in those States that have very weak or no "unauthorized practice of law" statutes.

In short, settlements wrought from claims pursued by "stock loss recovery" non-lawyer firms (1) have little no probative value for assessing whether a broker is a "bad broker" because these settlements, by

[166] A "frivolous suit" is defined as "a lawsuit having no legal basis, often filed to harass or extort money from the defendant." Black's Law Dictionary, 7th ed (1999), p 678. *See e.g.* Belfer v. Merling, 322 N.J.Super. 124, 144 (App. Div. 1999), *citing* Fagas v. Scott, 251 N.J. Super. 169, 189 (Law Div. 1991): "A claim will be deemed frivolous or groundless when no rational argument can be advanced in its support, when it is ***not supported by any credible evidence***, when a ***reasonable person could not have expected its success***, or when it is ***completely untenable***." (Emphasis supplied)

[167] *See* Martha Neil, Federal judge plans to sanction 16 lawyers for 'gamesmanship' and 'forum shopping, ABA Journal (April 15, 2016, 1:00 PM CDR) Source: http://www.abajournal.com/news/article/federal_judge_sanctions_16_lawyers_in_class_action_for_gamesmanship_in_movi; Joseph Robinson & Robert Schaffer, Federal Circuit Upholds Sanctions and Attorney's Fees for Vexatious Litigation and Frivolous Appeal, IPWatchdog (January 15, 2017) Source: http://www.ipwatchdog.com/2017/01/15/sanctions-attorneys-fees-vexatious-litigation-frivolous-appeal/id=77051/; Andrew J Kennedy, Litigation News Associate Editor, Lawyer Sanctioned for Pursuing Baseless Case to Summary Judgment, Litigation News from the ABA Litigation Section (June 30, 2016) ("Vigorous advocacy crosses the line into sanctionable conduct when an attorney pursues a suit long after it becomes clear there is no evidence to support the claims. * * * It should not chill future cases—it should chill this attorney from filing a case just to strong-arm a settlement from the other side.") Source: https://apps.americanbar.org/litigation/litigationnews/mobile/article-sanction-summary-judgment.html; Martin H. Orlick, United States Supreme Court Refuses to Entertain Appeal by Frivolous, Vexatious Litigant in Federal Courts: Good news for retailers, restaurants, hotels, other places of public accommodation and the disabled community, (November 20, 2008) Source: https://www.jmbm.com/docs/mho_frivolous.pdf.; Martha Neil, 7th Circuit Affirms $80K Sanction: If Lawyer Can't Pay, Bankruptcy Is Next Step, ABA Journal (February 28, 2009, 1:59 AM CST) (sanctions for vexatious litigation under 28 U.S.C. § 1927)
Source: http://www.abajournal.com/news/article/7th_circuit_affirms_80k_sanction_bankruptcy_is_next_step_if_lawyer_cant_pay

Louisiana lawyers have been disciplined for filing wholly meritless lawsuits. *See, e.g.*, In re Harvin, 117 So. 3d 907, 913 (La. 2013) (suspending lawyer for 30 days for causing unnecessary litigation when the lawyer filed notice of *lis pendens* for client who had no claim to the property in question). In re Cook, 932 So.2d 669, 676 (La. 2006) (disciplining lawyer for filing "repetitive and unwarranted pleadings" and making "frivolous and harassing claims for discovery"); In re Zohdy, 892 So. 2d 1277 (La. 2005) (suspending lawyer for six months for, among other offenses, unjustifiably obstructing a class action lawsuit); In re Stratton, 869 So. 2d 794 (La. 2004) (suspending lawyer for three years for filing frivolous lawsuit "designed to harass" former secretary); In re Hackett, 701 So. 2d 920 (La. 1997) (reprimanding lawyer for filing meritless motion to dissolve temporary restraining order); In re Caulfield, 683 So. 2d 714 (La. 1996) (disbarring a lawyer for staging fake automobile accident to defraud rental car company); In re Forman, 634 So.2d 330 (La. 1994) (suspending a lawyer for six months for filing frivolous fee-collection lawsuit); In re Williams-Bensaadat, 181 So.3d 684, 691-92 (La. 2015) (suspending lawyer for instituting a lawsuit against a former client instead of endorsing a settlement check and resolving fee dispute through *concursus* proceeding). A lawyer can also be disciplined for vexatious litigation conduct. *See, e.g.*, In re DuBarry, 814 So. 2d 1273 (La. 2002); *see also* In re Lester, 133 So.3d 1248 (La. 2014) (disbarring lawyer for engaging in "frivolous and vexatious litigation," among other rule violations).

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definition, have no merit and (2) are actually injurious to customers because of the hidden costs[168] of utilizing these non-lawyer firms.[169]

For these reasons, FINRA should undertake appropriate steps to discourage NAR participation in FINRA arbitration forums, starting with excluding these "stock loss recovery" non-law firm cases and their settlements from being treated as a "materiality" consideration in the proposal to amend NASD Rule 1010 Series (MAP) Rules.

6.C FINRA Should Exclude Certain Arbitration Settlements Entirely BrokerCheck Disclosure.

Given that "NARs have been alleged to charge investors $25,000 in non-refundable deposits for representation take [from] settlement money that the investors were not aware of and represented some investors without their consent";[170] and,

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[168] *See e.g.* Jesse Greenspan, Counting the Cost of a True Nuisance Settlement, Law360 (August 28, 2008) https://www.law360.com/articles/67683/counting-the-true-cost-of-a-nuisance-settlement.

[169] In these jurisdictions, the customer who retains a Cold Spring Advisory-type of non-lawyer "stock loss recovery firm" – in order to "break even" – must:

- Recoup the $10,000 to $25,000 forensics investigation fee paid to the "stock loss recovery firm".
- Pay to the "stock loss recovery firm" the "client's" share of the contingent fee arrangement.
- Pay the cost of hiring a defense attorney to represent the "client" in an attorney lien (and related causes of actions) brought by originally hired by the "client" on referral from the "stock loss recovery firm".
- Pay the compensatory damages won by the attorney who brings the charging lien claim against the "client" for breaching the Legal Services Contract at the prompting of the "stock loss recovery firm".
- Pay for other damages, such as punitive damages, for participating in ruining the attorney's business reputation.

See FINRA Investor Alerts, It Can Be Hard to Recover from "Recovery" Scams: (19 September 2016) Source: https://www.finra.org/investors/alerts/it-can-be-hard-to-recover-from-recovery-scams "It's an alluring offer. You hear from someone who claims to be able to help you recover money you lost from a previous investment. The information sounds credible and the organization sounds legitimate. Documents you receive also look authentic, and the money that's promised is not only welcome, but seems well-deserved compensation for previous losses. The catch? They want you to pay money upfront for the recovery "services," which in some cases are purely fraudulent. In addition to the original money you lost, you now may lose more money at the hands of professional con artists." (19 September 2016).

Accord The Giuliano Law Firm, Securities Regulators Caution Suckers to Avoid Fake Lawyers: "* * * Welcome to the 'Sucker's List'. * * * These persons [Non-Attorney Representatives or NARs] are not lawyers nor are from law firms, but generally are in fact former boiler room operators themselves, brokers barred from the business, seeking to further exploit investor victims. Because they have a list, they generally know the exact securities and the exact firm or firms where the investor lost money. ***They are not lawyers, they do not try cases, but they do offer their "services" often in consideration for an up-front fee of as much as $5,000 to $10,000 to perform an "analysis" of the account, and sometimes as much as 50% of whatever they may be able to recover for investors.*** " (Emphasis supplied) (26 September 2016). Source: https://securitiesarbitrations.com/securities-regulators-caution-suckers-avoid-fake-lawyers/.

[170] *See* Public Investors Arbitration Bar or PIABA ***has*** issued such an investor alert that should be issued by FINRA: Non-Attorney Representatives Are Real and Growing "Menace to Investors" in FINA Arbitration: NAR Firms Found to Include Individual Who Pled Guilty in Insurance Scheme and Brokers Barred from Industry: Unwary Investors have None of the Protections of Dealing with Attorneys and Often Recover Little of Lost Funds. (December 18, 2017, 13:57 ET). Source: https://piaba.org/piaba-newsroom/report-nar

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Given that "Non-attorney representatives often do not maintain malpractice insurance, have no ethical code or constraints like attorneys do not face potential sanctions from any regulatory or licensing body like a state bar association. Essentially, this system exposes the investor who was victimized by his or her broker to potential further victimization, with little chance of recovering damages caused by an unscrupulous or negligence NAR":[171] and,

Given that "The success rate of these NARs has been sub-par. For example, Cold Spring Advisory Group has been involved in at least 27 arbitration cases. In those cases, CSAG sought a total of $2,352,274 on behalf of its clients. CSAG's clients were award a zero in 19 out of 27 cases, resulting in investors receiving a positive award in only 29.63 percent of CSAG's cases, compared to the national average, which was most recently 41-42 percent However, CSAG's clients were likely only awarded a total of $86,216, or 3.66 percent of the damages sought for all its 27 cases. Other NAR firms are believed to recover even lower amounts for their clients:"[172]

Given the aforementioned, this Comment Letter recommends that:

- Whenever any "Non-Attorney Representative" firm (such as *but not limited to* Cold Spring Advisory Group) brings and settles a claim with a broker, and whenever the arbitration panel enters an award in favor of the broker, all reference should be removed from the broker's public record.
- Whenever any "Non-Attorney Representative" firm (such as *but not limited to* Cold Spring Advisory Group) brings and settles a claim with a broker, such claims should not be made available to the public at all because no arbitration award entered was entered in favor of the claimant.
- So long as the claim is in arbitration and until the claims resolved favorably for the claimant in an express award, his/her claim should be treated as a kind of *motion in limine*.[173]

In short, until there is an award in favor of the claimant in these "nuisance-value" cases, no reference should be made to this case in the broker's public record: *A Bell Once Rung Cannot Be Unrung*.[174]

[171] Id.

[172] Id.

[173] *See* Brodit v. Cambra, No. 02-15323 (9th Cir. November 26, 2003): "California state courts recognize pretrial motions in limine as useful tools precisely because such motions allow parties to resolve evidentiary disputes ahead of trial, without first having to present potentially prejudicial evidence in front of a jury. * * * Kelly v. New W. Fed. Savs., 49 Cal.App.4th 659, 56 Cal.Rptr.2d 803, 808 (1996) (noting that ***pretrial motions in limine to preclude the introduction of prejudicial evidence "avoid the obviously futile attempt to 'unring the bell' " once the evidence is aired before the jury***).

[174] *See e.g.* United States v. Maria Aide Delgado, No. 07-41041 (5th Cir. January 19, 2011): "[A]s this Court observed in overturning a conviction because of improper prosecutorial comment, despite a curative instruction, once such statements are made, the damage is hard to undo: 'Otherwise stated, ***one cannot unring a bell; after the thrust of the saber it is difficult to say forget the wound; and finally, if you throw a skunk into the jury box, you can't instruct the jury not to smell it***' " citing United States v. Garza, 608 F.2d 659, 666 (5th Cir.1979) (quoting Dunn v. United States, 307 F.2d 883, 886 (5th Cir.1962).(Emphasis supplied). *See also* United States v. Under Seal, No. 15-4539, No. 15-4569 (4th Cir. April 5, 2017): "When Appellant's identity was disclosed to the Adult Defense Attorneys, the affront to Appellant's privacy interest in his identity was completed. Appellant's identity is now known to the Adult Defense Attorneys; we cannot unring that bell." *And see* United States v. Smith, No. 14-60936 (5th Cir. February 10, 2016): " * * *the generic instruction given prior to the prosecutor's summation does not persuade us that the jury was unaffected by the prosecutor's misconduct. We have repeatedly observed, in like circumstances, that the damage resulting from such statements is difficult to undo—"[o]therwise stated, one 'cannot unring a bell' " citing United States v. Garza, 608 F.2d 659, 666 (5th Cir.1979) (quoting Dunn v. United States, 307 F.2d 883, 886 (5th Cir.1962).

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Publication of "nuisance-value" NAR settled cases in public forums violates Due Process because there simply are no powers[175] to remedy substantial harm to personal protected rights,[176] namely, the inflammatory and defamatory effect on a good broker's reputation.[177]

Furthermore, in the event of winning a "nuisance-value" case brought by a NAR, the broker, having already paid an expensive legal fee for defense in a bogus arbitration claim, should not need to expend additional expense of retaining legal counsel to pursue an expungement proceeding after winning or settling this bogus claim.

For these reasons, Arbitration Cases brought by NARs against brokers should not be reported on BrokerCheck.

6.D FINRA Should Amend Rule 8312 (Identifying "Bad Brokers" and Linking them to "Disciplined Firms" in a BrokerCheck Disclosure) to Avoid "Guilt by Association" in Violation of Fundamental Law.

When FINRA links a "disciplined firm" and the "bad broker" on BrokerCheck, FINRA needs to avoid "disciplined firm" guilt by association for those associated persons who work in operations and compliance departments of "Taping Firms" who, themselves, *have no disciplinary history.*

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[175] *See especially* Opala v. Watt, 454 F.3d 1154 (10th Cir. 2006), *cert. denied,* 549. U.S. 1078 (2006) (where 85-year-old Oklahoma Supreme Court Justice Marian Opala, who alleged that the state high court's other eight justices discriminated against him because of his age and the 10th Circuit stated that it lacks the power to resolve this dispute, writing: " * * * we lack the power to "reinstate the pre-determined sequential order to that which existed prior to the Rule 4 amendment." We simply cannot make Justice Opala Vice-Chief Justice again. This is precisely the type of retroactive equitable relief prohibited under the Ex Parte Young doctrine. The relief sought in the complaint-a declaration that New Rule 4 is unconstitutional - would not place Justice Opala in the position he was in on November 3, 2004. ***There is no prospective remedy that can unring that bell.*** Justice Opala's claimed injury is simply not redressable with prospective relief. Thus, the federal courts ***lack the power to resolve*** this dispute.")

[176] *See* United States v. Ferguson, ___ F.3d ___, 2017 U.S. App. LEXIS (3d Cir. Nov. 28, 2017). "We thus concluded that the district court had erred in the same way as had the *Berry* court: it impermissibly allowed a bare arrest record to influence the sentencing decision. Id. at 554. When such influence is evidenced in the record, a new sentencing is required. Notwithstanding a district court's subsequent consideration of factors appropriate under the Guidelines or §3553(a), ***most likely the court will not have been able to "unring the bell," and ipso facto the defendant will have been prejudiced by the error.*** Id. In other words, when a district court relies on mere arrests to determine a sentence, it is likely to engage in the kind of "unsupported speculation" forbidden in *Berry* and *Mateo-Medina* and thus to commit "plain error that ***affects substantial rights.*** Fed. R. Crim. P. 52(b)." *See* United States v. Murray, 784 F.2d 188, 189 (6th Cir.1986) (not even a curative instruction could "unring [the] bell" of a prejudicial reference to a polygraph examination; curative instruction not enough to remedy experienced FBI agent's deliberate statement that he had asked defendant to take a polygraph test).

[177] In certain jurisdictions, ***reputation*** is a ***state constitutionally protectable interest. See e.g.,*** Commonwealth of Pennsylvania Constitution Article I, Section 1 which designates the right to reputation as an inherent and indefeasible right:

> All men are born equally free and independent, and have certain ***inherent and indefeasible rights, among which are those of enjoying and defending*** life and liberty, of acquiring, possessing and protecting property ***and reputation,*** and of pursuing their own happiness. (Emphasis supplied)

Additionally, Article I, Section 11 of the Pennsylvania Constitution provides for a remedy through the courts for injury to a person's reputation:

> All courts shall be open; and every man for an injury done him in his lands, goods, person ***or reputation shall have remedy by due course of law,*** and right and justice administered without sale, denial or delay. Suits may be brought against the Commonwealth in such manner, in such courts and in such cases as the Legislature may by law direct. (Emphasis supplied)

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When constructing its BrokerCheck for associated persons who work in operations and compliance departments of "Taping Firms" who, themselves, *have no disciplinary history,* FINRA should see to it that no "guilt by association" is communicated to the public simply because their employment is held at a "Taping Firm". That is, for clean record employees of "Taping Firms", the "disciplined firm" *Scarlet Letter* should not be communicated to the public.

Failure to do so will violate more than two hundred years of Federal jurisprudence, not to mention more than eight hundred years of Common Law jurisprudence.

6.E FINRA Should Amend Rule 8312 (Identifying "Bad Brokers" and Linking them to "Disciplined Firms" in a BrokerCheck Disclosure) to Avoid *Ex Post Facto* "Guilt by Association" of Hiring Firms.

FINRA's proposed rules that connect "bad broker" / "high-risk brokers", "disciplined firm",[178] and "taping firm"[179] do not address, from the perspective of fundamental law, the scenario where a Hiring Firm takes on a brokers who:

- Have no "specified risk event"[180] that is a *matter of public record* while at the "Disciplined Firm" and at the time of hire by the Hiring Firm.

[178] FINRA defines "disciplined firm" in Rule 3170(a)(2)(A), in part, as follows: "For purposes of this Rule, the term "disciplined firm" means: (A) a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been *expelled* from membership or participation in any securities industry self-regulatory organization or is ***subject to an order of the SEC revoking its registration*** as a broker-dealer; * * * " (Emphasis supplied)

[179] See Rule 3170(5):

(A) For purposes of this Rule, the term "taping firm" means:

(i) A member with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity ***within the last three years***;

(ii) A member with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been associated with one or more disciplined firms in a registered capacity ***within the last three years***;

(iii) A member with at least twenty registered persons where 20% or more of its registered persons have been associated with one or more disciplined firms in a registered capacity ***within the last three years***.

(B) For purposes of calculating the number of registered persons who have been associated with one or more disciplined firms in a registered capacity within the last three years pursuant to this subparagraph (5), members should not include registered persons who:

(i) have been registered for an aggregate total of 90 days or less with one or more disciplined firms within the past three years; and

(ii) do not have a disciplinary history.

[180] In its proposed amendment to FINRA Rule 1011(o) (relating to Definitions), FINRA will define "The term 'specified risk event' [to]mean any one of the following events that are disclosed, or are or were required to be disclosed, on an applicable Uniform Registration Form;

(1) a final investment-related, consumer-initiated customer arbitration award or civil judgment against the person for a dollar amount at or above $15,000 in which the person was a named party;

(2) a final investment-related, consumer-initiated customer arbitration settlement or civil litigation settlement for a dollar amount at or above $15,000 in which the person was a named party;

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- Are not "bad brokers" *when hired* by the Hiring Firm.

- Have "specified risk event(s)" that come to light *after starting* employment at the Hiring Firm: Brokers are, for example, served with "nuisance-value" arbitration(s) or lawsuit(s) *after* brokers are already working at the Hiring Firm.

- Defend these "nuisance-value" arbitration(s) or lawsuit(s) while employed at the Hiring Firm, but the underlying allegations of the unsuitability, breach of fiduciary duty, breach of contract, negligence, etc. claim(s) against brokers relate to *activities that took place solely when brokers were employed at the Disciplined Firm.*

The customer's NAR "advocate" takes a "shot-gun" approach and sues the Hiring Firm along with the brokers since the "Disciplined Firm" is now out of business and the Hiring Firm is viewed as a potential "deep pocket" – especially for "nuisance-value" settlement purposes.

As a result of the "shot-gun" approach, the owners of the Hiring Firm are either named directly named as parties or otherwise indirectly impugned by these arbitrations or lawsuits.

But the owners of the Hiring Firm had no interaction with the complaining customers – the claimants in this/these arbitration(s) or plaintiff(s) in this/these "nuisance-value" cases.

Moreover, the owners of the Hiring Firm had no supervisory responsibilities over the brokers' market conduct activities at any time relevant to the unsuitability, breach of fiduciary duty, breach of contract, negligence, etc. claim(s) brought against brokers.

The "Disciplined Firm" goes out of business less than three (3) years after brokers are hired by the Hiring Firm.

Moreover, when a "good broker" becomes a "bad broker" *after the fact* (from the perspective of broker *status at the time of hire*), the Hiring Firm's Rule 3170(5) ("taping rule) percentage moves upwards to a threshold (depending on the number of brokers hired) where the Hiring Firm can become "back-doored" into become a "taping firm" – even when the hired brokers have committed no market conduct violations during their employment with the Hiring Firm.

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(3) a final investment-related civil action where the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000; and

(4) a final regulatory action where (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000; or (B) the sanction against the person was a bar (permanently or temporarily), expulsion, rescission, revocation, or suspension from associating with a member."

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In virtue of these proposed Rules, the Hiring Firm now becomes *ex post facto*[181] "guilty by association"[182] with the "Disciplined Firm".

It is duly noted that the United States Supreme Court has held, since its ruling in Calder v. Bull,[183]that the constitutional prohibition against *ex post facto* laws applies only to criminal matters, not civil matters. It is likewise duly noted that FINRA regulations are not criminal statutes.

Just the same, Thomas Jefferson has written that *ex post facto* laws are as "equally unjust in civil as in criminal cases".[184] Similarly Alexander Hamilton has written: "[I]t is easy for men ... to be zealous advocates for the rights of the citizens when they are invaded by others, and as soon as they have it in their power, to become the invaders themselves." [185] In a word, the Founders and Framers were on heightened alert for and were particularly averse to anything that might crack a window of opportunity for arbitrary governance.

In short, the concern here is that, while not technically a constitutional violation, the amendments to Rule 8312 proposed by FINRA, violate the *spirit* of the fundamental law principle prohibiting "inflicting punishment upon a person for some prior act that, at the time it was committed, was not illegal."

In this regard, it is respectfully requested that FINRA address this inherent injustice when a Hiring Firm obtains a Scarlet Letter (i.e., becoming a "bad broker/dealer") as a result of hiring "bad brokers" who *at the time of hire* were "good brokers".

At a minimum, when reconstructing the operation of FINRA Rule 9520 Series (Eligibility Proceedings) and FINRA Rule 8312 (BrokerCheck Disclosure) and NASD Rule 1010 Series (MAP Rules), FINRA is respectfully requested to take into consideration the unreasonably prejudicial effect on brokers by operation FINRA Rule 12206 requiring claims to be filed within six years from the date of the transaction or occurrence).

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[181] Latin for "from a thing done afterward." *Ex post facto* refers to laws that provide for the infliction of punishment upon a person for some prior act that, at the time it was committed, was not illegal.

[182] *See* Michael Heyman, Due Process Limitations to Accomplice Liability, 99 Minnesota Law Review 132, 139-140 (2015): 'At its core, * * * 'guilt by association' [means that an] ***individual cannot be held vicariously liable merely because she associates with a group or third party that commits a crime.*** There must be a sufficient, 'non-tenuous,' link between her association and the third party's criminal actions.' " (Emphasis supplied) Source: http://www.minnesotalawreview.org/wp-content/uploads/2015/08/Heyman_1fmt1.pdf, *citing* Alex Kreit, Vicarious Criminal Liability and the Constitutional Dimensions of Pinkerton, 57 AM. U. L. REV. 585, 606 (2008).

[183] 3 U.S. (3 Dall.) 386, 1 L. Ed. 648 (1798),

[184] Thomas Jefferson to Isaac McPherson Monticello (August 13, 1813): "Every man should be protected in his lawful acts, and be certain that no ex post facto law shall punish or endamage him for them. * * * ***The sentiment that ex post facto laws are against natural right,*** is so strong in the United States, that few, if any, of the State constitutions have failed to proscribe them. The federal constitution indeed interdicts them in criminal cases only; ***but they are equally unjust in civil as in criminal cases, and the omission of a caution which would have been right, does not justify the doing what is wrong.*** Nor ought it to be presumed that the legislature meant to use a phrase in an unjustifiable sense, if by rules of construction it can be ever strained to what is just." (Emphasis supplied)

[185] A. Hamilton, Esq., Second Letter from Phocion (New York, April, 1784).

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Since Rule 12206 gives the "nuisance-value" claimant six (6) years to bring a meritless claim in arbitration against a broker, it is respectfully requested that all such claims filed with FINRA arbitration and brought on behalf of a customer by a NAR be excluded from FINRA's calculations in connection with implementation and impact of these Rules, as they may be amended, with respect to the Hiring Firm becoming "back-doored" into "taping firm" status and a "Disciplined Firm" by reason of "guilty by association".

6.F FINRA Should Address the Vagueness, Overbreadth, Unconstitutional Conditions, Regulatory Taking Issues in Proposed Rule 9523 and Existing Rule 8311.

As written, the proposed Rule 9523, when read in conjunction with existing Rule 8311, is Vague and Overbroad.

It is very important that FINRA clarifies when it "may be permitted to continue to work in limited circumstances". (Emphasis in original) Under existing Rule 8311, when it is permitted to do so is anything but clear.

Until a member firm can with confidence determine when it *can pay* a broker having a statutory disqualification status – prior to resolution at the conclusion of the MC-400 application – most member firms will opt not to hire such brokers – let alone expend time, effort and funds to create a heightened supervision.

The goal here for securities industry members and FINRA alike is to rid themselves of brokers who are truly "bad brokers" (not brokers who have "specified risk events" created by nuisance-value arbitrations and settlements).

While ridding the industry of "bad brokers" through the proposed amendments to Rule 9523 are consistent with FINRA's mission, this underlying motivation becomes unconstitutional,[186] when proposed Rule 9523, read in conjunction with existing Rule 8311, is so vague and overbroad that it creates a scenario where FINRA interferes with an employer's common law property right to "hire, fire, promote, and demote" employees that is protected by the Commerce Clause of the U.S. Constitution.

It is in FINRA's best interest to address and resolve this "void for vagueness" and "overbroad" issue in accord with constitutional law principles because, failure to do so risks FINRA crossing over from

[186] It bears repeating, that proposed Rule 9523 (relating to Eligibility Proceedings) especially in relation to Rule 8311 is Vague and Overbroad hardly needs to be stated. Member Firms – again, especially Small Broker/Dealers – will be "chilled" from exercising their constitutionally protected conduct under the Commerce Clause to the U.S. Constitution as well as common law and state constitutionally protected property rights, as an employer, to expand business through hiring brokers, precisely because proposed Rule 9523 and 8311 are so vague, and precisely because the risk of violating these rules are so high – and expensive, especially to Small Broker/Dealers – that firms will simply "voluntarily choose not to engage in behavior protected by law or another basic right, just to be sure they're not accidentally breaking the overbroad law." This amounts to Regulatory Taking of Property without just compensation under state and federal constitutions, triggering the Doctrine of Unconstitutional Conditions.

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self-regulation designed to protect investors to self-regulation that results in monopoly or even tyranny – *cartelization*, in other words.

6.G <u>FINRA Adopt Due Process Safeguards That Brokers have in SEC Enforcement Actions.</u>

In the event that FINRA decides to go forward with implementing the proposed amendments set forth in Regulatory Notice 18-16, FINRA should embrace the same Due Process safeguards that Brokers have in SEC Enforcement Actions.

These safeguards include:

- The Fifth Amendment Right to not incriminate oneself.
- The right to exercise this constitutional right when responding to Rule 8210 requests.
- The right to exercise this constitutional right when giving live testimony in On-The-Record interviews with FINRA.
- The right of broker's legal counsel to object to improper questions (as defined under Federal Rules of Evidence) at OTRs with FINRA.
- The right of broker's legal counsel to instruct the broker not to answer improper questions (as defined under Federal Rules of Evidence) at OTRs with FINRA.
- The right of broker's counsel to ask questions of the broker at OTRs with FINRA for the purpose of clarifying statements made by the broker in order to prevent a misleading official record being created.
- The Fourth Amendment right against unreasonable searches and seizures.
- The Sixth Amendment right to an impartial hearing panel and adjudicatory on appeal.
- The Sixth Amendment right to be informed about the nature of the charges and evidence against a broker prior to giving on-the-record testimony.

7. <u>Concluding Remarks</u>

At the close of the Federal Constitutional Convention in September of 1787, Benjamin Franklin was queried as he left Independence Hall on the final day of deliberation. A lady approached Dr. Franklin, and asked: "Well Doctor what have we got, a republic or a monarchy?" Franklin replied, "A republic . . . Madame, ... if you can keep it."

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What was Ben Franklin getting at? The clue is in his April 17th 1787 unpublished letter to Abbés Chalut and Arnoux, wherein Dr. Franklin wrote: "… Let me add, that only a virtuous people are capable of freedom. As nations become corrupt and vicious, they have more need of masters."[187]

In other words, the need for legislation – rulemaking, in our present case – rises in direct proportion to the degree to which we stray from virtue in the public market place. "Bad brokers" are a problem that taints members of the securities industry who are not. Hence we have the real need for a solution to the problem.

FINRA's proposed amendments as set forth in Regulatory Notice 18-16 have been crafted with this problem in mind and are consistent with its mission to "to provide investor protection and promote market integrity".[188]

That said, there are deficiencies in the current state of these proposed rules. These deficiencies are serious in nature because, as crafted, the proposed amendments are not consistent with fundamental law and these are constitutional in dimension. This Comment Letter was drafted with addressing, respectfully, these deficiencies.

Going back to Dr. Franklin's unpublished letter, securities industry members and FINRA, both, need to refocus their efforts at bringing FINRA back to what it was intended to by the Maloney Act – a truly *self*-regulatory organization.

If we don't, then Ben Franklin's prophecy will come to pass: we will "have more need of masters." The constitutional remedies offered in this Comment Letter aim at preventing that from happening, because such event is inconsistent with "small 'r' " republican government.

Granted "that *the steps to create and enforce a cartel* are hard to distinguish from steps necessary to help investors through the policing of bad brokers", effort nevertheless has to be made, *increasingly by securities industry members especially*, because, if their efforts are unsuccessful, the industry will "have more need of masters."

This dilemma is at least as old as our Country's Founding when, in Federalist 51, James Madison wrote: "You must first enable the government to control the governed; *and in the next place oblige it to control itself.*"

In the final analysis, this is the reason for authoring this Comment Letter.

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[187] Source: http://franklinpapers.org/franklin/framedVolumes.jsp?vol=44&page=605

[188] https://www.finra.org/about/our-mission

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Respectfully submitted,

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APPENDIX "A"

Analysis of Arbitration Cases Brought Against Brokers by Non-Attorney Representative – Cold Spring Advisory Group

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Cold Springs Advisory Group cases in FINRA Arbitration

No.	Docket Number	Nature of Claim	Dollar Amount Claims	Award	Date of Award	Fits Criteria for Nuisance Lawsuit?
Summary						
	Time Range of Review		1 January 2016	25 June 2018		
	Source of Search: FINRA Arbitration Awards Online		https://www.finra.org/arbitration-and-mediation/arbitration-awards-online?search=%22Cold%20Spring%20Advisory%20Group%22&page=1			
	Search Criteria		"Cold Spring Advisory Group"	"CSAG"	"Jennifer Tarr"	
	Number of Cases Reported and Reviewed		35		100%	
	Number of Cases Fit Criteria for Nuisance Lawsuits		25	25/35		71.428%
	Number of Cases Fit Criteria for Nuisance Lawsuits – IN PART		3	3/35		8.572%
	Number of Cases Do NOT Fit Criteria for Nuisance Lawsuits		7	7/35		20.000%
1	18-00498	Unsuitability; Overconcentration; Failure to Supervise; Breach of Fiduciary Duty; Negligence; Breach of Contract; and a claim for lost opportunity damages.	$22,490.00 Compensatory	Claimant's claims are denied in their entirety	14 June 2018	Yes
2	18-00027	Breach of the duty of Care and Negligence.	$9,606.47 Compensatory $19,212.94 Treble Damages	(1) Claimant's claims are denied in their entirety (2) Claimant's request for punitive and	7 June 2018	Yes

Criteria for Nuisance-Value. Any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

Cold Springs Advisory Group cases in FINRA Arbitration

No.	Docket Number	Nature of Claim	Dollar Amount Claims	Award	Date of Award	Fits Criteria for Nuisance Lawsuit?
			$21,180.59 Punitive	treble damages is denied. 3) All other relief requests are denied.		
3	16-01128	Unsuitability, Unauthorized transactions, Failure to Supervise, and Breach of Fiduciary Duty.	$112,991.00 Compensatory	Broker is pay to Claimant $83,491.00 compensatory Broker to pay to Claimant $68,271.00 disgorgement damages.	11 May 2018	No
4	17-02491	Unsuitable high-risk investments for Claimant's age and income.	$10,180.00 Compensatory	Claimant reached settlement with Respondent, dismissal of case with prejudice.	31 May 2018	Yes
5	16-03026	Unauthorized Transactions, Failure to execute trades, Breach of fiduciary duty, Unsuitability, Negligence, Failure to Supervise, Excess Compensation, Securities Fraud and Respondeat Superior.	$2.7 million to $5.4 Million Compensatory	Parties reached a settlement in mediation. Significantly, "The Panel recommends the expungement of all references to the above-captioned arbitration from registration records" for Broker. See page 3 of Award.	15 May 2018	Yes

Criteria for Nuisance-Value. Any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

Cold Springs Advisory Group cases in FINRA Arbitration

No.	Docket Number	Nature of Claim	Dollar Amount Claims	Award	Date of Award	Fits Criteria for Nuisance Lawsuit?
6	16-01128	Unsuitability and Unauthorized Transactions, Failure to Supervise, and Breach of Fiduciary Duty; Failure to adhere to their basic duties when opening, administering, and supervising accounts.	$112,991.00 Compensatory	Broker liable to pay Claimant $83,491.00 in compensatory damages. Broker to pay $68,271.00 in disgorgement damages.	11 May 2018	No
7	17-02040	breach of contract for compensation/commissions owed; defamation on the Form U5; securities fraud; and failure to supervise	$1,291,358.90 Compensatory Additional compensatory damages for lost wages and loss of career in the amount of $500,000.00.	Claimant's claims are "denied in their entirety." Significantly, "The Panel recommends the expungement of the Termination Comment in Question 3 from Ryan Kuhn's (CRD# 6670036) Form U5". See page 2 of Award.	30 April 2018	Yes
8	17-01059	Unsuitable (qualitative suitability) transactions; failure to supervise; respondeat superior	$43,823.00 Compensatory	Claimant's claims dismissed, without prejudice to file in Court.	6 April 2018	Yes
9	16-00402	Unsuitability; failure to supervise; breach of fiduciary duty	$308,703.00 Compensatory	$233,703.00 in compensatory damages.	22 November 2017	No
10	16-03566	Unsuitability and unauthorized transactions; failure to	$36,351.00 Compensatory	Claimant failed to prove losses stemmed from	9 November 2017	Yes

Criteria for Nuisance-Value. Any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

Cold Springs Advisory Group cases in FINRA Arbitration

No.	Docket Number	Nature of Claim	Dollar Amount Claims	Award	Date of Award	Fits Criteria for Nuisance Lawsuit?
		supervise; breach of fiduciary duty		unsuitable investments; no basis for negligent supervision.		
11	17-00104	Excessive Trading (quantitative suitability); churning; unsuitable transactions (qualitative suitability); failure to supervise; respondeat superior; violation of FINRA Rules	$50,000.00 Compensatory	Claimant's claims against Firm dismissed with prejudice; Claimant's remaining claims are "denied in their entirety."	11 September 2017	Yes
12	16-03559	Excessive Trading; Suitability; Churning; Unauthorized Transactions	$29,949.00 Compensatory	Claimant's claims are "denied in their entirety". Respondents' requests for expungement are granted.	30 May 2017	Yes
13	16-02665	Unsuitability; Unauthorized Transactions; Failure to Supervise; Breach of Fiduciary Duty	$38,084.00 Compensatory	Claimant withdrew all claims without prejudice against all Respondents	18 May 2017	Yes
14	16-01643	Unsuitability; Failure to Supervise; Breach of Fiduciary Duty	$22,269.00 Compensatory	Claimant withdrew all claims without prejudice against all Respondents	8 March 2017	Yes

Criteria for Nuisance-Value. Any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

Cold Springs Advisory Group cases in FINRA Arbitration

No.	Docket Number	Nature of Claim	Dollar Amount Claims	Award	Date of Award	Fits Criteria for Nuisance Lawsuit?
15	16-00519	Unsuitability; Failure to Supervise; Breach of Fiduciary Duty; Unsuitable recommendations and over-concentrated account with certain investments.	$19,772.00 Compensatory plus $27,128.00 punitive	Claimant's claims denied in their entirety.[1]	1 March 2017	Yes
16	16-01655	Unsuitability; Unauthorized Transactions; Failure to Supervise; Breach of Fiduciary Duty.	$50,000.00 Compensatory	Claimant's claims against Brokers #1, #2, #3, and #4 are denied in their entirety. Claimant dismissed with prejudice claim against Broker #5 because of settlement.	27 February 2017	Yes
17	16-00350	Suitability; Failure to Supervise; Breach of Fiduciary Duty; Failure to adhere to basic duties when opening, administering, and supervising brokerage accounts; Unsuitable recommendations.	$294,316.00 Compensatory	Broker #1 liable for $83,000 in compensatory damages. Broker #2 liable for $20,000 in compensatory damages. Broker #3 liable for $195,737 in compensatory damages.	24 February 2017	In Part

[1] "Under FINRA Code of Arbitration Procedure, and as limited by Kansas law, the [Claimant's] pleadings are stricken, as neither Cold Spring Advisory Group nor non-attorney Jennifer Tarr can represent Claimant in this arbitration, and even if we were to address the merits, Claimant has not met his burden of proof on any count, so all awards are in favor of Respondents." (Emphasis supplied) See award page 9 of 11.

Criteria for Nuisance-Value. Any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

Cold Springs Advisory Group cases in FINRA Arbitration

No.	Docket Number	Nature of Claim	Dollar Amount Claims	Award	Date of Award	Fits Criteria for Nuisance Lawsuit?
				Claimant dismissed with prejudice all claims against Broker #4. Claimant dismissed with prejudice all claims against Broker #5.		
18	16-00441	Breach of Fiduciary Duty; Suitability; Failure to Supervise; Inappropriate recommendations; Failure to adhere to basic duties when opening, administering, and supervising brokerage accounts.	\$30, 236.00 Compensatory \$14,164.00 Punitive	Claimants' claims against Broker #1 and Broker #2 are "dismissed with prejudice". Claimant's claim against Broker #3 is dismissed without prejudice for lack of perfected service. Broker #4 and Firm are liable to pay \$32,517 to Claimants.	10 February 2017	In Part
19	15-01228	Churning; Unauthorized Trading; Breach of Fiduciary Duty; Breach of Contract; Elder Abuse;	\$715,204.54 Compensatory	Claimants claims, "each and all, are dismissed with prejudice."[2]	20 January 2017	Yes

[2] The Arbitrator writes: "Claimant ... failed and refused to participate in a pre-hearing telephone conference ... Claimant failing to provide a reasonable and non-evasive explanation for his actions." See page 4 of Award.

Criteria for Nuisance-Value. Any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

Cold Springs Advisory Group cases in FINRA Arbitration

No.	Docket Number	Nature of Claim	Dollar Amount Claims	Award	Date of Award	Fits Criteria for Nuisance Lawsuit?
		Disciplinary History and Failure to Supervise; and Quantum Meruit – Disgorgement.				
20	15-01225	Churning; Unauthorized Trading; Breach of Fiduciary Duty; Breach of Contract; Elder Abuse; Disciplinary History and Failure to Supervise; and Quantum Meruit – Disgorgement.	$123,553.46 Compensatory	Claimants to pay $37,500 to Respondents (Firm and Broker) on Counter-Claim.[3] Claimants to pay $7,500 to Respondents on Motion for Sanctions. "The Panel does not find the Claimants' allegations credible." Page 5 of Award.	6 January 2017	Yes
21	16-01121	Unauthorized Trading; Unsuitability; Failure to Supervise	$24,955.00 Compensatory	Claimant's claims are "denied in their entirety".	28 December 2016	Yes
22	16-00673	Suitability; Failure to Supervise; Churning; Breach of Fiduciary Duty; Unsuitable Strategy – investments in inferior quality companies; Over-	$50,000.00 Compensatory	Broker #1 and #2 liable for $46,500 in compensatory damages. Claimant dismissed with	22 December 2016	No

[3] The Arbitrator writes: "The Panel does not find the Claimants' allegations credible." (Emphasis supplied) See page 5 of Award.

Criteria for Nuisance-Value. Any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

Cold Springs Advisory Group cases in FINRA Arbitration

No.	Docket Number	Nature of Claim	Dollar Amount Claims	Award	Date of Award	Fits Criteria for Nuisance Lawsuit?
		concentrated positions.		prejudice claim against Broker #3 because of settlement.		
23	15-03326	Unsuitability; Breach of Fiduciary Duty	$86,524.00 Compensatory	Claimant's claim is "denied in its entirety."[4]	24 October 2016	Yes
24	15-02865	Suitability; Churning; Failure to Supervise; Unauthorized Trading.	$33,306.00 Compensatory	Claimant's claims are "denied in their entirety." Claimant is entitled to "No Award against Respondents either because of (a) the invalidity of Claimant's prior submissions,[5] and/or (b) the evidence submitted by Claimant, as refuted by Respondents, is insufficient * * * Claimant shall be responsible for 100% of FINRA	13 October 2016	Yes

[4] The Arbitrator writes:
- "The claim, allegation, or information is factually impossible or clearly erroneous, and
- "The claim, allegation, or information is false." (Emphasis added) See page 4 of Award.

[5] The Arbitrator writes: "IT IS HEREBY ORDERD that under Rule 12208 of the FINRA Code of Arbitration Procedure, as limited by Arizona law, CSAG [Cold Spring Advisory Group] and Ms. Tarr cannot represent Claimant in this arbitration." [Citations omitted with respect to state law prohibitions against non-attorney representation of clients in non-judicial proceedings.]

Criteria for Nuisance-Value. Any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

Cold Springs Advisory Group cases in FINRA Arbitration

No.	Docket Number	Nature of Claim	Dollar Amount Claims	Award	Date of Award	Fits Criteria for Nuisance Lawsuit?
				Forum fees related to this arbitration." See pages 5-6 of Award.		
25	16-00201	Unsuitability; Failure to Supervise; Breach of Fiduciary Duty.	$39,605.00 Compensatory	Claimant's claims are "denied in their entirety".	30 September 2016	Yes
26	16-00786	Unsuitability; Unauthorized Trading; Failure to Supervise; Breach of Fiduciary Duty.	$42,459.00 Compensatory	Claimant's claims are "denied in their entirety."	16 September 2016	Yes
27	15-03282	Unsuitability; Failure to Supervise; Breach of Fiduciary Duty.	$31,258.00 Compensatory	Claimants' claims are "denied in their entirety."	18 August 2016	Yes
28	15-02851	Unsuitability; Failure to Supervise; Overconcentration; Churning.	$44,734.00 Compensatory $2,500.00 Punitive	Broker #1 is liable to pay Claimant $44,734.00. Claimant withdrew without prejudice claim against Broker #2.	29 July 2016	In Part
29	16-00351	Unsuitability; Failure to Supervise; Breach of Fiduciary Duty; Day-Trading and Unsuitable Recommendations.	$50,000.00 Compensatory	Broker's #1, #2, #3, and #4 liable to pay Claimant $50,000 in compensatory damages.	19 July 2016	No
30	15-02570	Unsuitability; Failure to Supervise; Churning.	$24,610.00 Compensatory $20,390.00	Claimant's claims are "denied in their entirety".	22 June 2016	Yes

Criteria for Nuisance-Value. Any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

Cold Springs Advisory Group cases in FINRA Arbitration

No.	Docket Number	Nature of Claim	Dollar Amount Claims	Award	Date of Award	Fits Criteria for Nuisance Lawsuit?
			Punitive Damages			
31	15-03158	Unsuitability; Failure to Supervise; Fraud; Misrepresentation.	$50,000.00 Compensatory	Claimant's claims are "denied in their entirety".	3 June 2016	Yes
32	15-01416	Churning; Unsuitability; Failure to Supervise; Breach of Fiduciary Duty; Breach of Contract; Fraud; Misrepresentation.	$27,242.84 Compensatory	Claimant's claims are "denied in their entirety". <u>Expungement recommended</u> by Arbitrator.	17 May 2016	Yes
33	15-03002	Unsuitability; Failure to Supervise; Fraud; Misrepresentation.	$50,000.00 Compensatory	Broker's #1, #2, and #3 are jointly and severally liable to pay Claimant $50,000.	16 May 2016	No
34	15-01160	Churning; Unsuitability; Failure to Supervise; Unauthorized Trading; Breach of Fiduciary Duty; Breach of Contract; Fraud and Misrepresentation.	$26,336.57 Compensatory	Claimant's claims are "denied in their entirety".	5 May 2016	Yes
35	15-01911	Churning; Unsuitability; Failure to Supervise; Unauthorized Trading; Breach of Fiduciary Duty; Breach of Contract; Fraud and Misrepresentation.	$41,842.00 Compensatory	Respondents are liable to pay Claimant $41,842.	8 April 2016	No

Criteria for Nuisance-Value. Any combination of the following: relatively insignificant amount of damages claimed; cases that settle under these circumstances; cases that are dismissed with and without prejudice; claims denied in their entirety (with polite reprimand commentary by arbitrators); arbitrator grant of expungement; knowing that the claim has no merit; maneuvering the broker into settling the claim at or near this dollar amount short of going to trial, etc.

FINANCIAL SERVICES INSTITUTE | VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

June 29, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
The Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-16 | FINRA Requests Comment on FINRA Rule Amendments Relating to High-Risk Brokers and the Firms That Employ Them (Notice)

Dear Ms. Mitchell:

On April 30, 2018, the Financial Industry Regulatory Authority, Inc. (FINRA) published its request for public comment on proposed amendments to FINRA Rule 8312 (FINRA BrokerCheck Disclosure), as well as to FINRA rule series 9200 (Disciplinary Proceedings); 9300 (Review of Disciplinary Proceeding By National Adjudicatory Council and FINRA Board; Application for SEC Review); 9520 (Eligibility Proceedings); and to NASD Rule 1010 (Membership Proceedings) (collectively, Proposed Amendments and, each individually, a Proposed Amendment).[1]

In addition to the Notice, FINRA also filed with the Securities and Exchange Commission (SEC) a proposal to increase filing fees for individual statutory disqualification (SD) applications and imposing a first time filing fee on firm SD applications.[2] On April 30, 2018, FINRA published guidance to help firms implement effective plans of heightened supervision for advisors with a disciplinary history warranting such supervision.[3] Thereafter, on May 2, 2018, FINRA published Regulatory Notice 18-17 revising its sanction guidelines by encouraging adjudicators to consider stricter sanctions where the member's disciplinary history, prior arbitration awards, or prior settled arbitrations indicate a pattern.[4] These collective measures are part and parcel of FINRA's efforts to address high risk advisors and the firms that associate with those advisors.

The Financial Services Institute[5] (FSI) appreciates the opportunity to comment on this important proposal. FSI supports regulatory proposals addressing high risk advisors, and firms

[1] See FINRA Regulatory Notice 18-16 at p. 2 (April 30, 2018) (Notice).
[2] See S.E.C. Release No 34-83181; File No. SR-FINRA-2018-018 (May 7, 2018) at pp. 3-4.
[3] See FINRA Regulatory Notice 18-15 (April 30, 2018).
[4] See FINRA Regulatory Notice 18-17 (May 2, 2018).
[5] The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and 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 been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.

that choose to associate with those advisors, so long as the proposal: (a) is reasonable; (b) is narrowly tailored to address the intended class of advisors or firms and to discourage the targeted misconduct; (c) is not overly broad such that it has the unintended consequences of adversely impacting compliant advisors or firms or posing an impediment on firms' legitimate business activities; and (d) fosters investor protection. Applying that criteria to the present proposal, FSI supports the Proposed Amendments, subject to the suggested modifications discussed below.[6]

Background on FSI Members

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 US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.[7] These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).[8]

FSI's IBD member firms provide business support to independent 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 and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include 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 Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate $48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly $6.8 billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U.S. economic activity.[9]

Discussion

FSI appreciates the opportunity to comment on FINRA's proposal. As noted above, FSI supports the proposal. In particular, the numeric parameters and proposed criteria for Materiality Consultation (MatCon) filings is sound and reasonable. There are, nonetheless, certain aspects of the proposal that FSI is concerned may be interpreted too broadly. The basis for FSI's support of the MatCon filing parameters and criteria, as well as the basis for FSI's concerns regarding the

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[6] For the avoidance of doubt, FSI's support, subject to the modification discussed herein, of the Proposed Amendments should not be construed to infer that FSI supports (or does not support) the guidance and other proposals referenced in the first paragraph of this letter.

[7] Cerulli Associates, Advisor Headcount 2016, on file with author.

[8] The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. 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.

[9] Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

scope of certain other aspects of the proposal, are set forth more fully below for your consideration.

I. FSI Supports FINRA's Rule Proposal, Subject to Certain Modifications

A. Interim Orders by Adjudicators Should be Narrowly Tailored to Address the Violation

FINRA rules stay sanctions imposed by Hearing Panels while the matter is on appeal to the National Adjudicatory Council.[10] This includes sanctions to expel or bar a member from FINRA membership.[11]To heighten investor protection, FINRA proposes to adopt FINRA Rule 9285(a), which provides, in pertinent part, that:

> "The Hearing Panel or, if applicable, the Extended Hearing Panel ("Hearing Panel"), or Hearing Officer may impose such conditions or restrictions on the activities of a Respondent as the Hearing Panel or Hearing Officer considers reasonably necessary for the purpose of preventing customer harm."[12]

That proposal would, in sum, allow Hearing Panels who have found that a FINRA member violated a rule or statute, to impose restrictions on the member while the matter is under appeal. FSI supports this proposal because there has been an affirmative finding, by an adjudicator, that the respondent has engaged in wrongdoing. Under these circumstances, the firm's and advisor's fair process is not compromised by, for example, basing specialized requirements on pending proceedings that have not yet resulted in a determination by an adjudicator. Additionally, investor protection is heightened by placing restrictions on the firm's or advisor's activities while the appeal is pending. This proposal, therefore, appears to strike the appropriate balance between the FINRA member's rights and investor protection considerations.

However, while the Notice explains that the Hearing Panel would be qualified to "… craft tailored conditions and restrictions to minimize … potential harm,"[13] proposed rule 9285(a) does not require that the conditions or restrictions imposed be appropriately tailored. Rather, proposed rule 9285(a) only requires that the Hearing Panel believe the restriction or condition is "reasonably necessary for the purpose of preventing customer harm."[14] That language could be interpreted to grant Hearing Panels extensive power, resulting in Hearing Panels imposing restrictions or conditions that are overly broad. Overly broad restrictions or conditions, i.e., ones that are not substantially related to the violation, may not be fair to the advisor or firm. More importantly, however, they have little investor protection value because the restriction or condition is not tailored to address, prevent, or deter future instances of the violation. FSI suggests a solution below.

B. Interim Orders by Adjudicators Placing Restrictions or Conditions on Advisors Should Consider Firm Size and Resources

As noted above, the Hearing Panel may have the qualifications, based on their knowledge of the violation, to determine what restrictions or conditions may be necessary to prevent customer harm. However, in the case of an advisor that is associated with a FINRA member firm at the time

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[10] *See* FINRA Rule 9311(b).
[11] *See* Notice at p. 7.
[12] *See* Proposed FINRA Rule 9285(a).
[13] *Id.*
[14] *See* Proposed FINRA Rule 9285(a).

the Hearing Panel renders its adverse determination, that firm would have to be able to supervise the advisor to ensure that she complies with the restriction or condition. This may be problematic because the Hearing Panel would not have sufficient knowledge of the firm's supervisory structure to determine the nature of supervision that is feasible for the firm. Thus, the Hearing Panel should give due consideration to the firm's size and resources and the firm should be permitted to propose conditions or restrictions for the Hearing Panel's consideration.

Thus, FSI suggests that proposed rule 9285(a) be amended in the following regard:

> "The Hearing Panel or, if applicable, the Extended Hearing Panel ("Hearing Panel"), or Hearing Officer may impose such conditions or restrictions on the activities of a Respondent as the Hearing Panel or Hearing Officer considers reasonably necessary for the purpose of preventing customer harm <u>and that are reasonably designed to prevent further violations of the rule or rules the Hearing Panel of Hearing Officer has found to have been violated.</u>
>
> <u>In imposing conditions or restrictions in respect to a registered representative in accordance with this Rule, the Hearing Panel or Hearing Panel Officer shall:</u>
>
> i. <u>Provide the firm the registered representative is associated with at the time the conditions or restrictions are imposed, with the opportunity to propose conditions or restrictions reasonably designed to prevent further violations of the rule or rules the Hearing Panel of Hearing Officer has found to have been violated; and</u>
> ii. <u>Consider the firm's size, resources and overall ability to supervise the registered representative's compliance with the condition or restriction.</u>"

This additional language will prevent the Hearing Panel from imposing restrictions or conditions unrelated to underlying misconduct and from imposing restrictions that may be unduly burdensome to supervise, due to the firm's size or its limited resources.

C. <u>Respondents' Burden of Proof in Expedited Review Proceedings of Interim Orders by Adjudicators Should be Narrowly Tailored to Prevent Reoccurrences of The Underlying Misconduct</u>

A respondent may seek an expedited review of the conditions and restrictions imposed by a Hearing Panel.[15] The respondent's burden of proof in that proceeding is to demonstrate that the Hearing Panel committed an error and that the conditions or restrictions are not necessary to prevent customer harm.[16] To correspond with FSI's suggested amendments to proposed rule 9285(a), the respondent's burden of proof should be whether: a) the Hearing Panel committed an

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[15] *See* Proposed FINRA Rule 9285 (b)(1).
[16] *See* Proposed FINRA Rule 9285(b)(2).

error; and b) the conditions or restrictions are overly broad; or c) the restrictions or conditions are not narrowly tailored to prevent future occurrences of the underlying violations.

D. Proposed Rule 9285(c) Should Be Amended to Provide Firms with Additional Time to Impose a Well-Crafted Plan of Heightened Supervision

Pursuant to proposed rule 9285(c), where an adjudicator finds that the respondent violated a rule or statute, and the respondent decides to appeal that finding, the firm the respondent is associated with would have ten days to adopt a plan of heightened supervision with respect to that person. Regulatory Notice 18-15, published at nearly the same time as the Proposed Amendments, provides firms with guidance on adopting and implementing effective plans of heightened supervision.

That Notice suggests that, for a plan to be effective, at the very minimum, the firm should consider designating a qualified principal to implement and enforce the plan, requiring the respondent engage in additional training to address the violation and requiring that the respondent and the designated principal both acknowledge the plan, in writing.[17] In addition to these minimum requirements, Regulatory Notice 18-15 also includes a number of best practices that firms should consider and makes it clear that the guidance is not exhaustive.[18] Thus, in certain cases, for a plan to be effective, a firm would have to go beyond what is set forth in the guidance.

Thus, it is clear that an effective plan takes time and substantial internal collaboration to construct. Ten days may, simply, not be enough time for many firms to internally collaborate and craft a heightened supervisory plan in that requisite level of detail. Therefore, FSI suggest that FINRA require that firms implement a plan of heightened supervision as soon as possible, but no later than 30 days.

E. Comment on Numeric Parameters and Defined Criteria for MatCon Filings

FINRA has, specifically, requested that stakeholders provide feedback on the "proposed numeric threshold and criteria" that would trigger a MatCon filing.[19] The Proposed Amendments would require firms to file a MatCon where a proposed "owner, control person, principal, or a registered person of a member" has one or more "final criminal matter" (as defined in the proposal) or two or more "specified risk events" (as defined in the proposal) in the prior five-year period.[20]

FSI supports this proposal in terms of both the threshold and the proposed criteria because the specified risk events are: a) final; and b) investment or regulatory related. Also, to trigger the filing requirement, the criminal matter must not only be final, but also must be a matter that was either disclosed, or that the person should have disclosed, on their U4 or U5.[21] Therefore, Proposed FINRA Rule 1011(g) does not impose additional disclosure requirements on advisors and would only apply to final matters and not pending matters.[22] Further, due to the limited time-period of five years,[23] one criminal matter and two specified risk events, in that limited time, may

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[17] *See* FINRA Regulatory Notice 18-15 at p. 5 (April 30, 2018).
[18] *Id.*
[19] *See* Notice at p. 2.
[20] *See* Proposed FINRA Rule IM-1011-2.
[21] *See* Proposed FINRA Rule 1011 (g).
[22] *Id.*
[23] See Proposed FINRA Rule IM-1011-2.

be meaningful and FINRA should have the ability to assess the impact, if any, to the investing public or to marketplace integrity.

However, FSI notes that in addition to the present proposal, FINRA has published other proposals that would change the MatCon process from a voluntary process to a mandatory process.[24] Thus, prior to adopting any of these proposals, FSI suggests that FINRA consider placing rule based parameters around the MatCon process. These parameters may include remedies for firms should they not agree with the MatCon decision, timeframes around FINRA issuing a MatCon decision, limitations on FINRA's time to either issue a decision or ask additional questions, a requirement that FINRA provide written explanations regarding any determination that a change is material such that a membership application must be filed, etc..[25] Absent these parameters, firm's may end up in the MatCon process, for indefinite periods of time, for changes that are, arguably, not material to their business.

Conclusion

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with FINRA on this and other important regulatory efforts.

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 393-0022.

Respectfully submitted,

Robin Traxl

Vice President, Regulatory Affairs & Associate General Counsel

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[24] *See, e.g.*, FINRA Regulatory Notice 18-06 (February 8, 2018).

[25] FSI understands that FINRA has published guidance on the MatCon process. See, e.g., Overview of Materiality Consultation Process, available at http://www.finra.org/industry/overview-materiality-consultation-process. However, guidance and rules are different and if the MatCon process becomes a rule-based requirement; rather than a voluntary process, rules regarding the process are seemingly also appropriate.

Exhibit 3a: Disclosure Categories Considered for Criminal Matters and Specified Risk Events (Mapped to Form U4)

	Subcategories Considered		Subcategories Included	
Disclosure Categories*	**Subcategories**	**U4 Question #**	**Subcategories**	**U4 Question #**
Final Criminal Matters	(I) Convictions (II) Adjudicated charges with unspecified outcomes	(I) 14A(1)a, (2)a; 14B(1)a, (2)a (II) 14A(1)b, (2)b; 14B(1)b,(2)b	(I) Convictions	(I) 14A(1)a, (2)a; 14B(1)a, (2)a
Specified Risk Events				
a) Customer Awards (above de minimis threshold)**	Customer awards in which: (I) Individual was named (II) Individual was subject of	(I) 14I (1)b (II) 14I (4)b	Customer awards in which: (I) Individual was named	(I) 14I (1)b
b) Customer Settlements (above de minimis threshold)**	Customer settlements in which: (I) Individual was named (II) Individual was subject of	(I) 14I (1)c-d (II) 14I (2)a-b; 14I (4)a	Customer settlements in which: (I) Individual was named	(I) 14I (1)c-d
c) Final Civil Judicial	Sanctions ordered: (I) Monetary Sanctions (II) Cease and Desist Sanctions (III) Other Sanctions	Civil Judicial DRP, Q12A (I) Civil and Administrative Penalty(ies)/ Fine(s), Disgorgement, Monetary Penalty other than Fines, Restitution (II) Cease and Desist, Injunction (III) Other Sanctions	Sanctions ordered: (I) Monetary Sanctions (above de minimis threshold)**	Civil Judicial DRP, Q12A (I) Civil and Administrative Penalty(ies)/ Fine(s), Disgorgement, Monetary Penalty other than Fines, Restitution
d) Final Regulatory Actions	Sanctions ordered: (I) Bars and Suspensions (II) Monetary Sanctions (III) Cease and Desist Sanctions (IV) Other Sanctions	Regulatory Action-DRP 13 A (I) Bar (permanent), Bar (temporary), Rescission, Suspension, Revocation, Expulsion (II) Civil and Administrative Penalties/Fines, Restitution, Disgorgement, Monetary Penalty other than Fines (III) Censure, Cease and Desist, Prohibition (IV) Undertaking, Requalification, Denial, Letter of Reprimand, Other	Sanctions ordered: (I) Bars and Suspensions (II) Monetary Sanctions (above de minimis threshold)**	Regulatory Action-DRP 13 A (I) Bar (permanent), Bar (temporary), Rescission, Suspension, Revocation, Expulsion (II) Civil and Administrative Penalties/Fines, Restitution, Disgorgement, Monetary Penalty other than Fines

Notes and Assumptions:
* Excludes matters that are pending or are known to have reached a resolution in favor of the Individual (e.g. pending or dismissed complaints).
** Corresponds to a dollar threshold of $15,000.

Exhibit 3b: Disclosure Categories Considered for Criminal Matters and Specified Risk Events (Mapped to Form BD)

	Subcategories Considered		Subcategories Included	
Disclosure Categories*	**Subcategories**	**Form BD Question #**	**Subcategories**	**Form BD Question #**
Final Criminal Matters	(I) Convictions (II) Adjudicated charges with unspecified outcomes	(I) 11A(1), 11B(1) (II) 11A(2), 11B(2)	(I) Convictions	(I) 11A(1), 11B(1)
Specified Risk Events				
a) Customer Awards (above de minimis threshold)**	Customer awards in which: (I) Individual was named (II) Individual was subject of	N/A***	Customer awards in which: (I) Individual was named	N/A***
b) Customer Settlements (above de minimis threshold)**	Customer settlements in which: (I) Individual was named (II) Individual was subject of	N/A***	Customer settlements in which: (I) Individual was named	N/A***
c) Final Civil Judicial	Sanctions ordered: (I) Bars and Suspensions (II) Monetary Sanctions (III) Cease and Desist Sanctions (IV) Other Sanctions	Civil Judicial DRP Part II, 13 A (I) Bar, Suspension, Revocation/ Expulsion/Denial (II) Disgorgement/Restitution, Monetary/Fine (III) Censure, Cease and Desist/ Injunctions (IV) Other Sanctions	Sanctions ordered: (I) Bars and Suspensions (II) Monetary Sanctions (above de minimis threshold)**	Civil Judicial DRP Part II, 13 A (I) Bar, Suspension, Revocation/ Expulsion/Denial (II) Disgorgement/Restitution, Monetary/Fine
d) Final Regulatory Actions	Sanctions ordered: (I) Bars and Suspensions (II) Monetary Sanctions (III) Cease and Desist Sanctions (IV) Other Sanctions	Regulatory Action-DRP Part II, 12 A (I) Bar, Suspension, Revocation/ Expulsion/Denial (II) Disgorgement/Restitution, Monetary/Fine (III) Censure, Cease and Desist/ Injunctions (IV) Other Sanctions	Sanctions ordered: (I) Bars and Suspensions (II) Monetary Sanctions (above de minimis threshold)**	Regulatory Action-DRP Part II, 12 A (I) Bar, Suspension, Revocation/ Expulsion/Denial (II) Disgorgement/Restitution, Monetary/Fine

Notes and Assumptions:
* Form BD includes information on these disclosure categories for individual control affiliates. These disclosure categories exclude matters that are pending or are known to have reached a resolution in favor of the Individual (e.g. pending or dismissed complaints).

** Corresponds to a dollar threshold of $15,000.

*** Form BD does not include information on customer awards or settlements.

Exhibit 3c: Breakdown of Final Criminal Matters and Specified Risk Events*

	Lookback Period	Criminal Matters			Disclosures Considered in Developing Specified Risk Events (SREs): Regulatory Action Disclosures		Civil Judicial Disclosures		Customer Complaint, Arbitration, Civil Litigation Disclosures		Any SREs			Criminal Matters or SREs	
		Disclosure Subcategory	Events	Individuals with ≥1 events	Disclosure Subcategory	Events	Disclosure Subcategory	Events	Disclosure Subcategory	Events	Events	Individuals with ≥1 events	Individuals with ≥2 events	Events	Individuals with ≥1 Criminal Event Or ≥2 SREs
[1]	All years	All Criminal Disclosures	19,655	16,816	All Regulatory Action Disclosures	12,214	All Civil Judicial Disclosures	1,212	All Customer Complaint, Arbitration, Civil Litigation Disclosures	121,502	134,928	65,932	26,587	154,583	41,915
[2]	All years	Final Criminal Matters	15,591	13,724	Final Regulatory Actions	9,866	Final Civil Judicial Disclosures	159	Customer Awards and Settlements above de minimis threshold	33,205	43,230	26,690	7,565	58,821	20,919
[3]	5 years	Final Criminal Matters	1,005	965	Final Regulatory Actions	1,909	Final Civil Judicial Disclosures	46	Customer Awards and Settlements above de minimis threshold	6,317	8,272	5,569	931	9,277	1,886
[4]	5 years	Criminal Convictions	174	167	Final Regulatory Actions associated with i) bars and suspensions or ii) monetary sanctions above de minimis threshold	1,054	Final Civil Judicial Disclosures with monetary sanctions above de minimis threshold	24	Customer Awards and Settlements above de minimis threshold in which Individual was "named"	1,538	2,616	2,218	248	2,790	414

Notes and Assumptions:

* The exhibit represents disclosure events associated with all individuals regsistered for one or more days in the year 2018. De minimis threshold corresponds to a dollar threshold of $15,000.

[1]: Disclosures within each subcategory include all disclosures including pending and resolved events, regardless of the resolution.

[2]: Final events exclude matters that are pending or are known to have reached a resolution in favor of the Individual. Final criminal matters include convictions and outcomes that are not specified.

[3]: Five-year look-back is based on resolution date being within the last five years.

[4]: Regulatory Actions corresponding to bars and suspensions include permanent or temporary bar, suspension, revocation, rescission or expulsion. Customer Awards and Settlements in which the individual was "named" exclude any settlements prior to initiation of arbitration or civil litigation.

Exhibit 3d: Individuals and Firms Impacted by the Proposed Amendments to the MAP Rules

Year	Individuals impacted by Proposed Amendments to the MAP Rules				Firms impacted by the Proposed Amendments to the MAP Rules			
	Individuals meeting the Proposed Criteria who became:*							
	(1) Principal	(2) Registered Person	(3) Owner or Control Person	(1) or (2) or (3)	Small Firms	Mid-Size Firms	Large Firms	All Firms
2013	39	210	7	215	65	22	68	155
2014	32	181	5	188	52	11	66	129
2015	29	170	5	177	53	15	50	118
2016	16	127	2	130	31	16	48	95
2017	17	106	1	110	29	5	40	74
2018	17	119	0	120	34	12	45	91

Notes and Assumptions:

* Proposed criteria corresponds to individuals with one final criminal matter or two or more specified risk events within the prior five years reported on Forms U4, U5, U6 and Form BD.

Exhibit 3e: "New" Final Criminal Matters and Specified Risk Events (after identification) Associated with Individuals Meeting the Proposed Criteria in Proposed IM-1011-3 and Proposal 10(7)(a)(7) ("the Proposed Criteria")

Year	Number of Individuals Meeting the Proposed Criteria	Post-Identification Period	Number of "New" Final Criminal Matters and Specified Risk Events in the Post-Identification Period*
2013	215	2014-2018	35 (16x)**
2014	188	2015-2018	26 (18.7x)**
2015	177	2016-2018	21 (21.8x)**
2016	130	2017-2018	20 (49.3x)**
2013-2016	635	2014-2018	93

Notes and Assumptions:

* "New" Final Criminal Matters and Specified Risk Events correspond to events that were identified or occurred after the individual's meeting the Proposed Criteria, and do not include events that were pending at the time of identification and subsequently resolved.

** The factors reported in parentheses represent a multiple for the average number of new events (per individual) for individuals that would have met the Proposed Criteria relative to other individuals. For example, the factor of 16x for 2013 shows that individuals that met the Proposed Criteria had 16 times more new Final Criminal Matters and Specified Risk Events (per individual) in the years after identification (2014-2018) than other individuals that became owners, control persons, principals or registered representatives in 2013.

*** These 635 individuals correspond to the unique number of individuals that meet the Proposed Criteria in one or more years during this period. Some of these individuals meet the criteria in multiple years during the 2013-2016 period.

Exhibit 5

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.[1]

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FINRA Rules

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1000. MEMBER APPLICATION AND ASSOCIATED PERSON REGISTRATION

* * * * *

1011. Definitions

Unless otherwise provided, terms used in the Rule 1000 Series shall have the meaning as defined in Rule 0160.

(a) through (g) No Change.

<u>**(h) "final criminal matter"**</u>

<u>The term "final criminal matter" means a final criminal matter that resulted in a conviction of, or guilty plea or nolo contendere ("no contest") by, a person that is disclosed, or was required to be disclosed, on the applicable Uniform Registration Forms.</u>

(h) through (n) renumbered as (i) through (o).

<u>**(p) "specified risk event"**</u>

<u>The term "specified risk event" means any one of the following events that are disclosed, or are or were required to be disclosed, on an applicable Uniform Registration Form:</u>

[1] The text of FINRA Rules 1011, 1017 and CAB Rule 111 incorporates the changes approved in the MAP Rules Amendment Release.

(1) a final investment-related, consumer-initiated customer arbitration award or civil judgment against the person for a dollar amount at or above $15,000 in which the person was a named party;

(2) a final investment-related, consumer-initiated customer arbitration settlement or civil litigation settlement for a dollar amount at or above $15,000 in which the person was a named party;

(3) a final investment-related civil action where: (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000; or (B) the sanction against the person was a bar, expulsion, revocation, or suspension; and

(4) a final regulatory action where (A) the total monetary sanctions (including civil and administrative penalties or fines, disgorgement, monetary penalties other than fines, or restitution) were ordered for a dollar amount at or above $15,000; or (B) the sanction against the person was a bar (permanently or temporarily), expulsion, rescission, revocation, or suspension from associating with a member.

([o]q) "Subcommittee"

The term "Subcommittee" means a subcommittee of the National Adjudicatory Council that is constituted pursuant to Rule 1015 to conduct a review of a Department decision issued under the Rule 1000 Series.

(r) "Uniform Registration Forms"

The term "Uniform Registration Forms" means the Uniform Application for Broker-Dealer Registration (Form BD), the Uniform Application for Securities Industry Registration or Transfer (Form U4), the Uniform Termination Notice for Securities Industry Registration (Form U5) and the Uniform Disciplinary Action Reporting Form (Form U6), as such may be amended or any successor(s) thereto.

* * * * *

IM-1011-3. Business Expansions and Persons with Specified Risk Events

The safe harbor for business expansions in IM-1011-1 is not available to any member that is seeking to add a natural person who has, in the prior five years, one or more final criminal matters or two or more specified risk events and seeks to become an owner, control person, principal, or registered person of the member; in such circumstances, if the member is not otherwise required to file a Form CMA in accordance with Rule 1017, the member must comply with the requirements of Rule 1017(a)(7).

* * * * *

1017. Application for Approval of Change in Ownership, Control, or Business Operations

(a) Events Requiring Application

A member shall file an application for approval of any of the following changes to its ownership, control, or business operations:

(1) through (4) No Change.

(5) a material change in business operations as defined in Rule 1011([l]m); [or]

(6)(A) notwithstanding subparagraph (3) of Rule 1017(a), any direct or indirect acquisition or transfer of a member's assets or any asset, business or line of operation where the transferring member or an Associated Person of the transferring member has a Covered Pending Arbitration Claim (as defined in Rule 1011(c)(2)), unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a Form CMA in accordance with Rule 1017, unless the member has first submitted a written request to the Department, in a manner prescribed by FINRA, seeking a materiality consultation for the contemplated acquisition or transfer. The written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, the Department shall consider the written request and other information or documents provided by the member to determine in the public interest and the protection of investors that either (i) the member is not required to file a Form CMA in accordance with Rule 1017 and may effect the contemplated acquisition or transfer; or (ii) the member is required to file a Form CMA in accordance with Rule 1017 and the member may not effect the contemplated acquisition or transfer unless the Department approves the Form CMA; or

(B) notwithstanding IM-1011-1, any addition of one or more Associated Persons involved in sales as described in IM-1011-2, and one or more of those Associated Persons has a Covered Pending Arbitration Claim (as defined in Rule 1011(c)(1)), an unpaid arbitration award or unpaid settlement related to an arbitration, and the member is not otherwise required to file a Form CMA in accordance with Rule 1017, unless the member has first submitted a written request to the Department, in a manner prescribed by FINRA, seeking a materiality consultation for the contemplated business expansion. The written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, the Department shall consider the written request and other information or documents provided by the member to determine in the public interest and the protection of investors that either (i) the member is not required to file a Form CMA in accordance with Rule 1017 and may effect the contemplated business expansion; or (ii) the member is required to file a Form CMA in accordance with Rule 1017 and the member may not effect the contemplated business expansion unless the Department approves the Form CMA. The safe harbor for business expansions under IM-1011-1 shall not be available to the member when a materiality consultation is required under this paragraph (a)(6)(B)[.]; or

(7) notwithstanding subparagraphs (3), (4), (5) and (6) of Rule 1017(a) and IM-1011-1, whenever a natural person seeking to become an owner, control person, principal or registered person of a member has, in the prior five years, one or more final criminal matters or two or more specified risk events, and the member is not otherwise required to file a Form CMA in accordance with Rule 1017, unless the member has submitted a written request to the Department, in a manner prescribed by FINRA, seeking a materiality consultation for the contemplated activity; provided, however, this subparagraph (7) shall not apply

when the member is required to file an application or written request for relief pursuant to Rule 9522 for approval of the same contemplated association. The written request must address the issues that are central to the materiality consultation. As part of the materiality consultation, the Department shall consider the written request and other information or documents provided by the member to determine in the public interest and the protection of investors that either (A) the member is not required to file a Form CMA in accordance with Rule 1017 and may effect the contemplated activity; or (B) the member is required to file a Form CMA in accordance with Rule 1017 and the member may not effect the contemplated activity unless the Department approves the Form CMA. The safe harbor for business expansions under IM-1011-1 shall not be available to the member when a materiality consultation is required under this paragraph (a)(7).

(b) through (m) No Change.

* * * * *

8300. SANCTIONS

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8312. FINRA BrokerCheck Disclosure

(a) No Change.

(b)

(1) No Change.

(2) The following information shall be released pursuant to this paragraph (b):

(A) through (E) No Change.

(F) [in response to telephonic inquiries via the BrokerCheck toll-free telephone listing,]information as to whether a particular member is subject to the provisions of Rule 3170 ("Taping Rule");

(G) through (H) No Change.

(c) through (f) No Change.

• • • Supplementary Material: --------------

.01 through **.03** No Change.

* * * * *

9000. CODE OF PROCEDURE

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9200. DISCIPLINARY PROCEEDINGS

* * * * *

9235. Hearing Officer Authority

(a) Hearing Officer Authority

The Hearing Officer shall be selected by the Chief Hearing Officer and shall have authority to do all things necessary and appropriate to discharge his or her duties. In addition to the powers exercised by all members of the Hearing Panel or, if applicable, the Extended Hearing Panel, the powers of the Hearing Officer include, but are not limited to:

(1) through (5) No Change.

(6) creating and maintaining the official record of the disciplinary proceeding; [and]

(7) drafting a decision that represents the views of the majority of the Hearing Panel or, if applicable, the Extended Hearing Panel[.]; and

(8) ruling on a motion pursuant to Rule 9285 for conditions or restrictions.

(b) No Change.

* * * * *

9285. Interim Orders and Mandatory Heightened Supervision While on Appeal or on Discretionary Review

(a) Conditions and Restrictions

(1) Motion for Conditions or Restrictions

Unless otherwise ordered by a Hearing Officer, within 10 days after service of a notice of appeal from, or the notice of a call for review of, a decision issued pursuant to Rule 9268 or Rule 9269 in which the Hearing Panel or, if applicable, the Extended Hearing Panel or the Hearing Officer finds that a Respondent violated a statute or rule provision, the Department of Enforcement may file a motion for the imposition of conditions or restrictions on the activities of a Respondent that are reasonably necessary for the purpose of preventing customer harm. Notwithstanding the appeal or call for review, the Hearing Officer that participated in the underlying disciplinary proceeding shall have jurisdiction to rule upon a motion for the imposition of conditions or restrictions.

(2) Requirements for the Motion

A motion for the imposition of conditions or restrictions shall be filed with FINRA's Office of Hearing Officers and shall be served simultaneously on FINRA's Office of General Counsel and all other parties to the disciplinary proceeding. The motion shall specify the conditions or restrictions that are sought to be imposed and explain why the conditions or restrictions are reasonably necessary for the purpose of preventing customer harm.

(3) Opposition to the Motion

Any Respondent may file an opposition or other response to a motion for the imposition of conditions or restrictions within 10 days after service of the motion, unless otherwise ordered by the Hearing Officer. The opposition or other response shall explain why no conditions or restrictions should be imposed or specify alternate conditions or restrictions that are sought to be imposed and explain why the conditions or restrictions are reasonably necessary for the purpose of preventing customer harm.

(4) Reply

The Department of Enforcement shall have no right to reply to the opposition or other response of a Respondent unless the Hearing Officer permits a reply to be filed. Unless otherwise ordered by the Hearing Officer, the Department of Enforcement's reply submission shall be filed within three days after the Hearing Officer serves the order granting the motion to file a reply or a Respondent serves the opposition or other response to which the Hearing Officer previously ordered that a reply could be filed.

(5) Disposition of Motions for Conditions or Restrictions.

A motion for conditions or restrictions shall be decided by the Hearing Officer that participated in the underlying disciplinary proceeding. Unless ordered otherwise by the Hearing Officer, the motion for conditions or restrictions shall be decided based on the moving and opposition papers and without oral argument. The Hearing Officer shall have the authority to impose any conditions or restrictions that the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm. The Hearing Officer shall issue a written order ruling upon a motion for conditions or restrictions in an expeditious manner and no later than 20 days after any opposition or other response filed pursuant to paragraph (a)(3) or any reply filed that the Hearing Officer permits pursuant to paragraph (a)(4) of this Rule, and serve the order on all parties. The Office of Hearing Officers shall provide a copy of the order to each FINRA member with which the Respondent is associated.

(b) Expedited Review of Order Imposing Conditions or Restrictions

(1) Availability

A Respondent subject to a Hearing Officer's order imposing conditions or restrictions may file, within 10 days after service of the order imposing conditions or restrictions, a motion with the Review Subcommittee to modify or remove any or all of the conditions or restrictions.

(2) Requirements for the Motion

The Respondent has the burden to show that the conditions or restrictions imposed are not reasonably necessary for the purpose of preventing customer harm. The Respondent's motion to modify or remove conditions or restrictions shall be filed with FINRA's Office of General Counsel and shall be served simultaneously on the Office of Hearing Officers and all other parties to the disciplinary proceeding.

(3) Opposition to the Motion

Unless otherwise ordered by the Review Subcommittee, the Department of Enforcement shall have five days from service of Respondent's motion to file an opposition or other response to the motion.

(4) No Reply

The Respondent may not file a reply to the opposition.

(5) Disposition of Motion

Unless ordered otherwise by the Review Subcommittee, the motion to modify or remove conditions or restrictions shall be decided based on the moving and opposition papers and without oral argument. The Review Subcommittee shall issue a written order ruling upon a motion to modify or remove conditions or restrictions in an expeditious manner and no later than 30 days after any opposition filed pursuant to paragraph (b)(3) of this Rule, and serve the order on all parties. The Review Subcommittee may approve, modify or remove any and all of the conditions or restrictions. The Office of General Counsel shall provide a copy of the order to each FINRA member with which the Respondent is associated.

(6) Effectiveness

The filing with the Review Subcommittee of a motion to modify or remove conditions or restrictions shall stay the effectiveness of the conditions or restrictions ordered by a Hearing Officer until the Review Subcommittee rules on the motion.

(c) General

Except as otherwise provided in this Rule, all motions, oppositions, responses and replies pursuant to this Rule shall comply with Rule 9146.

(d) Duration of Conditions or Restrictions

Conditions or restrictions imposed by a Hearing Officer that are not subject to any stay, or imposed by the Review Subcommittee, shall remain effective until FINRA's final decision in the underlying disciplinary proceeding takes effect.

(e) Mandatory Heightened Supervision

(1) Requirement

When a Hearing Panel, Extended Hearing Panel or Hearing Officer issues a decision pursuant to Rule 9268 or Rule 9269, in which the adjudicator finds that a Respondent violated a statute or rule provision, any member firm with which the Respondent is associated must adopt a written plan of heightened supervision of the Respondent if any party appeals the decision to the National Adjudicatory Council, or if the decision is called for review pursuant to Rule 9312. The member must file the written plan of heightened supervision with FINRA’s Office of General Counsel and shall serve a copy on the Department of Enforcement and the Respondent, within 10 days of any party filing an appeal or the case being called for review. If the Respondent becomes associated with another member during the appeal of the decision of the Hearing Panel, Extended Hearing Panel or Hearing Officer, or review by the National Adjudicatory Council, that member, within 10 days of the Respondent becoming associated with the member, shall file a plan of heightened supervision with FINRA's Office of General Counsel and shall serve a copy on the Department of Enforcement and the Respondent. Any member that has adopted a written plan of heightened supervision for a Respondent pursuant to this paragraph (e) shall file and serve an amended written plan of heightened supervision that takes into account any conditions or restrictions imposed pursuant to Rule 9285, within 10 days of conditions or restrictions becoming effective.

(2) Provisions

The plan of heightened supervision, and any amended plan, shall comply with Rule 3110, and shall be reasonably designed and tailored to include specific supervisory policies and procedures that address the violations found by the Hearing Panel, Extended Hearing Panel or Hearing Officer and shall be reasonably designed to prevent or detect a reoccurrence of those violations. The plan of heightened supervision, and any amended plan, shall, at a minimum, include the designation of an appropriately registered principal who is responsible for carrying out the plan of heightened supervision, and take into account any conditions and restrictions imposed by the Hearing Officer or Review Subcommittee pursuant to paragraph (a) or (b) of this Rule.

(3) Signature of Principal

The plan of heightened supervision, and any amended plan, shall be signed by the designated principal, and shall include an acknowledgement that the principal is responsible for implementing and maintaining the plan of heightened supervision.

(4) Duration

The plan of heightened supervision, and any amended plan, shall remain in place until FINRA's final decision takes effect.

* * * * *

9300. REVIEW OF DISCIPLINARY PROCEEDING BY NATIONAL ADJUDICATORY COUNCIL AND FINRA BOARD; APPLICATION FOR SEC REVIEW

9310. Appeal to or Review by National Adjudicatory Council

9311. Appeal by Any Party; Cross-Appeal

(a) No Change.

(b) Effect

An appeal to the National Adjudicatory Council from a decision issued pursuant to Rule 9268 or Rule 9269 shall operate as a stay of that decision until the National Adjudicatory Council issues a decision pursuant to Rule 9349 or, in cases called for discretionary review by the FINRA Board, until a decision is issued pursuant to Rule 9351. Any such appeal, however, will not stay a decision, or that part of a decision, that imposes a permanent cease and desist order. Notwithstanding the stay of sanctions under this Rule, the Hearing Officer may impose such conditions and restrictions on the activities of a Respondent as the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm in accordance with Rule 9285(a), and the Review Subcommittee shall consider any motion filed pursuant to Rule 9285(b) to modify or remove any or all of the conditions or restrictions.

(c) through (f) No Change.

(g) FINRA Notification to Member

When an appeal is filed from a decision finding that a Respondent violated a statute or rule provision, the Office of Hearing Officers shall promptly notify each FINRA member with which the Respondent is associated that an appeal has been filed.

9312. Review Proceeding Initiated By Adjudicatory Council

(a) No Change.

(b) Effect

Institution of review by a member of the National Adjudicatory Council on his or her own motion, a member of the Review Subcommittee on his or her own motion, or the General Counsel, on his or her own motion, shall operate as a stay of a final decision issued pursuant to Rule 9268 or Rule 9269 as to all Parties subject to the notice of review, until the National Adjudicatory Council issues a decision pursuant to Rule 9349, or, in cases called for discretionary review by the FINRA Board, until a decision is issued pursuant to Rule 9351. Institution of any such review, however, will not stay a decision, or that part of a decision, that imposes a permanent cease and desist order. Notwithstanding the stay of sanctions under this Rule, the Hearing Officer may impose such conditions and restrictions on the activities of a Respondent as the Hearing Officer considers reasonably necessary for the purpose of preventing customer harm in accordance with Rule 9285(a), and the Review Subcommittee shall consider any motion filed pursuant to Rule 9285(b) to modify or remove any or all of the conditions or restrictions.

(c) Requirements

(1) through (2) No Change.

(3) When a decision finding that a Respondent violated a statute or rule provision is called for review, the Office of General Counsel shall promptly notify each FINRA member with which the Respondent is associated of the call for review.

(d) No Change.

* * * * *

9320. Transmission of Record; Extensions of Time, Postponements, Adjournments

9321. Transmission of Record

Within 21 days after the filing of a notice of appeal pursuant to Rule 9311 or a notice of call for review pursuant to Rule 9312, or at such later time as the National Adjudicatory Council may designate, the Office of Hearing Officers shall assemble and prepare an index to the record, transmit the record and the index to the National Adjudicatory Council, and serve copies of the index upon all Parties. Within seven days after a Hearing Officer issues an order imposing conditions or restrictions pursuant to Rule 9285, or at such later time as the National Adjudicatory Council may designate, the Office of Hearing Officers shall assemble and prepare an amended index and a supplemental record, transmit the amended index and supplemental record to the National Adjudicatory Council, and serve copies of the amended index upon all Parties. The Hearing Officer who participated in the disciplinary proceeding, or the Chief Hearing Officer, shall certify that the record or supplemental record transmitted to the National Adjudicatory Council is complete.

* * * * *

9500. OTHER PROCEEDINGS

9520. Eligibility Proceedings

* * * * *

9522. Initiation of Eligibility Proceeding; Member Regulation Consideration; and Requirements for an Interim Plan of Heightened Supervision

(a) through (e) No Change.

(f) Submission of an Interim Plan of Heightened Supervision

An application filed pursuant to paragraph (a)(3) or (b)(1)(B) of this Rule that seeks the continued association of a disqualified person must include:

(1) An interim plan of heightened supervision. The application shall identify an appropriately registered principal responsible for carrying out the interim plan of heightened supervision, who has signed the plan and acknowledged his or her responsibility for implementing and maintaining such plan. The interim plan of heightened supervision shall be in effect throughout the entirety of the application review process which shall be considered concluded only upon the final resolution of the eligibility proceeding. The interim plan of heightened supervision shall comply with the provisions of Rule 3110, and be reasonably designed and tailored to include specific supervisory policies and procedures that address any regulatory concerns related to the nature of the disqualification, the nature of the sponsoring member's business, and the disqualified person's current and proposed activities during the review process; and

(2) A written representation from the sponsoring member that the disqualified person is currently subject to an interim plan of heightened supervision as set forth in paragraph (f)(1) of this Rule.

(g) Determination that an Application is Substantially Incomplete

If the Department of Member Regulation determines that an application filed pursuant to paragraph (a)(3) or (b)(1)(B) of this Rule that seeks the continued association of a disqualified person is substantially incomplete, it may reject the application and deem it not to have been filed. In such case, the Department of Member Regulation shall provide the sponsoring member notice of the delinquency and its reasons for so doing. The sponsoring member shall have 10 business days after service of the notice of delinquency to remedy the application, or such other time period prescribed by the Department of Member Regulation. An application will be deemed to be substantially incomplete if:

(1) It does not include the representation required by paragraph (f)(2) of this Rule; or

(2) The Department of Member Regulation determines that it does not include a reasonably designed interim plan of heightened supervision that complies with the standards of paragraph (f)(1) of this Rule.

(h) Consequences for Failure to Timely Remedy an Application that is Substantially Incomplete

If an applicant fails to remedy an application that is substantially incomplete, the Department of Member Regulation shall serve a written notice on the sponsoring member of its determination to reject the application and its reasons for so doing. FINRA shall refund the application fee, less $1,000, which shall be retained by FINRA as a processing fee. Upon such rejection, the sponsoring member must promptly terminate association with the disqualified person.

* * * * *

9556. Failure to Comply with Temporary and Permanent Cease and Desist Orders, or Orders that Impose Conditions or Restrictions

(a) Notice of Suspension, Cancellation or Bar

(1) If a member, person associated with a member or person subject to FINRA's jurisdiction fails to comply with a temporary or permanent cease and desist order issued under the Rule 9200, 9300 or 9800 Series, FINRA staff, after receiving written authorization from FINRA's Chief Executive Officer or such other senior officer as the Chief Executive Officer may designate, may issue a notice to such member or person stating that the failure to comply with the temporary or permanent cease and desist order within seven days of service of the notice will result in a suspension or cancellation of membership or a suspension or bar from associating with any member.

(2) If a respondent fails to comply with conditions or restrictions imposed pursuant to Rule 9285 by a Hearing Officer or the Review Subcommittee, FINRA staff may issue a notice to a respondent stating that the failure to comply with the conditions or restrictions within seven days of service of the notice will result in a suspension or cancellation of membership or a suspension or bar from associating with any member.

(b) No Change.

(c) Contents of Notice

(1) [The]A notice issued pursuant to paragraph (a)(1) of this Rule shall explicitly identify the provision of the permanent or temporary cease and desist order that is alleged to have been violated and shall contain a statement of facts specifying the alleged violation. The notice shall state when the FINRA action

will take effect and explain what the respondent must do to avoid such action. The notice shall state that the respondent may file a written request for a hearing with the Office of Hearing Officers pursuant to Rule 9559. The notice also shall inform the respondent of the applicable deadline for filing a request for a hearing and shall state that a request for a hearing must set forth with specificity any and all defenses to the FINRA action. In addition, the notice shall explain that, pursuant to Rules 8310(a) and 9559(n), a Hearing Officer or, if applicable, Hearing Panel, may approve, modify or withdraw any and all sanctions or limitations imposed by the notice, and may impose any other fitting sanction.

(2) A notice issued pursuant to paragraph (a)(2) of this Rule shall explicitly identify conditions or restrictions that are alleged to have been violated and shall contain a statement of facts specifying the alleged violation. The notice shall state when the FINRA action will take effect and explain what the respondent must do to avoid such action. The notice shall state that the respondent may file a written request for a hearing with the Office of Hearing Officers pursuant to Rule 9559. The notice also shall inform the respondent of the applicable deadline for filing a request for a hearing and shall state that a request for a hearing must set forth with specificity any and all defenses to the FINRA action. In addition, the notice shall explain that, pursuant to Rules 8310(a) and 9559(n), a Hearing Officer or, if applicable, Hearing Panel, may approve, modify or withdraw any and all sanctions imposed by the notice, and may impose any other fitting sanction.

(d) through (h) No Change.

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Capital Acquisition Broker Rules

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100. MEMBER APPLICATION AND ASSOCIATED PERSON REGISTRATION

* * * * *

111. Membership Proceedings

(a) No Change.

(b) Safe Harbor for Business Expansions

All capital acquisition brokers are subject to FINRA IM-1011-1, [and] IM-1011-2 and IM-1011-3.

(c) No Change.

* * * * *

Funding Portal Rules

* * * * *

900. Code of Procedure

(a) No Change.

(b) Eligibility Proceedings

(1) through (2) No Change.

(3) Initiation of Eligibility Proceeding; Department of Member Regulation Consideration

(A) Initiation by FINRA

(i) No Change.

(ii) Notice Regarding a Funding Portal Member

A notice issued to a disqualified funding portal member shall state that the disqualified funding portal member may apply for relief by filing an Application or, in the case of a matter set forth in Funding Portal Rule 900(b)(9[8])(A) a written request for relief, within 10 business days after service of the notice. If the funding portal member fails to file the Application or, where appropriate, the written request for relief, within the 10-day period, the membership of the funding portal member shall be canceled, unless the Department of Member Regulation grants an extension for good cause shown.

(iii) Notice Regarding an Associated Person

A notice issued regarding a disqualified person to a funding portal member or applicant for funding portal membership under Funding Portal Rule 110(a) shall state that such funding portal member or applicant for funding portal membership may file an Application on behalf of itself and such person or, in the case of a matter set forth in Funding Portal Rule 900(b)(9[8])(A) a written request for relief, within 10 business days after service of the notice. If the funding portal member fails to file the Application or, where appropriate, the written request for relief, within the 10-day period, the funding portal member may not associate or continue to associate with the disqualified person, unless the

Department of Member Regulation grants an extension for good cause shown.

(iv) No Change.

(4) Obligation of Funding Portal Member to Initiate Eligibility Proceeding

(A) A funding portal member shall file an Application or, in the case of a matter set forth in Funding Portal Rule 900(b)(9[8])(A) a written request for relief, with RAD, if the funding portal member determines prior to receiving a notice under paragraph (b)(3)(A) of this Rule that:

(i) through (iii) No Change.

(5) Withdrawal of Application or Written Request for Relief

A funding portal member may withdraw its Application or, as set forth in Funding Portal Rule 900(b)(9[8])(A) its written request for relief, at any time prior to an appeal by filing a written notice with the Department of Member Regulation and RAD pursuant to FINRA Rules 9135, 9136, and 9137, as adopted pursuant to Funding Portal Rule 900(a). A funding portal member may withdraw its Application after the start of an appeal but prior to the issuance of a decision by the National Adjudicatory Council by filing a written notice with the Department of Member Regulation and the Office of General Counsel pursuant to FINRA Rules 9135, 9136, and 9137, as adopted pursuant to Funding Portal Rule 900(a).

(6) through (7) No Change.

(8) Interim Plan of Heightened Supervision

(A) Submission of an Interim Plan of Heightened Supervision

An application filed pursuant to Funding Portal Rule 900(b)(3)(A)(iii) or Funding Portal Rule 900(b)(4)(A)(ii) that seeks the continued association of a disqualified person must include:

(i) An interim plan of heightened supervision. The application shall identify a person with authority to carry out the interim plan of heightened supervision, who has signed the plan and acknowledged his or her responsibility for implementing and maintaining such plan. The interim plan of heightened supervision shall be in effect throughout the entirety of the application review process which shall be considered concluded only upon the final resolution of the eligibility proceeding. The interim plan of heightened supervision shall comply with the provisions of Funding Portal Rule 300, and be reasonably designed and tailored to include specific supervisory policies and procedures that address any regulatory concerns related to the nature of the disqualification, the nature of the sponsoring funding portal member's business, and the disqualified person's current and proposed activities during the review process; and

(ii) A written representation from the sponsoring funding portal member that the disqualified person is currently subject to an interim plan of heightened supervision as set forth in paragraph (b)(8)(A)(i) of this Rule.

(B) Determination that an Application is Substantially Incomplete

If the Department of Member Regulation determines that an application filed pursuant to Funding Portal Rule 900(b)(3)(A)(iii) or Funding Portal Rule 900(b)(4)(A)(ii) that seeks the continued association of a disqualified person is substantially incomplete, it may reject the application and deem it not to have been filed. In such case, the Department of Member Regulation shall provide the sponsoring funding portal member notice of the delinquency and its reasons for so doing. The sponsoring funding portal member shall have 10 business days after service of the notice of delinquency to remedy the application, or such other time period prescribed by the Department of Member Regulation. An application will be deemed to be substantially incomplete if:

(i) It does not include the representation required by paragraph (b)(8)(A)(ii) of this Rule; or

(ii) The Department of Member Regulation determines that it does not include a reasonably designed interim plan of heightened supervision that complies with the standards of paragraph (b)(8)(A)(i) of this Rule.

(C) Consequences for Failure to Timely Remedy an Application that is Substantially Incomplete

If an applicant fails to remedy an application that is substantially incomplete, the Department of Member Regulation shall serve a written notice on the sponsoring funding portal member of its determination to reject the application and its reasons for so doing. FINRA shall refund the application fee, less $1,000, which shall be retained by FINRA as a processing fee. Upon such rejection, the sponsoring funding portal member must promptly terminate association with the disqualified person.

[(8)](9) Matters That May Be Approved After the Filing of an Application or Written Request for Relief

(A) No Change.

(B) The Department of Member Regulation, as it deems consistent with the public interest and the protection of investors, may approve, upon the filing of an Application by a disqualified funding portal member or a sponsoring funding portal member and written consent to a heightened supervisory plan, all Applications seeking relief from disqualifications arising under Section 3(a)(39) of the Exchange Act.

(i) No Change.

(ii) If the heightened supervisory plan is rejected, the disqualified funding portal member, sponsoring funding portal member, or disqualified person shall be bound by the waivers made under paragraph (b)(9[8])(B)(i) of this Rule for conduct by persons or bodies occurring during the period beginning on the date the heightened supervisory plan was submitted and ending upon the rejection of the heightened supervisory plan and shall have the right to appeal such decision pursuant to Funding Portal Rule 900(b)(12[1]).

[(9)](10) Department of Member Regulation Consideration of Applications for New Funding Portal Members

In all instances where FINRA receives a Form MC-400 or Form MC-400A under this Rule, and such Application is submitted on behalf of an applicant for membership as a funding portal member under Funding Portal Rule 110(a), the Department of Member Regulation shall defer a decision on such Form MC-400 or Form MC-400A until such time as FINRA has issued a determination on the application submitted pursuant to Funding Portal Rule 110(a).

[(10)](11) Rights of Disqualified Funding Portal Member, Sponsoring Funding Portal Member, Disqualified Person, and Department of Member Regulation

(A) In the event the Department of Member Regulation does not approve a written request for relief from the eligibility requirements pursuant to Funding Portal Rule 900(b)(9[8])(A), the disqualified funding portal member or sponsoring funding portal member may file an Application under Funding Portal Rule 900(b)(9[8])(B). The Department of Member Regulation may require a disqualified funding portal member or sponsoring funding portal member to file an Application with RAD, notwithstanding the provisions of Funding Portal Rule 900(b)(9[8])(A).

(B) In the event the Department of Member Regulation does not approve an Application pursuant to Funding Portal Rule 900(b)(9[8])(B), the Department of Member Regulation shall inform the disqualified funding portal member or sponsoring funding portal member of its decision in writing. The decision shall explain in detail the reason for denial. The disqualified funding portal member or sponsoring funding portal member shall have the right to appeal such decision pursuant to Funding Portal Rule 900(b)(12[1]). If not timely appealed pursuant to Funding Portal Rule 900(b)(12[1]), the decision issued by the Department of Member Regulation shall constitute final action of FINRA and shall become effective immediately.

[(11)](12) Appeal of Department of Member Regulation's Decision to Deny an Application or a Written Request for Relief

(A) through (C) No Change.

(D) Notice of Hearing and Rights of Parties at Hearing

If a hearing is requested, the hearing shall be held no later than 90 days after the filing of a notice of appeal unless the subcommittee determines that there is good cause shown for extending the time period. The appellant and the Department of Member Regulation shall be notified via mail, email, facsimile, or overnight courier of the location, time, and date of the hearing not less than 14 business days before the hearing, unless the parties agree to shorten the time period or where good cause has been shown for an expedited proceeding under paragraph (b)(12[1])(F) of this Rule. The appellant and the Department of Member Regulation shall be entitled to be heard in person at a hearing, to be represented by an attorney, and to submit any relevant evidence.

(E) through (M) No Change.

[(12)](13) Discretionary Review by the FINRA Board

(A) Call for Review by the FINRA Board

A Governor may call a proposed National Adjudicatory Council decision regarding an eligibility proceeding for review by the FINRA Board if the call for review is made within the period prescribed in paragraph (b)(13[2])(B) of this Rule.

(B) No Change.

(C) Review at Next Meeting

If a Governor calls an eligibility proceeding for review within the period prescribed in paragraph (b)(13[2])(B) of this Rule, the FINRA Board shall review the eligibility proceeding not later than the next meeting of the FINRA Board. The FINRA Board may order the filing of briefs in connection with its review proceedings pursuant to this Rule.

(D) through (E) No Change.

[(13)](14) Application to SEC for Review

The right to have any action taken pursuant to this Rule Series reviewed by the SEC is governed by Section 19 of the Exchange Act. The filing of an application for review shall not stay the effectiveness of final action by FINRA, unless the SEC otherwise orders.

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